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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

AB-2001-6

Report of the Appellate Body

WORLD TRADE ORGANIZATION
APPELLATE BODY

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

Canada, *Appellant*
New Zealand, *Appellee*
United States, *Appellee*

European Communities, *Third Participant*

AB-2001-6

Present:

Taniguchi, Presiding Member
Abi-Saab, Member
Ganesan, 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 – 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 – Measures Affecting the Importation of Milk and the Exportation of Dairy Products* ("*Canada – Dairy*")[2] were not consistent with Canada's obligations under the *Agreement on Agriculture* and the *Agreement on Subsidies and Countervailing Duties* (the "*SCM Agreement*").

2. In *Canada – Dairy*, the original panel and the Appellate Body found, *inter alia*, that Canada had acted inconsistently with its obligations under Articles 3.3 and 8 of the *Agreement on Agriculture*, through its scheme of Special Milk Classes 5(d) and 5(e), by providing "export subsidies" within the meaning of Article 9.1(c) of that Agreement, in excess of the quantity commitment levels specified by Canada in its Schedule of Commitments under the *Marrakesh Agreement Establishing the World Trade Organization* (the "*WTO Agreement*"). On 27 October 1999, the DSB adopted the original panel and Appellate Body reports.

[1]WT/DS103/RW, WT/DS113/RW, 11 July 2001.

[2]The recommendations and rulings of the DSB resulted from the adoption, by the DSB, of the panel report in *Canada – Dairy*, WT/DS103/R, WT/DS113/R (the "original panel report"), as modified by the Appellate Body Report, WT/DS103/AB/R and Corr.1, WT/DS113/AB/R and Corr.1, both adopted 27 October 1999. 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".

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] On 19 January 2001, Canada affirmed that it would complete its implementation of the recommendations and rulings of the DSB by 31 January 2001.[5]

4. The measures taken by Canada to comply with the recommendations and rulings of the DSB included the elimination of Special Milk Class 5(e) and the restriction of exports of dairy products under Special Milk Class 5(d) to Canada's export subsidy commitment levels. Canada otherwise maintained its pre-existing milk supply management scheme, including the establishment of an annual Market Sharing Quota for industrial milk and its allocation to milk producers, as well as regulation of supplies and prices of milk through Milk Classes 1 to 4 and Special Milk Classes 5(a) to 5(d).[6] Canada also created a new class of domestic milk, Class 4(m), under which any over-quota milk could be sold only as animal feed. In addition, Canada introduced a new category of milk for export processing known as "commercial export milk" ("CEM"). Under pre-commitment contracts, that is, contracts concluded in advance of production, Canadian producers can sell any quantity of CEM to Canadian processors for export processing 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, and the revenues derived by the producer from sales of CEM are collected directly by it without government involvement. However, if a processed dairy product, which is produced using CEM, is sold on the domestic market, the processor is liable to financial penalties for diverting the dairy product into the domestic market.[7] The factual aspects of the new scheme are set out in greater detail in the Panel Report.[8]

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[3]WT/DS103/10, WT/DS113/10.

[4]WT/DS103/13, WT/DS113/13.

[5]WT/DS103/12/Add.6, WT/DS113/12/Add.6.

[6]For a description of the pre-existing milk supply management scheme, *see*, Appellate Body Report, *Canada – Dairy*, *supra*, footnote 2, paras. 6-16, and the original Panel Report, *Canada – Dairy*, *supra*, footnote 2, paras. 2.1-2.66.

[7]Panel Report, para. 6.77.

[8]*Ibid*., paras. 3.1-3.9.

5. Taking the view that certain of the measures taken by Canada to comply with the recommendations and rulings of the DSB were not consistent with its 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.[9]

6. 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.[10] Canada objected to the level of suspension proposed, and the matter was referred to arbitration, pursuant to Article 22.6 of the DSU.[11] However, the parties agreed to request the arbitrator to suspend its work pending the outcome of the Article 21.5 proceeding.[12]

7. Before the Panel, New Zealand and the United States claimed that Canada had acted inconsistently with Articles 3.3, 8, 9.1(c) and 10.1 of the *Agreement on Agriculture* through the creation of a CEM market and the continued operation of Special Milk Class 5(d). The United States also claimed that through these measures, Canada had acted inconsistently with its obligations under Articles 1.1 and 3.1 of the *SCM Agreement*. Before the Panel, Canada denied that the provision of CEM involved export subsidies under either the *Agreement on Agriculture* or the *SCM Agreement*.

8. In its Report, 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, for the marketing year 2000/2001.[13]

9. 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*."[14]

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[9]WT/DS103/16 and WT/DS113/16. Two of the three members of the Panel had previously served on the original panel. Panel Report, para. 1.10 and the original Panel Report, para. 1.8.

[10]WT/DS103/17 and WT/DS113/17.

[11]WT/DS103/18 and WT/DS113/18.

[12]Panel Report, para. 1.7; WT/DS103/14, para. 9 and WT/DS113/14, para. 9.

[13]Panel Report, para. 7.1. Having found that Canada had acted inconsistently with its obligations under Article 9.1(c) of the *Agreement on Agriculture*, the Panel declined to address the claims relating to Article 10.1 of that Agreement and to Articles 1.1 and 3.1 of the *SCM Agreement*. (Panel Report, paras. 6.88 and 6.102)

[14]*Ibid*., para. 7.3.

10. On 4 September 2001, 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 paragraph 4 of Article 16 of the DSU, and filed a Notice of Appeal pursuant to Rule 20 of the *Working Procedures for Appellate Review* (the "*Working Procedures*"). On 14 September 2001, Canada filed its appellant's submission.[15] On 1 October 2001, New Zealand and the United States each filed an appellee's submission.[16] On the same day, the European Communities filed a third participant's submission.[17]

11. The oral hearing in the appeal was held on 26 October 2001. The participants and the European Communities, as third participant, presented oral arguments and responded to questions put to them by the Members of the Division hearing the appeal.

II. Arguments of the Participants and Third Participant

A. *Claims of Error by Canada – Appellant*

1. Article 9.1(c) of the *Agreement on Agriculture* – "payments"

12. Canada appeals the Panel's finding that CEM sales by producers to processors constitute "payments" within the meaning of Article 9.1(c) of the *Agreement on Agriculture*.

13. Canada relies upon the finding of the Appellate Body in *Canada – Dairy* that "payments" under Article 9.1(c) are made to the recipient "[i]f goods or services are supplied … at reduced rates (that is, at below market-rates)".[18] In the present case, there is no such "payment", since the CEM scheme does not involve any government control over the price of milk destined for export processing, in contrast with the former scheme where the Canadian government was found to set lower prices for export milk through the Special Milk Classes and price-pooling mechanisms. Accordingly, the prices freely determined for CEM on a willing-buyer, willing-seller basis, outside the domestic price classification system, are prices at "market-rates", and not prices below "market-rates". The Panel's failure to consider the changes in market conditions as a result of the deregulation of CEM thus amounts to an error of law.

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[15]Pursuant to Rule 21 of the *Working Procedures*.

[16]Pursuant to Rules 22 and 23(3) of the *Working Procedures*.

[17]Pursuant to Rule 24 of the *Working Procedures*.

[18]Appellate Body Report, *supra*, footnote 2, para. 113.

14. Canada further submits that in determining whether there was a "payment", the Panel incorrectly used domestic regulated prices as the benchmark for comparison with the "market-determined" prices of CEM. A benchmark analysis is neither appropriate nor necessary in a situation where the alleged discounted price is a market-determined price. In Canada's view, it is not rational to use as a benchmark a "government-regulated" price to establish the "trade-distorting potential" of a "market-determined" price.

2. Article 9.1(c) of the *Agreement on Agriculture* – "financed by virtue of governmental action"

15. Canada also appeals the Panel's finding that the "payments" were "financed by virtue of governmental action", within the meaning of Article 9.1(c) of the *Agreement on Agriculture.*

16. According to Canada, the Panel erred by applying a standard "less stringent" than the one contemplated by Article 9.1(c) of the *Agreement on Agriculture*. The ordinary meaning of the three elements of Article 9.1(c), that is, "financed", "by virtue of ", and "governmental action", read individually and collectively, support Canada's view that there should be a "strong affirmative and positive linkage between the governmental action and the financing of the payments".[19] On the contrary, the Panel's interpretation suggests that Article 9.1(c) applies even when government is "merely involved" in export markets or where private action is "simply encouraged" by government. The Panel also misapplied the legal reasoning of the Appellate Body in *Canada – Dairy* where the Appellate Body found that "'governmental action' [was] not simply involved; it [was], in fact, indispensable to enable the supply of milk to processors for export, and hence the transfer of resources, to take place."[20] Under the new CEM scheme, where the government has deregulated the export transactions, there is no "strong affirmative and positive linkage" between the governmental action and the financing of the payments.

17. Canada argues that the "but for" test, applied by the Panel to determine whether the payments are "financed by virtue of governmental action", overlooks the word "financed" and falls short of the concept of "indispensability" referred to by the Appellate Body in *Canada – Dairy*. Canada submits that the Panel interpreted the word "financed" merely to mean that a payment is "made".[21] The word "financed", in its ordinary meaning, requires that a government "provide[] funds" or "perform[] functions of raising, furnishing or managing funds".[22] Canada finds support for this interpretation in

[19]Canada's appellant's submission, paras. 7, 49 and 52.

[20]Appellate Body Report, *supra*, footnote 2, para. 120.

[21]Canada's appellant's submission, para. 8.

[22]*Ibid*., paras. 10 and 49.

the levy example in Article 9.1(c), in the object and purpose of the *Agreement on Agriculture*, and in the Appellate Body Report in *Canada – Dairy*.

18. Canada also submits that the Panel misread Article 9.1(c) to mean that payments need not be "directly financed", provided that governments "*establish the conditions which ensure that* the payment … takes place".[23] (emphasis in original) Even if this standard were applicable under Article 9.1(c) of the *Agreement on Agriculture*, Canada submits that the CEM scheme would not fall within its scope, since Canada has not taken any measure to "ensure" or "compel" the provision of CEM to processors. CEM is provided by producers to processors of their own volition and at freely negotiated prices.

19. Furthermore, in the view of Canada, the Panel should have used the *SCM Agreement* as relevant context and interpreted the word "subsidy" as used in that Agreement. Canada argues that the *Agreement on Agriculture* and the *SCM Agreement* should be interpreted consistently, to the extent permitted by their wording, in order to determine whether subsidies are involved. In particular, Canada refers to the concept of "financial contribution" as a "cornerstone" in the meaning of "subsidy" under the *SCM Agreement*, and to the panel report in *United States – Measures Treating Exports Restraints as Subsidies* ("*US – Export Restraints*")[24] which provides an analysis of the fourth kind of "financial contribution " described in Article 1.1(a)(1) of the *SCM Agreement*. Canada explains that in *US – Export Restraints*, the panel rejected the proposition that the focus should be on the effects or results of governmental action, suggesting instead, that the focus should be on the nature of that action.[25]

20. Canada criticizes the "two-part" test used by the Panel to establish whether payments are "financed by virtue of governmental action". In the view of Canada, the Panel erroneously concentrated upon the alleged effects of the domestic regulation measures on commercial export transactions, while commercial export transactions by themselves should have been the real focus for an analysis under Article 9.1(c) of the *Agreement on Agriculture*. In particular, Canada submits that quotas which prevent producers "from selling more milk on the regulated domestic market at a higher price, than to the extent of the quota allocated to them"[26] do not constitute "governmental action" that "finances" payments on the export of dairy products manufactured with CEM. Quotas for the domestic market have no bearing on a producer's decision to produce or sell CEM, since this decision

[23]Panel Report, para. 6.38.

[24]Panel Report, WT/DS194/R and Corr.2, adopted 23 August 2001.

[25]Canada's appellants's submission, para. 77.

[26]Panel Report, para. 6.42.

is made before, not after, the production. Moreover, penalties for diversion of milk cannot be considered as "governmental action" that "finances" payments, since they occur once the transaction between the producer and processor is completed.

21. Canada stresses further that the Panel failed to take account of its deregulation of the export market for milk, of the existence of a regulated domestic market and a deregulated export market in Canada, and of the commercial nature of the transactions for the provision of CEM, namely, that the transactions are negotiated exclusively by private parties of their own free will. Canada recalls that the original panel noted that the mere existence of parallel markets with lower export prices did not, by itself, create an export subsidy, and that the issue was rather the extent of government involvement in providing the lower-priced product for export. As a result of this approach, the Panel effectively "collapsed" the domestic support disciplines and the export subsidy disciplines of the *Agreement on Agriculture*.

22. Canada challenges the Panel's conclusion that producers are "driven by governmental action to sell milk produced outside their quota into the export market".[27] Producers and processors are under no control or compulsion of the government; they now freely choose to sell or purchase CEM at prices and terms based on market forces. The Panel's conclusion that producers are "driven" to sell milk for export is premised on the assumption that producers behave in a "profit-maximizing" manner. Such an assumption is not a proper basis for identifying WTO-inconsistent subsidies. Article 9.1(c) does not equate export subsidies with choices between "profit-maximizing" options or "unfettered commercial freedom". Canada finds it "illogical" that the very act of "deregulating" was interpreted by the Panel to be governmental "intervention" that restricts producers' commercial freedom. The mere fact that markets exist within a legal framework established by the government does not imply that producers' choices are not free in those markets.

23. Canada also emphasizes that the standard developed by the Panel for Article 9.1(c) of the *Agreement on Agriculture* is more stringent than the one applicable for an export subsidy under the *SCM Agreement*, whereas the subsidy disciplines in the agricultural sector are designed to reduce agricultural support and protection over time, and are yet to achieve the level of disciplines imposed by the *SCM Agreement*.

24. Accordingly, in the view of Canada, there is no "governmental action" which "finances" payments through the supply of CEM within the meaning of Article 9.1(c) of the *Agreement on Agriculture*.

[27]Panel Report, para. 6.48.

3. Article 10.1 of the *Agreement on Agriculture* and Article 3.1 of the *SCM Agreement*

25. In the event that the Appellate Body deems it necessary to complete the Panel's analysis, Canada presents the following arguments with respect to Article 10.1 of the *Agreement on Agriculture*. In essence, Canada claims that there is no subsidy provided to processors within the meaning of Article 1(e) of the *Agreement on Agriculture* and Article 1.1 of the *SCM Agreement*, including item (d) of the Illustrative List of Export Subsidies (the "Illustrative List") in Annex I of the *SCM Agreement*. Accordingly, Canada's measures are not inconsistent with Article 10.1 of the *Agreement on Agriculture.*

26. Canada asserts further that it is not circumventing its export subsidy commitments within the meaning of Article 10.1 of the *Agreement on Agriculture*, since there is no export subsidy involved in CEM transactions; neither is it circumventing its export subsidy commitments by "non-commercial transactions" so as to attract application of Article 10.1 of the *Agreement on Agriculture.*

27. Finally, Canada argues that, as there are no "subsidies" conferred on processors within the meaning of Article 1.1 of the *SCM Agreement*, there can be no "export subsidy" within the meaning of Article 3.1 of the *SCM Agreement*.

B. *Arguments of New Zealand – Appellee*

1. Article 9.1(c) of the *Agreement on Agriculture* – "payments"

28. New Zealand submits that Canada's new measures also are "payments" within the meaning of Article 9.1(c) of the *Agreement on Agriculture*. Although prices are determined through negotiations between producers and processors under the CEM scheme, producers only sell and negotiate prices for CEM because they are prevented from selling that milk into the domestic market. Canada's contention that prices are determined by "arm's length private transactions" is based on the erroneous assumption that these transactions are genuinely voluntary and are purely market-based. Processors are the beneficiaries of an artificially constructed market which provides them with milk for export processing at prices lower than those applicable to the domestic market.

29. New Zealand argues that Canada incorrectly assumes that there are two separate markets. The domestic and the export markets are, in reality, identical in terms of participants and products, and they differ only with regard to the degree of government involvement. Should Canada's argument on "separate markets" be accepted, it would allow Members with domestic supply management schemes to evade their export subsidy commitments by simply creating a "separate" artificial market through

which processors for export would have access to inputs at subsidized prices. Even if the CEM market were to be treated as a "separate" market, there would still be "payments" within the meaning of Article 9.1(c) of the *Agreement on Agriculture*, because the determinative question is whether processors for export obtain milk at reduced rates, not whether milk is obtained through one market or another.

2. Article 9.1(c) of the *Agreement on Agriculture* – "financed by virtue of governmental action"

30. New Zealand submits that Canada erroneously restricts the interpretation of Article 9.1(c) of the *Agreement on Agriculture* to mean that only "overt" action by government, such as the setting of prices or the imposition of a levy, would satisfy the requirement that payments are "financed by virtue of governmental action". New Zealand contends that such an approach is not supported by the Appellate Body's ruling in *Canada – Certain Measures Concerning Periodicals* [28], or by the negotiating history of the *Agreement on Agriculture*. Canada improperly isolates the word "financed" from the other words of the phrase "financed by virtue of ". Furthermore, the phrase "by virtue of " indicates that Article 9.1(c) cannot be read to mean that it is limited to measures with "levy-type characteristics". New Zealand contends that Canada overlooks the ordinary meaning of "by virtue of " by substituting its own standard of "a strong affirmative and positive linkage between the government action and the financing of the payments". New Zealand supports the Panel's view that the degree of government involvement is not a decisive factor, and that "indispensability" is the appropriate standard to be applied under Article 9.1(c), in this case, although it is not necessarily the only standard applicable under this article.

31. New Zealand argues further that the Panel rightly used the "but for" test as it is grounded in the ordinary meaning of "indispensable". In applying the "but for" test, the Panel did not use "less than a stringent standard", nor is it founded on mere or incidental governmental involvement.

32. With regard to "governmental action", New Zealand criticizes Canada's argument that its involvement is not "indispensable" for the financing of payments in this case because it has eliminated many of the specific factors that were found to be violative in the Appellate Body Report in *Canada – Dairy*. Canada's view implies that Article 9.1(c) of the *Agreement on Agriculture* would be violated only if the types of action that previously existed under Special Milk Classes 5(d) and 5(e) were present in the new scheme also. The application of the Appellate Body's ruling in *Canada – Dairy* cannot be restricted to such narrowly defined circumstances.

[28] Appellate Body Report, WT/DS31/AB/R, adopted 30 July 1997, DSR 1997:I, 449.

33. Citing the facts of this case, New Zealand argues that governmental action is clearly indispensable to the financing of payments made from producers to processors, as concluded by the Panel by using correctly its "two-part" test.

34. New Zealand expresses its deep reservations on Canada's reference to the *SCM Agreement* as contextual support for interpreting Article 9.1(c) of the *Agreement on Agriculture*. There is insufficient similarity between the terms of Article 1.1(a)(1) of the *SCM Agreement* and of Article 9.1(c) of the *Agreement on Agriculture* for the *SCM Agreement* to be of any decisive guidance. Moreover, Canada, by relying on the panel report in *US – Export Restraints*, creates an unwarranted dichotomy between the nature of governmental action and its "effects".

35. New Zealand also believes that Canada is seeking to re-argue the facts of this case by asserting that producers make free decisions, and that this question falls outside the scope of appellate review. No rational, profit-maximizing producer would voluntarily forego the opportunity of using high-priced sales in the domestic market to make additional profits, albeit by low-priced sales in the export market. Canada seeks to reinterpret Article 9.1(c) incorrectly by trying to restrict its application only to governmental action that, by itself, finances the transfer of resources.

36. Finally, New Zealand disagrees with Canada's view of the Panel's decision as one that penalizes governments that decide to deregulate.

3. Article 10.1 of the *Agreement on Agriculture*

37. In the alternative, New Zealand argues that, should the Appellate Body find that Canada's schemes are not export subsidies within the meaning of Article 9.1(c), the Appellate Body should conclude that the schemes constitute export subsidies within the meaning of Article 10.1 of the *Agreement on Agriculture*.

38. New Zealand argues that the CEM scheme, under which Canada enables processors for export to obtain milk at prices that are lower than those on the domestic market, constitutes an "export subsidy" within the meaning of item (d) of the Illustrative List of the *SCM Agreement*. Accordingly, it constitutes an "export subsidy" within the meaning of Article 1(e) of the *Agreement on Agriculture*, and, hence, within the meaning of Article 10.1 of that Agreement. The CEM scheme also results in non-commercial transactions being used to circumvent Canada's export subsidy commitments. Finally, New Zealand asserts that CEM transactions are "non-commercial transactions" that fall within Article 10.1 of the *Agreement on Agriculture*. Therefore, even if the Appellate Body were to conclude that the CEM scheme does not constitute an "export subsidy" under

Article 9.1(c), it is in a position to complete the analysis and conclude that the schemes have been applied in a manner that is contrary to Article 10.1 of the *Agreement on Agriculture*.

C. *Arguments of the United States – Appellee*

39. At the outset, the United States emphasizes that Article 10.3 of the *Agreement on Agriculture* shifts the burden of proof to Canada to establish that, through its milk management scheme, including CEM, Canada has not subsidized exports of milk in excess of its export subsidy commitment levels specified in its Schedule of commitments under the *WTO Agreement*. According to the United States, the Panel rightly concluded that Canada has failed to carry its burden.

1. Article 9.1(c) of the *Agreement on Agriculture* – "payments"

40. The United States rejects Canada's argument that the processors do not receive a "payment" within the meaning of Article 9.1(c) of the *Agreement on Agriculture*. The Panel properly concluded that a "payment" is conferred upon the processors through the provision of discounted milk for export, whether the price of export milk is compared with the price of domestic milk or with the terms of imported milk under the Import for Re-export Program ("IREP"), which are the only other sources of milk available to exporters in Canada.

41. In the view of the United States, the Panel's benchmark analysis is necessary and applicable to the present case. The Panel did not fail to consider Canada's argument that the deregulated CEM prices cannot be compared with the regulated prices for milk in the domestic market. In determining whether there is a "payment" within the meaning of Article 9.1(c) of the *Agreement on Agriculture*, the Panel considered Canada's assertion, and found that the degree of government intervention is not relevant at this stage of the analysis. The United States notes that this approach is consistent with the Appellate Body Reports in *Canada – Measures Affecting the Export of Civilian Aircraft* ("*Canada – Aircraft*")[29] and *Canada – Dairy*, and that the Panel correctly relied upon the context of Articles 9.1(b) and 9.1(e) of the *Agreement on Agriculture* for determining the appropriate benchmark, and the object and purpose of the *Agreement on Agriculture*, as support for its conclusion.

42. The United States agrees with the Panel that the CEM market is not a market in which transactions occur "privately at arm's length." This market for export milk would cease to exist absent government intervention. The only difference between Canada's so-called "two" markets is the degree of government regulation in each. The buyers, the sellers and the product, are all the same.

[29]WT/DS70/AB/R, adopted 20 August 1999.

Other than price, there is no distinction between milk destined for the export market and milk destined for the domestic market. Canada has confirmed, during the Panel proceedings, that milk destined for the export market is not stored or processed separately from other milk. [30]

43. The United States rejects Canada's argument that no benchmark is necessary and that no benchmark should be used other than the price of CEM itself. The correct approach in analyzing "payments" under Article 9.1(c) of the *Agreement on Agriculture* requires a comparison between what is received by the processor and what is otherwise available to it as an alternative source, and this comparison remains unaffected by government intervention. Therefore, there is no reason to disregard domestic price as the appropriate benchmark, particularly because of the fact that the "two" markets are in reality "one" that has been partitioned by government for differential pricing purposes. The Appellate Body in *Canada – Dairy* never suggested to exclude the use of a benchmark and, more particularly, the use of the domestic market price (or the IREP price). Moreover, the Appellate Body's interpretation of the term "benefit" in Article 1.1 of the *SCM Agreement* in *Canada – Aircraft*, provides context for the interpretation of "payment" in Article 9.1(c) of the *Agreement on Agriculture* and further support for the use of a benchmark.

44. The United States emphasizes that even under the new scheme, exporters still receive milk that is priced lower than what is otherwise available to them either on the domestic market or through the IREP. Producers are providing milk for export at a substantial discount to the market price for milk delivered for domestic consumption. Thus, even under the replacement measures, producers are foregoing revenue and processors are receiving a benefit in the same manner that the Appellate Body in the original proceeding found to constitute a "payment" within the meaning of Article 9.1(c).

45. Finally, the United States submits that Canada cannot dispute that the payment (that is, the provision of lower-priced milk) is only available in the case of milk purchased for the manufacture of dairy products destined for the export market. Consequently, the payment constitutes a payment "on the export of an agricultural product" under Article 9.1(c) of the *Agreement on Agriculture.*

2. Article 9.1(c) of the *Agreement on Agriculture* – "financed by virtue of governmental action"

46. According to the United States, the Panel properly concluded that the payments are "financed by virtue of governmental action" within the meaning of Article 9.1(c) of the *Agreement on Agriculture*.

[30] Panel Report, footnote 105 to para. 6.16.

47. In particular, the United States is of the view that the Panel rightly referred to the Appellate Body's analysis in *Canada – Dairy* in applying what it terms as the "'indispensability' test" in order to determine whether the payments are "financed by virtue of governmental action." The United States considers that the "but for" test of the Panel is only an alternative formulation for the "'indispensability' test", and that this standard, in this case, is grounded in treaty language. Thus, the Panel did not erroneously equate "by virtue of " with "merely influences" or "encourages" as asserted by Canada, and the Panel only applied the same "'indispensability' test" that the Appellate Body applied in *Canada – Dairy*. Canada attempts to restrict unduly the scope of Article 9.1(c) to the specific levy example. Moreover, the standard proposed by Canada, that is, a "strong affirmative and positive linkage between the government action and the financing of the payments", seems less stringent than the one applied by the Panel, which requires governmental action to be "necessary" or "vital" to the transfer of economic resources in determining whether payments are "financed by virtue of governmental action".

48. The United States also refers to Canada's argument that the Panel should have considered the context of the *SCM Agreement*. The fact that the Panel did not consider the *SCM Agreement* as context does not invalidate the Panel's otherwise valid conclusion regarding the proper standard and that Agreement, in fact, supports the Panel's conclusion. However, the United States disagrees with Canada's argument relating to Article 1.1(a)(1)(iv) of the *SCM Agreement*, based on the panel's interpretation of that article in its report in *US – Export Restraints*. The United States is of the view that the panel's finding in that report is "irrelevant" and that the passages quoted by Canada are "of decidedly questionable validity given their hypothetical and advisory nature". Furthermore, the panel's analysis of Article 1.1(a)(1)(iv) in that case only constitutes "*obiter dictum* at best and therefore [is] of no legal effect." [31]

49. The United States further argues that the Panel properly applied the "'indispensability' test" to the facts of the case by articulating its "two-part" test, and by applying the test, examined whether the governmental actions oblige producers to forego revenue and to sell to the export market. Having correctly found that these two facts are established in the present case, the Panel concluded that the governmental action is indispensable to the transfer of resources from the producers to the processors. The United States supports the Panel's finding that, in the absence of either of the governmental measures described in its "two-part" test, lower-priced milk could not be provided by the producers to the processors. Without quotas on the volume of milk that a producer can sell in the higher-priced domestic market, an "economically rational producer" would not choose to sell in a lower-priced

[31]United States' appellee's submission, paras. 44 and 45.

export market. Without the governmental requirement that milk contracted for export be exported and the governmental enforcement of that requirement, export milk would be diverted into the domestic market thereby undermining the low export price as well as the high domestic price.

50. The United States claims that Canada's response to the "two-part" test in this appeal is to "re-argue the facts". This falls outside the scope of appellate review. Furthermore, the Panel rightly found that Canada had not discharged its burden of proof. Therefore, the Appellate Body should uphold the Panel's conclusion that processors are receiving payments "financed by virtue of governmental action".

51. The United States disagrees with Canada that the Panel, through its "two-part" test, improperly focused on the effects of domestic regulation instead of on the measures taken to comply with the recommendations and rulings of the DSB. The governmental action guarantees that milk in excess of the quota will be exported and available for exports at a lower price. The "domestic regulation" referred to by Canada is nothing more than an "artificial segregation" of the milk market into a "domestic" market and an "export" market. By examining the segregation of the markets, the Panel analyzed government intervention in the export market, not only in the domestic market, and considered government action as a whole before concluding that governmental action is indispensable to the producers providing lower-priced milk to processors. The United States rejects Canada's view that the Panel failed to take into account the "deregulation" of the export market.

52. Finally, the United States argues that the factual record establishes that processors are provided milk at discounted prices, contingent on export, only through governmental action. Therefore, the Panel's conclusion that processors are receiving payments "financed by virtue of government action" should be upheld.

3. Article 10.1 of the *Agreement on Agriculture* and Article 3.1 of the *SCM Agreement*

53. Should the Appellate Body decide to complete the legal analysis of the Panel, the United States submits that, in the alternative, Canada's revised export schemes constitute export subsidies within the meaning of Article 10.1 of the *Agreement on Agriculture*. In the view of the United States, such a finding would be supported by the fact that the revised schemes satisfy each of the criteria identified in item (d) of the Illustrative List of the *SCM Agreement*. The United States further argues that Canada's revised export schemes result in subsidized exports without any limitation, and threaten to lead to circumvention of Canada's export reduction commitments on milk products, within the meaning of Article 10.1 of the *Agreement on Agriculture*. The United States

also emphasizes that, in this case, there is actual circumvention of Canada's export commitment levels as shown by the fact that Canada's exports of cheese have in fact already exceeded the limitations set out in Canada's Schedule of Commitments.

54. Finally, should the Appellate Body deem it necessary to complete the analysis of the Panel, the United States submits that Canada's revised export schemes are prohibited export subsidies under Article 3.1 of the *SCM Agreement* as well.

D. *Arguments of the European Communities – Third Participant*

55. The European Communities supports Canada's contention that the Panel erroneously broadened the reach of Article 9.1(c) of the *Agreement on Agriculture* to include a measure which is not a subsidy within the meaning of that article. The European Communities also agrees with Canada that Article 9.1(c) can and should be interpreted against the background of the general concept of "subsidy" as defined under the *SCM Agreement*. The concept of "subsidy" should not be subject to diverging interpretations, and it should be interpreted consistently like the concept of "export contingency". In the view of the European Communities, there are compelling arguments that support a consistent approach to the interpretation of a subsidy, in particular, the consideration that the objective of the *Agreement on Agriculture* is only to limit subsidization of agricultural products, not to create stricter disciplines on agricultural subsidies than those applicable to industrial products.

1. Article 9.1(c) of the *Agreement on Agriculture* – "payments"

56. The European Communities considers that the ordinary meaning of the word "payment", read together with the term "financed", and the levy example contained in Article 9.1(c) of the *Agreement on Agriculture*, suggests a transfer of money. In the event that the Appellate Body reaffirms that the word "payments" includes "payments-in-kind", the European Communities argues that the Panel erred in finding that the regulated domestic market price constitutes the correct benchmark to determine whether a "payment" exists. Unlike Articles 9.1(b) and 9.1(e), Article 9.1(c) does not indicate that the domestic market is the decisive benchmark. The decisive benchmark must be what is otherwise commercially available to processors on the market, as supported by the immediate context of Article 9.1(c) as well as Article 14 of the *SCM Agreement* and item (d) of the Illustrative List of the *SCM Agreement*. Since the domestic market in milk is not available to processors for export, the world market should be used in this case.

57. With regard to the Panel's finding on the requirement that "payments" be "on the export", the European Communities considers that the Appellate Body should declare this finding to be "moot and

without legal effect" because the Panel erroneously "decoupled" the term "on the export" from the term "payment" and then equated it with the concept of export contingency, although the notion of "payment *on* the export" involves a more direct and strict link with the export operation.

2. Article 9.1(c) of the *Agreement on Agriculture* – "financed by virtue of governmental action"

58. The European Communities considers that the Panel erroneously developed the "but for" test to determine whether the payment is "financed by virtue of governmental action". The Panel's approach cannot be supported by the term "financed" and the levy example contained in Article 9.1(c). The European Communities also submits that the Panel's reasoning fails to take account of the interpretative guidance provided by Article 1.1 of the *SCM Agreement*, notably, the phrase "financial contribution".

59. According to the European Communities, the element "financial contribution" in the *SCM Agreement* is an "important filter" to "sift" WTO-inconsistent subsidies from any other governmental measure that may have trade-distorting effects. The test for determining the element "financial contribution", as developed by the panel in *US – Export Restraints*, indicates that Article 9.1(c) should be limited to cases where governments address a clear command to agricultural producers to transfer a certain amount of economic resources at a certain price.

60. Finally, the European Communities is of the view that the Appellate Body should not uphold the Panel's conclusion that "payments" were "financed by virtue of governmental action" because the Panel incorrectly based its conclusion solely on the two governmental actions set out in its "two-part" test. Although these actions, if established, may encourage producers to sell CEM, the European Communities fails to see how the provision of lower-priced milk to processors can be said to be "imposed" on producers by the government in the circumstances of the present case.

III. Issue Raised in this Appeal

61. The issue raised in this appeal is whether the Panel erred in finding, in paragraph 6.79 of the Panel Report, that the supply of "commercial export milk" ("CEM") by domestic milk producers to domestic dairy processors involves "payments" on the export of milk "that are financed by virtue of governmental action" within the meaning of Article 9.1(c) of the *Agreement on Agriculture*.

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

62. Before the Panel, New Zealand and the United States claimed that the supply of CEM by Canadian milk producers to Canadian dairy processors, as an input for exports of processed dairy products, involved export subsidies under Article 9.1(c) of the *Agreement on Agriculture*. The Panel addressed this claim by: first, examining whether sales of CEM involve "*payments*"; second, having found that they do, whether those payments are "*financed by virtue of governmental action*".[32] (emphasis added); and third, examining whether the payments are made "on the *export* of an agricultural product", and concluded that they are.[33] (emphasis added)

63. Canada appeals the Panel's findings on the first and second of these three elements, but does not appeal the Panel's finding on the third. In our examination of these issues raised by Canada's appeal, we will follow the same order of analysis, examining, first, the Panel's finding that the measure involves "payments" and, second, the Panel's finding that those payments are "financed by virtue of governmental action".

A. *"Payments"*

64. The Panel recalled our statement in the original proceedings:

> … the word "payments" in Article 9.1(c) denotes a transfer of economic resources, and … the ordinary meaning of the word "payments" in Article 9.1(c) encompasses "payments" made in forms other than money, including revenue foregone.[34] (footnotes omitted)

65. The Panel also referred to the following passage from our Report in *Canada – Dairy*:

> In our view, the provision of milk at discounted prices to processors for export under Special Classes 5(d) and 5(e) constitutes "payments", in a form other than money, within the meaning of Article 9.1(c). If goods or services are supplied to an enterprise, or a group of enterprises, at reduced rates (that is, at below market-rates), "payments" are, in effect, made to the recipient of the portion of the price that is not charged. Instead of receiving a monetary payment equal to the revenue foregone, the recipient is paid in the form of goods or services. But, as far as the recipient is concerned, the economic value of the transfer is precisely the same.[35]

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[32]Panel Report, paras. 6.27 and 6.77.

[33]*Ibid*., para. 6.78.

[34]*Ibid*., para. 6.12; Appellate Body Report, *Canada – Dairy*, *supra*, footnote 2, paras. 107 and 112.

[35]Panel Report, para. 6.12; Appellate Body Report, *supra*, footnote 2, para. 113.

66. The Panel took the view that a determination that CEM is sold by producers at "discounted" or "reduced" rates, which are "below market", requires a comparison between the prices of CEM and a "benchmark" that provides a basis for comparison. The Panel found that the "right benchmark", in this dispute, is the price at which milk is sold by producers in the *domestic* market.[36] In reaching this conclusion, the Panel relied, *inter alia*, on sub-paragraphs (b) and (e) of Article 9.1 of the *Agreement on Agriculture* as context.

67. The Panel also examined a second, alternative benchmark based on world market prices. Canadian processors wishing to export processed dairy products may import raw milk, or milk derivatives, under Canada's Import for Re-Export Programme ("IREP"), provided that the processed products are exported. The Panel did not examine the parties' arguments regarding the "competitive relationship" between CEM and dairy products imported under IREP.[37] Instead, the Panel examined only the terms and conditions on which dairy products may be imported under IREP. The Panel held that imports under IREP depend upon the exercise by government of "wide and untrammelled discretion", as an import permit is required.[38] In addition, the Panel found that an administrative fee must be paid to obtain an import permit under IREP. On this basis, and without comparing the prices of CEM with the prices of dairy products imported under IREP, the Panel concluded that IREP imports are not "effectively" available on "equally favourable terms" as those offered for commercial export milk.[39]

68. The Panel concluded that "the provision of milk at discounted prices to processors for export under the CEM scheme constitutes 'payments', in a form other than money, within the meaning of Article 9.1(c) of the *Agreement on Agriculture*."[40]

69. On appeal, Canada argues that the Panel failed to take sufficient account of the fact that supplies of CEM are "no longer subject to government regulation".[41] Canada points out that we stated in *Canada – Dairy* that "payments" are made when goods are supplied at "below market-rates" and for "less than full consideration".[42] Canada emphasizes that the price of CEM is freely

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[36]Panel Report, para. 6.22.

[37]*Ibid*., para. 6.26. Imports under IREP, generally, involve whole milk powder, while CEM involves fluid milk. The Panel noted in this paragraph that the parties had submitted "conflicting evidence" regarding fluid milk equivalent prices of whole milk powder.

[38]Panel Report, para. 6.25.

[39]*Ibid.*

[40]*Ibid*., para. 6.27.

[41]Canada's appellant's submission, para. 40.

[42]Appellate Body Report, *supra*, footnote 2, paras. 87 and 113.

negotiated in the marketplace between the producer and the processor, on a willing-buyer, willing-seller basis and, accordingly, it represents both market price and full consideration for the milk. Consequently, Canada contends that no comparison with any benchmark is required.[43] In Canada's view, there is, therefore, no "payment" when a producer sells CEM to a processor.

70. Article 9.1(c) of the *Agreement on Agriculture* reads:

> The following export subsidies are subject to reduction commitments under this Agreement:
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> …
>
> 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;
>
> …

71. We observe, first, that the "payment" which the Panel found to exist in this dispute is effected through the supply of goods – commercial export milk or CEM. The alleged payment is, thus, not a monetary payment but a payment-in-kind. As the Panel observed, we held in the original proceedings that the word "payments" in Article 9.1(c) "encompasses 'payments' made in forms other than money, including revenue foregone."[44] It is not contested, in this appeal, that "payments" can include payments-in-kind in Article 9.1(c) of the *Agreement on Agriculture*.

72. In the original proceedings, in order to identify whether there were "payments" in Article 9.1(c), through the supply of milk under Special Milk Classes 5(d) and 5(e), the panel identified two benchmarks against which to compare the price of milk sold under these Special Milk Classes. These two benchmarks were (1) domestic prices and (2) the price of milk available to processors from world markets through imports under IREP. The original panel found that supplies under Special Milk Classes 5(d) and 5(e) were available on terms and conditions more favourable than those applicable under both of the two benchmarks on which it relied.[45] The original panel's

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[43]Canada's appellant's submission, para. 46; *see also*, para. 36 and footnote 28 thereto.

[44]Appellate Body Report, *Canada – Dairy*, *supra*, footnote 2, para. 112. We note that the *Agreement on Agriculture* and the *SCM Agreement* both use the word "foregone", which can also be spelled "forgone".

[45]Original Panel Report, *Canada – Dairy*, *supra*, footnote 2, para. 7.58. The original panel's analysis of the benchmarks forms part of its examination of the claims made in those proceedings regarding "payments-in-kind" under Article 9.1(a) of the *Agreement on Agriculture*. In examining the claims made regarding payments-in-kind under Article 9.1(c), the panel relied on its earlier findings under Article 9.1(a). *See*, original Panel Report, paras. 7.90 and 7.101.

findings regarding the benchmarks under Articles 9.1(a) and 9.1(c) were not challenged on appeal and we merely based our examination on the fact that Special Milk Classes 5(d) and 5(e) were supplied to processors at "discounted" prices or at "below market-rates". In this appeal, Canada's challenge to the Panel's finding focuses squarely upon the Panel's use of a benchmark as a basis for determining whether there are "payments" in this dispute.[46]

73. Although we did not have to examine whether the benchmarks used by the panel in the original proceedings were appropriate, our findings in those proceedings provide guidance in identifying when "payments" are made under Article 9.1(c). We recall that we upheld the original panel's finding that "the provision of *discounted* milk to processors or exporters under Special Classes 5(d) and 5(e) involves 'payments' within the meaning of Article 9.1(c) of the *Agreement on Agriculture*."[47] (emphasis added) In reaching this conclusion, we noted that, where milk is sold at "*reduced* rates (that is, at *below market-rates*), 'payments' are, in effect, made to the recipient of the portion of the price that is not charged."[48] (emphasis added) We noted that the producer of the milk "foregoes" the uncharged portion of the price.[49] In short, we indicated that there are "payments" under Article 9.1(c) when the price charged by the producer of the milk is less than the milk's *proper value* to the producer.[50]

74. Thus, the determination of whether "payments" are involved requires a comparison between the price actually charged by the provider of the goods or services – the prices of CEM in this case – and some objective standard or benchmark which reflects the proper value of the goods or services to their provider – the milk producer in this case. We do not accept Canada's argument that as the producer negotiates freely the price with the processor, and CEM prices are, therefore, market-determined, it is not necessary to compare these prices with an objective standard.

75. Article 9.1(c) of the *Agreement on Agriculture* does not expressly identify any standard for determining when a measure involves "payments" in the form of payments-in-kind. The absence of an express standard in Article 9.1(c) may be contrasted with several other provisions involving export subsidies which do provide an express standard. Thus, for instance, even within Article 9.1 itself,

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[46]*See, supra*, para. 69.

[47]Appellate Body Report, *Canada – Dairy*, *supra*, footnote 2, para. 114.

[48]*Ibid*., para. 113.

[49]*Ibid.*

[50]We will examine below the concept of the proper value of goods to the producer, in the context of these proceedings. *See, infra*, paras. 86 to 96.

sub-paragraphs (b) and (e) expressly provide that the domestic market constitutes the appropriate basis for comparison.[51]

76. We believe that it is significant that Article 9.1(c) of the *Agreement on Agriculture* does not expressly identify a standard or benchmark for determining whether a measure involves "payments". It is clear that the notion of "payments" encompasses a diverse range of practices involving a transfer of resources, either monetary or in-kind. Moreover, the "payments" may take place in many different factual and regulatory settings. Accordingly, we believe that it is necessary to scrutinize carefully the facts and circumstances of a disputed measure, including the regulatory framework surrounding that measure, to determine the appropriate basis for comparison in assessing whether the measure involves "payments" under Article 9.1(c).

77. We turn now to examine the factual and regulatory setting of the disputed measure in this appeal. We note that, in these proceedings, certain aspects of the measure at issue are substantially different from those of the measure at issue in the original proceedings.

78. In the original proceedings, sales of milk under Special Milk Classes 5(d) and 5(e) were entirely regulated by the Canadian government or its agencies. The government granted permits for these sales, and also negotiated the sales price with the processors on a transaction-by-transaction basis. The government also collected the revenues from the sales transactions and allocated them to producers. The role of the government in regulating the export sales of producers mirrored the role of the government in regulating sales in the domestic market, where supplies were strictly controlled by the government through a quota system and where prices were determined by the provincial marketing boards, which were found by us to be government agencies under the *Agreement on Agriculture*.[52]

79. While continuing to regulate the domestic market in the same way, the Canadian government has now altered its role in regulating export sales by the producers. At present, there are two categories of export sales of milk by producers. First, under the Special Milk Classes 5(a) to 5(d), the Canadian government continues to require that export sales be made within a quota and under government permit. As in the original proceedings, prices for export sales under these Special Milk

[51]*See also*, items (c), (d), (f), (g), (h), (j) and (k) of the Illustrative List of the *SCM Agreement*, each of which expressly identifies one or more benchmarks to be used as a basis for comparison in determining whether a measure involves export subsidies. *See further*, paragraphs 8 and 13 of Annex 3, and paragraph 2 of Annex 4, of the *Agreement on Agriculture*, which expressly identify one or more benchmarks for calculating the amount of domestic support.

[52]Appellate Body Report, *Canada – Dairy*, *supra*, footnote 2, para. 102.

Classes, including in particular Special Milk Class 5(d), are regulated by the government. However, besides abolishing Special Milk Class 5(e), Canada has now established a second category of export milk, known as commercial export milk or CEM. Sales of CEM do not require any permit from the government, and the volume and price of CEM sales are freely negotiated between the producer and the processor. Each producer decides for itself whether, and when, to produce and sell milk as CEM. Many producers may find that the production of additional milk for sale as CEM is not profitable and they are free to decide not to produce such additional milk for export sale. This is borne out by the fact that many producers do choose not to produce and sell CEM.[53] Milk sold as CEM cannot be diverted into the domestic market and dairy products produced with CEM must be exported.

80. With these factual and regulatory circumstances of the new measure in mind, we now examine the appropriate standard for determining whether the measure at issue involves "payments" under Article 9.1(c) of the *Agreement on Agriculture*. In so doing, we begin by reviewing the Panel's finding that the domestic market provides the "right benchmark" for this dispute.

81. The domestic price in this case is an administered price fixed by the Canadian government as part of the regulatory framework established by it for managing the supply of milk destined for consumption in the domestic market. As with administered prices in general, this price expresses a government policy choice based, not only on economic considerations, but also on other social objectives. The Canadian regulatory framework for managing domestic milk supply, including the establishment of the administered price, is not in dispute in this case. There can be little doubt, however, that the administered price is a price that is favourable to the domestic producers. Consequently, sale of CEM by the producer at less than the administered domestic price does not, necessarily, imply that the producer has foregone a portion of the proper value of the milk to it. In the situation where the producer, rather than the government, chooses to produce and sell CEM in the marketplace at a price it freely negotiates, we do not believe it is appropriate to use, as a basis for comparison, a domestic price that is fixed by the government.

82. We, therefore, reverse the Panel's finding, in paragraph 6.22 of the Panel Report, that the "right benchmark" in these proceedings is the "domestic market price".[54]

[53]Canada asserted before the Panel that about 30 percent of Canadian producers had participated in CEM transactions since deregulation measures were introduced in August 2000. (Panel Report, para. 4.24)

[54]*See also*, our reasoning, *infra*, in para. 90.

83. The alternative "benchmark" which the Panel relied upon to determine whether CEM prices involve "payments" was the terms and conditions on which alternative supplies are available to processors on world markets, through IREP.[55] In reviewing this benchmark, we recall that, in these proceedings, the standard used to determine whether there are "payments" under Article 9.1(c) must be based on the proper value of the milk to the producer, in order to determine whether the producer foregoes a portion of this value. If a producer wishes to sell milk for export processing, it is obvious that the price of the milk to the processor must be competitive with world market prices. If it is not, the processor will not buy the milk, as it will not be able to produce a final product that is competitive in export markets. Accordingly, the range of world market prices determines the price which the producer can charge for milk destined for export markets.[56] World market prices do, therefore, provide one possible measure of the value of the milk to the producer.

84. However, world market prices do not provide a valid basis for determining whether there are "payments", under Article 9.1(c) of the *Agreement on Agriculture*, for, it remains possible that the reason CEM can be sold at prices competitive with world market prices is precisely because sales of CEM involve subsidies that make it competitive. Thus, a comparison between CEM prices and world market prices gives no indication on the crucial question, namely, whether Canadian export production has been given an advantage. Furthermore, if the basis for comparison were world market prices, it would be possible for WTO Members to subsidize domestic inputs for export processing, while taking care to maintain the price of these inputs to the processors at a level which equalled or marginally exceeded world market prices. There would then be no "payments" under Article 9.1(c) of the *Agreement on Agriculture* and WTO Members could easily defeat the export subsidy commitments that they have undertaken in Article 3 of the *Agreement on Agriculture*.[57]

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[55]Panel Report, paras. 6.22 ff. *See, supra*, para. 67. We note that, in examining the terms and conditions on which IREP is available, the Panel focused exclusively on the requirements to obtain a discretionary permit and to pay an administrative fee. In assessing whether alternative sources of supply are available on more favourable terms, we consider that panels should take account of all the factors which affect the relative "attractiveness" in the marketplace of the different goods or services. The primary consideration must be price, while the importance of administrative formalities will depend on their nature and characteristics. For instance, if an import permit were granted to importers as a matter of course, in the context of straightforward import procedures, and if import fees were only administrative charges to cover expenses, these formalities would be unlikely, on their own, to mean that imports were available on less favourable terms and conditions.

[56]New Zealand acknowledged, before the Panel, that the price of CEM "will be essentially world market prices". (New Zealand's first submission to the Panel, para. 4.05) Canada also argued that the processor offers producers a price for CEM that is based on world market conditions. (Canada's first submission to the Panel, para. 37; Canada's second submission to the Panel, para. 13; Canada's oral statement before the Panel, paras. 21, 30, 49 and 51; Canada's appellant's submission, para. 39 and footnote 32 thereto)

[57]We note that none of the participants in these proceedings argued that world market prices are the appropriate benchmark for determining whether supplies of CEM involve "payments" within the meaning of Article 9.1(c) of the *Agreement on Agriculture*. *See also, supra*, footnote 43.

85. We do not, therefore, accept that world market prices are an appropriate basis for determining whether sales of CEM by producers involve "payments" under Article 9.1(c) of the *Agreement on Agriculture*.

86. We turn now to determine the appropriate standard for assessing whether sales of CEM by producers involve "payments" under Article 9.1(c) of the *Agreement on Agriculture*. We reiterate that the standard must be objective and based on the value of the milk to the producer.

87. Although the proceeds from sales at domestic or world market prices represent two possible measures of the value of milk to the producer, we do not see these as the only possible measures of this value. For any economic operator, the production of goods or services involves an investment of economic resources. In the case of a milk producer, production requires an investment in fixed assets, such as land, cattle and milking facilities, and an outlay to meet variable costs, such as labour, animal feed and health-care, power and administration. These fixed and variable costs are the total amount which the producer must spend in order to produce the milk and the total amount it must recoup, in the long-term, to avoid making losses. To the extent that the producer charges prices that do not recoup the total cost of production, over time, it sustains a loss which must be financed from some other source, possibly "by virtue of governmental action".

88. In our view, reliance upon the total cost of production, in this dispute, as a basis for determining whether there are "payments" within the meaning of Article 9.1(c), is in harmony with the domestic support and export subsidies disciplines of the *Agreement on Agriculture*. Under Article 3 of the *Agreement on Agriculture*, WTO Members are entitled to provide "*domestic support*" to agricultural producers within the limits of their domestic support commitments. The same Article establishes separate disciplines on *export subsidies* which prohibit WTO Members from providing such subsidies in excess of their export subsidy commitments.

89. It is possible that the economic effects of WTO-consistent domestic support in favour of producers may "spill over" to provide certain benefits to export production, especially as many agricultural products result from a single line of production that does not distinguish whether the production is destined for consumption in the domestic or export market.

90. We believe that it would erode the distinction between the domestic support and export subsidies disciplines of the *Agreement on Agriculture* if WTO-consistent domestic support measures were automatically characterized as export subsidies because they produced spill-over economic benefits for export production. Indeed, this is another reason why we do not agree with the Panel that sales of CEM at any price below the administered domestic price for milk can be regarded as

"payments" under Article 9.1(c) of the *Agreement on Agriculture*. Such a basis for comparison would tend to collapse the distinction between these two different disciplines.

91. However, we consider that the distinction between the domestic support and export subsidies disciplines in the *Agreement on Agriculture* would also be eroded if a WTO Member were entitled to use domestic support, without limit, to provide support for exports of agricultural products. Broadly stated, domestic support provisions of that Agreement, coupled with high levels of tariff protection, allow extensive support to producers, as compared with the limitations imposed through the export subsidies disciplines. Consequently, if domestic support could be used, without limit, to provide support for exports, it would undermine the benefits intended to accrue through a WTO Member's export subsidy commitments.

92. In our view, by relying upon the total cost of production in this dispute, to determine whether there are "payments", the integrity of the two disciplines is best respected. The existence of "payments" is determined by reference to a standard that focuses upon the motivations of the independent economic operator who is making the alleged "payments" – here the producer – and not upon any government intervention in the marketplace. More importantly, using this basis for comparison, the potential for WTO Members to export their agricultural production is preserved, provided that any export-destined sales by a producer at below the total cost of production are not financed by virtue of governmental action. The export subsidy disciplines of the *Agreement on Agriculture* will also be maintained without erosion.

93. Our approach is supported by the standards used in items (j) and (k) of the Illustrative List of the *SCM Agreement*. Item (j) is concerned with export subsidies that arise through the provision by the government of a variety of export credit guarantee and insurance programmes. Under item (j), the provision of such services by the government involves export subsidies when the premium rates charged do not "cover the *long-term operating costs and losses* of the programmes". (emphasis added) Thus, the measure of value under item (j) is the overall cost to the government, as the service provider, of providing the service. Likewise, in item (k), where the government provides export credits, the measure of the value of the service provided by the government is the amount "which [governments] actually have to pay for the funds so employed (or would have to pay if they borrowed on international capital markets…)". Again, the measure of value is by reference to the cost to the government, as the service provider, of providing the service. Therefore, items (j) and (k) give contextual support and *rationale,* for using the cost of production as a standard for determining whether there are "payments" under Article 9.1(c) of the *Agreement on Agriculture* in these proceedings.

94. A producer's cost of production may be measured in, at least, two ways. First, for any given unit of production, for instance a hectolitre of milk, there is an average total cost of production, which is the total cost of production divided by the total number of units produced, regardless of whether the production is destined for the domestic or export markets. The total cost of production includes *all* fixed and variable costs incurred in the production of all the units in question. Second, there is also the marginal cost of production which includes only the additional costs incurred by the producer in producing an extra unit of production. Generally, the marginal cost of production does not include any amount for the fixed costs of production. Although a producer may very well decide to sell goods or services if the sales price covers its marginal costs, the producer will make losses on such sales unless all of the remaining costs associated with making these sales, essentially the fixed costs, are financed through some other source, such as through highly profitable sales of the product in another market.

95. In the ordinary course of business, an economic operator chooses to invest, produce and sell, not only to recover the total cost of production, but also in the hope of making profits.

96. Accordingly, in the circumstances of these proceedings, where the alleged payment is made by an independent economic operator and where the domestic price is administered, we believe that the average total cost of production represents the appropriate standard for determining whether sales of CEM involve "payments" under Article 9.1(c) of the *Agreement on Agriculture*. 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.

97. We observe that, in this part of our findings, we are examining only whether there are "*payments*" within the meaning of Article 9.1(c) of the *Agreement on Agriculture*. Although sales by a producer below average total cost of production might involve "payments", this does not, by itself, mean that such sales involve *export subsidies*. The export subsidy described in Article 9.1(c) comprises of several elements, the first of which is that there must be "payments". But the "payments" will be an export subsidy only when they are financed by virtue of governmental action. Thus, on the basis of the standard of average total cost of production, there will be an export subsidy only if the below-cost portion of an export sale is "financed by virtue of governmental action".

98. As we have reversed the Panel's findings regarding the standard for determining the existence of "payments" and have, instead, identified the appropriate standard for these proceedings, namely, the average total cost of production, we now consider whether we can resolve this aspect of the dispute by completing the analysis. The Panel found that, in these proceedings, Article 10.3 of the

Agreement on Agriculture reverses the burden of proof so that Canada must establish "that no export subsidy … has been granted".[58] Although the burden of proof is on Canada, we must nonetheless complete the analysis solely on the basis of factual findings made by the Panel and uncontested facts in the Panel record.

99. As regards the cost of production, New Zealand submitted evidence from the Canadian Dairy Commission (the "CDC") that the cost of production of milk in Canada was C$56.83 per hectolitre.[59] The United States argued that "less than 30 percent of Canadian farmers cover their cost of production at an average price of C$57.41/hl and less than 1 percent could cover costs at export market prices of around C$30/hl."[60] The United States submitted a graph illustrating producers' costs of production.[61] According to this graph, it appears that the lowest cost of production of any producer is around C$30 per hectolitre. However, the data in the graph and the assumptions behind the data are not clear.

100. Canada contested these figures before the Panel. It argued that the figures relied upon by New Zealand and the United States were too high because they included "imputed returns to labour, management and equity – costs that are additional charges not generally associated with costing for production decisions".[62] Canada submits that a "far more relevant" figure would be based on "direct input costs (such as costs for feed and supplies) and costs associated with fixed costs (such as interest payments on debt and depreciation on buildings and equipment)."[63] In addition, Canada stated that the cost of production would also include "all cash costs of production" but would exclude "imputed or assigned" amounts that "do not represent actual expenses".[64] Canada submitted its own graph illustrating the cost of production based on generally accepted accounting principles ("GAAP").[65] According to this graph, it appears that the lowest cost of production of any producer is around C$19 per hectolitre. However, the data in the graph and the assumptions behind the data are not clear.

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[58]Panel Report, para. 6.6. Canada has not appealed this finding.

[59]New Zealand's second submission to the Panel, footnote 9 to para. 2.05, and Exhibit NZ-21 submitted by New Zealand to the Panel. In support of this figure, New Zealand cited a speech given by the Chairman of the CDC in January 2000 in which he said that a CDC study "estimated the cost of production for milk in Canada to be C$56.83/hl at that time." New Zealand also provided an exhibit containing the publicly-available speaking notes of the Chairman for that speech. In these notes, it is said that the CDC determined a "new [cost of production] of $58.89 per hL".

[60]United States' second submission to the Panel, para. 13, and Exhibit US-24 submitted by the United States to the Panel.

[61]Exhibit US-24 submitted by the United States to the Panel.

[62]Canada's oral statement before the Panel, para. 19.

[63]*Ibid*., para. 20.

[64]*Ibid*., footnote 1 to para. 20.

[65]Exhibit CDA-26 submitted by Canada to the Panel.

101. The Panel record contains data relating to the prices of CEM and domestic market milk. Canada submitted to the Panel that sales of CEM have been made in the price range of C$19.06 to C$36.86 per hectolitre, and New Zealand and the United States submitted figures which appear to be consistent with this range of prices.[66] New Zealand submitted to the Panel that the price of milk in the domestic market is between C$49.48 and C$56.06 per hectolitre, while the United States gave an average figure of C$52.92 per hectolitre. Canada did not contest these figures.[67] We note, as did the Panel, that there is a "clear differential" between the prices of CEM and the domestic market price.[68] This suggests the possibility that the prices of CEM might be below the average total cost of production and, thus, might involve "payments" under Article 9.1(c).

102. However, the Panel did not find it necessary to make any factual findings on the costs of production and the facts relating to this issue were not the subject of agreement between the parties. Moreover, the Panel proceedings were conducted without the parties arguing their case, or the Panel making enquiries, from the perspective of the average total cost of production standard we have adopted.

103. In these circumstances, we are unable to complete the analysis by determining whether the supply of CEM involves "payments" under Article 9.1(c) of the *Agreement on Agriculture*. Yet, we do not wish to be understood as holding that the supply of CEM does *not* involve "payments" under Article 9.1(c). We are simply not in a position to make a ruling on this issue.

104. In conclusion, we have reversed the Panel's finding, in paragraph 6.22 of the Panel Report, that the "right benchmark" in this dispute is the domestic market price, and we have also rejected the Panel's alternative benchmark based on world market prices. Instead, we have adopted as a standard, for these proceedings, the average total cost of production of the milk producers.[69] In the light of the factual record before us, we are unable to determine whether supplies of CEM involve "payments" under Article 9.1(c) of the *Agreement on Agriculture*. In these circumstances, we reverse the Panel's finding, in paragraph 6.27 of the Panel Report, that the provision of CEM "constitutes 'payments', in a form other than money, within the meaning of Article 9.1(c) of the *Agreement on Agriculture*." As a result, we also reverse the Panel's finding, in paragraph 6.79 of the Panel Report, that the measure at

[66]Panel Report, para. 6.10. At the oral hearing, Canada stated that the weighted-average price for sales of CEM, for the period of 1 August 2000 to 31 July 2001, in Manitoba, Ontario and Quebec, was C$29 per hectolitre.

[67]Panel Report, para. 6.10. At the oral hearing, Canada stated that the price for Class 3 domestic industrial milk in Canada, for the period of 1 August 2000 to 31 July 2001, was C$58 per hectolitre.

[68]Panel Report, para. 6.10.

[69]*Supra*, para. 96.

issue involves export subsidies under Article 9.1(c) of the *Agreement on Agriculture* and its finding, in paragraph 7.1 of the Panel Report, that Canada acted inconsistently with its obligations under Articles 3.3 and 8 of that Agreement "through the CEM scheme and the continued operation of Special Milk Class 5(d)". This does not amount to a finding that the measure at issue is WTO-consistent, but simply that the Panel's findings are vitiated by error of law.

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

105. We turn now to examine Canada's appeal of the Panel's findings on the phrase "financed by virtue of governmental action". In so doing, we recognize that the Panel's findings were predicated on the existence of "payments", under Article 9.1(c) of the *Agreement on Agriculture*, in the form of supplies of milk at prices below the domestic market prices and that we have found that this is not the appropriate basis for determining whether there are "payments". We also recognize that the factual record does not allow us to determine whether there are "payments" under the measure at issue based on the standard we have adopted of average total cost of production.

106. The Panel took the view that the phrase "financed by virtue of governmental action" implies "a certain degree of causality".[70] Recalling our Report, the Panel considered that governmental action has to be "indispensable" for the payment to take place.[71] The Panel found that it is not required that a government "force", "direct", or "compel" producers to sell into the commercial export market.[72]

107. Having examined the general meaning of the phrase "financed by virtue of governmental action", the Panel formulated the issue before it in the following way: "would milk processors for export have access to lower priced commercial export milk in Canada *but for* governmental action?"[73] (emphasis in original) The Panel opined that this "but for" standard would be met if the following two elements were demonstrated:

> … that governmental action, *de jure* or *de facto*: (i) prevents Canadian milk producers from selling more milk on the regulated domestic market, at a higher price, than to the extent of the quota allocated to them; and (ii) obliges Canadian milk processors to export all milk contracted as lower priced commercial export milk, and, accordingly, penalizes the diversion by processors of milk contracted as commercial export milk to the domestic market.[74]

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[70]Panel Report, para. 6.35.

[71]*Ibid*., paras. 6.37, 6.40-6.41 and 6.44.

[72]*Ibid.*, para. 6.44.

[73]*Ibid*., para. 6.41.

[74]*Ibid.*, para. 6.42.

108. The Panel explained that underlying this analysis was the assumption that milk producers are "economically rational" and will "try to maximize [their] profits".[75] In the light of this assumption, the Panel concluded that, if the two elements above were demonstrated, "the choice left to the Canadian producer is *not a real choice*."[76] (emphasis added) In those circumstances, the Panel found that "the 'reason' [for producers to sell CEM] would be the governmental action *driving* producers to the economically second-best option of producing for export."[77] (emphasis added) Moreover, demonstrating these circumstances "would establish that producers choose the economic second-best option as a totally rational and predictable reaction to government action taking away the first-best option [that is, sale in the domestic market at higher prices]."[78] The Panel also insisted that, to satisfy its standard, governmental "anti-diversion measures" be in place to "ensure" that export milk is not diverted back to the domestic market.[79]

109. Applying this reasoning, the Panel found, relying on Canadian federal and provincial governmental action, that the two elements, set forth in the passage cited above from paragraph 6.42 of the Panel Report, were established.[80] This, the Panel said, meant that CEM "would not be available to Canadian processors *but for* the … federal and provincial actions … obliging producers, at least *de facto*, to sell outside-quota milk for export".[81] (emphasis in original, underlining added) Accordingly, the Panel found that "payments" under CEM are "financed by virtue of governmental action".[82]

110. On appeal, Canada argues that the Panel applied a standard that fails to ensure "a strong affirmative and positive linkage between governmental action and financing of payments."[83] Canada contends that the Panel erred by interpreting "financed" to mean simply that a payment is "made".[84] Instead, the word "financing" requires that a "government performs functions of raising, furnishing or

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[75]Panel Report, paras. 6.43 and 6.45.

[76]*Ibid.*, para. 6.45.

[77]*Ibid.*

[78]*Ibid*.

[79]*Ibid.*, paras. 6.42 and 6.48.

[80]*Supra*, para. 107.

[81]Panel Report, para. 6.77.

[82]*Ibid.*, para. 6.79.

[83]Canada's appellant's submission, paras. 7, 49 and 52.

[84]*Ibid*., para. 8.

managing funds".[85] In this case, supplies of CEM do not involve any such funding either by the government or by a government mandate.

111. We begin with Article 9.1(c) of the *Agreement on Agriculture*, which covers "payments … *financed by virtue of governmental action*, whether or not a charge on the public account is involved". (emphasis added) We recall that, in the original proceedings, the role of the government in managing the supply of milk for export was manifest. We stated that:

> "[G]overnmental action" is not simply involved; it is, in fact, *indispensable* to enable the supply of milk to processors for export, and hence the transfer of resources, to take place. In the regulatory framework, "government agencies" stand so completely between the producers of the milk and the processors or the exporters that we have no doubt that the transfer of resources takes place "by virtue of governmental action".[86] (emphasis added)

112. Although the phrase "financed by virtue of governmental action" must be understood as a whole, it is useful to consider separately the meaning of the different parts of this phrase. Taking the words "governmental action" first, we observe 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). In the original proceedings, we stated that "[t]he essence of 'government' is … that it enjoys the effective power to 'regulate', 'control' or 'supervise' individuals, or otherwise 'restrain' their conduct, through the exercise of lawful authority."[87] In our opinion the word "action" embraces the full-range of these activities, including governmental action regulating the supply and price of milk in the domestic market.

113. Mere governmental action is not, however, sufficient for a finding that there is an export subsidy under Article 9.1(c). 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. In our view, the link between governmental action and the financing of payments will be more difficult to establish, as an evidentiary matter, when the payment is in the form of a payment-in-kind rather than in monetary form, and all the more so when the payment-in-kind is made, not by the government, but by an independent economic operator. In any event, it will not be sufficient simply

[85]Canada's appellant's submission., paras. 10 and 49.

[86]Appellate Body Report, *Canada – Dairy*, *supra*, footnote 2, para. 120.

[87]*Ibid.*, para. 97.

to demonstrate that a payment occurs as a consequence of governmental action because the word "financed", in Article 9.1(c), must also be given meaning.

114. The word "financed" might be given a rather specific meaning such that it would be confined to the financing of "payments" in monetary form or to the funding of "payments" from government resources. However, we have already recalled that "payments", under Article 9.1(c), include payments-in-kind, so the word "financed" needs to cover both the financing of monetary payments and payments-in-kind.[88] In addition, Article 9.1(c) explicitly excludes a reading of the word "financed" whereby payments must be funded from government resources, as the provision states that payments can be financed by virtue of governmental action "whether or not a charge on the public account is involved". Thus, under Article 9.1(c), it is not necessary that the economic resources constituting the "payment" actually be paid by the government or even that they be paid from government resources. Accordingly, although the words "by virtue of " render governmental action essential, Article 9.1(c) contemplates that payments may be financed by virtue of governmental action even though significant aspects of the financing might not involve government.

115. It is extremely difficult, however, 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. Governments are constantly engaged in regulation of different kinds in pursuit of a variety of objectives. For instance, we can envisage that governmental action might establish a regulatory framework merely enabling a third person freely to make and finance "payments". In this situation, 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" (emphasis added) 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*, even if by a third person, and governmental action.[89] In our opinion, the existence of such a demonstrable link must be identified on a case-by-case basis, taking account of the particular governmental action at issue and its effects on payments made by a third person.

116. Although the Panel addressed this issue in different ways, we consider that the Panel's reasoning, taken as a whole, was directed towards establishing the demonstrable link between

[88]*Supra*, para. 71.

[89]Where "payments" *do* involve a "charge on the public account", the link between the financing of the payments and governmental action is clearly less difficult to establish.

governmental action and the financing of the payments.[90] We quoted earlier the Panel's statement, in paragraph 6.42 of its Report, of the two elements which, if demonstrated, would, according to the Panel, establish that the payments are "financed by virtue of governmental action".[91] In determining that these two elements were demonstrated, the Panel concluded that governmental action "*obliges*" or "*drives*" producers to sell CEM.[92]

117. It is true that Canadian governmental action establishes a regulatory regime whereby some milk producers can make additional profits only if they choose to sell CEM.[93] However, even though Canadian governmental action prevents further domestic sales[94], we do not see how producers are obliged or driven to produce additional milk for export sale. As we said above, each producer is free to decide whether or not to produce additional milk for sale as CEM.[95] Furthermore, as we also said, the majority of Canadian milk producers choose not to sell CEM.[96] For these reasons, we disagree with the Panel's characterization of the measure as "obliging producers, at least *de facto*, to sell outside-quota milk for export".[97]

118. In view of our findings on "payments" above, it is not necessary for us to consider further the Panel's findings on the phrase "financed by virtue of governmental action".

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[90]We observe that the Panel stated: (i) that governmental action need "only *establish the conditions which ensure that* the payment … takes place. The governmental action is, in that sense, a necessary condition for the transfer to take place" (emphasis in original, Panel Report, para. 6.38); (ii) "the Panel considers that for a payment to be 'financed by virtue of governmental action', it must be established that a payment would not be financed, i.e. resources would not be transferred from grantor to recipient, *but for* governmental action" (emphasis in original, Panel Report, para. 6.39); (iii) there must be "action which is '*indispensable*' to the financing of [the] payment" (emphasis in original, Panel Report, paras. 6.40 and 6.44); and (iv) "[t]he question which the Panel needs to address is the following: would milk processors for export have access to lower priced commercial export milk in Canada *but for* governmental action? Put another way, have the Canadian government and its agencies taken action which is *indispensable* for the lower priced milk to be available to processors for export?" (emphasis in original, Panel Report, para. 6.41)

[91]*See*, *supra*, para. 107.

[92]*See*, Panel Report, paras. 6.42, 6.45, 6.48 and 6.77.

[93]We note that milk sold as CEM could also be sold as animal feed under Milk Class 4(m). The price of milk sold under Class 4(m) is approximately C$10 per hectolitre and is, therefore, commercially unattractive when compared with the prices of CEM. *See*, Panel Report, paras. 4.25 and 6.52.

[94]According to Canada, the sole purpose of obliging processors to export dairy products manufactured with commercial export milk and penalizing diversion of this milk into the domestic market, is to protect quota-holding producers' entitlement to the higher regulated price. (Canada's statement at the oral hearing)

[95]*Supra*, para. 79.

[96]Canada asserted before the Panel that about 30 percent of Canadian producers had participated in CEM transactions since deregulation measures were introduced in August 2000. (Panel Report, para. 4.24)

[97]*Ibid.*, para. 6.77.

V. Article 10.1 of the *Agreement on Agriculture*

119. New Zealand and the United States claim, in the alternative, that, if the measure at issue were not an export subsidy under Article 9.1(c) of the *Agreement on Agriculture*, it would be an export subsidy under Article 10.1 of that Agreement.

120. Article 10.1 of the *Agreement on Agriculture* reads:

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

121. It is clear from the opening clause of Article 10.1 that this provision is residual in character to Article 9.1 of the *Agreement on Agriculture*. If a measure is an export subsidy listed in Article 9.1, it cannot simultaneously be an export subsidy under Article 10.1. In light of the facts available to us, we have found that we are unable to determine whether the measure at issue is an export subsidy listed in Article 9.1(c). However, it remains possible that the measure *is* such an export subsidy. Clearly, in that event, the opening clause of Article 10.1 means that the measure could not also be an export subsidy under Article 10.1. In these circumstances, where we are unable to determine the legal character of the measure under Article 9.1 of the *Agreement on Agriculture*, we are similarly unable to rule upon the legal character of the measure under Article 10.1 of that Agreement.

VI. Article 3.1 of the *SCM Agreement*

122. In these proceedings, the United States also claims that the measure is a prohibited export subsidy under Article 3.1 of the *SCM Agreement*. The United States reiterates the arguments it made to the Panel concerning this claim in its appeal. [98]

123. The relationship between the *Agreement on Agriculture* and the *SCM Agreement* is defined, in part, by Article 3.1 of the *SCM Agreement*, which states that certain subsidies are "prohibited" "[e]xcept as provided in the Agreement on Agriculture". This clause, therefore, indicates that the WTO-consistency of an export subsidy for agricultural products has to be examined, in the first place, under the *Agreement on Agriculture*.

[98]United States' appellee's submission, para. 82.

124. This is borne out by Article 13(c)(ii) of the *Agreement on Agriculture*, which provides that "export subsidies that conform fully to the [export subsidy] provisions of Part V" of the *Agreement on Agriculture*, "as reflected in each Member's Schedule, shall be … exempt from actions based on Article XVI of GATT 1994 or Articles 3, 5 and 6 of the Subsidies Agreement."

125. In this appeal, we are unable to determine whether the measure at issue "conforms fully" to Articles 9.1(c) or 10.1 of Part V of the *Agreement on Agriculture*. In these circumstances, we decline to examine the claim made by the United States that the measure is inconsistent with Article 3.1 of the *SCM Agreement*.

VII. Findings and Conclusions

126. For the reasons set forth in this Report, the Appellate Body reverses the Panel's findings, in paragraph 6.79 of the Panel Report, that the supply of CEM by domestic milk producers to domestic dairy processors involves "payments" on the export of milk "that are financed by virtue of governmental action" under Article 9.1(c) of the *Agreement on Agriculture*, and, in consequence, reverses the Panel's finding in paragraph 7.1 of the Panel Report.

127. However, in the light of the factual findings made by the Panel and the uncontested facts in the Panel record, the Appellate Body is unable to complete the analysis of the claims made by New Zealand and the United States under Articles 9.1(c) or 10.1 of the *Agreement on Agriculture*, or the claim made by the United States under Article 3.1 of the *SCM Agreement*.

Signed in the original at Geneva this 12th day of November 2001 by:

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Yasuhei Taniguchi
Presiding Member

_____ _____

Georges Michel Abi-Saab
Member

A. V. Ganesan
Member