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The *Dispute Settlement Reports* of the World Trade Organization (the "WTO") include panel and Appellate Body reports, as well as arbitration awards, in disputes concerning the rights and obligations of WTO Members under the provisions of the *Marrakesh Agreement Establishing the World Trade Organization*. The *Dispute Settlement Reports* are available in English, French and Spanish. Starting with 1999, the first volume of each year contains a cumulative index of published disputes.

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CANADA - MEASURES AFFECTING THE IMPORTATION OF MILK AND THE EXPORTATION OF DAIRY PRODUCTS

Report of the Panel
WT/DS103/R
WT/DS113/R

Adopted by the Dispute Settlement Body
on 27 October 1999
as modified by the Appellate Body Report

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I. INTRODUCTION

1.1 This proceeding has been initiated by two complaining parties, the United States and New Zealand.

1.2 In a communication dated 8 October 1997 (WT/DS103/1), the United States requested consultations with Canada in accordance with Article 4 of the Understanding on Rules and Procedures Governing the Settlement of Disputes ("DSU"), pursuant to Article XXII:1 of the General Agreement on Tariffs and Trade 1994 ("GATT 1994"), Article 19 of the Agreement on Agriculture, Article 30 of the Agreement on Subsidies and Countervailing Duties ("the SCM Agreement") and Article 6 of the Agreement on Import Licensing Procedures with respect to export subsidies of Canada on dairy products and the administration by Canada of its tariff-rate quota for fluid milk and cream. The United States and Canada held consultations in Geneva on 19 November 1997 but these consultations did not result in a resolution of the dispute.

1.3 On 29 December 1997 New Zealand requested consultations with Canada pursuant to Article 4 of the DSU, under Article 19 of the Agreement on Agriculture and Article XXII:1 of the GATT 1994 with regard to Canada's Special Milk Classes Scheme. New Zealand and Canada held consultations on 28 January 1998 but these consultations did not result in a resolution of the dispute.

1.4 On 2 February 1998, the United States (WT/DS103/4) and on 12 March 1998, New Zealand (WT/DS113/4), each requested the establishment of a panel with standard terms of reference.

1.5 In its request, the United States claims that:

(a) "The Government of Canada is providing subsidies, and in particular export subsidies, on dairy products through its national and provincial pricing arrangements for milk and other dairy products without regard to the export subsidy reduction and other WTO commitments undertaken by Canada. Specifically, the Government of Canada established and maintains a system of special milk classes through which it maintains high domestic prices, promotes import substitution, and

provides export subsidies for dairy products going into world markets. These practices distort markets for dairy products and adversely affect US sales of dairy products."

(b) "In addition, although Canada committed under the Marrakesh Agreement Establishing the World Trade Organization to permit access to an in-quota quantity of 64,500 tonnes (product weight basis) under a tariff-rate quota for imports of fluid milk and cream, Canada has refused to permit commercial import shipments within the quota. Instead, Canada is administering this tariff-rate quota in a manner that denies market access."

(c) "These measures appear to be inconsistent with the obligations of Canada under the General Agreement on Tariffs and Trade 1994 (GATT 1994), the Agreement on Agriculture, the Agreement on Subsidies and Countervailing Measures, and the Agreement on Import Licensing Procedures. The measures in question are the Canadian Dairy Commission Act, agreements of the Canadian Dairy Commission, the Interprovincial Comprehensive Agreement on Special Class Pooling (as well as the P-4, P-6, and P-9 interprovincial pooling agreements), the National Milk Marketing Plan (and amendments thereto), operations of the Canadian Milk Supply Management Committee, the Dairy Products Marketing Regulations, and Canada's administration of its tariff-rate quota on fluid milk and cream (as reflected in its implementation of its WTO Schedule of Concessions)."

(d) "These measures are inconsistent with the obligations of Canada under Articles II, X, XI, and XIII of the GATT 1994; Articles 3, 4, 8, 9, and 10 of the Agreement on Agriculture; Article 3 of the Agreement on Subsidies and Countervailing Measures; and Articles 1, 2 and 3 of the Agreement on Import Licensing Procedures."

1.6 In its request, New Zealand claims that:

(a) "The Government of Canada is providing export subsidies on dairy products in contravention of its export subsidy reduction and other WTO commitments as encapsulated by the Agreement on Agriculture and the General Agreement on Tariffs and Trade 1994 (GATT 1994). The dairy export subsidy scheme in question is commonly referred to as the "special milk classes" scheme. The background to, and details of, the "special milk classes" scheme is contained, though not necessarily exclusively, in the following documents:

(i) the Canadian Dairy Commission Act;

(ii) the Comprehensive Agreement on Special Class Pooling (the P9 Agreement);

(iii) the National Milk Marketing Plan (NMMP);

(iv) the Agreement on All Milk Pooling (the P6 Agreement); and

(v) the Western Milk Pooling Agreement (the P4 Agreement)."

(b) "The "special milk classes" scheme referred to above is inconsistent with Canada's obligations under the following provisions:

(i) Articles 3, 8, 9 and 10 of the Agreement on Agriculture; and

(ii) Article X:1 of the GATT 1994."

1.7 The Dispute Settlement Body (DSB) agreed to each of these requests for a panel at its meeting of 25 March 1998 (WT/DSB/M/44). The DSB further agreed that the two panels be consolidated as a single panel pursuant to Article 9.1 of the DSU with the following standard terms of reference:

"To examine, in the light of the relevant provisions of the covered agreements cited by the United States in document WT/DS103/4 and by New Zealand in document WT/DS113/4, the matters referred to the DSB respectively by the United States and New Zealand in these documents, and to make such findings as will assist the DSB in making the recommendations or in giving the rulings provided for in those agreements".

1.8 On 12 August 1998, the parties to the dispute agreed on the following composition of the Panel:

Chairman: Professor Tommy Koh

Members: Mr. Guillermo Aguilar Alvarez

Professor Ernst-Ulrich Petersmann

1.9 Australia and Japan, and the United States in respect of the New Zealand claims, reserved their rights to participate in the Panel proceedings as third parties.

II. FACTUAL ASPECTS

A. The Canadian Dairy Sector

1. General

2.1 In Canada, milk production is divided into two categories: fluid milk and industrial milk. Of all milk deliveries, approximately 40 per cent is processed into table milk and cream (fluid milk); the remaining 60 per cent is processed into dairy products such as butter, cheese, milk powders, ice cream and yoghurt (industrial milk).[1]

2.2 Dairy producers are individual farmers who are licensed to produce milk and sell it, through marketing boards, to dairy processors. The processors are made up of the dairies that process the raw milk for fluid or industrial use, as well as further processors who use the basic dairy components as inputs for other products (such as frozen pizzas, prepared flour mixes, and confectionery). The processors then sell the value-added product on the domestic market or export it on international markets.

2.3 In Canada, there are approximately 23,800 dairy farms which in 1996/97 produced 77.5 million hectolitres of milk, compared to 84,260 dairy farms which produced 75.5 million hectolitres of milk in 1974/75 following the introduction of sup-

[1] The raw milk provided by the farmer to the processor is usually broken down at the initial stage of processing into its basic "constituents" (cream and skim milk) or into "components" (such as butterfat, protein and other milk solids). The various types of fluid milk (e.g., 3.25 per cent, 2 per cent, 1 per cent) and cream are created by re-blending the cream and skim milk to the desired butterfat content level.

ply management.[2] Virtually all production of milk comes from farms that produce for both fluid and industrial markets.

2.4 While fluid milk in general is produced and consumed locally within each of Canada's provinces, industrial milk products move in significant volumes across provincial boundaries or are exported from Canada.

2.5 Quebec and Ontario are the most important dairy-producing provinces in Canada. Quebec is the largest producer of industrial milk, retaining close to 50 per cent of the national share of industrial milk, followed by Ontario with approximately 30 per cent. The dairy processing industry is also centred primarily in Quebec and Ontario.

2. Components of the Canadian Dairy Policy

2.6 The basic components of Canada's supply management system for industrial milk are:

(a) production quotas;

(b) administered support prices; and

(c) border protection.

2.7 Regulatory jurisdiction over trade in dairy products is divided between the federal government and the provinces. While the federal government has constitutional authority over inter-provincial and international trade, other aspects of production and sale of milk are under provincial jurisdiction.

2.8 The federal government pays a subsidy of C$3.04 per hectolitre for industrial milk produced to meet domestic requirements. To this point in time, this subsidy is being phased out with the subsidy reduction being passed on to the marketplace through support price adjustments. The subsidy is expected to be eliminated by February 2002.

2.9 The federal government maintains tariffs and tariff quotas on imported dairy products. The following table summarizes the base and final bound tariffs for selected dairy products as bound in Canada's WTO Schedule:

Table 1 - Tariff Binding for Selected Dairy Products

Products	Base Tariff	Final Bound Rate (2000)
Milk	283.8%, minimum $40.6/hl	241.3%, minimum $34.5/hl
Cheddar Cheese	289.0%, minimum $4.15/kg	245.6%, minimum $3.53/kg
Butter	351.4%, minimum $4.71/kg	298.7%, minimum $4.00/kg
Yoghurt	279.5%, minimum $0.55/kg	237.5%, minimum $0.47/kg
Ice Cream	326.0%, minimum $1.36/kg	277.1%, minimum $1.16/kg
Skim Milk Powder	237.2%, minimum $2.36/kg	201.6%, minimum $2.01/kg

2.10 Low-rate tariff quota commitments are applicable to the following products and quantities: fluid milk (64,500 tonnes); cream - not concentrated (394 tonnes); concentrated or condensed milk or cream (11.7 tonnes); butter (1,964 tonnes in-

[2] 1996/97 Annual Report of the Canadian Dairy Commission and Agriculture and Agri-Food Canada: "Long Term Dairy Policy Consultation Paper" (May 1996).

creasing to 3,274 tonnes); cheese (20,412 tonnes); yoghurt (332 tonnes); powdered buttermilk (908 tonnes); dry whey (3,198 tonnes); other products of milk constituents (4,345 tonnes).

2.11 Canada operates an Import for Re-Export Programme under the authority of the Export and Import Permits Act.[3] Under this programme permits to import dairy products on an Import Control List may be issued by the responsible Minister subject to such conditions as are described in the permit or in the regulations. There are no specific policy guidelines or administrative instructions with respect to this programme, which has been in operation for a number of years. Imports under this programme consist of storable and tradeable components of milk, such as skim and whole milk powders and butter. No permits for milk for manufacturing purposes have been requested by Canadian processors under this programme, but fluid milk is imported under the programme in retail packages for use on, or eventual re-export by, cruise ships passing through Canada.

3. The Canadian Dairy Commission (the "CDC")

2.12 The Canadian Dairy Commission is a Crown corporation established under the Canadian Dairy Commission Act (the "CDC Act").[4] Its mandate is set out in the following way in the text of the CDC Act:

> "The objects of the Commission are to provide efficient producers of milk and cream with the opportunity of obtaining a fair return for their labour and investment and to provide consumers of dairy products with a continuous and adequate supply of dairy products of high quality."[5]

2.13 The powers of the CDC are set out in Article 9.(1) of the CDC Act (Box 1).

Box 1

"9. (1) The Commission may

(a) purchase any dairy product and sell, or otherwise dispose of, any dairy product purchased by it;
(b) package, process, store, ship, insure, import or export any dairy product purchased by the Commission;
(c) make payments for the benefit of producers of milk and cream for the purpose of stabilizing the price of those products, which payments may be made on the basis of volume, quantity or on any other basis of volume, quality or on any basis that the Commission deems appropriate;
(d) make investigations into any matter relating to the production, processing or marketing of any dairy product, including the cost of producing, processing or marketing that product;
(e) undertake and assist in the promotion of the use of dairy products, the improvement of the quality and variety of and the publication of information in relation to those products;

[3] Canada, Exhibit 35.
[4] The abbreviation "CDC Act" refers to the CDC Act as amended.
[5] CDC Act, Section 8.

(f) establish and operate a pool or pools in respect of the marketing of milk or cream, including
(i) distributing money to producers of milk or cream received from the marketing on any quantity of milk or cream, or any component, class, variety or grade of milk or cream from the pool or pools;
(ii) deducting from the money distributed under sub-paragraph (i) any necessary and proper expenses of operating the pool or pools;
(g) establish the price, or minimum or maximum price, paid or to be paid to the Commission, or to producers of milk or cream, the basis on which that payment is to be made and the terms and manner of payment that is to be made in respect of the marketing of any quantity of milk or cream, or any component, class, variety or grade of milk or cream;
(h) collect the price paid or to be paid to the Commission, or to any producer in respect of the marketing of any quantity of milk or cream, or any component, class, variety or grade of milk or cream, or recover that price in a court of competent jurisdiction;
(i) subject to an agreement entered into under section 9.1, establish and operate a programme in respect of the quantities and prices of milk or cream, or of any component, class, variety or grade of milk or cream, necessary for the competitive international trade in, and the promotion and facilitation of the marketing of, dairy products, including:
(i) distributing money for the purpose of the equalization of returns to producers in respect of that milk or cream, or that component, class, variety or grade, from which those dairy products are made, and
(ii) deducting from the money distributed under sub-paragraph (i) any necessary and proper expense of operating the programme; and,
(j) do all acts and things necessary or incidental to the exercise of any of its powers or the carrying out of any of its functions under this Act."

2.14 The CDC receives its funding from the federal government of Canada as well as from producers and from market transactions.[6] Its members (a Chairman, Vice-Chairman and Commissioner) are appointed by the federal government, and the CDC is accountable to the federal Parliament, reporting to the Minister of Agriculture and Agri-Food.[7]

2.15 The CDC establishes a national target price for industrial milk, which is an amount deemed to be adequate for producers to cover their costs and receive a fair return on their labour and investments. Using the target price as a basis, the CDC also establishes support prices[8] for butter and skim milk powder.[9]

[6] 1996/1997 Annual Report of the Canadian Dairy Commission, pp. 26 and 28-29.

[7] CDC Act, Section 4, establishes that: The Commission [CDC] is for all purposes of this Act an agent of Her Majesty in right of Canada.

[8] Currently, support prices are only used by the CDC for programmes to buffer domestic supplies seasonally and, to a very minor extent regionally and between processors. This is done through Plans A and B. Under Plan A, the CDC maintains butter stocks to buffer the domestic market against seasonal supply fluctuations. Sales from stocks acquired under this programme in 1996-97 amounted to less than 1 per cent of butter disappearance. Under Plan B, processors may sell butter to the CDC on condition that they repurchase it within the year. Sales of butter covered by this programme amounted to 18 per cent of domestic disappearance in 1996-97.

[9] 1996/1997 Annual Report of the Canadian Dairy Commission, under "Price Setting".

4. Provincial Milk Marketing Boards

2.16 In each province a milk marketing board exists. The provincial milk marketing boards operate within a framework established under federal and provincial legislation. The CDC Act defines a board as[10]:

> "'Board' means a body that is constituted under the laws of a province for the purpose of regulating the production for marketing, or the marketing, in intraprovincial trade of any dairy product".

2.17 The provincial milk marketing boards have all been given general authority by the federal and provincial governments in respect of the issuance and administration of quota, the pooling of returns, pricing, producer records keeping and reporting, inspection, and agreements to cooperate with other provinces and the CDC.

2.18 The membership of the provincial milk marketing boards is made up mostly or exclusively of dairy producers.[11]

2.19 It is prohibited for milk producers to sell any milk individually, without using the provincial milk marketing boards as an intermediary.

2.20 With the exception of 15 producers in Ontario, a producer must have a minimum quota holding to market milk on the domestic or international market.

5. The NMMP

2.21 At a national level, the provincial marketing boards cooperate under the National Milk Marketing Plan (NMMP). The NMMP is signed by the boards for nine[12] of the ten provinces, some provincial government representatives[13], and the CDC.

2.22 The text of the NMMP states that the

> "[p]lan is a federal-provincial agreement in respect of the establishment of a National Milk Marketing Plan for the purpose of regulating the marketing of milk and cream products relating to Canadian domestic requirements and for any additional industrial milk requirements in Canada."[14]

2.23 The NMMP sets out the structure for the calculation of an annual national production target for industrial milk - the national Market Sharing Quota (MSQ).

2.24 The NMMP is supplemented by:

(a) the Comprehensive Agreement on Special Class Pooling , (the "P9") which deals with the pooling of revenues from the Special Classes;

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[10] CDC Act, Section 2 (Definitions).

[11] This is true for Ontario and Quebec and all other provinces except Nova Scotia, Alberta and Saskatchewan. In Nova Scotia, the board members are appointed by the provincial government with one member of five to be a producer. In Alberta and Saskatchewan, the provincial governments also appoint the members but historically producers are well represented on the boards. Currently, each five-member board includes two producers, one consumer representative and one processor representative. Nova Scotia, Alberta and Saskatchewan accounted for 1.91 per cent, 4.77 per cent and 2.51 per cent of domestic production in 1997. (Canada, Exhibit 3)

[12] Newfoundland is not a party to the NMMP (its producers produce almost exclusively for the local fluid milk market and it has not traditionally contributed to the industrial milk supply that was the subject of the NMMP).

[13] Canada, Exhibit 10 contains a full list of signatories.

[14] NMMP, A. (Introduction).

(b) the Western Milk Pooling Agreement (the "P4"); and

(c) the Agreement on All Milk Pooling (the "P6").

2.25 The Comprehensive Agreement on Special Class Pooling is an Agreement among the authorities of nine provinces and provincial producer boards that are signatories of the NMMP in respect of pooling of revenues from sales of milk components in special classes of milk used to service domestic and external markets. The Agreement provides for the adoption of the Memorandum of Understanding on Special Class Pooling (MOU) and an Addendum to that Memorandum of Understanding.[15]

2.26 The powers necessary to create the Special Classes and to administer the Special Milk Classes Scheme were conferred on the CDC by amendment to federal legislation (the CDC Act). It is implemented by the Canadian Milk Supply Management Committee (CMSMC).

6. The CMSMC and the MSQ.

2.27 As noted above, the CMSMC, established under the NMMP[16], is the body that oversees the implementation of the Comprehensive Agreement on Special Class Pooling.[17]

2.28 It is composed of representatives of each provincial marketing board and the respective provincial governments.[18] Representatives of the Dairy Farmers of Canada (the "DFC"), the National Dairy Council (the "NDC") representing the dairy processors/exporters, and the Consumers Association of Canada participate although they do not have voting rights. The CDC acts as chair of the CMSMC.

2.29 Based on production and demand forecasts developed by the CMSMC Secretariat (economists from the CDC, the producer boards, the DFC and the NDC), the CMSMC sets the level of the MSQ. The MSQ is monitored and adjusted periodically to reflect changes in demand. Acting under the provisions of the NMMP[19], the CMSMC calculates shares of the MSQ among the provinces.[20]

2.30 In *setting* the MSQ, the CMSMC takes into consideration:

(a) the estimate of domestic demand for industrial milk in the coming year;

(b) the estimated amount of butterfat that will enter the industrial milk system as surplus from fluid milk production, i.e., the "skim-off";

(c) anticipated imports;

(d) stocks of dairy products; and

(e) planned exports.

2.31 Once a national MSQ has been agreed upon by the CMSMC, the next step is to *allocate* the MSQ between the provinces. This is done essentially on the basis of

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15 Comprehensive Agreement on Special Class Pooling, Introduction.
16 NMMP, Section H.1.
17 MOU, Schedule I, Section 1.
18 Newfoundland sits on the CMSMC as an observer.
19 NMMP, Section I, Quota Allocation.
20 1996/1997 Annual Report of the Canadian Dairy Commission, pp. 7-8.

historical market shares, with some limited latitude for adjustment through transfers of quota within regional arrangements. Since 1995 the MSQ has been established at the following levels (million hectolitres):

Marketing Year	*1995/96*	*1996/97*	*1997/98*	*1998/99*
MSQ Level	44.2	44.2	43.3	44.7

2.32 Subsequently, the provincial milk marketing board allocates quotas to individual farmers. In most provinces[21], the board makes a single allocation[22] to each producer, which represents that producer's share of the domestic, and traditional export, milk market. The individual producer's share of the provincial quota, the producer's quota, is determined by the permanent quota rights held by that producer. While quotas were originally allocated on the basis of historic production levels, these quota rights are commercially tradable and, in many cases, have been acquired on a commercial basis.

2.33 In general, CMSMC decisions are taken by consensus. When votes occur, each province that is a member of the NMMP (provincial government representative and producer marketing board representative together) receives one vote. Some votes require a majority while others require unanimous consent. The CDC is empowered to take a decision in the event of a failure by members to agree at two meetings where the question concerns a matter *not* covered by the Comprehensive Agreement on Special Class Pooling. The Comprehensive Agreement on Special Class Pooling requires *unanimity*, including on all matters with respect to export trade.

B. The Canadian Special Milk Classes Scheme

1. Background

2.34 Prior to 1995, the proceeds of levies paid by producers were utilized to fund the CDC's losses in exporting dairy surpluses.

2.35 Following the signing of the WTO Agreement in April 1994, the CDC "directed its activities toward developing alternatives to the use of producer levies".[23] With this in mind, a Dairy Industry Strategic Planning Committee was established. The CDC chaired this Committee and provided research and secretariat support for it. In October 1994, the Committee recommended the implementation of a "classified pricing system based on the end use of milk, national pooling of market returns, and coordinated milk allocation mechanisms."[24]

2.36 A Negotiating Subcommittee of the CMSMC was established, with representation from all provinces, to resolve how to implement a "special milk classes" scheme. This subcommittee presented its recommendations to federal and provincial Ministers of Agriculture in December 1994, who agreed that "some form of pooling of milk returns was urgently required to enable the dairy industry to meet Canada's

[21] In Alberta, producers receive two quotas, one for fluid milk, expressed in litres per day, and one for industrial milk, expressed in kilograms of butterfat per annum.
[22] This is usually expressed in kilograms of butterfat per day.
[23] 1994/1995 Annual Report of the Canadian Dairy Commission, page 4.
[24] 1994/1995 Annual Report of the Canadian Dairy Commission, pages 3-4.

international obligations and changing market conditions."[25] Ministers also agreed that the CDC Act should be amended to allow the CDC to administer the Special Milk Classes permit and national pooling arrangements. These amendments were passed in July 1995.[26]

2.37 The Special Milk Classes Scheme, which replaced the producer-financed levy system eliminated in 1995, is embodied in a Comprehensive Agreement on Special Class Pooling. The CDC, the provincial producer boards and the provinces that participate in the NMMP are the signatories of the Comprehensive Agreement on Special Class Pooling which became effective on 1 August 1995.

2. The Special Classes

2.38 The "Special Milk Classes" are the sub-classes of Class 5 milk in the national common classification system, under which the pricing of milk is based upon the end use to which the milk is put by processors. Classes 1 to 4 comprise:

(a) Class 1: Fluid milk and cream for the domestic market;

(b) Class 2: Industrial milk for the domestic market: ice cream, yoghurt and sour cream;

(c) Class 3: Industrial milk for the domestic market: cheese;

(d) Class 4: Industrial milk for the domestic market: butter, condensed and evaporated milk, milk powders and others.

2.39 The definition of the Special Milk Classes under Class 5 as contained in the Comprehensive Agreement on Special Class Pooling is as follows[27]:

(a) Class 5(a) Cheese ingredients for further processing for the domestic and export markets.

(b) Class 5(b) All other dairy products for further processing for the domestic and export markets.

(c) Class 5(c) Domestic and export activities of the confectionery sector.

(d) Class 5(d) Specific negotiated exports including cheese under quota destined for United States and United Kingdom markets, evaporated milk, whole milk powder and niche markets.

(e) Class 5(e) Surplus removal.

2.40 Class 5(e), which is referred to as "surplus removal", is made up of both in-quota and over-quota milk. The *over-quota* portion of Class 5(e) represents the production that is in excess of the MSQ. The *in-quota* portion of Class 5(e) exports represents the milk production that is surplus to domestic and planned export needs. This "surplus" may be derived either from the:

(a) "sleeve"[28];

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[25] 1994/1995 Annual Report of the Canadian Dairy Commission, pages 3-4.

[26] *Ibid.*

[27] Comprehensive Agreement on Special Class Pooling, Annex A.

(b) structural surplus of solids non-fat[29] resulting from setting the MSQ at a level that meets demand for butterfat; or

(c) other in-quota surpluses.[30]

2.41 Table 2 shows Canada's total exports compared to their export volume commitments under the WTO. Canada also provided data on the amount of exports generated through Classes 5(d) and (e) but requested that this data be kept confidential on the ground that the amounts for some entries make identification of individuals possible. The figures provided indicate that the total amount of exports generated through Classes 5(d) and (e) exceeds Canada's export quantity commitment level in respect of all three marketing years and this for all products contained in Table 2 other than skim milk powder (see also paragraph 7.115).

Table 2

Product	Marketing year	Export Quantity commitment level	Total exports[31]	Total exports generated through Classes 5(d) and (e)[32]
Butter	1995/1996	9,464	13,956	
	1996/1997	8,271	10,987	
	1997/1998	7,079	10,894	
Cheese	1995/1996	12,448	13,751	
	1996/1997	11,773	20,409	
	1997/1998	11,099	27,397	
Skim milk powder	1995/1996	54,910	35,252	
	1996/1997	52,919	24,888	
	1997/1998	50,927	29,886	
Other milk products	1995/1996	36,990	37,573	
	1996/1997	35,649	62,146	
	1997/1998	34,307	71,023	

3. In-Quota Milk and Over-Quota Milk

2.42 A national production quota (the national MSQ) for *industrial milk* is set each year by the CMSMC (paragraph 2.29 and 2.30). Each province is allocated a share of the MSQ which is then allocated among producers within a province by the various provincial milk marketing boards and agencies.

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[28] The "sleeve" is a safety margin built into the annual estimate of Canadian domestic requirements - its purpose is to cover for any unexpected changes in domestic demand in the course of the dairy year.

[29] This structural surplus, which consists of skim milk powder, had declined in recent years to about 17,800 tonnes of skim milk powder.

[30] Such surpluses could arise where there is a temporary imbalance in supply and demand, such that milk is available in a province which is not needed immediately on the domestic market in that province. This can also be described as seasonal variation in demand through the year.

[31] Data provided in response to Panel Question: Source of Total Exports: Statistics Canada.

[32] The data provided by Canada in response to Panel questions on exports generated through Classes (d) and (e), which is more extensive than that reproduced in paragraph 7.114 below, is on record and is available to the Appellate Body as necessary.

2.43 If a province exceeds its share of the MSQ, the milk that is in excess of the province's share of the MSQ is referred to as "over-quota" milk (further detail in paragraph 2.57). If a province does not exceed its share of the MSQ, all of the province's milk is referred to as "in-quota" milk.

2.44 Prior to 1995, the percentage of farmers producing in excess of 105 per cent[33] of their allocated quota was small. In 1994-95, only 10 per cent of producers were in this group, a figure consistent with levels observed since 1992. A year later, under the new system, 25 per cent of farmers produced over 105 per cent of quota. By 1997-98, 34 per cent of Canadian producers were producing over 105 per cent of their quota.

2.45 In each of the regional pooling arrangements, *fluid milk* requirements are estimated on a regional basis, based on previous years' consumption. Since fluid milk demand is the highest priority use for milk supplies in the system, the industrial milk system acts as a buffer for any fluctuations in fluid milk demand or supply. In the event of a milk shortage, for instance, milk that would otherwise have found an industrial use is sent into the fluid milk system to cover the shortfall.

2.46 Each province's share of the total in-quota milk market is the sum of its share of the MSQ and the fluid milk market within its regional pooling arrangement.

4. The Price of Milk to the Processor

(a) Other Classes (Classes 1 - 4)

2.47 The prices in Classes 1-4 reflect the target return for sales on the domestic market. Although the prices for these classes are established independently in each province by the provincial marketing boards, the boards have agreed in the regional pooling arrangements not to have large differences in these prices.

(b) Class 5 (Special Classes)

2.48 To obtain dairy products under Class 5, the processors/exporters must apply for a *permit* from the CDC. A permit holder then presents the permit to the relevant provincial marketing board or marketing agency, which upon acceptance of the recommendation contained therein, provides the milk for export.

2.49 The CDC issues two types of permit for Class 5 milk:

(a) The first type of permit applies to the activities under Classes 5(a), 5(b), and 5(c) and is issued to processors/exporters on an *annual basis*.

(b) The second type of permit applies to Classes 5(d) and (e) and is issued to exporters on a *transaction-by-transaction* basis.

2.50 Prices in Classes 5(a) and (b) are set through a formula negotiated in and decided upon by the CMSMC. This formula links Class 5(a) and (b) prices to US industrial milk prices. The CDC collects the data and does the necessary calculations

[33] This is based on the assumption that 105 per cent of quota is a level that reflects a deliberate decision to produce for the over-quota market, allowing for other factors such as weather and biological variability in milk production that may cause producers not to meet their quotas exactly.

for the consideration of the CMSMC. The price of milk in Class 5(c) is negotiated between the CMSMC and the confectionery manufacturers.

2.51 Prices for Classes 5(d) and (e) are negotiated and established on a case-by-case basis with the processors/exporters. The CDC conducts these negotiations in accordance with the criteria agreed upon in the CMSMC.

Table 3 - Average Selected Milk Component Prices by Class and Product January to June 1997

		Component Prices ($/kg.)			*$/hl*
Class	**Product**	**BF**	**Protein**	**OS**	**Total**
1a)	Fluid milk	5.46	6.56	3.70	**61.61**
1b)	Table Cream	5.43	5.22	3.58	**56.62**
2)	Yoghurt and Ice Cream	5.43	4.00	3.89	**54.37**
3a)	Specialty Cheeses	5.47	9.04	0.58	**51.78**
3b)	Cheddar Cheese	5.48	8.59	0.58	**50.40**
4a)	Butter, Ingredients	5.4	3.51	3.51	**50.82**
4b)	Condensed Milk	5.44	3.62	3.62	**51.71**
5a)	Specialty Cheeses	2.99	7.01	0.57	**36.37**
5a)	Cheddar Cheese	3.05	7.01	0.57	**36.55**
5b)	Fluid Milk	3.08	2.92	2.92	**37.00**
5b)	Creams	3.05	2.92	2.92	**36.89**
5b)	Yoghurt	3.05	2.92	2.92	**36.91**
5b)	Butter, Ingredients	2.98	2.91	2.94	**36.75**
5c)	Milk products for Confectionery	2.64	2.59	2.59	**32.51**
5d)	Milk	2.18	2.18	2.12	**27.28**
5d)	Cream	2.46	2.46	2.46	**30.69**
5d)	Yoghurt	2.57	2.57	2.57	**32.06**
5d)	Specialty Cheeses	1.94	4.87	0.51	**25.37**
5d)	Cheddar Cheese	3.97	6.72	0.51	**38.56**
5d)	Butter	1.83	1.83	1.83	**24.91**
5e)	Milk	2.15	2.15	2.15	**26.87**
5e)	Cream	2.20	2.20	2.20	**27.47**
5e)	Specialty Cheeses	1.50	4.54	0.51	**22.75**
5e)	Cheddar Cheese	1.86	4.92	0.51	**25.23**
5e)	Butter	1.28	1.28	1.28	**15.98**

Notes: BF = butterfat, hl = 100 litres, OS = other solids

One hectolitre of milk = approximately 3.6 kg. of butterfat, 3.2 kg. of protein and 5.7 kg. of other solids.

Source: United States, Exhibit 22, *An Inquiry Into the Importation of Dairy Product Blends Outside the Coverage of Canada's Tariff-Rate Quotas*, Report of the Canadian International Trade Tribunal, June 1998 p. 13 (source referred to in United States, Exhibit 22: Canadian Dairy Commission).

5. Returns to Producers from Exports

(a) General

2.52 Exports of dairy products from Canada fall within two categories, exports that result from:

(a) milk from *in-quota* sources such as planned production for exports to traditional markets and the part of the sleeve not used in domestic markets;

(b) milk that is the result of *over-quota* production.

(b) In-Quota Exports

2.53 In-quota milk for export use consists of milk that falls within the annual MSQ but is not used for the domestic market. It is sourced from a fixed amount set aside for planned export within Class 5(d), as well as MSQ milk surplus to domestic requirements (under Class 5(e)).

2.54 The CMSMC specifies the amount of sales under Class 5(d), currently 1.2 million hectolitres. Exporters with access to these traditional markets approach the CDC with proposals to purchase milk under Class 5(d).[34] Sales of surplus milk (i.e., Class 5(e)) begin with a declaration that milk surplus to domestic requirements is available. The determination whether there is in fact milk available in system surplus to domestic and traditional export market requirements is made by the Surplus Removal Committee, which is formally known as CDC Advisory Group on Preemptive Surplus Removal (hereafter the "SRC") of the CMSMC. If the SRC determines that milk is available[35] and the CDC believes that the proposal should be accepted, it provides a permit to the exporter that is subject to acceptance by the relevant board. This permit carries a recommendation to the board that the required amount of milk should be supplied at the recommended price.

2.55 Once the exporter has agreed on a milk price with the board it may export the resulting processed products. It keeps the export documentation available for examination by the CDC auditors. To allow the CDC to maintain its monitoring programme on behalf of the CMSMC, the exporter is also required to file proof of export with the CDC. All holders of such permits must provide the CDC with regular reports on their dairy ingredient purchases and use.

2.56 The returns to the producer for in-quota milk sold for export use are based on world market conditions, resulting from prices negotiated between the processor/exporter and the CDC. These returns are *subject to pooling* with domestic market returns before receipt by the individual producers.

(c) Over-Quota Exports

2.57 Exports of dairy products produced with over-quota milk may arise in two ways:

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[34] These traditional sales are linked to certain trade opportunities, such as TRQs that are traditionally made available to Canadian exporters, as well as sales arising out of long-term trade patterns. The main markets for Class 5(d) transactions are aged cheddar to the U.K, cheese to the United States under Canada-specific tariff quotas, cheese to Mexico, mainly evaporated milk to Libya, skim milk powder and whole milk powder to Algeria and skim milk powder, whole milk powder and evaporated milk to Cuba.

[35] The Comprehensive Agreement on Special Class Pooling states that the CDC will be guided by the decisions of the SRC.

(a) Over-quota production: There are production quotas at the individual farm level and at the provincial level. At the provincial level, over-quota production occurs when producers in a province produce milk in excess of their individual quotas and as a result a province as a whole exceeds its share of the national MSQ in a defined period of time. Independent of the level of production in a province as a whole, at the farm level, an individual producer may exceed his individual farm production quota. It is noted that returns to the producer are calculated on the basis of the over-quota production at the individual level.

(b) Optional Export Programme (OEP): The OEP is a programme whereby milk is produced in addition to quotas and sold *outside of the classification system* to meet a specific marketing need.[36] OEP contracts are negotiated between the producer marketing board and a processor. The board then offers the agreed terms to the producers who can voluntarily accept to produce for the OEP contract.

2.58 The returns to the producer from over-quota production is based on a three month average reflecting actual Class 5(e) prices, as calculated by the CDC. At year's end, returns during the year for over-quota milk are adjusted to reflect actual total returns. Over-quota returns through Class 5(e) sales are *not pooled* with the domestic market returns before being paid to the individual producer. Returns from sales under the OEP are likewise, *not pooled* with the domestic market returns before being paid to the individual producer.

6. Pooling

2.59 Pooling calculations are made under the Comprehensive Agreement on Special Milk Classes (P9).

[36] This is to be contrasted with over-quota production. Over-quota production is also produced over and above quotas but is not linked to any specific export market need. Producers are paid for OEP milk on the basis of the prior negotiated price, whereas the board pays the producer for over-quota milk on the basis of actual returns on Class 5(e) sales, i.e., returns from sales made in the spot market. The OEP Agreement is Annex C of the Comprehensive Agreement on Special Milk Classes (P9).

2.60 Revenues from all in-quota sales of milk are pooled between provinces in two regional pools (Table 4).

Table 4

P6 **Agreement on All Milk Pooling**	**P4** **Western Milk Pooling Agreement**
Ontario	British Columbia
Quebec	Alberta
New Brunswick	Saskatchewan
Nova Scotia	
Prince Edward Island	
Manitoba *Note: Manitoba currently belongs to both pools.* *It first pools its revenues under the P4, then under the P6.*	
P9 **Comprehensive Agreement on Special Class Pooling** **"National Pool"** **(all 9 provinces)**	

2.61 The pooling process is illustrated by way of an example with the following assumptions:

ASSUMPTIONS

- Production		P4	P5	P9
	Class 1-4	15 hl	45 hl	
	Class 5 in-quota	2 hl	5 hl	
	Total	17 hl*	50 hl	67 hl
- Actual returns				
	Class 1-4	$58 / hl	$55 / hl	
	Class 5	$21 / hl	$22 / hl	
- Target return: (Class 1-4): $54.00 / hl				
* *Includes 3 hl from Manitoba.*				

2.62 There are four steps in the pooling process:

STEP 1

Remove from pooling calculations sales from:

- **Over-quota**.
- **Optional Export Programme.**

STEP 2

Pool Class 5 in-quota: at **actual price obtained**.
Pool Classes 1-4: at the **target price: $54.00 / hl.**

Gives: Revenue to be pooled by region.

REGIONS:		P4	P5	P6	P9
Target Revenue @ **$54.00 / hl.**					
	Class 1-4	$810	$2,430		
	Class 5 (@ $21 and $22 / hl)	$42	$110		
	Total	**$852**	**$2,540**		$3,392

STEP 3

Class 5 in-quota is pooled with all Classes. Gives: **Average return, all classes**.
Adjustment between regional pools is calculated

REGIONS:		P4	P5	P6	P9
Class 5 is pooled in all Classes					
	$3,392 / 67 hl				**$50.63 / hl**
Revenue at:					
	Target return				
	total in Step 2	$852	$2,540		
	Pooled return (all classes)				
	@ $50.63 / hl	$861	$2,531		
	Difference (Adjustment)	+ **$9**	**- $9**		

STEP 1

Remove from pooling calculations sales from:

- **Over-quota**.
- **Optional Export Programme.**

STEP 2

Pool Class 5 in-quota: at **actual price obtained**.
Pool Classes 1-4: at the **target price: $54.00 / hl.**

Gives: Revenue to be pooled by region.

REGIONS:		P4	P5	P6	P9
Target Revenue @ **$54.00 / hl.**					
	Class 1-4	$810	$2,430		
	Class 5 (@ $21 and $22 / hl)	$42	$110		
	Total	**$852**	**$2,540**		$3,392

STEP 3

Class 5 in-quota is pooled with all Classes. Gives: **Average return, all classes**.
Adjustment between regional pools is calculated

REGIONS:	P4	P5	P6	P9
Class 5 is pooled in all Classes				

STEP 4

Pool the P4 at actual market returns from all milk sales. Apply the adjustment for P9.

Pool P5 at actual market returns from all milk sales.
Manitoba adds revenues from P4 into the P5. **This becomes the P6**.

Pool the P6 at actual returns from all milk sales. Apply the adjustment for P9.

REGIONS:		P4	P5	P6	P9
Actual revenue					
	Class 1-4 (@ $58 and $55 / hl)	$870	$2,475		
	Class 5 (@ $21 and 22 / hl)	$42	$110		
	Total	$912	$2,585		$3,497
Adjusted revenue		+ $9	- $9		
	Total	$921	➔	$2,576	
	Quantity (P4)	17 hl		50 hl	
	Average Return (P4)	**$54.18 / hl**			
	+ Manitoba (3hl @ 54.18)			+$162.5	
	Total Return P6			$2,738.5	
	Quantity (P6)			53 hl	
	Average Return P6			**$51.67 / hl**	

2.63 The result is that each provincial board in a regional pooling arrangement receives:

(a) a regional average return for all its Class 1-4 sales;

(b) a national average return for all of its adjusted Class 5 sales derived from in-quota milk; and

(c) an average world market return for any over-quota shipments.

C. Canada's Tariff-Rate Quota on Fluid Milk and Cream

2.64 In Canada's WTO Schedule V, the tariff-rate quota for fluid milk (HS 0401.10.10) is 64,500 tonnes (product weight basis). The following text is contained under "other terms and conditions":

> "This quantity represents the estimated annual cross-border purchases imported by Canadian consumers."

2.65 Currently, Canada does not impose any monitoring of cross-border imports of consumer packaged milk (limited to the value of C$20.00 per entry).

2.66 Canada has applied the over-quota tariff to fluid milk shipments in commercial containers or in bulk. As noted above in paragraph 2.11, no permits have been issued for imports of milk (HS 0401) for industrial use under the Import for Re-Export Programme.

III. CLAIMS OF THE PARTIES

A. Exportation of Dairy Products

1. Product Coverage and Period of Time

3.1 The dairy products and marketing years covered by the claims of **New Zealand** and the **United States** are set out in Table 1 below.

Table 1- Products[1] and marketing years[2] subject to the complainants' claims

	Butter	Cheese	Other Milk Products
New Zealand	1995/96 1996/97	1995/96 1996/97	1996/97
United States	1996/97	1996/97	1996/97

[1] *Butter* consists of products classified in 0405.10 and 0405.90. *Cheese* consists of products provided for in 0406.10, 0406.20, 0406.30, 0406.40, and 0406.90. *Other Milk Products* includes milk and cream in 0401.10, 0401.20, 0401.30; powdered whole milk and cream in 0402.21 and 0402.29; condensed evaporated milk in 0402.91 and 0402.99; buttermilk and yoghurt in 0403.10 and 0403.90; milk protein concentrate, 0404.90; and ice cream, 2105.00. Although the United States understood that Canadian exports of *Skim Milk Powder* were not in excess of Canada's WTO commitments, the United States considered that all exports under the SMP category that were exported through the Special Milk Classes Scheme should have been notified as subsidies to the WTO.

[2] New Zealand did not refer to the marketing year 1997/98 because official figures for that period were not available. Nevertheless, if those figures were to indicate that Canada's actual exports also for that period exceeded its reduction commitments in respect of the products mentioned in the table, New Zealand would consider that Canada had also breached its WTO obligations in respect of those products for the 1997/98 marketing year. The United States noted that although Canada had not yet reported to the WTO its export quantities for the 1997/98 period, based on preliminary information for that period, the volume of exports appeared to remain at levels exceeding the pertinent reduction commitments. After our first substantive meeting, the figures for marketing year 1997/1998 became available and are incorporated above in Table 2 in para.2.41.

2. Nature of Measure

3.2 **New Zealand** and the **United States** claimed that there was extensive government involvement in all critical aspects of Canada's Special Milk Classes Scheme, from its initiation through to its administration and operation. Canada's Special Milk Classes Scheme was a product of governmental authority and was operated under the auspices of the federal and provincial governments. This government involvement in the scheme was sufficient to constitute government action within the meaning of the jurisprudence developed by GATT and WTO panels.

3.3 **Canada** claimed that the Complainants' assumptions of government control, direction or mandate were without basis in fact and were, therefore unsustainable. Government involvement was limited to providing an appropriate regulatory framework and essentially responsive to the initiatives of the Canadian dairy industry.

3. Agreement on Agriculture

(a) Article 1(e)

3.4 Both **New Zealand** and the **United States** claimed that the Special Milk Classes Scheme was an export subsidy in the sense of Article 1(e) of the Agreement on Agriculture.

3.5 **Canada** claimed that as the sales of milk at differing prices under Special Classes 5(d) and (e) did not constitute a "subsidy" pursuant to the definition of the SCM Agreement, it followed that these sales could not constitute a subsidy for the purposes of the Agreement on Agriculture. Therefore, by definition, such sales could

not constitute an "export subsidy" within the meaning of the definition in Article 1(e) of the Agreement on Agriculture.

(b) Article 9.1(a) and (c)

3.6 **New Zealand** and the **United States** claimed that the Special Milk Classes Scheme constituted export subsidy practices listed in Article 9.1(a) and (c). As such, these practices were subject to reduction commitments under the Agreement on Agriculture. **Canada** refuted both these claims.

(c) Article 3.3 and Article 8

3.7 **New Zealand** and the **United States** claimed that Canada's provision of export subsidies under Article 9.1(a) and (c) of the Agreement on Agriculture in excess of its scheduled export subsidy commitments was a violation of Article 3.3 of that Agreement. Furthermore, Canada was in violation of its obligation under Article 8 of the Agreement on Agriculture not to provide export subsidies otherwise than in conformity with the Agreement on Agriculture.

3.8 **Canada** claimed that since the sales of milk at differing prices for domestic and export markets did not constitute an "export subsidy" as that term was defined in Article 1(e) of Agreement on Agriculture, the practice at issue did not fall within the scope of Article 8; that article could therefore not apply.

(d) Article 10

3.9 Alternatively, **New Zealand** and the **United States** claimed that Special Classes 5(d) and (e) of the Special Milk Classes Scheme constituted an export subsidy not listed in Article 9.1 that was being applied in a manner which circumvented or threatened to lead to circumvention of Canada's export subsidy commitments contrary to Article 10.1 and 10.3 of the Agreement on Agriculture.

3.10 **Canada** claimed that Article 10 did not apply in the present case as it could not be established that there existed "export subsidies", including those export subsidies listed in Article 9.1. Nor could it be established that there was actual or threatened circumvention of Canadian export subsidy commitments.

4. Agreement on Subsidies and Countervailing Measures ("SCM Agreement")

(a) Article 1 and Paragraph (d) of the Illustrative List of Export Subsidies in Annex I

3.11 **New Zealand** and the **United States** claimed that even on the basis of Canada's own approach to the interpretation of the term "subsidy" Canada had not shown that the Special Milk Classes Scheme fell outside the definition of subsidy under the SCM Agreement. The Scheme constituted a subsidy within the meaning of Article 1 of the SCM Agreement. In addition, that the Special Milk Classes Scheme constituted the provision of an export subsidy within the meaning of Paragraph (d) of the Illustrative List of Export Subsidies in Annex I of the SCM Agreement.

3.12 **Canada** claimed that the sale of milk at differing prices did not constitute a "subsidy" within the meaning of Article 1 of the SCM Agreement. Further, Canada claimed that the practices at issue were not "export subsidies" in the sense of Para-

graph (d) of the Illustrative List of Export Subsidies in Annex I of the SCM Agreement.

(b) Article 3

3.13 The **United States** claimed that as Canada's Special Milk Classes Scheme was inconsistent with Canada's obligations under the Agreement on Agriculture it was consequently in violation of Article 3 of the SCM Agreement.

B. Importation of Milk

1. Article II of GATT 1994 and the Agreement on Import Licensing Procedures

3.14 The **United States** claimed that Canada's administration of its tariff-rate quota on fluid milk[37] which restricted access to the in-quota quantity of its tariff-rate quota for fluid milk to entries that were valued at less than C$20 and that were for the personal consumption of Canadian residents, was inconsistent with its obligations under Article II:1(b) of GATT 1994 and Article 3 of the Agreement on Import Licensing Procedures.

3.15 **Canada** claimed that its current treatment of fluid milk imports was fully consistent with the terms and conditions of the tariff concession for fluid milk (HS 0401.10.10) in its Schedule. Canada further refuted any alleged violation of the Import Licensing Agreement.

C. Recommendations Requested by the Parties

3.16 **New Zealand** requested that the Panel, in accordance with Article 19 of the DSU, recommend that Canada bring its measures into conformity with the Agreement on Agriculture.

3.17 The **United States** requested that the Panel find the Canadian Special Milk Classes Scheme and the denial of access to imports under the tariff-rate quota on fluid milk and cream to be inconsistent with Canada's WTO obligations. Accordingly, the Panel should recommend that Canada bring those measures into conformity with its obligations under the GATT 1994, the Agreement on Agriculture, the Agreement on Subsidies and Countervailing Measures, and the Agreement on Import Licensing Procedures. More specifically, the Panel should recommend (i) that Canada either withdraw its export subsidies or reduce the level of its subsidized exports of dairy products to a level commensurate with its reduction commitments and (ii) that such action be taken without delay. In this regard, the United States saw no reason why Canada could not bring its export subsidies into compliance within 30 days of the adoption by the Dispute Settlement Body of recommendations and rulings. With respect to market access, the United States respectfully submitted that the Panel should recommend that Canada not apply its tariff-rate quota in a manner that denies

[37] The specific products subject to this claim were classified in Canada's tariff schedule within tariff item numbers 0401.10 and 0401.20. The US claim relating to Canada's fluid milk tariff-rate quota related to the last three years (1995-1997) as well as the current year (1998).

entry at the in-quota rate to any fluid milk imports made within the quantitative limit of the tariff-rate quota.

3.18 **Canada** requested the Panel to find that (i) Canada's Special Milk Classes did not provide an export subsidy and thus did not violate Canada's obligations under Articles 8, 9 or 10 of the Agreement on Agriculture nor under Article 3 of the SCM Agreement; and (ii) that Canada's administration of its tariff-rate quota on fluid milk and cream was consistent with Canada's obligations under Article II:1(b) of the GATT 1994 and Article 3 of the Agreement on Import Licensing Procedures. Canada requested the Panel to dismiss all claims brought against Canada in this case by the United States and New Zealand.

IV. ARGUMENTS OF THE PARTIES

A. Exportation of Dairy Products

1. Nature of Canada's Special Milk Classes Scheme

(a) Outline

4.1 **New Zealand** argued that the government was implicated in all critical aspects of Canada's Special Milk Classes Scheme, from its initiation through to its administration and operation. Likewise, the **United States** claimed that Canada's Special Milk Classes Scheme was a product of governmental authority and was operated under the auspices of the federal and provincial governments. The Complainants claimed that the government involvement in the scheme was sufficient to constitute government action within the meaning of the jurisprudence developed by GATT and WTO panels.

4.2 **Canada** claimed that the Complainants' arguments rested entirely on erroneous descriptions of the Canadian dairy system. This was particularly true of the way that they had attempted to miscast the means by which milk was marketed for export use in Canada. Exports of milk from Canada were controlled and directed by Canadian dairy *producers*, not governments. As such, the assumptions of government control, direction or mandate that premised each of the Complainants' arguments was without basis in fact. Therefore, each of these arguments was unsustainable. Governments did play a role, but it was limited and essentially responsive to the initiatives of the industry.

4.3 Canada emphasized that the objective behind the institution of the Special Milk Classes Scheme had been to provide export opportunities that were consistent with Canada's WTO commitments, while providing reasonable continuity to dairy producers. Canada noted that the current dispute was not about domestic dairy supply management in Canada: it was about the marketing of milk in Special Classes 5(d) and (e). Even if the Canadian domestic supply management regime were found to be governmental, in Canada's view, that would not necessarily imply that the marketing of milk in Special Classes 5(d) and (e) would be governmental as such.

(b) The Authority and Role of the Canadian Dairy Commission (CDC)

4.4 **New Zealand** argued that the price that processors paid for milk, both for domestic and export use, was determined by the exercise of governmental authority

through the operation of the CDC and provincial marketing boards and agencies. The CDC and the provincial marketing agencies were in effect a part of the executive branch of government. The fact that they were composed largely of producers could not be allowed to disguise that fact. This was evident, in New Zealand's view, from several Canadian sources. The Act establishing the CDC granted it authority to "establish the price, or minimum or maximum price, to be paid ... to producers of milk or cream ... " (paragraph 2.12 and following).[38] The British Columbia Milk Marketing Board, whose members were appointed by the Lieutenant Governor in Council, was "authorized to regulate the marketing of milk in inter-provincial and export trade ... "[39] The CDC's internet website[40], describing the relationship between the federal and provincial authorities in the marketing of milk stated: "certain marketing activities related to industrial milk are carried out jointly between the federal government and participating provinces". The Annual Report of the CDC for 1996-97 described the Commission as a "crown corporation" and referred to the "framework" provided by the Commission for "the federal/provincial participation that is crucial to the success of the dairy sector".[41] It referred to the authority of the CDC "to purchase, store, process or sell dairy products" and "to make payments to milk and cream producers".[42]

4.5 New Zealand noted, in respect of a few key features of the operating procedures of the CMSMC[43], that it was noteworthy that the CDC, as Chair of the CMSMC, had a de facto veto power over almost all aspects of that Committee's decision-making.[44] In other words, if the CDC disagreed with the rest of the CMSMC, it could then resolve the disagreement by its own unilateral decision. In this and in other respects, the CMSMC was intrinsically linked to the CDC, a Crown agency, and to the federal government.

4.6 The **United States** argued that the Canadian Special Milk Classes Scheme depended for its existence on legislation enacted by the Government of Canada. The Canadian Government's role did not stop with the planning and enactment of the authorizing federal legislation. The CMSMC established and revised the annual national production quota. The CDC established the target prices and Special Milk Class prices. The CDC issued the permits that were required to initiate surplus removal, which was then exported. The CDC, working with the provincial marketing boards (the powers of which were derived from the provincial and federal governments), calculated the sales returns received by the provinces, and adjusted those

[38] Section 9(1)(g) of the CDC Act, New Zealand, Annex 13.
[39] Section 3 of the British Columbia Milk Order, 1994 (SOR/94-511).
[40] http://www.cdc.ca/shared.html
[41] New Zealand, Annex 7, p.6.
[42] *Ibid*.
[43] National Milk Marketing Plan (the document which constitutes and lays down the operating procedures of the CMSMC), New Zealand, Annex 12.
[44] New Zealand referred, in particular, to Section 3 of the Memorandum of Agreement, November 1982, which forms part of the National Milk Marketing Plan. Section 3 provides that the CDC shall resolve disagreements in cases where unanimity is not required. The only operative requirement for unanimity is in respect of the provincial shares of the production quota (Section 18 of the Memorandum of Agreement).

returns to reflect participation in the Special Milk Classes. The CDC had even financed the Special Class distributions by obtaining a line of credit.[45]

4.7 The United States argued that the Canadian federal and provincial governments had demonstrated the compulsory nature of the dairy regime's production quotas, administered price levels, and revenue pooling; the CDC and the Province of British Columbia, had for over a decade, sought through legal action to prevent producers in that province from shipping milk without the benefit of a quota allotment under the federal/provincial MSQ.[46] Those milk producers had contested the authority of the provincial government to regulate the production and marketing of milk. The reaction of the federal and provincial government was instructive regarding the urgency with which they met this perceived challenge to supply management and the levies which subsidized dairy exports.[47] Following an initial set back in litigation in British Columbia, both the federal government and provincial governments throughout Canada amended the governing legislative authority to address the court's finding that the provincial marketing board in British Columbia possessed only the power to regulate intra-provincial trade and, therefore, could not either regulate production or impose the levies necessary to finance the system relating to industrial milk. In response to the court's decision, the applicable federal legislation was amended to delegate authority to the provinces to regulate inter-provincial and export trade and the provinces then amended their own authority to reflect this delegation of administrative powers from the Government of Canada.[48]

4.8 The United States noted that the Attorney-General for Canada joined the litigation to preserve the authority to collect levies to finance dairy product exports and to dispute the contentions of the unlicensed dairy farmers that the exercise of power by the provincial marketing board and the Canadian Dairy Commission was *ultra vires*.[49] In submissions to the court, the Attorney General stated that "it was intended

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[45] Canadian Dairy Commission, Annual Report, 1996/97. (United States, Exhibit 8)

[46] British Columbia Milk Marketing Board and Canadian Dairy Commission v. Luigi Aquilini, et al, Supreme Court of British Columbia, No. A950636. (United States, Exhibit 26)

[47] The United States noted that when the CDC Act was amended in 1995 to provide powers to the Commission to create the Special Classes, Canada's Attorney-General was also given authority to seek injunctive relief in actions on behalf of the Canadian Dairy Commission. (United States, Exhibit 5)

[48] The Governor in Council's Orders revising the delegation of authority to the provinces of Ontario and Quebec to include administrative powers respecting inter-provincial and export trade are contained in United States, Exhibit 27.

[49] The United States noted that in February 1997, Agriculture Minister Ralph Goodale separately explained the reason for federal intervention in the litigation as follows: "Right now, some Alberta and British Columbia producers are trying to take advantage of supply management by selling milk illegally. The only way to stop it is to bring them in court, which means a lot of expenses. We believe that producers shouldn't be the only ones to pay a bill in which the governments have a responsibility." *The Western Producer*, 6 February 1997 edition, "Ottawa may share B.C. dairy battle legal costs". (United States, Exhibit 28) Notably, one of the regulations that the British Columbia Board and the CDC sought to enforce in the B.C. litigation was the imposition of the levies on producers used to support supply management and to fund export subsidies. The government succeeded in this pursuit when the Supreme Court of British Columbia in a 12 September 1997 opinion ruled that unpaid provincial and federal levies were enforceable debts. "Oral Reasons for Judgment", Mr. Justice Wong, 12 September 1997, p. 6.

by Parliament that the Governor in Council delegate to others the administration of such a scheme [administration of a quota based regulatory system] and, in the *Federal Regulations* there was a valid delegation of administrative powers to the Commission [the CDC], the Committee [the CMSMC], and to provincial Boards."[50] Later in the same document, the Attorney General declared that the:

> "*Federal Regulations* were passed to provide federal legislative support to the continued regulation of the dairy industry in Canada. At its core, regulation of this industry is accomplished by the joint participation of both federal and provincial authorities. This is reflected in the National Plan and in the marketing scheme created by the *Federal Regulations*".[51]

4.9 The United States noted that the Special Milk Classes Scheme was established through the collaborative efforts of the federal and provincial governments. Specifically, the Special Milk Classes Scheme was created by the Comprehensive Agreement on Special Class Pooling (P9 Agreement, see also paragraph 2.24).[52] That Agreement was an agreement between the federal government in Canada and the provincial governments. The powers necessary to create the Special Classes and to administer the Special Milk Classes Scheme had been conferred on the Canadian Dairy Commission, a Crown corporation, by amendment to federal legislation, the Canadian Dairy Commission Act.[53]

4.10 The United States emphasized that the powers of the Canadian Dairy Commission, as set forth in Section 9 of the CDC Act (paragraph 2.13)[54], were numerous and broad. The Act conferred the authority to the CDC: (i) to purchase any dairy product and sell, or otherwise dispose of, any dairy product purchased by it; (ii) to establish and operate a pool or pools in respect of the marketing of milk and cream; (iii) to establish the price, or minimum or maximum price, paid or to be paid to the Commission, or to producers of milk or cream; (iv) to collect the price paid or to be paid to the Commission, or to any producer in respect of the marketing of any quantity of milk or cream; and (v) to do all acts and things necessary or incidental to the exercise of any of its powers or the carrying out of its functions under the Act. The power to establish a pool, to establish prices, and to collect the price to be paid had all been added in 1995 at the time of the creation of the Special Class system. Furthermore, conspicuous by its absence in the CDC's enumerated powers was any qualification that those powers were subject to the decision of milk producers.

4.11 The United States further noted that the Comprehensive Agreement on Special Class Pooling contained several interrelated elements. First, the Agreement provided for the adoption of both the Memorandum of Understanding on Special Class Pooling ("MOU on Special Classes") and also an Addendum to the Memorandum of Understanding. The MOU on Special Classes provided that the provincial govern-

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[50] "Outline of the Argument of the Attorney General of Canada," filed 24 September 1996, in the Supreme Court of British Columbia in British Columbia Milk Marketing Board and CDC v. Luigi Aquilini, p. 8. (United States, Exhibit 29)

[51] United States, Exhibit 29, p.12.

[52] United States, Exhibit 5.

[53] United States, Exhibit 15.

[54] United States, Exhibit 37.

ments would enter into a revenue pooling arrangement for milk in the Special Classes. The MOU directed the CDC to determine the percentage of total production by special class utilization in each province. The MOU also contained an agreement to establish and harmonize prices for Special Classes in the CMSMC. Significantly, section 11 of the MOU stated that a province could join the MOU only by the action of the individual provincial governments, not through the action of the marketing boards, or the decision of milk producers, either individually or collectively. Annex B of the Comprehensive Agreement addressed the question of surplus removal and confirmed the role of the CDC in the operation of surplus removal. The Annex provided that there would be both a CDC-initiated surplus removal plan, as well as provision for processor-initiated surplus removal. Paragraph C(1)(iii) of Annex B provided that the CDC would remove the surplus milk by authorizing dairy processors to acquire milk under Special Class 5(e) and manufacture dairy products for purchase by the CDC for export. Sub-paragraph (vii) stipulated that the processor would receive an assured margin and that the level of the margin would be negotiated by the CDC with the processor. No mention was made at all in this Annex for a decision-making role for milk producers in any of these decisions. Nor were producers given such a role in connection with a decision of processor-initiated surplus removal. While the MOU established an advisory group, consisting of an equal number of processors and milk producers, their role was to advise the CDC on when the CDC-initiated surplus removal should be initiated.

4.12 **Canada** did not deny that the CDC played an important role in the Canadian dairy system but it was not the central directing agency that the Complainants alleged. The CDC acted as a centre of technical expertise that was available to the dairy industry as a whole and to the producer-dominated decision-makers at the CMSMC. It supplied recommendations and data for the consideration of the CMSMC to assist it in deciding on the annual MSQ. It also calculated a "Support Price"[55] used by the producer boards to assist them in negotiating and establishing domestic price levels. Furthermore, the CDC's role as chair of the CMSMC was one of facilitation. The role of the CDC for practical, legal, historical and political reasons, was necessarily that of facilitator and consensus-builder.

4.13 Canada argued that although the CDC did indeed act as the chair of the CMSMC, the CDC did not act in the manner suggested by the Complainants: that of dominant director, telling the industry how they were going to carry out federal government policy. Its role was that of facilitator and technical advisor. Ultimately, the CDC implemented the policies and programmes agreed upon in the CMSMC; it neither dictated nor directed them. Canada argued that the CDC, in its role as the administrator of aspects of the dairy system, operated under the direction and control of the CMSMC and was routinely subject to rigorous scrutiny at each meeting of the CMSMC. The CMSMC, unlike the CDC, was not a governmental body. For example, CDC-initiated surplus removal did not begin with a decision of the CDC. It be-

[55] Canada stressed that the CDC did not operate a price support system. In the past, it set a "support price" which was in fact applied in operating an open offer to purchase programme. This programme had been terminated, although the CDC still set a misnamed "support price" which, as noted, was used for reference purposes by the producer boards, as well as certain limited domestic seasonality programmes.

gan with a decision of the Advisory Group on the Surplus Removal Programme (known as the SRC, paragraph 2.54 and footnote thereto refers), a body composed of producers and processors.[56] Only when the industry representatives on the SRC had decided that the domestic market was being satisfactorily supplied, did it instruct the CDC to open such a programme. Once the CDC-initiated surplus removal programme had been opened, the CDC entertained proposals from private exporters with whom it negotiated on behalf of the producers as agent. Canada rejected the US suggestion that Annex B of the Comprehensive Agreement on Special Class Pooling confirmed the role of the CDC in surplus removal (paragraph 4.11). What the Comprehensive Agreement on Special Class Pooling did was empower the continuation of the CDC role at the direction of the CMSMC. The difference was important because the role of the CDC had changed profoundly in 1995. The old Offer to Purchase Programme, under which butter was bought on open offer by the CDC and then sometimes exported, had been eliminated. Instead, the CDC was instructed to be guided by the decisions of the SRC in deciding whether surplus removal activity was required. In other words, the empowerment for any activity was now squarely with the industry, not the CDC.

4.14 Canada emphasized, in respect of the CDC's role as Chair of the CMSMC and its "de facto veto power", as alleged by New Zealand (paragraph 4.5), that the Comprehensive Agreement on Special Class Pooling had now all but superseded the provisions in the NMMP. Pursuant to Article 1 of Schedule I of the Comprehensive Agreement on Special Class Pooling, all decisions relating to matters covered by that Agreement required *unanimity*, including all matters with respect to export trade. Given the breadth of coverage of the Comprehensive Agreement on Special Class Pooling, little of significance was left without a unanimity requirement. Hence, very little scope had been left for the CDC to take a decision where no consensus was reached in the CMSMC. In addition, Canada noted that the Comprehensive Agreement on Special Class Pooling had a formal dispute settlement process to ensure that no "de facto" CDC veto existed. The Complainants would have been better informed if they had taken note of the clear direction given in the Comprehensive Agreement on Special Class Pooling:

> "The Canadian Milk Supply Management Committee (CMSMC) will be the supervisory body which will oversee the implementation of this agreement."[57]

4.15 Canada further argued that similarly, the process of negotiation with exporters with respect to the price for Special Class 5(d) and (e) sales was subject to CMSMC control and direction. Even more importantly, the CDC was required under the terms of the Comprehensive Agreement on Special Class Pooling to act in these negotiations as agent. Section 2 of Schedule II of the Agreement stated that the "CDC shall act as agent in carrying out the administrative functions in the operations of the programme".

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[56] Canada noted that the CDC required under the terms of the Comprehensive Agreement on Special Class Pooling to form the SRC, to be composed of producers and processors. The processors had insisted that they have such a significant role so that their interests would be respected.

[57] The Comprehensive Agreement on Special Class Pooling, the ("P9 Agreement"), Schedule I, Section 1. (Canada, Exhibit 7)

4.16 Canada emphasized the importance of the character of the Government's participation as it occurred in practice. Canada argued that to suggest that the mere presence of legislative authority under which an industry operated made that business "governmental" in character was untenable. All businesses operated to some degree within legal and regulatory frameworks established by government to ensure that the public interest was protected. If it were true that a legislative framework made business "governmental" then any regulated industry, including banking or utilities, would be deemed to be "governmental" in nature. It would even be possible to argue that private corporations established under corporation law were "governmental". This would be absurd. Obviously, to establish that business was "governmental" in nature, significantly more governmental intervention had to be shown.

4.17 Canada argued that once established, producer boards were provided with the authority they required to operate their affairs. This was done through enabling legislation.[58] It established the framework for producer board operations and enabled the board to exercise certain functions when and as required. These discretionary functions related to the issuance and administration of quota, the pooling of returns, prices, producer record-keeping and reporting, inspection and the ability to enter into co-operative arrangements with other producer boards and the CDC. The critical point in this regard was that the authority provided to the producer boards was enabling, not mandatory. The producer boards were not directed or obligated by the enabling legislation to carry out certain tasks or functions, as might be the case with mandatory legislation or regulation. The result of establishing producer boards equipped with authority under enabling legislation had to be to allow producers to join together to run their own affairs, subject to a government oversight function to ensure that this authority was used in the public interest. It was absurd to suggest that, where governments had taken steps to enable citizens or industries to govern their own affairs, and withdrawn from or avoided imposing government direction and control, that the resulting self-governing regime was an arm or extension of government.

4.18 Canada noted that the authority provided to the producer boards was now essentially exercised primarily with respect to the domestic market. Producers had to be licensed to participate in the industry either with respect to milk for domestic or export sales. One of the criteria for such licensing was the holding of a minimal amount of marketing quota, quota that could be purchased in the open market. Producer boards only used their pricing authority with respect to the domestic and general use classes (Classes 1 through 5(c)) and, even in those cases, prices were usually the result of negotiations between the producer boards and the processors. More particularly, the pricing authority was not used with respect to the export classes: Special Classes 5(d) and (e). Prices for sale in these classes were the result of transaction by transaction negotiations between the processor/exporter and the CDC, acting as

[58] Canada noted that due to the constitutional division of responsibilities in Canada, legislation was required at both the provincial and federal levels. In the case of the dairy industry, enabling authority within the provincial sphere was passed directly to the producer boards through provincial legislation. On the federal side, the required enabling authority was provided initially to the Canadian Dairy Commission, which in turn, pursuant to an agreement, conveyed authority to the provincial producer boards.

agent for the producers. In addition, the pooling function was not exercised with respect to over-quota sales under Special Class 5(e).

4.19 Canada acknowledged that the CDC was involved in the negotiation with exporters of prices to be paid for the milk for export purposes. However, the CDC was acting under the direction of the CMSMC, whose policies were driven by the producer-run marketing boards. Further, in acting as intermediary with the exporter, the CDC was acting as an agent on behalf of producers and in furtherance of their interests. The CDC was expected to obtain the best possible price for the producers based on prevailing returns in the world market. CDC performance in this regard was carefully monitored by the CMSMC. The producers proceeded on the expectation that the CDC would, in its negotiations, obtain the highest possible return for them. If, on review at the regular meeting of the CMSMC, there was some question that the CDC had not maximized producer returns on the export market, the CMSMC could direct the CDC to abandon the market in question or work to obtain better prices.

4.20 Furthermore, Canada argued that these negotiations were true commercial negotiations. The CDC, acting for the producers, negotiated with competing processors, pressing for the best price for the producers. The exporter sought the lowest price. The competition among exporters coupled with the forces of the international marketplace drove the negotiations. The CDC was in no position to offer, contrary to the interests of the producers, prices lower than those dictated by the world market. Nor could the CDC force an exporter to pay for a particular transaction more than world prices permitted for it to be profitable. The issuance of a "permit" by the CDC was merely a recommendation to the respective board that milk be supplied for a particular proposal. The producers, through their boards, were under no obligation to accept that recommendation. Nor was the permit recipient required to actually carry out the proposed export. The CDC did not control milk supply. Thus, it was evident that the ultimate control over decisions to produce milk for export and to pursue any particular sale rested with the producers. It was equally evident that control of production and sales relating to exports did not rest with government.

4.21 **New Zealand** noted that Canada did not seek to deny that the CDC and the provincial milk marketing boards and agencies derived their authority from statute. Instead, Canada argued that reference to the statutory basis of these bodies gave a misleading picture because many of the powers that existed in legislation were not used in practice (paragraph 4.16). But this ignored the fact that the statutory powers of a body gave it a status and character that existed regardless of whether all aspects of those powers were exercised in fact. It did not need to exercise every power that it had on every occasion, or at all, in order to maintain the authority that the government had given it. Its governmental authority derived just as much from its residual as from its exercised authority. Thus, describing legislation as "enabling" did not prove anything. The fact that the federal and provincial legislation in question "enabled" the operation of the Special Milk Classes Scheme was not disputed. The question was whether that scheme entailed sufficient government involvement to meet the relevant definition of an export subsidy. In this respect, enabling legislation was an important first step. It "enabled" the construction of the market for milk into two separate markets. It "enabled" the compelling of producers to ship their milk into one or the other of those markets, and it "enabled" the provision of lower-priced milk to exporters, the subsidy that was the subject of this case.

4.22 New Zealand argued that the above could be demonstrated by reference to the authority of the CDC to resolve differences in the Canadian Milk Supply Management Committee (the CMSMC) by its own unilateral decision.[59] The fact that it might not do so in practice, as Canada alleged, was irrelevant. The fact that it *had* the authority to make such decisions would have a significant impact on the reaching of consensus within the CMSMC. The process of reaching consensus when one party had the ultimate power of decision was fundamentally different from the process of reaching consensus when no one could individually make that decision. Moreover, in this case, the power of decision rested, not just with a private entity, but with an agency vested with all the authority of government.

4.23 Furthermore, Canada had amended the legislation establishing the CDC in order to enable it to implement the Special Milk Classes Scheme. Thus, there was no lack of opportunity for legislative amendment in Canada. If the Canadian Government's argument that the regulation and pricing of milk was not a matter of governmental authority, New Zealand questioned why then it had been necessary to amend both provincial and federal legislation to provide such powers; for example, why had it been necessary to amend the CDC Act to provide that the CDC may "establish the price, or minimum or maximum price, paid or to be paid to the Commission, or to producers of milk or cream ... "[60]

4.24 New Zealand noted that the process by which milk was accessed for export implicated federal and provincial authorities in an integral way. Exporters had to obtain a permit under Special Class 5(d) or 5(e) from the CDC. That permit was presented to the relevant provincial milk marketing agency in order to obtain milk at the Special Class 5(d) or (e) price. Canada claimed that this permit was "merely a recommendation" (paragraph 4.20). But that was simply a statement about the relationship of the CDC to the provincial marketing agencies, reflecting constitutional authority regarding the setting of prices for milk in a federal system. The exporter had no choice in the matter. The only way to access milk for export in Classes 5(d) and (e) was with a permit. The system was mandatory and the source of that authority was not producer agreement; it was derived from the statutory authority of the CDC and the provincial marketing agencies to compel such behaviour.

4.25 New Zealand argued that Canada's assertion that the CDC operated as a collective bargaining agent for producers, and was controlled by those producers acting through their producer-run marketing boards, equally did not withstand analysis. Canada claimed that the CDC's performance in negotiating prices for exports had to satisfy the boards and the producers or they would require a re-evaluation of CDC practices through the CMSMC (paragraph 4.15). The impression sought to be conveyed was that the CDC was somehow subservient to producers and not exercising government authority. New Zealand claimed that the opposite was the case. The CMSMC could not control the CDC which ultimately had a veto within the CMSMC, whether or not in practice that veto ever needed to be exercised. Naturally, the CDC would want to maximize returns for producers; that was part of its statutory mandate. And, if producers were unhappy with the CDC, political pressure would be

[59] New Zealand referred to Section 3 of the Memorandum of Agreement, November 1982, which formed part of the National Milk Marketing Plan (NMMP). (New Zealand, Annex 12)

[60] Section 9(1)(g) of the CDC Act. (New Zealand, Annex 13)

brought to bear on it. Yet this was a normal description of how government agencies functioned. It did not demonstrate that somehow the CDC lost its governmental character through participating in the administration of the Special Milk Classes Scheme. New Zealand noted that Canada downplayed the role of the CDC, arguing that it did not exercise the statutory functions that it had in fact been given. Yet, in New Zealand's view, the actual functions exercised by the CDC were more than sufficient to show the necessary government involvement in the administration and operation of the Special Milk Classes Scheme.

4.26 New Zealand noted that Canada also sought to argue that New Zealand had wrongly focused on the CDC when it was the CMSMC which was the key decision-maker in respect of special milk classes. The CMSMC, Canada argued, was not a governmental body (paragraph 4.13). Yet the CMSMC was created under the National Milk Marketing Plan (the NMMP)[61] and the NMMP was described by Canada as a "contractual agreement", hence the CMSMC "is a contractual body not a creation of government".[62] New Zealand agreed that the NMMP was indeed an agreement. Its opening words were "This Plan is a federal-provincial agreement ... ". It was entered into by the CDC, a federal Crown Corporation, and the provinces. In some instances the agreement was signed by the Ministers of Agriculture for the province as well as the representative of the provincial milk marketing board; in other instances it was signed by the milk marketing board for the province. The NMMP was an intergovernmental agreement entered into between the representative of the federal government, the CDC, and the authorized representatives of the provinces who varied province by province. As a result, the CMSMC was a creature of intergovernmental agreement. Thus, to characterize it as a "contractual body not a creature of government" was misleading. The preamble to the Plan recognized that "the participation of the Federal and Provincial authorities is required to assure the adoption and implementation of such Plan".[63]

4.27 New Zealand noted that although Canada did not deny that the CDC was a Crown agency and was the representative of the Government of Canada, it argued that its role on the CMSMC, which it chaired, was not governmental. Canada said that the CDC's role was that of "facilitator and technical adviser," and the CDC "implements the policies and programmes agreed upon in the CMSMC; it neither dictates nor directs them". Such a view ignored the ultimate decision-making powers of the CDC whose influence through research and technical expertise, as well as its authority derived from the fact that it was the representative of the government of Canada, could not be hidden by focusing on a collegial decision-making process within CMSMC meetings. The CDC did not need to "dictate" or "direct" the policies of the CMSMC. The fact that at the end of the day it could do so, gave the CDC *the* central role in the CMSMC. New Zealand noted that in the *Bari* case, the British Columbia Supreme Court had found that the provincial boards and the CMSMC had

[61] New Zealand, Annex 12.

[62] New Zealand referred to p. 21 of the text accompanying Canada's audio-visual presentation at the first substantive meeting of the Panel.

[63] New Zealand referred to the fourth preambular paragraph of the NMMP.

valid administrative powers - derived from the CDC Act - "to carry out ... the efficient marketing of milk and milk products".[64]

4.28 New Zealand noted that Canada denied that the CDC had a veto power within the CMSMC claiming that the Comprehensive Agreement on Special Class Pooling had "all but superseded" the provisions of the NMMP which grant such authority to the CDC (paragraph 4.14). It was notable that Canada carefully qualified this statement about the redundancy of the NMMP. It was particularly important to do so because what Canada sought to rely on to support its position simply did not prove its point. The "veto power", Canada said, had been replaced by a unanimity rule. But that made New Zealand's point; it did not contradict it. Under a unanimity rule, the CDC would have a "de facto veto power". The Chairman of the CDC, Mr Guy Jacob, when describing the role of the CDC within the CMSMC to the Canadian House of Commons Standing Committee on Agriculture and Agrifood, in March of 1998[65], said:

> "On occasion, the [CDC] Commissioners may take decisions on issues when [the CMSMC] Committee members are not unanimous."

4.29 New Zealand pointed out that in its Annual Report for 1996/97, the CDC stated that it "is largely responsible for the administration of the National Milk Marketing Plan, [and] the federal/provincial agreement governing industrial milk production and management in Canada ... ".[66] The reality was that the Special Milk Classes Scheme operated through the combined actions of the CDC, a federal government agency, and provincial milk marketing boards. New Zealand noted that these institutions, acting individually, or collectively within the CMSMC, exercised governmental functions that were essential for the operation of the Special Milk Classes Scheme. They established and administered the quota regime on which the Special Milk Classes Scheme was based. They set prices and determined whether milk was to be sold in domestic or export markets. They prohibited entry by new producers except in accordance with the quota regime. They exercised enforcement authority over both quota holders and those outside the system. In respect of the federal government agency - the CDC - it had specific authority within the framework of the CMSMC when unanimity was not reached. It also issued permits to exporters, which constituted the only way in which access to lower-priced milk could be obtained.

4.30 New Zealand noted that regardless of the *composition* of provincial milk marketing boards, these boards exercised governmental functions - functions that had been expressly mandated by government in the boards' constituent statutes or regulations, or functions that had been delegated to them by the federal government's agency, the CDC. The CDC both functioned independently as a governmental actor under the Special Milk Classes Scheme and was the source of delegated governmental authority exercised by the provincial milk marketing agencies.

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[64] British Columbia Milk Marketing Board and the CDC v. Aquilini et al, (Vancouver Registry, No. A950636). para. 31.

[65] Mr. Guy Jacob, President, CDC, p. 2, United States, Exhibit 45.

[66] *1996/1997 Annual Report of the Canadian Dairy Commission,* p.5. (New Zealand, Annex 7)

4.31 The **United States** stressed that the Special Milk Classes Scheme could not exist without the CDC to oversee its operations. As noted by New Zealand (paragraph 4.23), if this had not been the case, it would have been unnecessary to amend the Canadian Dairy Commission Act to grant specific additional powers to the CDC to supervise establishment of the Special Classes, to empower it to pool revenue from the Special Classes, and to establish the price to be paid.

4.32 In respect of the producers' involvement in the price-setting of milk, the United States argued that while Canada contended that the MOU on Special Class pooling appointed the CDC to negotiate prices with the processors as *agent* for the milk producers, Canada had been unable to point to specific language that established this principal-agent relationship. Canada failed to identify any provision that demonstrated that the CDC negotiated prices as agent for the producers. In fact, Section 4 of the CDC Act specifically stated that the CDC was the agent of the Crown for all purposes of the Act. Indeed, the facts suggested to the contrary that the CDC was primarily negotiating a price for inputs for the exporters that would allow them to be competitive in world markets for processed dairy products. Furthermore, the language of the MOU specifically contradicted Canada's assertion that the producers negotiated the processors' assured margin on the latter's export sales. Paragraph C(1)(vii) of Annex B to the MOU directed that this was the role of the CDC, not the milk producers.[67]

4.33 The United States argued that an examination of the documents that provided the foundation for the Special Milk Classes Scheme revealed that the Canadian argument that producers retained the ultimate decision-making authority was baseless. The United States had already detailed the scope of the powers that Canada's Parliament granted to the CDC to operate the Special Milk Classes Scheme, as well as the authority provided to the CDC to delegate some of its newly-created powers to both the provincial governments and the provincial milk marketing boards - powers which had been provided mainly through amendment of the CDC Act and the Dairy Product Marketing Regulations (paragraph 4.10 and following).[68] The Memorandum of Understanding establishing the Special Classes was an agreement between the provinces and the CDC, a Canadian Crown corporation. Paragraph 11(a) of Schedule I of the MOU stated that "[i]f a Province wishes to become a party to this agreement, its Provincial *Government representative* shall send a note of its intent to the CDC" (emphasis added). The MOU did not state that provinces would join the Special Classes Agreement when the milk producers or the provincial milk marketing boards so decided. The MOU very plainly stated that Provinces joined the Agreement by the action of their Provincial Government representative. While milk marketing boards were also signatories to the Agreement, the dispositive fact for each province was whether its Government representative indicated an intent to join. The United States did not dispute that most Provincial governments conferred with their industry representatives to determine whether the industry supported the Special Classes Agree-

[67] The United States noted that Annex B of the Comprehensive Agreement addressed the question of surplus removal and confirmed the role of the CDC in the operation of surplus removal. No mention was made at all in this Annex for a decision-making role for milk producers in any of these decisions.

[68] United States, Exhibit 37.

ment. However, government/industry consultations and a government's receptivity to citizen's input did not alter the essential legal fact that the Comprehensive Agreement on Special Class Pooling was first, and foremost, between the Provincial governments and the CDC.

4.34 The terms of the National Milk Marketing Plan, which had long been the centre piece of Canada's dairy supply management, were similar in effect to the Special Class MOU. The opening paragraph of the NMMP stated "[t]his Plan is a federal-provincial agreement in respect of the establishment of a National Milk Marketing Plan ... ". The Preamble, in fact, stated that "the participation of the Federal and Provincial authorities was required to assure the adoption and implementation of the Plan." In contrast, the terms of the Plan made it clear that the participation of milk marketing boards was not essential to the working of either the Plan or the CMSMC. Paragraph H(3) of the Plan provided:

> "In the event that there are no Signatories of a province which are producer boards, representatives of producer organizations shall be seated as full participants in the deliberations of the Committee, *except that they shall not have the right to vote*." (Emphasis added.)

4.35 Moreover, the United States noted that the Governor in Council had delegated some of his powers to the CDC. For example, the Dairy Products Marketing Regulations provided that the CDC shall cause a federal licence to be issued only to a person to whom a share of the portion of the federal quota had been allocated. Moreover, the regulations stipulated that no person should engage in the marketing in inter-provincial or export trade of a dairy product unless the dairy product was, or was made from, milk or cream that was produced by a person who held a federal licence. The CDC, thus, could deny any milk producer that did not possess a federal quota the right to market milk. The regulations were also important in that they provided specifically for the delegation of federal powers to the dairy marketing boards which operated in the various provinces. Thus, when those dairy boards acted with respect to the Special Classes and inter-provincial or export trade, they functioned under powers delegated by the federal government. Hence, the source of the authority for the regulation of the milk marketing in inter-provincial and export trade was federal law and the Canadian Parliament. The entities that had been tasked with performing the functions necessary to implement the legislated regime were also federal and provincial governments, or marketing boards acting with authority delegated from the federal government, not from the Canadian dairy industry. The price the processors paid for milk, both domestically and for export, was determined by the exercise of governmental authority through the operation of the CDC and provincial marketing boards and agencies. The United States noted that Section 3 of Bill C-86, which was the legislation which amended the CDC Act in 1995[69] gave the CDC the authority, with the approval of the Governor in Council, to enter into agreements with a province or a marketing board to set prices, establish pools, and collect prices to be paid.

4.36 The United States noted that Canada had stated that although the CDC issued permits to processors to enable them to purchase milk at reduced prices, such "per-

[69] United States, Exhibit 15.

mits" did not actually require that milk be made available to the processors at such discounted prices. Instead, Canada claimed that the permits were only recommendations, and that the milk boards were not compelled to provide milk to the processors according to the terms of the permit. However, there was no question that the processors could not obtain the milk at the lower price without the permits.[70] In this sense, Canada minimized two equally, if not more, important practical considerations: (i) the milk producers were essentially price takers; and (ii) processors could not access the lower priced Class 5(d) and (e) milk without a permit. Thus, a CDC issued permit was a condition for receipt by the processor of the Special Class 5(d) and (e) milk, and boards possessed few options but to accept the price that was offered.

4.37 **Canada** argued that to the extent that authority in respect of the Special Milk Classes Scheme was conferred on the CDC, this was to assist in the implementation of the decisions taken through the producer-boards and the CMSMC as reflected in the Comprehensive Agreement on Special Class Pooling. Canada stressed that the amendments to the CDC Act were intended to supplement the existing authority of provincial producer boards with the necessary federal enabling authority so that the producer boards could fulfil their tasks effectively. It was not intended by Parliament that the enabling amendments to the Act would result in the CDC directing the producer boards to conduct their functions in a particular way. On the contrary, Section 9.1 of the amended Act contemplated agreements providing for the performance by those very boards of functions otherwise vested in the CDC in respect of interprovincial and export trade. In the specific case of pricing, Sections 9(1)(g) and 9.1 of the amended Act were together intended to permit the producer boards' pricing functions in respect of Classes 1 - 4 and 5(a), (b) and (c) to be supplemented with the requisite federal authority, thereby filling the legal gap identified in the *Bari II* case. Contrary to what was suggested by the Complainants, the CDC did not, as a result of the inclusion of Section 9(1)(g) in the Act, exercise price-setting powers. Pricing for Classes 1 - 4 and Classes 5(a), (b) and (c) was negotiated and decided by the provincial boards either directly or through the CMSMC. Pricing for Classes 5(d) and (e) was negotiated on a contract-by-contract basis, with the producer boards exercising ultimate control over the supply of milk at the negotiated price recommended by the CDC. Class 5(d) and Class 5(e) prices were not fixed through the exercise of regulatory powers, whether under Section 9(1)(g) or otherwise, but were established on a commercial basis based on world market conditions.

4.38 In respect of the US assertion that Canada had not identified specific language that established a principle-agent relationship in respect of the CDC's role as agent for the milk producers in price negotiations with processors (paragraph 4/32), Canada drew the Panel's attention to Section 2, Schedule II, Addendum of the Comprehensive Agreement on Special Class Pooling, which stated that: " ... that the Canadian Diary Commission (CDC) shall act as agent in carrying out administrative functions in the operation of the programme" and, also, in Section 1, Schedule I to the same Agreement which stated that the CMSMC "... will be the supervisory body

[70] The United States referred to the testimony of Mr. Guy Jacob, President, CDC: "In other words in order for an exporter to be able to buy milk at a lower price, he must first obtain a permit from the Canadian Dairy Commission." (United States, Exhibit 45, p. 2)

which will oversee the implementation of the [Comprehensive Agreement on Special Class Pooling] agreement."

4.39 Canada emphasized that the role of the CDC as a technical advisor and consensus builder - rather than as a decision-maker at the CMSMC - was evident in the setting and allocation of the MSQ. In practice, the CMSMC asked the CMSMC Secretariat to develop estimates of market requirements for Canadian industrial milk (paragraph 2.27 and following refer). The CDC presented the estimates developed by the Secretariat to the CMSMC for consideration in advance of each dairy year. The technical estimates prepared by the Secretariat were then actively debated by the CMSMC. Typically, the market requirements initially calculated by the CMSMC Secretariat were revised on the basis of directions received from the CMSMC. Canada stressed that the CMSMC was in no way bound to accept the figures suggested by the Secretariat. Nor did the CMSMC merely rubber stamp these suggested market requirements. Only after the CMSMC was satisfied with the market requirements estimates was a decision made on the MSQ allocations among the various provinces. Canada reiterated that it was the CMSMC, not the CDC, that decided on the MSQ allocation. Such allocation required unanimity.

4.40 Canada argued that the Complainants had suggested that because many types of discretionary authority had been conferred on the CDC through the CDC Act, this somehow indicated that the CDC carried out all of the things it was empowered to do. This was insupportable both in principle and in fact. First, simply because enabling legislation permitted an entity to carry out certain acts, this did not mean that they would be exercised. The entity could be constrained from acting by other legal obligations, or may simply find that certain actions were not needed in a particular circumstance. Alternatively, it could not be in a political or technical position to undertake the action it was authorized to do. The point was: enabling legislation did not compel any action. In practice, the list of functions actually carried out by the CDC was much more circumscribed than the list of functions in the CDC Act.[71] Further, Canada argued that the Complainants' argumentation ignored the fundamental principle in the WTO and the GATT that obligations were only attached to what a Member actually did, not what they could do. For example, an entity could have all the necessary power to provide subsidies in excess of a Member's obligations, but this was of no consequence unless such subsidies were actually provided.

(c) Government Involvement

4.41 **New Zealand** argued that the Special Milk Classes Scheme was a response to the belief that export subsidies, which existed under the producer levy scheme, would no longer be compatible with Canada's international trading obligations. The fact that Canada had chosen to abandon the producer levy-based subsidies in favour of an alternative scheme made it clear that the reduction and eventual elimination of the incentives provided by those subsidies was not an option Canada was prepared to follow. The Special Milk Classes Scheme was not, as Canada maintained, a response to the fact that as a result of the new WTO Agreements Canada no longer had

[71] Canada noted that a fuller discussion of the actual activities of the CDC, as opposed to the list put forward in United States, Exhibit 37, was attached as Annex C to its Second Submission.

to limit production of milk. New Zealand argued that the Special Milk Classes Scheme was a substitute for the old producer levy-based subsidy. Moreover, it was a federal government agency, the CDC, that had spearheaded the process that led to the development of the Special Milk Classes Scheme.

4.42 New Zealand noted that the question of the *degree* of governmental involvement necessary for measures to be regarded as government measures had arisen on several occasions under both the GATT 1947 and the WTO. The 1960 GATT Panel studying the obligation on states to notify subsidies financed by a non-governmental levy under GATT Article XVI, spoke of schemes "which are dependent for their enforcement on some form of government action."[72] The Panel on *Japan - Photographic Film* emphasized the fact that where non-binding action of government "creates incentives or disincentives largely dependent on governmental action for private parties to act in a particular manner, it may be considered a governmental measure."[73]

4.43 New Zealand contended that in the present case, an obvious parallel could be drawn with the decision of the Panel in *EEC - Restrictions on Imports of Dessert Apples*.[74] In deciding whether the EEC regime relating to the marketing of apples constituted a governmental measure within the meaning of GATT Article XI:2(c)(i), the Panel noted that:

> " … the EEC internal régime for apples was a hybrid one, which combined elements of public and private responsibility. Legally there were two possible systems, direct buying-in of apples by Member State authorities and withdrawal by producer groups. Under the system of withdrawals by producer groups, which was the EEC's preferred option, the operational involvement by public authorities was indirect. However, the régime as a whole was established by Community regulations which set out its structure. Its operation depended on Community decisions fixing prices, and on public financing; apples withdrawn were disposed of in ways prescribed by regulation. The Panel therefore found that both the buying-in and withdrawal systems established for apples under EEC Regulation 1035/72 (as amended) could be considered to be governmental measures for the purposes of Article XI:2(c)(i)."[75]

4.44 Hence, New Zealand noted that in such a situation, of combined public and private responsibility, the Panel had considered the EEC regime to be governmental in nature - even although the involvement by public authorities was indirect.

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[72] Panel Report on *Review Pursuant to Article XVI:5*, adopted 24 May 1960, L/1160, BISD 9S/188, p. 192; Panel Report on *Japan - Trade in Semi-Conductors*, (hereafter "*Japan - Semi-Conductors*"), adopted 4 May 1988, L/6309, BISD 35S/116, pp.154-155.

[73] Panel Report on *Japan - Measures Affecting Consumer Photographic Film and Paper*, (hereafter "*Japan - Photographic Film*"), adopted 22 April 1998, WT/DS44/R, pp. 383-384 (para. 10.45).

[74] Panel Report on *EEC - Restrictions on Imports of Dessert Apples (Complaint by Chile)*, (hereafter "*EEC - Dessert Apples*"), adopted 22 June 1989, BISD 36S/93.

[75] Panel Report on *EEC - Restrictions on Imports of Dessert Apples (Complaint by Chile)*, (hereafter "*EEC - Dessert Apples*"), adopted 22 June 1989, BISD 36S/93, p. 126 (para. 12.9); *Japan - Photographic Film*, WT/DS44/R, 31 March 1998 at pp. 383-384 (para. 10.45).

4.45 New Zealand contended that the Special Milk Classes Scheme had been initiated with direct government involvement. The CDC, a federal Crown corporation, had identified the need for changes to the programmes it offered as early as 1992.[76] It was a participant in the industry Consultation Committee which concluded that export subsidy reduction commitments would "render the use of levies ineffective".[77] A federal-provincial task force was established to review the matter. The CDC chaired the "Dairy Industry Strategic Planning Committee" that recommended a classified pricing system for milk based on end-use and a national pooling system. A negotiating sub-committee of the CMSMC brought those recommendations to federal and provincial Ministers of Agriculture in December 1994. This was the genesis of the government-initiated Special Milk Classes Scheme.

4.46 New Zealand contended that the Special Milk Classes Scheme was implemented through government action. It was embodied in a federal-provincial agreement, the Comprehensive Agreement on Special Class Pooling. The CDC ACT was amended to allow the CDC to administer the Special Milk Class permit system and the pooling arrangements. Under the Comprehensive Agreement on Special Class Pooling the CDC was to "act as agent [of the federal Government] in carrying out administrative functions in the operation of the programme" (Schedule II).

4.47 New Zealand stressed that the scheme required continued government involvement for its operation and enforcement. In order to be effective and to provide the appropriate incentives, the scheme had to be mandatory and new entrants prohibited. This was done through the exercise of statutory authority. Government involvement was therefore essential to the scheme's existence. The mandatory character of pooling, the administrative functions of the CDC and of the provincial milk marketing boards or agencies in the operation of "special milk class" access, pricing and pooling, were all activities of government. Indeed, in *Canada - Import Restrictions on Ice Cream and Yoghurt*[78], Canada itself had claimed that its milk supply management system constituted governmental measures within the meaning of GATT Article XI:2(c)(i).

4.48 New Zealand claimed that the centrality of governmental involvement in the Special Milk Classes Scheme was readily apparent when the question was asked whether the scheme could continue to operate if the governmental presence were removed. There would be no legislative basis for the operation of the scheme. There would be no NMMP, there would be no Comprehensive Agreement on Special Class Pooling. In the absence of government authority, there would be no mechanism to set prices or to compel compliance except through the agreement of the members of the "producers' club". Nothing could prevent those outside the "club" from marketing milk domestically. There would be no government agency, no CDC, to chair the CMSMC and resolve differences where unanimity could not be reached, and there would be no delegated governmental powers residing in provincial marketing boards. Furthermore, to the extent that some agency was needed to administer a permit sys-

[76] *1992/1993 Annual Report of the Canadian Dairy Commission,* p.3. New Zealand recalled that the Dunkel draft was the basis of the Agreement on Agriculture.

[77] Report of the Consultation Committee on the Future of the Dairy Industry, p.12.

[78] Panel Report on *Canada - Import Restrictions on Ice Cream and Yoghurt* (hereafter "*Canada - Yoghurt*"), L/6568, BISD 36S/68, adopted 5 December 1989, p. 73 (paragraph 22).

tem under which access to "special class" milk was provided, it would have to be a private agency established by the producer members themselves. New Zealand argued that the Special Milk Classes Scheme would simply not function if everything was left to private producer agreement. Indeed, any attempt at price setting by private producer agreement would raise questions about compliance with competition laws. It did not do so under Canada's supply management system because of the very involvement of government in the scheme. Hence, government involvement was critical to the functioning of all aspects of the Special Milk Classes Scheme. Canada's argument that the scheme operated through the private activity of producers with only a government oversight function simply was not credible.

4.49 New Zealand recalled that Canada had not argued that there had been any real change to the role of government after the introduction of special milk classes. At no point had Canada sought to suggest that special milk classes heralded a shift in the extent of federal and provincial governments' involvement in the dairy marketing system. Instead, the picture Canada painted of government activity within the dairy supply management system was one of continuity. To Canada, it had remained a producer-driven and dominated dairy marketing system (paragraph 4.62). New Zealand argued that, if this were the case, there would not have been sufficient government involvement within Canadian terms under the old producer levy scheme to meet the requirement of government involvement in order to constitute an export subsidy. It would simply have been a system whereby producers within their own organizations - milk marketing agencies and the CMSMC - decided to levy themselves in order to support exports, and government involvement would simply have been to act as the designated agent of the producers to assist in implementing the system. Although this was the consequence of Canada's position, even Canada had admitted that its old producer levy system would have constituted a subsidy under Article 9.1(c) of the Agreement on Agriculture.[79] In New Zealand's view, such an admission undermined Canada's portrayal of government involvement in the Special Milk Classes Scheme.

4.50 New Zealand noted that Canada claimed that the government role was one of oversight only and provincial and federal governments simply provided a framework for the activities of producer-run marketing boards; within the CMSMC, the government's role was to ensure that the system was operated in accordance with the general public interest (paragraph 4.16). Canada sought to equate the role of government in the operation of the Special Milk Classes Scheme, and in dairy supply management more broadly, to that of its role in society generally - to act in the public interest. However, the role of government in the Special Milk Classes Scheme was much more intrusive than the exercise of its general function of oversight in the public interest. Without the active participation of government in the administration and operation of the scheme, including its residual enforcement authority, the system could not work. Instead of describing the nature of the government involvement, Canada had gone to the other extreme and sought to have the government disappear altogether from the Special Milk Classes Scheme.

4.51 New Zealand argued that in the case of non-mandatory measures, the determining factor in deciding whether conduct could be ascribed as resulting from gov-

[79] Canada's Second Written Submission, Annex B, pp. 7-9.

ernmental action had been whether there were sufficient incentives or disincentives for the measures to take effect.[80] Most recently, a WTO Panel had noted that "the fact that an action is taken by private parties does not rule out the possibility that it may be deemed to be governmental if there is sufficient government involvement with it".[81] The Panel had gone on to note that it was difficult to establish definitive rules, and that a case-by-case analysis was required.

4.52 New Zealand maintained that under any of these tests the operation of the Special Milk Classes Scheme was a government activity. The scheme derived from the agreement of agencies of the federal and provincial governments created by statute. These agencies administered a supply management scheme that could function only through the interplay of the exercise of federal and provincial authority. The *Bari* litigation demonstrated that provincial authority alone was not sufficient to give effect to a quota regime affecting inter-provincial and export trade. There had to be the joint action of federal and provincial governments to enable the system to function.

4.53 The Special Milk Classes Scheme, as an aspect of Canada's supply management system, was compulsory: essentially, the only way that milk could be sold on the export market was through special milk classes. Producers did not have the option of selling on the export market independently of a government-mandated scheme. The subsidy that exporters received under the Special Milk Classes Scheme was provided through the cooperative activity of the CDC and the provincial milk marketing agencies. Exporters had to obtain a permit from the CDC and obtain milk through the provincial milk marketing agency. The scheme was thus government-mandated, maintained through the actions of government agencies, and enforced by government authority.

4.54 The **United States** also agreed that milk would not be available to processors of dairy products for export at the indicated prices absent the structure of the dairy regime established by the Canadian federal and provincial governments and which was administered and enforced by those governments. The pervasiveness of the government's role in the Special Milk Classes Scheme was evident from consideration of the legislatively granted authority that those entities possessed and exercised (paragraph 4.4 and following). Despite Canada's claims to the contrary, government action and authority was not transformed into private action simply because private parties, in this case dairy farmer organizations, could approve in specific instances of the actions taken by their government. If this were the case, any action by a government to benefit a portion of its citizenry would be converted into private action. For example, most anti-dumping measures would be "private actions" by definition and the WTO Agreement on Anti-Dumping would be nullified.

4.55 The United States argued that it was sufficient to look to the marketing boards' own statements about the source of their powers to lay to rest Canada's contention that the boards receive their power from the dairy farmers. For example, the British Columbia Milk Marketing Board's Consolidated Order of 1 August 1997, described both its purpose and the basis for the Board's authority. The stated purpose

[80] Panel Report on *Japan - Semi-Conductors*, *op. cit.*, p. 155.
[81] Panel Report on *Japan - Photographic Film*, *op. cit.*, para.10.56.

of the Order prominently referenced both the provincial and federal authority that permitted the Board to act.[82] Also, a regulation issued by the Ontario Milk Marketing Board in June 1995 had a similar effect with respect to the powers delegated to it by the federal government as the authority for its control over the marketing of milk produced in the Province of Ontario.[83]

4.56 The United States argued that both the manner of creation of the Special Classes and the actions by the provincial and federal governments following the *Bari II* litigation also refuted Canada's allegations that the Special Milk Classes Scheme represented an agreement between private parties that was simply pursued within an overall legislative and regulatory framework that was government created.[84] Indeed, if the Special Milk Classes Scheme were simply an agreement between the various producer dominated provincial marketing boards, the United States questioned: (i) why any government involvement was required; (ii) why did the Comprehensive Agreement state that it applied only to those provinces whose provincial governments had approved it[85]; (iii) why was it necessary for the Canadian Parliament to amend the CDC Act to provide specific powers to the CDC to operate the Special Classes; and (iv) why such powers could not simply be conferred by the dairy marketing boards in their capacity as representatives of the dairy farmers. Canada had not, in the US view, provided responses to any of these questions. Its only answer was that the provincial marketing boards (which performed most, if not all, of their relevant responsibilities by virtue of powers delegated to them by both the federal and provincial governments) could not remain in office if they did not satisfy the desires of their dairy farmer constituency (paragraph 4.19). The United States argued that if this were the test for determining whether action was governmental or not, any action by a popularly-elected government would be deemed not to be governmental action. Moreover, every time a government agency or legislature took action which benefited a class of individuals, that action would no longer be considered to be governmental in character.

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[82] "The British Columbia Milk Marketing Board (the "Board") has approved this Consolidated Order for the purpose of promoting, controlling and regulating the production, transportation, packing, storing and marketing of milk, fluid milk, and manufactured milk products within British Columbia under provincial authority, and for the purpose of regulating the production for marketing, or the marketing, in inter-provincial trade of milk, fluid milk, and manufactured milk products, under federal authority". The United States noted that then, in the immediately succeeding section of the Order, the Board identified the specific bases for its authority, citing the Natural Products Marketing (B.C.) Act, the British Columbia Milk Marketing Board Regulation, the British Columbia Milk Order - made under the Agricultural Products Marketing Act (federal legislation), and the Dairy Products Marketing Regulations - made under the Canadian Dairy Commission Act (again federal legislation). (United States, Exhibit 43)

[83] "This regulation has been enacted by the Board under its delegated Federal authority to ensure that all milk marketed is covered by the authority of the Ontario Milk Marketing Board. This Regulation makes it clear that the same requirements that exist for producer licenses, license fees, quota, pooling and transportation that apply to local trade apply to any milk attempted to be marketed in inter-provincial or export trade." (United States, Exhibit 44)

[84] The United States noted that Canada's Answer to Question 7 of the Panel also confirmed the necessity of the delegation of additional federal powers to enable the marketing boards to act.

[85] REO Paragraph 11 of the Comprehensive Agreement on Special Class pooling. (United States, Exhibit 5)

4.57 The United States noted that a body of legal authority had developed in the GATT and WTO that was relevant to the issues before this Panel. Several GATT and WTO panels had considered, primarily in the context of Article XI of the GATT, whether actions by a government that did not impose specific requirements on private parties were, nonetheless, government measures. While this analysis had necessarily to be conducted on a case-by-case basis, the consistent conclusion that each Panel had reached was that action need not be mandated by a government to constitute enforcement of a government measure. This issue was first addressed in *Japan - Restrictions on Imports of Certain Agricultural Products* (hereafter "*Japan - Certain Agricultural Products*").[86] There the Panel had wrestled with the question of whether the Japanese system relating to restrictions on domestic production provided for "enforcement of government measures". The Panel found that the restrictions emanated from the government and that "administrative guidance" from the Government of Japan played an important role in the enforcement of those measures.[87] This principle was taken a step further by the Panel in *Japan - Semiconductors*.[88] In that dispute, the Panel found that "an administrative structure had been created by the Government of Japan which operated to place maximum possible pressure on the private sector to cease exporting at prices below company-specific costs."[89] The Panel concluded that despite the absence of any legally binding obligation, the complex of measures that Japan had adopted operated in a manner equivalent to mandatory requirements.[90]

4.58 Also, the United States claimed that the analysis of the panel which examined *Japan - Photographic Film*[91] demonstrated exactly how schemes such as the Special Milk Classes Scheme fitted within the body of WTO law. The *Photographic Film* panel addressed the related issues of whether certain governmental actions were "measures" for the purposes of the non-violation nullification or impairment remedy under GATT Article XXIII:1(b) and were "laws, regulations or requirements" for the purposes of GATT Article III. Agricultural trade measures of a hybrid nature had been the subject of GATT panel findings. As the *Photographic Film* panel observed, "a 1989 panel on EEC - Restrictions on Imports of Dessert Apples noted that 'the EEC internal regime for apples was a hybrid one, which combined elements of public and private responsibility. Legally there were two possible systems, direct buying-in of apples by Member State authorities and withdrawals by producer groups'. That panel found that both the buying-in and withdrawal systems established for apples under the EEC regulation could be considered to be governmental measures for the purposes of Article XI:2(c)(i)."[92] The rule formulated by the *Photographic Film* panel was that

> " ... the fact that an action is taken by private parties does not rule out the possibility that it may be deemed to be governmental if there is sufficient government involvement with it. It is difficult to establish

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86 Report adopted 22 March 1988, L/6253, BISD 35/163.
87 *Ibid.*, para. 5.4.1.4.
88 Report on *Japan - Semi-Conductors*, *op. cit.*
89 *Ibid.*, para. 117.
90 *Ibid.*
91 Panel Report on *Japan - Photographic Film, op. cit.*
92 Panel Report on *EEC - Dessert Apples*, *op. cit.*, p. 126.

> bright-line rules in this regard, however. Thus, that possibility will need to be examined on a case-by-case basis."[93]

4.59 The United States noted that the *Photographic Film* panel also examined the Fair Trade Promotion Council's 1984 Self-Regulating Standards. Whereas Japan argued that this Council was a mere private entity, the panel had noted the extensive links between the Council and the Japanese government - "dependence of the Fair Trade Promotion Council on liaison with the JFTC for the establishment of these standards" - and found that these standards were attributable to the Japanese government.[94] The *Photographic Film* panel examined a Retailers Fair Competition Code and its enforcement body, the Retailers Fair Trade Council. Japan argued that this Code was only self-regulation among business entities, and the Council was a voluntary organ to implement this self-regulation. The panel rejected Japan's position:

> " ... Viewed in the context of the JFTC having approved the Fair Competition Code and the Retailers Council, and of Article 10(5) appearing to give a governmental exemption from certain provisions of the Antimonopoly Law to actions by the Retailers Council and code members under the code, it is difficult to conclude that investigation, enforcement and governmental liaison actions of the Retailers Council under the code are purely private actions of a private trade association. ... we note that a finding to the contrary would create a risk that WTO obligations could be evaded through a Member's delegation of quasi-governmental authority to private bodies. In respect of obligations concerning state trading, the provisions of GATT explicitly recognize this possibility. In this regard, an interpretative note to Articles XI, XII, XIII, XIV and XVIII states: "Throughout Articles XI, XII, XIII, XIV and XVIII, the terms "import restrictions" or "export restrictions" include restrictions made effective through state-trading operations". The existence of this note demonstrates that the drafters of the General Agreement recognized a need to address explicitly one aspect of the government-delegation-of-authority problem. In our view, it supports our finding that measure for purposes of Article XXIII:1(b) should be interpreted so as to prevent actions by entities with governmental-like powers from nullifying or impairing expected benefits."[95]

4.60 The United States argued that the same dangers that the *Photographic Film* Panel found, also existed in the context of Canada's Special Milk Classes Scheme. Canada was giving disproportionate weight to the involvement of private dairy farmers in the operation of the marketing boards, and would minimize the greater importance of the boards' dependence on powers delegated by the federal and provincial governments in Canada. The United States argued that if the current Panel found that the Special Milk Classes Scheme was outside the WTO Agreements simply because it incorporated some private elements into an essentially government scheme, other countries, led by the United States, would be impelled to similarly rearrange their

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93 Panel Report on *Japan - Photographic Film*, *op. cit.*, para. 10.56.
94 *Ibid.*, para. 10.314.
95 Panel Report on *Japan - Photographic Film*, *op. cit.*, para. 10.328.

affairs. The economics of dairy trade provided overwhelming pressure to imitate Canada's regime if it was determined to be WTO consistent, a result which the United States believed would be entirely unjustified.

4.61 The United States emphasized that the Special Class prices for exported milk were determined by the CDC or the provincial marketing boards. This was essentially achieved by the CDC negotiating an assured margin for processors, which was then subtracted with other costs to provide a net return to the milk producers. In cases of exports by the CDC, this was the end of the matter. Where the CDC reached agreement with a processor on a price to be paid to the producers, Canada insisted that the marketing boards then could determine whether to accept the price obtained. Nonetheless, Canada admitted that the boards rarely failed to accept the price. But more importantly, when the boards accepted that price, they were exercising the governmental powers that had been delegated to them. Their actions, therefore, were no less governmental than those of the CDC. It was not an exaggeration that the boards were essentially extensions of the executive branch of the Government of Canada for most purposes relating to regulation of milk marketing and the Special Classes in particular.[96]

4.62 **Canada** argued that governments did play a role, in that they had taken the necessary steps to provide enabling authority to the producers and their organizations to ensure that the system could fulfill its supply management objectives while retaining an oversight function to ensure that such enabling authority was not misused and that the public interest was protected. Subject to this oversight function, governments in Canada had devolved discretionary authority to the dairy industry so it could run its own affairs. This function was diametrically opposed to the fanciful image suggested by the Complainants of coercive government control and direction.

4.63 Canada refuted the US argument that producer boards were essentially extensions of the executive branch of its government (paragraph 4.61). The executive branch of the Government of Canada consisted of officials and departments directed by ministers of the Crown and the principal executive body, the Cabinet, headed by the Prime Minister. Producer-run and producer-controlled provincial marketing boards could in no way be equated with the executive branch of any government, merely because they carried out certain activities pursuant to enabling legislation and were subject to government oversight. Canada rebutted as equally ill-founded the characterization by New Zealand of the producer boards as "government agencies". The hallmark of a government "agency" (referred to in Canadian, and New Zealand, legal parlance as a "Crown agency") was a "body which was subject at every turn in executing its powers to the control of the Crown".[97] The producer boards in the Canadian dairy sector had a vastly greater degree of independence, private accountability and discretion than "government agencies". Hence, far from being government

[96] The United States referred to Canada's answers to the Panel's Questions 9(a), 8(a) and 7(c).

[97] Canada noted that one of the leading cases on this point in Canada was the Supreme Court of Canada decision in *Westeel-Rosco Limited v. Board of Governors of South Saskatchewan Hospital Centre*, [1977] 2 S.C.R. 238 which in turn referred to a decision of the Privy Council, *Metropolitan Meat Industry Board v. Sheedy*, [1927], A.C. 899 holding that an agricultural board which had government-appointed members and was subject to a government veto power on certain matters was nonetheless not a Crown agency.

agencies, the producer boards had the character of private agents representing dairy producers. The boards were collective agents for producers as a group. Producers could revoke the agency at any time. However, as was characteristic of a collective agency role performed by trade unions, revocation decisions were made on a collective not an individual basis. Canada argued that the activities carried out by the producer-run boards (the private bodies in question) were necessary for the proper operations of their affairs. The authority provided to them by governments, fell short of the test of being "governmental" in character.[98]

4.64 Canada further refuted the US claim that the recent Panel Report in *Japan - Photographic Film* provided support for the proposition that the Canadian dairy export measures at issue were to be treated as governmental in character (paragraph 4.58). Canada argued that that panel report did not provide a rule with respect to determining whether or not a measure is governmental:

> "These past GATT cases demonstrate the fact that an action taken by private parties does not rule out the *possibility* that it may be deemed to be governmental if there is sufficient government involvement with it. *It is difficult to establish bright line rules in this regard, however. Thus, that possibility will need to be examined on a case by case basis.*"[99] (emphasis added)

4.65 Canada argued that an examination of GATT cases showed, if anything, that the opposite conclusion than that argued by the United States could be drawn. The *Japan - Semi-Conductors* case,[100] involved a situation where the Government of Japan had initiated a policy of its own volition and then sought to impose it on the industry. In the words of the panel in *Japan - Photographic Film*, this policy was "operated to exert maximum possible pressure on the private sector".[101] Thus, this was a clear case of top-down direction from government, through the private sector. By contrast, it was clear that in the present case there was no policy being imposed by governments. In particular, there was no government imposed policy whatsoever on export methods or levels. This was left to the producers and producer boards to determine. Involvement by government had been limited to oversight. The Complainants had referred to the *EEC - Dessert Apples* case (paragraphs 4.43 and 4.58) suggesting that the facts in that case were relevant to the current matter. As in the case of *Japan - Semi-Conductors*, Canada pointed out that the fact was that the measures in question in *EEC - Dessert Apples* represented top-down government direction in a mixed government/private sector environment. In particular, the Panel in *EEC - Dessert Apples* noted:

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[98] Canada noted that except for the producer board in the province of British Columbia, which had been given the capacity of natural person, the other provincial milk producer boards had the status of private (i.e., non-governmental) bodies corporate. The *Fédération des producteurs de lait du Québec* was a professional union incorporated under the Professional Syndicates Act (L.R.Q. c. S-40) as recognized by the Farm Producers Act (L.R.Q. c. P-28) and it grouped together 14 regional unions of milk producers. It was charged by producers to act as a marketing board and to administer the collective marketing plan established following a decision of its members.

[99] Panel Report on *Japan -Photographic Film, op. cit.*, para. 10.56.

[100] Panel Report on *Japan - Semi-Conductors*, *op. cit.*

[101] Panel Report on *Japan - Photographic Film*, *op. cit.*, para. 10.54.

> "The regime as a whole was established by Community regulations which set out its structure. Its operation depended on Community decisions fixing prices, and on public financing; apples withdrawn were disposed of in ways prescribed by regulation."[102]

4.66 Canada argued that the distinction between the *EEC - Dessert Apples* situation, with direct action by government to implement the policy, and the present case where government provided enabling discretionary authority without policy direction was obvious. In sum, the theme through all these cases was one of governments participating in a top-down, policy-directing and initiating role. The Complainants had failed to show any evidence of governments in Canada setting and dictating policies with respect to the operation of the Canadian dairy system and, in particular, the Special Class export practices at issue. Accordingly, this was suggestive that, using the case-by-case approach, the current case fell outside of the type of situation that could be considered to be governmental.

4.67 Canada further refuted the significance attributed by both New Zealand and the United States to the *Bari* case. The *Bari* cases involved a group of non-licensed British Columbia producers and a processor who were custom processing milk for those producers for marketing in inter-provincial trade. The litigation arose well before the Special Milk Classes Scheme was introduced and, more importantly, had nothing whatsoever to do with export trade in milk or milk products. In response to constitutional gaps in the domestic milk marketing regime identified at an earlier stage in the litigation, regulations were established in 1994 pursuant to the CDC Act. The *Bari III* case referred to by New Zealand addressed the validity and applicability of the Regulations in a purely domestic context. The *Bari* litigation had little relevance to the export of products made from milk sold under Special Classes 5(d) and (e).

4.68 Canada also refuted the Complainant's assertion that milk would not be available to producers of dairy products for export at the indicated prices absent the structure of the dairy regime established by the Canadian federal and provincial governments (paragraphs 4.48 and 4.54). Canada argued that the reality was that export milk was sold to processors at prices negotiated in arms-length transactions directly responsive to world market conditions. Canada argued that even if the CDC were to cease to perform the negotiating activities on behalf of producers that it currently performed, the realities of the world market which drove those export prices would still be the same. Indeed, Canada argued that if the CDC were to exit the export pricing negotiations altogether and producers were to negotiate export sales through their producer boards, processors might easily succeed in negotiating a slightly lower price with nine producer boards having less experience than the CDC in world markets. In this context, to assert the existence of a "benefit" to Canadian processors flowing from the negotiating role performed by the CDC was not only counter-intuitive, it was nonsensical.

4.69 Canada cautioned the Panel in respect of New Zealand's arguments relating to the 1960 Working Party Report regarding the notification of export subsidies under Article XVI of GATT 1947 (paragraph 4.41). That Working Party Report occurred in

[102] Panel Report on *EEC -Dessert Apples*, *op. cit.*, p.126, para. 12.9.

a context in which there was no consensus among GATT Contracting Parties as to what constituted a subsidy. The entire focus of the report was to decide what measures were to be notified. Accordingly, the report advanced the Contracting Parties trade policy objectives by requiring notification of certain matters so that the Contracting Parties could assess the resulting trade impacts. Given that there now existed binding obligations with respect to subsidies, the Panel had to be careful in using that Report for the purpose of reading context into the definition of "subsidy".

4.70 The **United States** noted that Canada argued that the *Bari* case was irrelevant because it allegedly did not address the issue of exports. This was a remarkable statement by Canada in light of the fact that the principal issue was the authority of the provincial boards over export and inter-provincial trade. In addition, the Canadian court specifically addressed the question of the authority to impose a levy on production. That levy, of course, was used to fund exports and to allow exports of dairy products to be competitive on world markets. Those issues appeared to the United States to be relevant to exports despite Canada's protestations to the contrary.

4.71 In respect of the 1960 Panel Report, the United States noted that Canada's argument that the 1960 Panel Report regarding notification of subsidies should not be given weight because it was issued at a time when the current consensus on those subsidies under the current Agreements had not been concluded totally ignored the fact that the view of producer-financed subsidies had not changed in over 30 years since the Report was issued. In fact, relevant language to this dispute first appeared in that Report and now had been incorporated into the SCM Agreement. Those considerations argued for greater not less weight for the 1960 Report.

(d) Producers' Involvement

4.72 **New Zealand** noted that the Canadian arguments focused almost exclusively on the role of producers within the system in order to distract the Panel from the fact that it was exporters, and not producers, who were being subsidized. New Zealand recognized that producers operating individually and collectively were *involved* in the export regime for Canadian milk products. The fact that a body was composed of producer members did not alter the character it had been granted through its statutory mandate (paragraph 4.21). The power "to regulate the marketing of milk in inter-provincial and export trade" - a power possessed, for example, by the British Columbia Milk Marketing Board[103] - did not cease to be the exercise of a governmental regulatory function in respect of export trade because the Board happens to be composed of producers. New Zealand argued that contrary to the impression conveyed by the Canadian arguments, provincial milk marketing boards were not producer clubs. They had regulatory functions, and their authority to regulate was derived from statute, not from the agreement of producers. Milk producers had to comply with the decisions of the provincial boards. They had no right to produce milk and market it except in accordance with the systems established through the combined actions of the CDC and the provincial marketing boards and agencies. Access to the system could only be gained through the purchase of existing quota.

[103] Section 3 of the British Columbia Milk Order, 1994, (SOR/94-511).

4.73 New Zealand noted that Canada had also sought to portray the production of milk for export as the result of the individual decisions of producers relying on their own business sense (as argued by Canada in paragraph 4.109). Yet the power of individual producers was largely limited to deciding upon their level of milk production. The revenue they received for that milk did not depend on market forces. The revenue a producer received depended on whether the milk produced was classified as in-quota or over-quota, and whether it was exported or sold on the domestic market. And those decisions were not made by the individual producer. They were made through the interaction of the CDC and the provincial milk marketing boards and agencies, under the auspices of the CMSMC (further argued in paragraph 4.93 and following).

4.74 New Zealand argued that Canada's description of the operation of the Special Milk Classes Scheme as one that was "developed on a bottom-up basis by Canadian producers" where Governments simply implemented what they were directed to do by producers was an implausible explanation of how governments operated. In any event, it did not prevent the conclusion that there was an export subsidy.

4.75 The **United States** noted that Canada argued that the Special Milk Classes Scheme gave milk marketing in Canada a market-orientation that it had lacked under the producer levies that were eliminated during 1995. In particular, Canada contended that whereas the old system was dependent largely on supply management, the new Special Milk Classes Scheme allowed Canada's milk *producers* to price to the various markets available for their products. At the core of Canada's argument was its assertion that the over-quota levy that existed under the pre-1995 system served as a disincentive to production above quota limits.[104] The United States argued that since the Special Class prices were set at approximations of the world market prices, there appeared to be comparatively little difference between the economic treatment of over-quota production under the levy system as contrasted with the present Special Class 5(e), which was applicable to over-quota production. Canada's assertion that the change to the Special Milk Classes Scheme heralded a new day of producer independence was, in the US view, unfounded.

4.76 The United States stressed that producers could not on their own achieve the national coordination of prices and production that was essential to the operation of the Special Milk Classes Scheme. Canada had, in their view, exaggerated the legal basis for the producers' role in the system and particularly their role in decision-making. The United States claimed that Canada ignored two important factors. The part played by producers was permitted by: (i) the delegation of government powers to producer marketing boards; and (ii) the provincial governments' designation of producers as representatives to the CMSMC. In both instances the producers' participation was at the discretion of the governments involved.

4.77 The United States argued that the omission of several critical facts distorted Canada's portrayal of the scope of the legal authority possessed by the milk marketing boards in their role as *designated* representatives for the Provinces on the CMSMC. While Canada contended that most of the voting representatives participating in the Canadian Milk Supply Management Committee were from producer

[104] The United States referred to Canada's First Submission, para. 42.

marketing boards, Canada neglected to give any weight to the most critical fact. The voting representative from each province was selected by the provincial government, the provincial government commission overseeing the industry, and the provincial marketing board.[105] Thus, any *producer* who was a representative of a province at the CMSMC did so by virtue of the decision of three separate entities, two of which were entirely governmental. Therefore, any producer representative designated to sit at the CMSMC table did so at the discretion of the provincial governments. Even were this not the case, the fact that producers sat on the CMSMC, a policy making committee, again did not alter the fact that the CMSMC itself was a creation of a federal-provincial government agreement. Canada, which contended that the CMSMC was run by milk producers and was the decision-maker for dairy policy, also failed to explain why Canada's Attorney-General in the *Bari* litigation described the CMSMC as "a federal body, a federal functionary ...

> "In discharging its duties under the *Federal Regulations*, the Committee acts as a federal body, a federal functionary concerned solely with matters related to the federal quota.
>
> This exercise of co-operative federalism, suggested by many judicial decisions as the only practical and effective way to regulate in Canada the marketing of agricultural products under divided jurisdiction, is at the heart of the Governor in Council's recognition of the Committee. The Committee's composition includes, inter alia, representatives *appointed* by provincial signatories who are bodies *established under provincial law to exercise statutory powers* in relation to the marketing of dairy products in intraprovincial trade." (emphasis added.)[106]

4.78 The United States argued that while Canada's portrayal of the provincial milk marketing boards admitted that federal and provincial delegation of powers were essential to their functioning, Canada failed to acknowledge the binding decision-making powers of the provincial government authorities respecting the boards' operations. The CDC's website description of the operation of dairy management in each of the provinces was enlightening for this purpose.[107] In connection with the province of Nova Scotia, the CDC's internet site stated: "The Nova Scotia Dairy Commission is a government agency which controls the province's marketing." In Ontario, according to the same report, "[t]he Farm Products Marketing Commission, a branch of the Ontario Ministry of Agriculture and Food, acts as a supervisory board for the industry." With respect to Quebec, the website stated that: "In all cases of unresolved dispute, the Regie des marchés agricoles et alimentaires - a government organization - has the authority to intervene, and will act as a tribunal and hand down a final and binding decision." In New Brunswick, the same report explained that while the milk marketing board possessed the main responsibility for milk marketing, the Farm Products Marketing Commission, a government agency, which adminis-

[105] Canada's Second Written Submission, Annex B, footnote 4.
[106] Outline of the Argument of the Attorney General of Canada, paras. 47-48 (United States, Exhibit 29)
[107] United States, Exhibit 54. (This United States Exhibit, in addition to including documents from the CDC's website, includes a chart excerpted from the Report identified in United States, Exhibit 25.)

tered the Farm Products Marketing Act, oversaw the activities of the milk marketing board. As Canada already admitted that the milk marketing boards in the provinces of Alberta and Saskatchewan were government operated, there was no need to examine them further. Thus, in at least six of the provinces, accounting for an overwhelming majority of milk production, the provincial governments retained ultimate authority respecting the operation of the milk marketing boards. Although the milk producers could choose who sat on the board, it was the provincial and federal governments that determined the respective board's authority, and it was the provincial government that had the final say on the operation of the boards.

4.79 Hence, the United States argued, regardless of the fact that producers had a role in the Special Milk Classes Scheme, which was not denied by United States, the fundamental authority, practices, and operations necessary for the national application of the Special Milk Classes Scheme were governmental. That the governments at both the federal and provincial levels had entrusted certain powers to the milk marketing boards, and thus indirectly to producers, did not alter the fact that the powers exercised by those boards were governmental in origin and that the boards as institutions were ultimately answerable to the overseeing government authorities.

4.80 The United States argued that the Special Milk Classes Scheme, as outlined in its own and New Zealand's arguments above, was created under the authority of the federal and provincial governments, and was administered, maintained, and enforced by them. Now that it existed, milk producers did not have a choice in its application. Milk producers could not market the milk that they produced without a government assigned quota and a CDC issued license. Milk producers also did not have any input into whether their milk was sold into one of the Special Classes or another. They could not opt not to participate in the Special Class pool.

4.81 In respect of price, the United States stressed that the dairy farmer had no input in the pricing of milk for over-quota production. Canada stated that all over-quota production received the 3 month rolling-average Special Class 5(e) price. The Special Class 5(e) price was approximately 50 per cent of the price obtained for the same milk components in the domestic market in Canada. The milk producer had absolutely no ability to sell over-quota milk at the domestic price levels. The Special Milk Classes Scheme closed this alternative to the milk producer. Although Canada asserted that the CDC, a Crown corporation, only negotiated the Special Class 5(e) price for the farmers and their boards, Canada had conceded that the price was rarely, if ever, rejected by either. Yet, for example, the British Columbia Consolidated Milk Marketing Order provided in Part VIII, paragraph 31, that "[t]he Board will determine the minimum Producer price for over quota production based upon the calculated world price published by the Commission."[108] It was noteworthy that this regulation did not say that the Board *could* base the Producer price on the Commission published price, but that it *will* base the price on the CDC published price. Similarly, the Manitoba Milk Producers newsletter published monthly the CDC Special Class price for over-quota production and indicated that this was the price that would ap-

[108] "Commission" was defined elsewhere in the Order to mean the Canadian Dairy Commission. Part I, paragraph 3 of the Order. (United States, Exhibit 43)

pear on producers' monthly pool statements.[109] Again, this left little question but that as a practical matter, the CDC calculated price was the only price available for over-quota milk.[110] In this sense, the United States argued that it would be more accurate to state that the CDC was negotiating a milk price for the dairy exporter, rather than for the dairy farmers. This was because a dairy processor with an opportunity for an export sale approached the CDC with the price that it could obtain in the international market for the dairy product export, such as butter, or cheese. The CDC then negotiated with the processor/exporter an "assured margin" which incorporated an amount for profit as well as the processor's costs.[111] This amount was then subtracted from the processor's selling price for butter, cheese, or some other dairy export in world markets. The international sales price for the dairy export, less the processor's "assured margin," was the amount paid to the dairy farmer for his or her milk.

4.82 Thus, the entire calculation procedure was aimed at assuring a price to the processor/exporter that allowed the export to take place at world market prices. While presumably the interests of the dairy producers were considered, the over-riding objective was to ensure that surplus dairy products were exported. The major benefit derived by the milk producers from such exports was that they assisted in administering the supply management of dairy products and producers got some return for this surplus production. Without such exports, the surplus would be destroyed with obvious political ramifications.

4.83 Hence, the United States submitted that Canadian exporters of dairy products were provided with milk priced at the lower Special Class 5(d) and (e) levels only as a result of the Special Milk Classes Scheme, that had been put into place by the joint action of the federal Government of Canada and the provincial governments. Without the government action that required the removal of surplus in-quota and over-quota production at prices negotiated or set by the CDC, those producers of dairy product exports would not receive the lower priced milk necessary for them to compete in international markets. It was not normal commercial practice for a government entity to customize the price of an input to match particular sales opportunities.

4.84 **Canada** maintained that the creation of the Special Milk Classes Scheme was a producer-initiated process and that contrary to the assertions of the Complainants, the Special Milk Classes Scheme was not imposed by governments. It was developed on a bottom-up basis by Canadian producers through their producer organizations

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[109] The United States noted that in each month, *Milkline,* the Manitoba newsletter reports the over-quota prices in this manner: "The following is the price for over-quota production (world price) effective September 1, 1996, *as calculated by the Canadian Dairy Commission*." (Emphasis added.) The world price will be reported regularly in the Milkline and on the monthly pool statement. (United States, Exhibit 47)

[110] The United States noted that it was worth considering what alternative the board had if it found the CDC negotiated price to be unacceptable. Given that milk was a highly perishable product, the board did not have long to consider its options. Furthermore, since the Class 5(e) permits were only issued, according to Canada, when the milk in question was surplus to domestic requirements and could not be sold in the domestic market at the prices set for that market, what real alternative did the board have except to accept the CDC determined price?

[111] The United States noted that Sub-paragraph (vii) of Annex B of the Comprehensive Agreement provided that a processor would receive an assured margin and that the level of the margin would be negotiated by the CDC with the processor. (United States, Exhibit 5)

and the producer-dominated CMSMC. Through their decisions in these bodies, the producers had reached agreement on the principles that would form the foundations of such a system. In those resolutions, they called on governments to take the necessary steps to provide the enabling authority that would allow such a system to come into being.

4.85 Canada noted that as early as 1993, proposals were being circulated for a revision of the Canadian supply management system to include new features such as possible pooling systems and an optional export programme. The purpose of these proposals had been to respond to perceived new market conditions and to introduce added flexibility and competitiveness so as to take advantage of the new export opportunities that would emerge from the conclusion of the Uruguay Round. In Quebec, for example, an early initiative in this direction was taken at the 14-15 April 1993 meeting of the General Assembly of Fédération des producteurs de lait du Québec to begin the process of renegotiating the terms of the NMMP. Further decisions in the General Assembly in 1994 and 1995 advanced this process, particularly with respect to regional pooling arrangements. These decisions fundamentally modified the basis of the Quebec dairy marketing plan and the conditions that applied to the marketing negotiations conducted between producers and processors in Quebec. Parallel developments were taking place within the industry in other provinces, developments that ultimately culminated in the decisions taken at the CMSMC to propose the Special Milk Classes Scheme. Thus, Canada argued that governments in Canada had not imposed arrangements on the dairy producers and processors. Governments had responded to the initiatives of the industry by providing the discretionary authority required to implement industry proposals, provided those proposals were in the public interest. On the other hand, had the processors and producers rejected the concept of a national Special Milk Classes Scheme, it was quite certain that such a system would never have been implemented.

4.86 Canada argued that the object of the supply-management system in Canada had been to provide the Canadian dairy industry with the means by which they could effectively govern their own affairs, so as to yield a fair return to producers while balancing the interests of processors and consumers. The purpose of the supply management system was to take the necessary steps to match, as closely as possible, the quantity of milk to be marketed for domestic use with Canadian domestic demand. This, coupled with border measures to control imports into the domestic market, allowed for the maintenance of price levels for milk in the domestic market higher than would otherwise be obtained in the absence of such measures. In order to provide Canadian dairy producers with the means to operate such a system, governments in Canada had put in place the legislative and regulatory framework to allow such a self-governing regime to function. Provincial governments had passed enabling legislation to provide for the establishment of producer-run marketing boards.

4.87 It followed that the Canadian dairy marketing system rested on the foundation of the producers themselves. Canada noted that the United States conceded that the producer-run boards were "private entities", "private parties" and "dairy producer organizations".[112] They were organized throughout Canada, from the local level, in-

[112] Canada referred to the United States' Second Written Submission, paras. 59 and 10.

cluding co-operatives, and then up to the provincial[113] and national[114] levels. Through these producer organizations, the individual producers maintained close links with each other and had an effective means for the development of policies and other marketing initiatives. At the provincial level, the key producer-controlled institutions were the milk marketing boards (the "producer boards"). In each province, these boards only came into being through an affirmative vote of the producers. In most provinces,[115] and in Ontario and Quebec in particular, the membership of the boards consisted exclusively of producers. Through on-going consultations at the district and provincial levels, the producers held these elected representatives responsible for their actions. In Quebec, many of the important decisions of the board were the subject of individual voting at general meetings of the producers. Thus, without question, the boards were controlled by, and act on behalf of, the producers.[116]

4.88 Canada argued that the heart of the Canadian dairy system was to be found in the CMSMC (paragraph 2.27). The central actors in the CMSMC were the various provincial producer boards. Each province sent a delegation. These delegations were led by "designated representatives" who were senior executives with the respective producer boards.[117] Provincial government officials participate in an oversight role, without having voting rights. It was the producer board representatives who had the right to vote on and thus directly participate in the CMSMC decisions. As a result, for seven of the nine provinces, representing 92 per cent of Canada's dairy producers, the designated representative was a dairy producer elected to the producer board by fellow dairy producers.[118] Canada noted that even a cursory review of the signature pages of the Comprehensive Agreement on Special Class Pooling showed the signatures of producer boards in addition to the signature of government officials. Nevertheless, Canada did not argue that *only* the producers or the industry were involved. The Comprehensive Agreement on Special Class Pooling, like the NMMP and the CMSMC, represented a co-operative arrangement in which all interested parties, the

[113] At the provincial level, the key organizations were the producer run boards, e.g. the *Dairy Farmers of Ontario*, the *Fédération des producteurs de lait du Québec*, and the *Manitoba Milk Producers*.

[114] At the national level, the producer organization was the *Dairy Farmers of Canada*.

[115] Canada noted that this did not include Nova Scotia, Saskatchewan and Alberta. These three provinces represent less than 10 per cent of Canadian dairy producers.

[116] Canada noted that the very names of the producer boards in Ontario and Quebec, in particular, gave testimony to the boards' own view of themselves: in Ontario, the Dairy Farmers of Ontario and, in Quebec, the Fédération des producteurs de lait du Québec.

[117] Except in Nova Scotia, where the designated provincial representative was a member of the Board of the Nova Scotia Milk Producers Federation and the President of the Dairy Farmers of Canada.

[118] Canada noted that Annex A (attached to its Second Submission) contained a full list and biographical background to the designated provincial representatives to the CMSMC. Canada also referred to comment #2 in Annex 13 with respect to the mischaracterization of provincial delegation representation in Exhibit 36 of the United States. The only non-dairy producer designated representatives were from Alberta and Saskatchewan, which accounted for less than 8 per cent of Canada's dairy farmers.

producers, through the producer boards, and government representatives in their public interest capacity[119] participated.

4.89 Canada argued even a minimal knowledge of Canadian political life would confirm that no federal government institution could ever begin to dictate to provincial representatives where provincial jurisdiction and interests were at stake. Indeed, in this case, the chief provincial speakers were representatives of the industry, not government, this made the picture of unilateral federal government action painted by the Complainants even less credible. The true character of the CMSMC, based on co-operation and consensus, was representative of the character of the Canadian dairy system as a whole. Although the processors did not have voting status in the formal arrangements for the CMSMC, they had a prominent role at the CMSMC table. This was because, as a matter of practice, every effort was made to reach a consensus that could be supported by all provincial producer representatives as well as the other stakeholders in the industry.

4.90 Canada noted that the Complainants, rather than addressing the CMSMC, preferred to stress the CDC, a federal crown corporation, suggesting that it was the true controller of the Canadian dairy system. Their approach was understandable given the true character of the CMSMC, i.e., control in the hands of the producers in consultation with other concerned parties, and the difficulties that this presented for the Complainants' case. Canada argued that whereas the NMMP had provided that the CDC could take decisions for the CMSMC where no consensus was reached in the CMSMC, the provisions of the Comprehensive Agreement on Special Class Pooling took that override authority away with respect to all matters covered by that Agreement (paragraph 2.337). Since the matters covered by the Comprehensive Agreement on Special Class Pooling were very broad, this had left very little subject to the original override provision in the NMMP. This reality fundamentally undermined the attempt by the Complainants to allege that it was the CDC that controlled the Canadian dairy system, not the CMSMC.

4.91 Alternatively, Canada noted that the Complainants had argued that even to the extent that the CMSMC ran the system, it was a body composed of government officials. Canada recalled that for meetings of the CMSMC, for seven of the nine provinces, it was the representative of the producers who took the lead in discussions between provincial delegations. This producer representative, the "designated representative", was elected to the respective producer board by fellow dairy producers. As a result, it was producers who spoke most prominently with respect to the various aspects of the Canadian dairy system as they were brought before the CMSMC and this provided an important flavour to the nature of those proceedings. Nonetheless, representatives of provincial governments did attend and did speak at the meetings of the CMSMC when matters arose touching on their responsibility to oversee the public interest. Thus, through its consensus-based decision making structure, the CMSMC served to bring together the representatives of industry who took the lead on operational matters and representatives of government who ensured that the public interest was respected.

[119] Canada noted that this public interest included ensuring that the interests of consumers and the processors were respected.

4.92 Canada noted that with respect to the processor margins (paragraph 4.81), transactions occurred at the highest milk price which the CDC believed it could achieve, subject to the potential exporter's willingness to participate. Canada argued that there were no standard mark-ups or margins, although the CDC used the return for milk producers that would be generated by making butter and SMP for export as the baseline in negotiating the milk price. The processor margin for CDC export sales was the subject of extensive negotiations between producers and processors following the completion of the Comprehensive Agreement on Special Class Pooling on how the surplus removal system would be implemented.

(e) In- and Over-Quota Milk and the Producers' Choice

4.93 **New Zealand** noted that Canada placed considerable emphasis on the distinction between in-quota and over-quota milk that was destined for export. New Zealand maintained that the objective of the Canadian distinction between in-quota and over-quota milk was to distance over-quota milk even further from government agencies such as the CDC and the provincial milk marketing agencies. However, the distinction between in-quota and over-quota milk was an irrelevant distraction. It was an artificial distinction created for Canadian regulatory purposes that had no reflection in reality. Milk was milk in the tank or in Special Class 5(d) or (e). What Canada had done through the Special Milk Classes Scheme was to determine that the revenue that producers received for their milk would be based on one price for a certain quantity of milk and on a different price for another quantity of milk. Canada had decided that exporters were to pay a different price for milk for products destined for export than that for products destined for domestic consumption; it had thus provided an export subsidy regardless of whether the milk sold to processors for export was classified as in-quota or over-quota milk.

4.94 New Zealand noted that the distinction between in-quota and over-quota milk was not as clear-cut as Canada described it. Whether or not an increase in producers' supply would constitute over-quota production was a determination made by others, not by the producers. Each province managed a complex system according to its own rules. As the Chairman of the CDC had said in April 1998, "there are almost as many ways to manage provincial quota, over-quota production and payment mechanisms as there are provinces".[120] Most provinces had a complex monthly credit and debit system according to which producers who did not fill their quota one month could carry over "quota credits" for future months, or indeed, in the case of Manitoba, for future years.

4.95 New Zealand noted that Canada claimed that over-quota production arose when producers in a province produced milk in excess of their quotas *and as a result* the province as a whole exceeded its share of the national MSQ in a month. Thus, whether a producer produced what ultimately would be determined to be over-quota milk might depend on the level of production in the province as a whole. Furthermore, it was ultimately the CMSMC which decided what would be sold as in-quota

[120] The Chairman of the CDC's Address to the Federation des Producteurs de Lait du Quebec. New Zealand noted that this text was available on the Canadian Dairy Commission's Website (http://www.cdc.ca).

and what would be sold as over-quota milk. Hence, a producer could not know whether milk produced on any particular day, week or month would be treated as in-quota or over-quota, or whether it would be used for domestic or for export purposes. A producer could simply decide to produce more milk. The consequences of producing more milk were in the hands of the milk marketing boards and the CMSMC. Thus, the concept of producers systematically deciding to produce over-quota milk for export purposes after considering current world market prices was far-fetched.

4.96 Nevertheless, New Zealand emphasized that focusing attention on whether a producer produced in-quota or over-quota milk ignored what was really at issue in this case. That was, whether providing exporters with access to lower-priced milk for products destined for export - as occurred with Special Class 5(e) in- and over-quota, as well as with Special Class 5(d) - constituted a subsidy within the meaning of the Agreement on Agriculture.

4.97 New Zealand argued that Canada's claim that individual producers decided, on market considerations, whether to produce over-quota milk misrepresented the facts. Over-quota milk production was not always a result of a deliberate decision by a producer to produce for export.[121] It made sense for producers to slightly overshoot their quotas to allow for fluctuations in milk production caused by weather or biological factors. This was not a deliberate decision to produce for the export market; it was a rational decision to maximize revenue by ensuring they do not underfill their more lucrative in-quota entitlement.

4.98 The **United States** argued that milk was milk; it was not labelled in-quota or over-quota when it was sold - the distinction was not of concern to processors or exporters. What was of concern to exporters was the ability to access their major input at a low cost, which was precisely what classes 5(d) and (e) set out to achieve. Like New Zealand, the United States emphasized that there were a variety of factors, mostly beyond the control of Canadian dairy farmers, that determined whether there was over-quota production in the first place. Many factors, including weather, quality of feed, and the biological condition of the dairy herd, would affect the amount of milk produced in any given time period. Thus, despite a farmer's best efforts to confine production to the amount of his/her quota, doing so was more an art than a science. Production could not be regulated with precision. Moreover, a farmer had an incentive to try to produce the full amount of his/her quota. This was because producing the full amount of quota provided the best opportunity to recover as much of the applicable fixed costs of production as possible since within-quota production was entitled to receive the higher domestic prices, or, at least, a blended price that included primarily higher domestic prices.

4.99 The United States argued that several authorities had testified regarding the difficulty of precisely producing to the level of the quota. Mr. Rick Phillips, Director of Government Affairs, Dairy Farmers of Canada, made the following statement regarding the uncertainty of over-quota production:

[121] New Zealand noted that Canada had noted that only those producers who produce in excess of 105 per cent of their quota were considered to be deliberately producing for the export market. In fact, Canada had admitted that only one third of producers produced milk in excess of 105 per cent of their quota. (Footnote 37 of Canada's First Submission, para. 47)

> "In 1997, Dairy Farmers of Ontario conducted a survey to determine the extent of producer interest in providing milk for the Optional Export Programme. Now, as you probably differentiate this milk supply, which represents a conscious and voluntary exposure to world markets from over-quota milk - and I wouldn't want that to be said in public, as well - producers produced or filled their quota, and that's basically a producer behaviour, and the level of over-quota milk as Mr. Core [President of Dairy Farmers of Ontario] has stated a bit earlier, is sort of dependent on the biological conditions that they find on the farm. In fact, if you happen to be in a state where the feed is good and the cows are calving properly and there is not a whole bunch of diseases, these can add together to create a fairly significant level of over-quota milk. When in fact, under normal chance circumstances, if you didn't have a lot of good things happening at the same time, the level of over-quota milk would be much less."[122]

4.100 The United States noted that Mr. Phillips' views were confirmed by the testimony of Mr. Guy Jacob, President, Canadian Dairy Commission, before Canada's Parliamentary Standing Committee on Agriculture and Agri-Food.

> "Last year the quota was cut by 3%. A farmer had the choice of reducing his production by 3%. He could sell one cow out of that barn and reduce his net revenue. He had to reduce his production because the quota was cut last year by 3%. That's the choice he has. He may decide to keep his production at the level of the previous year and then produce 3% over quota. Then it may happen that this year the feed was a little better, the climate was a little better, and it just happens that he's producing 6% over his quota. That milk is being removed by the CDC at the international price."[123]

4.101 The United States argued that when the level of production by dairy farmers was so greatly influenced by factors largely beyond the producers' control, Canada's assertion that an increase in over-quota production in a single year evidenced the willingness of its farmers to sell at world price levels was simply not credible. Rather, farmers' willingness to sell milk for use in the OEP[124] would be a far better gauge of interest in selling at the Special Class 5(e) price for export. Yet testimony from Mr. Phillips[125], indicated that dairy farmers in Ontario had shown very little interest in participating in the OEP. There had been virtually no use of the OEP for

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[122] Testimony before the Canadian International Trade Tribunal. (United States, Exhibit 33)

[123] United States, Exhibit 45, pp. 21-22. The United States noted that it was significant that Mr. Jacob's testimony had been given in March 1998, nine months into the 1997/98 marketing year. Thus, his comments had particular force respecting the reasons for over-production in that year, including the reduction in the quota that was made at the outset of the marketing year. Mr. Jacob also made the following additional observation about the unpredictability of production levels: "If we could manage to put in some kind of a system instead of having just over-quota production, which is there this year and might not be there next year ... no one can really count on it. A dairy farmer just happens to be producing over quota.", p. 15.

[124] Para. 2.57(b) refers.

[125] United States, Exhibit 33.

the first two years of its authorized usage. [126] Any increase in usage during the 1997/98 year was most likely attributable to the unusual level of over-quota production in that year and the fact that farmers had an opportunity to obtain a higher price for their milk under the OEP than from the CDC dictated price under Special Class 5(e). For example, Manitoba was selling milk for OEP contracts in 1997/98 at $32 per hectolitre compared to the Special Class 5(e) price of between $23 and $25.[127]

4.102 The United States further noted that Mr. Phillips had predicted in hearings before the Canadian International Trade Tribunal that it was very unlikely that dairy producers would voluntarily participate in a new special class:

> "So, again, I would note that a 5-B, which is a typical Class 5 price, most of the variable costs are covered. But when we go down to the world price, the $23.38 in this instance, look across there, you find that the cutoff point is around 18 percent of producers whose variable costs would be covered. That means that a vast majority of producers would definitely not want to produce milk at the world price."[128]

4.103 The United States also observed that Mr. Phillips had testified that only one-half of one per cent of producers in Ontario had shown any interest in participating in the OEP that, like the Special Classes, involved the sale of milk for export at approximations of world market prices.[129]

4.104 The United States stressed that Canada's argument that an increase in over-quota production since the implementation of the Special Milk Classes was evidence that milk producers were deliberately choosing to export milk at world market prices was flawed. First, over-quota production actually declined in the first full year, 1996/97, after the implementation of the Special Milk Classes Scheme. The annual report of the Dairy Farmers of Canada showed that over-quota production actually declined between 1995/96 and 1996/97, both in actual volume and as a percentage of total production.[130] Furthermore, the purported increase in over-quota production between 1996/97 and 1997/98 appeared to be attributable in large part to a decision to reduce the Market Share Quota (MSQ) for 1997/98. The United States noted that information contained in Canada's Exhibit 16 showed that the MSQ had been reduced by one million hectolitres between 1996/97 and 1997/98. When such a major reduction in MSQ occurred, it all but compelled an increase in over-quota production, as it was difficult, if not impossible, for milk producers to reduce production in such a precipitous manner. A one million hectolitre reduction in the MSQ equalled almost one-half of the total over-quota production in 1996/97, which according to the DFC was 2.21 million hectolitres.

4.105 The United States argued that there was the definitional question of what actually constituted over-quota production. Various "flexibility" provisions authorized by several provinces allowed for a departure from the pre-existing practice of

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[126] The United States noted that Mr. Phillips' testimony was confirmed by Canada's answer to the additional questions of the United States.

[127] United States, Exhibit 46.

[128] Hearings before the Canadian International Trade Tribunal in its "Inquiry Into the Importation of Dairy Product Blends", testimony by Mr. Phillips. (United States, Exhibit 33)

[129] *Ibid.* (United States, Exhibit 33)

[130] United States, Exhibit 38.

determining whether a particular milk producer was over-quota based on an analysis of a dairy farmer's daily or monthly production levels. Canada had confirmed the United States understanding that both Alberta and Manitoba permitted such adjustments.[131] Alberta and Saskatchewan performed a year-end price adjustment which applied under-delivered quota against over-quota deliveries. Manitoba currently allowed flexibility for up to 25 days of quota production. This was characterized as a credit that the dairy farmer could use on a rolling basis to apply against over-quota production. The United States understood that other provinces had similar provisions. In addition, Manitoba had introduced a so-called "cover-off" that provided yet another hedge against over-production.[132] While this "cover-off" mechanism was originally instituted for only the months of August through November, Manitoba later extended it to additional months. To the extent that other provinces had similar arrangements, their existence undermined Canada's contention that there existed a consistent definition of over-quota production that dairy farmers consider in their daily production plans.

4.106 The United States noted that whether milk was in-quota or over-quota and what Class price it received was in fact so confusing, that many milk producers apparently did not know whether their production was over-quota and, if it was, what price they would receive for the over-quota production. The Manitoba Milk Marketing Board's newsletter Milkline has responded to milk producers confusion with a number of articles attempting to explain the mechanics of these various schemes.[133] In the face of such uncertainty, it was difficult to comprehend Canada's assertion that dairy farmers were producing over-quota milk in response to price signals from the world market. Moreover, the United States stressed that the price earnings information provided to producers was largely, if not entirely, retrospective.[134] While Canada stated that producers knew that Special Class 5(d) and (e) prices were set on the basis of negotiated transactions, Canada omitted to mention that the returns that producers received from Special Class sales were pooled under the Special Class Agreement if they consisted of in-quota production. In the case of over-quota production, the producer also received a weighted average return based instead on *all* Class 5(e) transactions during the year. Thus, any individual negotiated transaction price was of no direct consequence to an individual producer; his ultimate return from in-quota exports was determined based on the Special Class pooled price and over-quota sales were based on a weighted average Class 5(e) price.

4.107 **Canada** recalled that milk to be used in exported products under the Special Classes arose from two sources of milk: in-quota production and over-quota production.

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[131] The United States referred to Canada's replies to the Panel's Questions 4(b) and 4(d).

[132] United States, Exhibit 49.

[133] The United States referred to United States, Exhibit 48 as an example. In addition, it was noted that the British Columbia Milk Marketing Board reported in its May 1998 newsletter that the increase in over-quota production in the four western provinces during 1997/98 had been attributable not to over-production of industrial milk, but was the result of decreased fluid milk sales (beverage milk). The United States noted that presumably, fluid milk had been diverted into the industrial milk classes as a result and then had showed up as over-quota production. Again, this occurrence had nothing to do with milk producers deliberately deciding to accept world market prices for their milk.

[134] The United States referred to Canada's response to the Panel's Question No. 19(g).

(a) *In-quota milk*: Producers, acting collectively through their milk marketing boards and the CMSMC, controlled the quota level and the amount of milk that was likely to be exported from in-quota production. If prices obtained for milk used to make products for export were not high enough, producers could decide, through their boards, to reduce the quantity of MSQ.[135]

(b) *Over-quota milk*: Individual producers decided whether to supply milk above their individual production quota in the full knowledge[136] that over-quota shipments would receive world market returns. In fact, considerable numbers of producers voluntarily, as a business matter, chose to engage in over-quota production.

4.108 Canada noted that the Complainants suggested that there was no real distinction between over-quota and in-quota milk: "milk was milk", it was all fungible. Canada argued that this was irrelevant: the molecules of milk were not tracked into export or domestic markets. What was relevant was that the producer was perfectly aware when his milk was picked up at the farm gate that his shipment was within his marketing quota or was "over-quota". If it was "over-quota", then the producer knew that his return for this shipment would be in accordance with actual Class 5(e) prices, world market-based prices. This was true regardless of where the molecules in that truckload of milk actually ended up.

4.109 Canada argued that for both in- and over-quota milk, the essence of the Canadian system was that it exposed milk producers to market signals from the export market and allowed them to make business decisions based on those signals. In contrast to the allegations of the Complainants, the government did not direct milk to be used for manufacturing products for export. On the contrary, while milk sold on the domestic market was subject to marketing quotas and price regulation or approval, the quantity or price of milk sold for use in products destined for export markets was determined on a strictly commercial basis. There was no government involvement whatsoever in decisions to participate in the export market. That was a choice left entirely to the producers. Over-quota production for exports did not constitute any sort of pre-condition for a producer's annual allocation of quota for milk sales into domestic markets. In short, the decision to produce for the export market or not was one that was made by producers alone on the basis of true price signals with the objective of profit maximization. The essential feature was that the milk producer was *exposed* to world market-driven prices for dairy products and *responded entirely* on a

[135] Canada noted that most in-quota milk was marketed for domestic use. A limited amount of in-quota milk was marketed for export use. The sources of this milk were the planned fixed amount under Class 5(d) and any additional in-quota milk resulting from the "sleeve" or other milk intended for, but not required by, the domestic market. Canada claimed that the amount of this additional in-quota milk had significantly diminished in recent years. On the other hand, all over-quota milk was intended for the export market, with returns paid to the producer based on Class 5(e) export returns, even if it was required to be re-directed to the domestic market in the event of in-quota shortfall.

[136] Canada stressed that each producer knew the amount of his individual quota and his production. This was clearly indicated on producer cheques. While a producer might not know whether his province was over-quota, the individual over-quota producer received a Class 5(e) return whether or not the province's producers taken collectively were in an over-quota position (Alberta, accounting for 4.77 per cent of Canadian producers was an exception).

commercial, market-driven basis. Canada emphasized that the individual farmers knew their individual quota level and knew that any production above their individual quota would be paid to them at world market prices.[137]

4.110 Canada argued that in the case of *in-quota milk*, the decision to provide for a certain amount of milk within the annual Market Sharing Quota (the "MSQ") was taken by the producers collectively. These decisions were taken at the producer board-dominated Canadian Milk Supply Management Committee (the "CMSMC"), in consultation with the processors. Producer representatives on the CMSMC were accountable through a system of producer democracy that began at the district level, with elected district or regional milk committees. Generally elected members of these committees were directors at the provincial level, and provincial boards were the main voice in deciding on production targets in the CMSMC. Thus, the producers were free to collectively determine whether and to what extent they wished to provide in-quota milk for export purposes. There was no evidence of government control, direction or coercion in this process.

4.111 In the case of *over-quota milk*, any qualified dairy producer in Canada was free to produce as much milk as he or she chose. Specifically, the producer was free to produce any amount of milk over his or her domestic marketing quota, i.e., over-quota production with the understanding that their return for over-quota milk would be based on actual world market-based prices, i.e., the prices realized from Special Class 5(e) sales, taking into account their individual cost structures. The individual over-quota producer received a Special Class 5(e) return whether or not the province's producers taken collectively were in an over-quota position.[138] Accordingly, decisions to participate in over-quota production and to supply milk for export use were market-driven choices made by individual producers. As such, the absence of any government control or direction was clear and unequivocal.

4.112 In respect of the assertions of the United States with respect to testimony of officials of the Dairy Farmers of Canada (DFC) before the Canadian International Trade Tribunal (CITT), Canada argued that the testimony had been taken completely out of context and did not support the US proposition (paragraph 4.102). The context of the DFC testimony was an inquiry by the CITT, initiated at the request of the Canadian government, into issues raised by increased imports of blends of dairy products, particularly butteroil/sugar blends, into Canada. Among the various options considered by the CITT was the possibility that producers may wish to create a Special Class price to service the *domestic* butterfat market at world prices. The DFC testimony to which the United States referred was addressing this option, not the question of individual producers deciding to produce milk at world market prices for the export markets. This distinction had been made abundantly clear in the DFC's Final Agreement before the CITT:

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[137] Canada noted that this was with the exception of producers in Alberta and Saskatchewan, where under-shipment by some producers would lead to adjustments of the prices paid for over-quota shipments by others.

[138] Canada noted that in Alberta, shipments in excess of an individual farm quota could be offset because of under-production on other farms. In all other provinces and individual that produced milk in excess of the individual farm quota received the world price for that milk, regardless of the production of other individuals.

> "7.1.6 There is evidence that some dairy producers produce quantities in excess of MSQ. This is done by producers who voluntarily seek to increase production for participation in world markets. Certain low cost producers may also voluntarily decide to actively participate in world markets through the Optional Export programme. These producer decisions, however, must not be confused with a proposal to service the domestic butterfat market using within quota production at world prices. The recent decision to reduce MSQ is clear evidence that dairy producers are not willing to produce irrespective of domestic market requirements."[139]

4.113 In the case of both in-quota and over-quota milk production, the claim of the Complainants that the Canadian dairy system was government-controlled and directed had to fail. Particularly with respect to the marketing of over-quota milk for export purposes, this represented a decision, by the governments, not to intervene, to avoid the use of the discretionary authority provided to the boards and rely instead on market-driven results. To suggest that such a restraint from intervention constituted government action resulting in export subsidies was not logical.

4.114 In respect of pooling, Canada argued that contrary to suggestions from the Complainants, pooling was not an obligation that had been forced on the producers by coercive governments. Pooling was a consensus-based arrangement that the producers, through their boards, had agreed to, pursuant to the terms in the Comprehensive Agreement on Special Class Pooling (the P9 Agreement) and the P6 and P4 Agreements (paragraph 2.24). The producer boards were full signatories of those agreements, which were co-operative agreements involving all interested stakeholders. These agreements were not agreements between governments to impose on the dairy industry and the dairy producers, in particular, certain arrangements and requirements, as suggested by the Complainants. Each producer board had joined in pooling freely, and they were equally free to leave the pooling arrangements. The provincial producer boards could agree at any time to cease any sharing of revenues and markets. Indeed, to give a practical example, the Manitoba producer board had temporarily opted out of the P6 pool, pending their evaluation of their participation. Under the enabling legislative framework, such decisions could not be overridden by provincial or federal governments.

4.115 Canada noted that it was also possible for a provincial producer board to partially withdraw from the pooling of revenues if it so chose. For example, as outlined in US Exhibit 39, under an experimental programme introduced in the province of Manitoba, two per cent of each producer's daily quota had become optional and was no longer pooled. Producers could choose to ship this quantity of their quota, at a known, non-pooled return, based on realized returns in Class 5. The volumes associated with this experimental programme approximated the share of in-quota Class 5(d) and (e) production in Manitoba. By filling this portion of the provincial MSQ through voluntary shipments by producers at non-pooled prices, the producer board reduced the exposure of other producers who did not ship the optional quantity to

[139] Canada referred to arguments of the DFC, Dairy Farmers of Ontario, *Federation des producteurs de lait du Québec*, 20 April 1998 (Canada, Exhibit 52, p.21, para. 7.1.6).

Class 5 returns. In other words, contrary to US assertions, this was an example of a provincial producer board giving its members an option to increase or decrease their participation in Class 5 sales. Significantly, this was a unilateral decision by the Manitoba producers acting through their board. Contrary to the image of government coercion suggested by the Complainants, no permission was required from the Government of Canada or the CDC. No government sanctions followed this decision by producers to reduce their participation in the pooling of returns. Canada emphasized that the Special Milk Classes Scheme was producer-driven and necessarily based on co-operation and consensus.

4.116 Canada noted that the United States had stated that the amount of in-quota milk sold for export use exceeded that from over-quota sources. While it was true that in-quota export sales did exceed over-quota sales in 1995/96, by 1996/97 the two were in balance. Most recently, in the 1997/98 dairy year, with the growth of over-quota and the full use of the "sleeve" in domestic markets, over-quota export sales had begun to greatly exceed in-quota export sales. It was also suggested that over-quota production was actually in decline. The United States noted that there was a decline from 1995/96 to 1997/98. There was indeed a small decline between those two years but it was misleading to suggest that this was the general trend.[140] In fact, there had been substantial growth the previous year and an even greater increase in 1997-98. It had also been suggested that growth in over-quota production was the result of the reduction of MSQ. Yet this was equally invalid. The growth in over-quota had greatly exceeded any reduction in MSQ.[141]

4.117 Canada noted that the Complainants assumed that when products were exported at lower prices than those same products would command in the home market, there had to be a subsidization of the lower-priced exported products through profits obtained on the domestic market. Canada rejected these arguments. The Complainants had offered no evidence or explanation of why, in the absence of government direction or without the linking of domestic sales quota to export performance, producers would give away their profits from domestic sales in order to make unprofitable export sales. Indeed, they had failed to demonstrate *any* incentive to finance export sales from domestic profits. This argument was based on an assumption that milk producers behaved irrationally, or that governments somehow, in some unexplained way, forced them to reduce their net profits to engage in export sales. Canada argued that as a result of the supply management system and the presence of border protection, there were two very different markets: (i) a limited domestic market allocated to producers via quotas; and (ii) an open international market available to any producer willing to supply under conditions prevailing in that market. There was nothing in the Canadian milk marketing system that forced producers to supply the international market if they did not want to do so. The Complainants had failed to provide any evidence supporting the existence of any such mandatory performance requirement imposed on Canadian producers that would confer a benefit to exporting processors. Hence, Canada argued that the decision to produce or not to produce was one made on the basis of the same criteria that every commodity producer, indeed,

[140] Canada referred to the graphic attached as Figure 2 of Canada's Annex D.
[141] Canada referred to the graphic attached as Figure 2 of Canada's Annex D.

any business person would make - the enhancement of the producer's net profits. The only reason for Canadian producers to sell products for the export market was because they could do so profitably. The protection of the domestic market afforded by tariffs did not alter this basic fact.

4.118 In respect of the price difference between OEP sales and Class 5(e) sales, Canada emphasized that the price difference between OEP sales and Class 5(e) sales stemmed from the commercial terms of the contract under which producers produced OEP milk. In OEP transactions, both the volume of milk supplied to the processor by the individual producer and the price paid for that OEP milk by the processor were contractually negotiated well in advance of the milk production with a view to fulfilling a pre-planned export contract made by the processor with a foreign buyer. By way of contrast, Class 5(e) milk sales were not pre-planned. Class 5(e) milk was normally used in dairy products sold on international spot markets. The pre-planned nature of an OEP transaction provided the processor with a secure supply of milk, an assured level of plant utilization and a guaranteed export sale price for a transaction identified in advance for its superior returns. For this assurance of supply, processors were willing to pay a premium for OEP milk. Canada argued that these market characteristics would exist even if producers negotiated Class 5(e) sales prices on their own or through their producer boards rather than using the CDC as a collective sales agent. As for the matter of processor margins, OEP processor margins were commercially confidential to the individual processor and were not made known to the producers, the producer boards or the CDC.

4.119 Canada argued that over-quota and OEP production came down to a matter of individual producer choice, as was illustrated by the dairy producer leaders who were CMSMC representatives and members of the Board of Directors of Dairy Farmers of Canada. Some of those producer representatives simply aimed to fill their domestic quota and not to participate in export market opportunities through the production of over-quota or OEP milk. For example, the DFC Director for Saskatchewan, Leo Bertoin, had been 0.04 per cent over, 0.03 per cent under and 0.004 per cent over his producer quota for 1995/1996, 1996/1997 and 1997/1998, respectively. By way of contrast, the President of DFC, Barron Blois, a producer from Nova Scotia who was also a provincial spokesperson at the CMSMC, had actively participated in over-quota export opportunities made possible by changing his feeding programme to reduce cash costs. Mr. Blois had consistently been in an over-quota position since the Special Milk Classes Scheme was introduced and was currently producing 20 per cent above his producer quota. The DFC Director for New Brunswick, Jacques Laforge, who was also the provincial spokesperson for New Brunswick at the CMSMC, had only produced to the level of his domestic quota but had also actively concentrated on available OEP markets.[142]

4.120 The **United States** noted that Canada's argument that producers collectively decided to produce for export as part of their determination of MSQ for the year was contradicted by Canada's experience in 1997. In 1997/98, the MSQ was set at the

[142] Canada noted that Mr. Laforge filled 100.01 per cent of his quota in 1995-1996 and was currently at almost exactly 100 per cent of his quota. Mr. Laforge has participated in an OEP contract for the sale of evaporated milk to the Caribbean.

beginning of the year at a level that presumably built in a specific amount for planned exports, in the so-called "sleeve". However, Canada had stated that almost all of the sleeve had been used last year for the domestic market. Consequently, any decision to produce for export within in-quota production, based on the MSQ at the beginning of the year, simply had not been realized when the domestic marketplace required more milk. Instead, those producers received primarily domestic prices for almost all of their in-quota production. As had been noted, whether milk was classified as in-quota or over-quota was subject to a variety of factors, and especially the fluctuation of MSQ from year to year.

4.121 The United States emphasized the significant increase in MSQ for the 1998/99 year (see table under paragraph 2.31). This increase was the clearest evidence that the CDC/CMSMC had seriously misjudged domestic requirements in the previous year. The reduction in MSQ in 1997/98 also was in large measure responsible for the unusual change in the relative proportion of over-quota versus in-quota exports in that year.[143] Even if domestic consumption in Canada remained at the high levels enjoyed in 1997/98, the 1998/99 increase in MSQ would necessarily result in a significantly higher percentage of in-quota exports in the current marketing year. The United States submitted that the 1997/98 marketing year was an aberration with respect to the low level of in-quota milk that was used for planned exports or determined to be surplus. That situation was primarily a result of a reduction in MSQ that turned out to be totally unjustified by market circumstances. In this connection, the United States noted that this judgment error had been corrected for the 1998/99 marketing year as the MSQ for the current year had been readjusted to restore the full amount of this reduction and actually included an increase over the 1996/97 MSQ level. This should result in a decline in over-quota production. The restoration of MSQ to earlier levels no doubt was a result of milk producers' complaints that they were being compelled to sell milk at Class 5(e) prices by the reduction in MSQ in 1997/98 which bore no relationship to market conditions. The United States argued that this significant shift of MSQ highlighted the artificiality of the over-quota/in-quota distinction, and the inability of milk producers to quickly adjust to dramatic swings in the MSQ such as occurred between 1996/97 and 1997/98. In fact, the reduction in MSQ in 1997/98 of approximately 3 per cent, when factored with Canada's statement that only over-quota production by individual producers above the 105 per cent level could be considered to be deliberate (see Footnote 121), accounted for at least two thirds of all over-quota production during the 1997/98 marketing period. Thus, Canada's assertion that over-quota production reflected milk producers' deliberate decisions was belied by the very information that Canada had submitted.

4.122 Like New Zealand, the United States stressed that the designation of milk as "surplus" was essentially an arbitrary one. The Canadian system was predicated on the assumption that the domestic population would only consume so much butter, so much cheese, so much ice cream and yoghurt, etc., at desired price levels in a given year and that this translated into class prices for milk. However, many of these dairy products were storable. Therefore, the decision to designate milk as "surplus" was

[143] The United States referred to Figure 2 of Canada's Response to the First Set of Questions from the Panel.

really a decision not to build domestic stocks of dairy products for later consumption. Processors resisted stock building because as stocks grew they exercised downward pressure on the prices at which processors could sell their dairy products, and processors' profit margins would be eroded as a result. Producers disliked stocks because dairy product stocks represented a quantity of milk that would not be required at a future date, i.e., milk production would have to be cut while Canadians consumed the products in stock. Canada's solution was to export the surpluses using subsidies, and thereby maintain both high domestic price and production levels.

4.123 The United States refuted Canada's comparison of how prices were established under the OEP versus under Class 5(e) milk (paragraph 4.118). Canada's own explanation supported the conclusion that the Special Class prices were particularly low, given the international dairy marketing conditions. Canada was over-simplifying the commercial context of these sales. While Canada contended that OEP prices could be higher, in part, because they generally involved advance purchases of milk and, therefore, established a secure source of milk for the processors - Canada had earlier stated that many of the export transactions under Special Class 5(e) involved repeat sales involving the same exporters and international customers. If that was true, then the distinction that Canada now attempted to draw between OEP and Class 5(e) sales lacked a factual foundation.

2. "Export Subsidy" - the Interpretive Context

(a) The SCM Agreement and the Agreement on Agriculture

4.124 **Canada** argued that the definition of "export subsidies" for the purposes of the Agreement on Agriculture was found in Article 1(e) of the Agreement. This definition contained two components:

(a) the first component was "subsidies contingent on export performance";

(b) the second component included as export subsidies for the purposes of the definition the export subsidies specifically listed in Article 9 of the Agreement.

4.125 Canada further noted that Article 10.1 of the Agreement on Agriculture made an explicit reference to "(e)xport subsidies not listed in paragraph 1 of Article 9." Article 10.3 spoke of "no export subsidy, whether listed in Article 9 or not." Thus, Canada submitted that Article 10 in general, and Article 10.1 in particular, recognized the dual nature of the definition found at Article 1(e) of the Agreement. Article 10.1 applied only[144] with respect to "export subsidies" as defined in Article 1(e) other than those export subsidies that were included in the definition by virtue of having been explicitly listed in Article 9. What was left of the definition of "export subsidies" was the first component of the definition (i.e., "subsidies contingent on export performance" without including export subsidies specifically listed in Article 9 of the

[144] Canada noted that the other instance in which Article 10 applied was with respect to non-commercial transactions but this application was not relevant in the present matter before the Panel (para. 4.258).

Agreement). Thus, the "other export subsidies" referred to in Article 10.1 meant "subsidies contingent on export performance", excluding the export subsidies specifically listed in Article 9 of the Agreement.

4.126 The term "subsidies contingent on export performance" itself had two components: (i) "subsidies" and (ii) "contingent on export performance". The term "subsidy" was not defined in the Agreement on Agriculture. Canada's position was that the prime contextual interpretative source for the meaning of the term "subsidy" was the definition of "subsidy" found in the SCM Agreement.[145] While the potential application of other sources for the interpretation of the term "subsidy" in the Agreement on Agriculture could not be excluded, the Complainants had not been able to identify any source having anything like the interpretative force of the definition of "subsidy" found in the SCM Agreement. Accordingly, "other export subsidies", as used in Article 10.1 of the Agreement on Agriculture, included "subsidies" (as interpreted in the context of the SCM Agreement) that were contingent on export performance, other than the export subsidies specifically listed in Article 9 of the Agreement on Agriculture.

4.127 Canada argued that the list of export subsidy practices found in Article 9.1 served two purposes in the Agreement on Agriculture. On one hand, it served as an exhaustive list of export subsidy practices that were subject to the reduction requirements set out in the Agreement. It also provided an illustrative list of export subsidy practices to be included within the definition of "export subsidy" in Article 1(e) of the Agreement. Both as an exhaustive list under Article 9 and as an illustrative list for the definition in Article 1, the text precisely reflected the common agreement by all Members regarding which practices should be considered "export subsidies" for the purposes of the Agreement on Agriculture. By the same token, the text also reflected where there was an absence of common agreement with respect to whether a particular practice should be considered to be an export subsidy (paragraphs 4.446 and following). In respect of criteria for export subsidies relating to differences between export and domestic prices, no reference could be found amongst the items listed in Article 9.1, with the exception of Article 9.1(b). The fact that a reference to domestic and export prices was included *only* with respect to paragraph (b) of Article 9.1 suggested that the negotiators could agree to such a reference *only* with respect to Article 9.1(b).[146]

4.128 Canada emphasized the importance of the origin and character of the definition of a "subsidy" in the SCM Agreement. The SCM Agreement achieved what had not been possible during the life of the GATT 1947: a definition for the term "subsidy". This definition reflected a compromise reached by the negotiators in the Uruguay Round. As such, it reflected the practical realities of negotiations and represented a statement of what, by the end of the negotiations, the negotiators had been able to agree would be a "subsidy" for WTO purposes. It followed, therefore, that

[145] Canada agreed that the definition of "subsidy" in the SCM Agreement was not the "definition", in the technical sense, of "subsidy" in the Agreement on Agriculture.

[146] Canada noted that the other provision involving domestic and export price differences in the context of export subsidies was Paragraph (d) in the Illustrative List to the SCM Agreement. In that instance, the example provided was extremely carefully limited to very particular circumstances in recognition of the far-reaching implications of the concept.

any measure or practice that did not fall within the terms of the definition could not be considered to be a subsidy for WTO purposes, regardless of any other conceptions or proposals as to what ought to constitute a "subsidy". Canada argued that it was not suggesting the agreed definitions of "subsidy" and "export subsidy" were perfect conceptions. There was no doubt that many WTO Members would prefer amendments in pursuit of their own policy objectives preferences. Perhaps proposals would be brought to the negotiating table for the next round of WTO negotiations. What the Complainants could not be allowed to do was to create an effective alteration of the negotiated texts through litigation.

4.129 **New Zealand** claimed that sources relevant to the interpretation of the word "subsidy" were: the Agreement on Agriculture, which provided the immediate context for the interpretation of the term "subsidy", and subsequently, the broader context of the WTO. The latter included, in particular, the SCM Agreement together with its Illustrative List of Export Subsidies, GATT 1994 and WTO/GATT practice.

4.130 New Zealand argued that in the present case, the question of the meaning of the term "subsidy" arose on two occasions: in the interpretation of Article 9.1(a) which referred to "direct subsidies"; and in the interpretation of Article 10 which referred to "export subsidies ... applied in a manner which results in, or which threatens to lead to, circumvention ... ". In each case, the question had to be asked what constituted a subsidy. New Zealand contended that the answer to this question had to be sought *initially* in the context of the Agreement on Agriculture and then more broadly in the context of the WTO Agreements as a whole. In this regard, the particular relationship of the Agreement on Agriculture and the SCM Agreement, recognized by the Appellate Body in *Brazil - Measures Affecting Desiccated Coconut*[147], meant that the SCM Agreement was clearly part of the context to be referred to within the meaning of Article 31 of the Vienna Convention on the Law of Treaties (the "Vienna Convention") when interpreting the Agreement on Agriculture.[148]

4.131 However, referring to the SCM Agreement as part of the context for the interpretation of the concept of "subsidy" in the Agreement on Agriculture was not the same as simply fastening onto one definition from the SCM Agreement and treating it as if it were an overriding definition for the purposes of all of the WTO Agreements. In fact, reference to the SCM Agreement could include reference to the definition in Article 1, or to the Illustrative List of Export Subsidies in Annex I, or to parts of those definitions and lists. Reference could also be made within this broader context to what constituted a subsidy under GATT 1947 and under GATT practice.

4.132 In New Zealand's view Canada's approach in this case was based on a fundamental interpretative error. Rather than addressing the key issue of interpretation in this case - the meaning of the term "export subsidy" as used in Article 9.1 and Article 10 of the Agreement on Agriculture - Canada instead focussed on the meaning of the term "subsidy", and proceeded to argue that the exercise of interpretation of this term as used in the Agreement on Agriculture could be largely confined to a consideration

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[147] Appellate Body Report on *Brazil - Measures Affecting Desiccated Coconut*, (hereafter "*Brazil - Desiccated Coconut*"), WT/DS22/AB/R, adopted 20 March 1997, DSR 1997:I, 167.

[148] New Zealand noted that the SCM Agreement was particularly relevant, as it contained a list of export subsidies which constituted the background against which the export subsidy provisions of the Agreement on Agriculture were negotiated.

of the definition of subsidy found in Article 1 of the SCM Agreement. Canada's failure to locate the interpretation of export subsidies within the Agreement on Agriculture resulted in its ignoring the rules of interpretation applicable to the WTO Agreements which had been endorsed by the Appellate Body, and in limiting the scope of the disciplines that were carefully negotiated in the Agreement on Agriculture. Canada was hence inviting the Panel to read into the WTO Agreements an extravagant interpretative relationship between the Agreement on Agriculture and the SCM Agreement, and to make broad pronouncements on the scope of the SCM Agreement that were not necessary for this dispute.

4.133 New Zealand argued that by its very wording Article 1 of the SCM Agreement was limited to that Agreement. The opening words of Article 1 were "For the purposes of *this* Agreement" (emphasis added). Article 1 went on to say, "a subsidy *shall be deemed* to exist if ..." (emphasis added). Hence, New Zealand argued that the drafters did not intend this to be a definition for all purposes; it was simply a listing of what was deemed to be a subsidy for the purposes of the SCM Agreement. Canada had, in New Zealand's view, interpreted the terms of Article 1 of the SCM Agreement in isolation and therefore ignored the specific context of the SCM Agreement itself. If Canada had interpreted Article 1 in the context of the SCM Agreement as a whole, it would have been forced to conclude that, in the context of a discussion on export subsidies, the meaning of Article 1 had to be read also in the light of the Illustrative List of Export Subsidies. Yet, in New Zealand's view, for Canada, the Illustrative List appeared to stand alone as a separate list of export subsidies having no necessary relationship to Article 1 of the SCM Agreement.

4.134 New Zealand further argued that there was nothing in the Agreement on Agriculture that incorporated the SCM Agreement definition. Indeed, the implication of Article 21 of the Agreement on Agriculture, which subordinated the provisions of GATT 1994 and the other Multilateral Trade Agreements in Annex 1A to the WTO Agreement to any contrary provision in the Agreement on Agriculture, was that if the Agreement on Agriculture was to be dependent on another Agreement, that dependency would have to be express. The fact that at the end of the implementation period agricultural export subsidies would be subject to the disciplines of the SCM Agreement, as contemplated in Article 13(c) of the Agreement on Agriculture, did not necessitate that there had to be a coincidence of definition between the two Agreements on what constituted a subsidy. New Zealand argued that the relevance of Article 21 of the Agreement on Agriculture was that it made plain that in the event of a conflict between the Agreement on Agriculture and another WTO Agreement, the Agreement on Agriculture was to prevail. In other words, if an export subsidy were to meet the terms of one of the sub-paragraphs of Article 9.1 (relating to the category of export subsidies subject to reduction commitments) but yet did not meet the definition of Article 1 of the SCM Agreement, it would nonetheless still constitute an export subsidy for the purposes of the Agreement on Agriculture.

4.135 New Zealand argued that to simply transpose the definition provided in Article 1 of the SCM Agreement made no sense within the context of the Agreement on Agriculture. Article 1(e) defined the term "export subsidies" as referring to "subsidies contingent upon export performance, including the export subsidies listed in Article 9 of this Agreement." At the outset, this was potentially a broader definition than Article 1 of the SCM Agreement because Article 9 subsidies were included within it whether or not they met the definition of subsidy in Article 1 of the SCM Agreement

or any other definition. They were export subsidies by virtue of the definition in Article 1(e) of the Agreement on Agriculture. It made no sense to re-test them by reference to some other definition of subsidy.

4.136 New Zealand argued that in effect, the relationship between the export subsidies listed in Article 9.1 of the Agreement on Agriculture and the definition of export subsidies set out in Article 1 of that Agreement was similar to the relationship that existed in the case of the Illustrative List of Export Subsidies in Annex I of the SCM Agreement and Article 3.1 of that Agreement. These were export subsidies *by definition* and they did not need any further testing against a definition of subsidy or export subsidy set out in the respective provisions of the two Agreements.

4.137 New Zealand further argued that while the export subsidies listed in Article 9 of the Agreement on Agriculture were exhaustive of the export subsidies for which reduction commitments had to be entered by Members, they were also, by virtue of their inclusion in the definition of "export subsidies" in Article 1 of the Agreement on Agriculture, indicative or illustrative of the broader category of export subsidies referred to elsewhere in the Agreement. This, too, argued against an interpretation of the term "subsidy" in the Agreement that limited it to the specific requirements of Article 1 of the SCM Agreement. It also had implications for the determination of what constituted an "export subsidy" under Article 10 to which the non-circumvention provisions of that Article applied.

4.138 The **United States** argued that the term "export subsidy" was defined in Article 1(e) of the Agreement on Agriculture, although the term "subsidy" was not. Article 9 of the Agreement on Agriculture, however, set forth a non-exhaustive list of export subsidies. That list served to inform the meaning of the term "subsidy" for the purpose of the Agreement on Agriculture.

4.139 The United States stressed that the meaning of the term "subsidy" in the Agreement on Agriculture had to be determined in its context, including the other WTO Agreements and the GATT 1994; it was not governed either exclusively or primarily by Article 1 of the SCM Agreement. The United States maintained that Canada's argument that the SCM Agreement's definition of "subsidy" was the exclusive basis for discerning the meaning of that term for purposes of all the WTO Agreements, including the Agreement on Agriculture, disregarded the plain meaning of the opening words of Article 1 of SCM Agreement as well as the views of the Appellate Body.[149] The definition of "subsidy" in the SCM Agreement was relevant for purposes of interpreting the same term used in the Agreement on Agriculture, but it was not to be given more weight, however, than the provisions of the Agreement on Agriculture.

[149] The United States noted that the Appellate Body also recognized this relationship when it stated that "with respect to subsidies on agricultural products ... [t]he Agreement on Agriculture and the SCM Agreement reflect the latest statement of WTO Members as to their rights and obligations concerning agricultural subsidies." Appellate Body Report on *Brazil - Desiccated Coconut, op. cit., p. 13*, DSR 1997:I, 178 IV C..

(b) The Relevance of the Vienna Convention and Negotiating History

4.140 **New Zealand** argued that there was no need to define the term "subsidy" in the abstract. The term needed definition when it arose in the context of a particular provision of the Agreement. What constituted an export subsidy under Article 10 would necessarily differ from what constituted an export subsidy under Article 9, because Article 10 was concerned with export subsidies that were not listed in Article 9. Yet both articles used the term "subsidy". The correct approach to interpretation in the case at issue was to apply the customary principles of interpretation of public international law as required by Article 3 of the DSU. This meant applying the principles of interpretation set out in the Vienna Convention on the Law of Treaties - that is, giving words their ordinary meaning in their context and in the light of the object and purpose of the treaty as a whole.

4.141 New Zealand argued that there was nothing in the negotiating history of the Agreement on Agriculture or the SCM Agreement that suggested that the negotiators intended that the definition of "subsidy" in the SCM Agreement would be simply accepted as the definition of subsidy in the Agreement on Agriculture, or for that matter in other WTO Agreements. Indeed, the fact that the negotiations were conducted separately, and that two separate Agreements were concluded, suggested that, contrary to the Canadian position, there was no understanding reached that the definition of Article 1 of the SCM Agreement would be the exhaustive or governing definition of subsidy for the purposes of the Agreement on Agriculture. Furthermore, the negotiators did not purport to work out all the details of the relationship between the two Agreements. It was well understood at the end of the Uruguay Round that the relationship between the Agreement on Agriculture and the SCM Agreement was to be worked out in practice.[150]

4.142 New Zealand argued that the Uruguay Round did not result in a universal definition of the term "subsidy" for the purposes of all of the WTO Agreements. There was a definition for the purposes of the SCM Agreement in Article 1 of that Agreement, although that definition had also to be read in the light of the list of export subsidies in the Illustrative List. The Agreement on Agriculture did not contain any such definition. Thus, in interpreting the Agreement on Agriculture other definitions in the WTO Agreements, in particular the SCM Agreement, were relevant but not determinative.

4.143 The **United States** noted that although the Agreement on Agriculture did not list all export subsidies or define the term "subsidy," the Appellate Body had indicated that it was neither necessary nor appropriate to confine the interpretative analysis of the terms of an Agreement to the text of the particular treaty provision.[151] In addition, treaty interpreters could look to the customary rules of interpretation of public international law reflected in the Vienna Convention for assistance in con-

[150] New Zealand noted that commentators had noted that "one of the principal tasks for WTO member countries during the implementation period will be to sort out the overlap" between the Agreement on Agriculture and the SCM Agreement; Stewart T. P. (ed.), The World Trade Organisation: The Multilateral Framework for the 21st Century and US Implementing Legislation, Washington, American Bar Association, 1996, p. 171.

[151] Appellate Body Report on *Brazil - Desiccated Coconut, op. cit.*

struing the terms of a treaty provision. As an additional aid to interpretation the Appellate Body had emphasized Article XVI:1 of the WTO Agreement[152] which provided that:

> "Except as otherwise provided under this Agreement or the Multilateral Trade Agreements, the WTO shall be guided by the decisions, procedures and customary practices followed by the CONTRACTING PARTIES to GATT 1947 and the bodies established in the framework of GATT 1947."[153]

4.144 The United States noted that the reports developed under GATT Article XVI, the Tokyo Round Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the GATT ("the Subsidies Code"), and the SCM Agreement were therefore relevant to interpretation of the term "export subsidy" as used in the Agreement on Agriculture.

4.145 The United States noted that a recurring theme appeared in the GATT and WTO discussions of subsidies. There had long been a reluctance to provide a specific and exhaustive definition of the term "subsidy" for fear of inadvertent exclusion of a particular practice or inability to foresee the development of some new type of subsidy.[154] Thus, a 1960 panel on subsidies noted the longstanding lack of an explicit definition for the term.[155] Another panel "considered that it was neither necessary or feasible to seek an agreed interpretation of what constituted a subsidy."[156] Despite this initial reluctance to confine the scope of the term subsidy by compiling lists of recognized subsidy practices, panels had identified various guidelines inherent in the GATT rules on subsidies as to what could be considered to fall within the term subsidy and what lay outside.[157] Article 1 of the SCM Agreement now provided a definition of subsidy.

4.146 The United States noted that one of the first illustrative lists of subsidies was contained in a 1960 Working Party Report, which was the precursor for the illustrative lists contained in both the Tokyo Round Subsidies Code and the WTO SCM Agreement.[158] That Report set forth a detailed list of measures that had been considered to be export subsidies by a number of Contracting Parties, including both the

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[152] Appellate Body Report on *Brazil - Desiccated Coconut, op. cit.*, p. 12.

[153] The United States noted that the term subsidy had not been expressly defined in either the GATT 1947 or in the Tokyo Round Subsidies Agreement interpreting GATT Article XVI. It had not been until the entry into force of the SCM Agreement (under the WTO), that the term "subsidies" had been defined in either a GATT or WTO Agreement.

[154] BISD 10S/201, L/1442, adopted 21 November 1961, para. 23.

[155] "Operation of the Provisions of Article XVI", adopted 21 November 1961, BISD 10S/208, para. 23. The United States noted that one commentator had noted that in spite of the great care taken by the GATT to establish detailed procedures to regulate the use of subsidies, there was no internationally binding definition of what constituted a subsidy for a substantial time period. Beseler, *Anti-dumping and Anti-subsidy Law* p.119.

[156] J. Jackson, "World Trade and the law of the GATT" (1969), citing GATT, BISD 10S/201, para. 23.

[157] The United States referred to, *e.g.,* Working Party Report on *Provisions of Article XVI:4*, L/1381, BISD 9S/185, adopted 19 November 1960, para. 5.

[158] *Ibid.*

United States and Canada.[159] Among the practices determined to be an export subsidy were the deliveries by government or governmental agencies of production inputs "for export business on different terms than for domestic business ... "[160] This was, in the view of the United States, the essence of the Special Milk Classes Scheme, which provided for provincial government dairy boards to deliver discounted milk to manufacturers of dairy products for export. During the same year, another panel examined the scope of the export subsidy reporting requirement under Article XVI of GATT 1947.[161] The panel in its review considered whether producer-financed subsidies were notifiable under Article XVI and determined that they were subject to the reporting requirement where the "levy/subsidy schemes affecting imports or exports ... are dependent for their enforcement on some form of government action."[162] The panel's conclusion was that producer-financed export subsidies that were part of a government-directed system were essentially indistinguishable from direct government export subsidies.[163]

> "The Panel examined the question whether subsidies financed by a non-governmental levy were notifiable under Article XVI. The GATT does not concern itself with such action by private persons acting independently of their government except insofar as it allows importing countries to take action under other provisions of the Agreement. In general there was no obligation to notify schemes in which a group of producers voluntarily taxed themselves in order to subsidize exports of a product. The Panel felt that in view of the many forms which action of this kind could take, it would not be possible to draw a clear line between types of action which were and those which were not notifiable. *On the other hand, there was no doubt that there was an obligation to notify all schemes of levy/subsidy affecting imports or exports in which the government took a part either by making payments into the common fund or by entrusting to a private body the functions of taxation and subsidization with the result that the practice would in no real sense differ from those normally followed by*

[159] The United States referred to, *e.g.,* Working Party Report on *Provisions of Article XVI:4*, L/1381, BISD 9S/185, adopted 19 November 1960, p. 188 (the "industrialized countries in Western Europe and North America.").

[160] The United States noted that although the example contained in the list referred to inputs consisting of imported raw materials, the concept of differential prices constituting a subsidy when the preferential prices were extended exclusively to export production had been recognized, para. 5. See also, Paragraph (d) of the Illustrative List of Export Subsidies contained in Annex I to the SCM Agreement.

[161] Panel Report on *Review Pursuant to Article XVI:5, op. cit.*

[162] *Ibid.*, p.192, para. 12.

[163] The United States noted that the Government of Sweden later reached an identical conclusion as observed in its 1990 WTO offer, where it stated that: "In the country list, Sweden has indicated how producer-financed export subsidies in Sweden have had an effect similar to budget financed export subsidies. It is consequently Sweden's opinion that producer-financed export subsidies could be just as trade distorting as government funded export subsidies, and should therefore be tightly circumscribed in order not to compromise reform efforts on the latter form of subsidies. This should be reflected in the disciplines to be worked out under the GATT to govern producer-financed export subsidies."

> *governments.* In view of these considerations the Panel feels that the question of notifying levy/subsidy arrangements depends upon the source of the funds and the extent of government action,[164] if any, in their collection. Therefore, rather than attempt to formulate a precisely worded recommendation designed to cover all contingencies, *the Panel feels that the CONTRACTING PARTIES should ask governments to notify all levy/subsidy schemes affecting imports or exports which are dependent for their enforcement on some form of government action.*" (emphasis added) [165]

4.147 The United States argued that the analysis of the May 1960 panel was also reflected in work prepared by the GATT Secretariat in support of the Uruguay Round negotiations on the Subsidies and Countervailing Measures Agreement. In a paper prepared by the Secretariat, broadly examining a variety of issues pertinent to the subsidies negotiations,[166] the Secretariat recounted the discussion of the 1960 Panel Report and its conclusions regarding the lack of a meaningful distinction between the producer-financed export subsidies that were enforceable by a government and direct government subsidization of exports.[167] The United States noted that the SCM Agreement recognized in Article 1.1(a)(1)(iv) that entities other than governments could perform functions normally vested in the government, and that that could also constitute a subsidy (this argument is further developed in paragraph 4.333 and following).

4.148 The United States pointed out that in the Uruguay Round, producer-funded export assistance with significant government related action continued to be viewed as an export subsidy. Thus, the discussions during the Uruguay Round in the Secretariat papers prepared for the Chairman of the Committee on Agriculture[168], as well as the proposed framework agreement developed by Chairman de Zeeuw[169] and the notes prepared by Chairman Dunkel[170] all characterized producer-financed export assistance as export subsidies. The only issue that surrounded producer-financed export payments and other producer-financed export assistance was not whether they were export subsidies, but whether they should be exempted from any disciplines imposed on export subsidies on agricultural products. The Agreement on Agriculture resolved this question by including such subsidies in Article 9.1 of the Agreement.

4.149 The United States argued that producer-financed export subsidies had been treated as export subsidies because they were likely to have the same distorting effect on trade and competition as subsidies paid from a government treasury. Producer-financed subsidies conferred a benefit on the exported product and, when substantial

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[164] The United States noted that the high domestic prices which made a levy economically feasible were often, as in the case at issue, a result of government action in fixing import barriers, production quotas, and price supports, although these factors had not been noted by the panel.

[165] Working Party Report on *Provisions of Article XVI:4*, *op. cit.*, para. 12.

[166] "Subsidies and Countervailing Measures," MTN.GNG/NG10/W/4 (28 April 1987).

[167] "Subsidies and Countervailing Measures," MTN.GNG/NG10/W/4 (28 April 1987), p.9.

[168] Note Prepared By the Secretariat in Consultation with the Chairman, AG/W/9/Rev.3, App. C-IV.

[169] MTN.GNG/NG5/W/170. (United States, Exhibit 30)

[170] MTN.GNG/AG/W/1; MTN.GNG/AG/W/1/Add.1. (United States, Exhibits 31 and 32)

government involvement was present, as in Canada's Special Milk Classes Scheme, the resulting subsidy could not be distinguished from purely governmental action. This fact was recognized in Article 9.1(c) of the Agreement on Agriculture that provided that producer-financed export payments were an export subsidy subject to the Agreement's reduction commitments (further developed in paragraph 4.196 and following).

4.150 In this respect, the United States pointed out that Article 9.1 of the Agreement on Agriculture referenced six broad classes of export subsidy practices which were subject to reduction commitments. There had been no apparent effort in Article 9.1 to specify particular subsidy programmes. Instead the intent had been, as initially set forth in Chairman de Zeeuw's "Framework" and later in Chairman Dunkel's "Checklist" and "Notes", to develop a list as all-encompassing as possible to address "direct budgetary assistance to exports, other payments on products exported and other forms of export assistance."[171] Thus, these export subsidy categories were defined broadly, similar to the illustrative list in the SCM Agreement. In fact, there was substantial commonality between several paragraphs of Article 9.1 of the Agreement on Agriculture and the Illustrative List which results from the drafters' initial consideration of the Illustrative List, as well as the SCM Agreement's definition of export subsidy, as possible models for the export subsidy disciplines in the Agreement on Agriculture. Indeed, the six categories were sufficiently broad that there was potential (and actual) overlap between the coverage of the subsections. For example, subsidies used to reduce the cost of marketing exports of agricultural products that were addressed in subsection (d) of Article 9.1 could also be captured under the broader category of direct export subsidies set forth in Article 9.1(a) of Article 9.1.

4.151 The United States noted that both the SCM Agreement and the Agreement on Agriculture considered the provision of products or services at a price lower for export than the comparable price charged for the like product to buyers in the domestic market to be a central feature of many export subsidies.[172] This principle was also reflected in the language of Article XVI:4 of the GATT 1947, which provided that:

> "Further, as from 1 January 1958 or the earliest practicable date thereafter, contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market."

4.152 The United States submitted that in the unlikely event of a conflict between the definition of subsidy contained in the SCM Agreement and the non-exhaustive list of export subsidies in the Agreement on Agriculture, the latter would prevail for

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[171] MTN.GNG/NG5/W/170, para. 17. (United States, Exhibit 30)

[172] The United States referred to *e.g.*, Paragraph (b) of Article 9.1 of the Agreement on Agriculture and Annex I, Paragraph (d) of the SCM Agreement. One recent work commissioned by the Organization of Economic Cooperation and Development (the "OECD"), found that "Implicit subsidies occur when a government programme or agency provides a subsidy in kind ... In some cases, subsidies take the form of below-market input prices ... " N. Bruce, "Measuring Industrial Subsidies: Some Conceptual Issues", *OECD Dept. of Economics and Statistics Working Paper No. 75* (February 1990), p.2.

purposes of interpretation of a provision in the latter Agreement. In other words, if one of the six categories of export subsidies set forth in Article 9.1 of the Agreement on Agriculture were determined not to be a "subsidy" within the meaning of Article 1 of the SCM Agreement, the practice would still comprise a "subsidy" for the purposes of the Agreement on Agriculture. This result was dictated by Paragraph 1 of Article 21 of the Agreement on Agriculture which provides that:

> "The provisions of GATT 1994 and of the other Multilateral Trade Agreements in Annex 1A to the WTO Agreement shall apply subject to the provisions of this Agreement."

4.153 **Canada** argued that Article 3.2 of the DSU recognized that the covered agreements were to be interpreted in accordance with "customary rules of interpretation of public international law." The Vienna Convention set out some of the applicable rules of international law. The rights and obligations of the Parties under the SCM Agreement and the Agreement on Agriculture must therefore be interpreted in accordance with the Vienna Convention and, in particular, Articles 31 and 32.[173] Canada argued that based on these governing provisions, the interpretation of the text of WTO agreements had to proceed on the following basis:

(a) the starting point was always the actual text and its ordinary meaning;

(b) the ordinary meaning of the terms of the agreement was to be read in their context;

(c) "context" had to comprise the text of the agreement, including other contemporaneous agreements reached by all the parties, as outlined in Article 31.2 of the Vienna Convention; and

(d) recourse could be taken to supplementary means of interpretation, such as negotiating history, in the event of ambiguity or to confirm a meaning.

4.154 Canada noted that the Appellate Body reiterated in its Report in *India - Pharmaceuticals*,

> "The legitimate expectations of the parties to a treaty are reflected in the language of the treaty itself. The duty of a treaty interpreter is to examine the words of the treaty to determine the intentions of the parties. This should be done in accordance with the principles of treaty interpretation set out in Article 31 of the *Vienna Convention. But these principles of interpretation neither require nor condone the importation into a treaty of words that are not there or the importation into a treaty of concepts that were not intended.*"[174] (emphasis added)

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[173] Appellate Body Report on *United States - Standards for Reformulated and Conventional Gasoline* (Hereafter "*US - Reformulated Gasoline*"), WT/DS2/AB/R, adopted on 20 May 1996, DSR 1996:I, 3, at 16-17, III B; Appellate Body Report on *Japan - Taxes on Alcoholic Beverages* (Hereafter "*Japan - Liquor Tax*"), WT/DS8/DS10/DS11/AB/R, adopted 1 November 1996, pp. 10-12; confirmed in the Appellate Body Report on *India - Patent Protection for Pharmaceutical and Agricultural Chemical Products* (Hereafter "*India - Pharmaceuticals*"), WT/DS50/AB/R, adopted 16 January 1998, paras. 43-48.

[174] Appellate Body Report on *India - Pharmaceuticals*, *op. cit.*, para. 45.

4.155 Canada argued that under Article XVI:1 of the WTO Agreement, the body of adopted pre-WTO GATT panel reports and other "decisions, procedures and practices" had been given a certain status as points of non-binding reference.[175] It was evident from the views of the Appellate Body in *Japan-Taxes on Alcoholic Beverages*[176] that pre-WTO GATT materials carried some weight but it was strictly limited. At best, these materials could be considered as supplementary means of interpretation in the context of the rules of the Vienna Convention. Supplementary means of interpretation were, by definition, supplementary. They were not to be given primacy over the principles set out in Article 31. Nor were they to be treated as having on the same significance as the text or the "context" of the terms in question.

4.156 Canada argued that the weight to be ascribed to pre-WTO materials was also governed by relevance. Where the WTO text in question incorporated a pre-WTO text, then the relevance was stronger. However, in those circumstances where new agreements were reached in the negotiations in the Uruguay Round, materials relating to previous agreements that had been overtaken by the new regime could be of less interpretative value.

4.157 Therefore, Canada argued that the role of the Vienna Convention was fundamental. It was the starting point for any interpretative inquiry and that inquiry had be conducted in accordance with the principles that were laid out in its provisions. Canada maintained that the United States and New Zealand appeared to be reluctant to begin with the "ordinary meaning" of the term "export subsidies" in its context in the Agreement on Agriculture or to consider the close relationship between the provisions of the SCM Agreement and the Agreement on Agriculture respecting "export subsidies". However, this was not an option open to a treaty interpreter. The starting point under Article 31 of the Vienna Convention must be *ordinary meaning* of the actual words agreed upon by the parties in their context, which in this case included the SCM Agreement.

4.158 Canada maintained that the Complainants, while acknowledging the application of the Vienna Convention, had departed from its principles; they did not appear to give the Vienna Convention adequate recognition as the primary guide to interpretation of WTO Agreements. In particular, the United States appeared to confuse the relationship between Article XVI:1 of the WTO Agreement, which brought prior GATT practice into the WTO, with the principles of the Vienna Convention. This led to an analysis that mixed past GATT practice with the treatment of "export subsidies" under the SCM Agreement.

4.159 Canada reiterated that the Agreement on Agriculture defined an "export subsidy" as a "subsidy" contingent upon export performance. However, the Agreement on Agriculture did not provide a definition of the term "subsidy". Canada recalled that Article 31 of the Vienna Convention directed that the meaning of a term had to be sought in its ordinary meaning and in its context. It then specifically included companion agreements within "context". While there was no express link between the definition of "subsidy" in the SCM Agreement and the definition of the "export subsidy" in the Agreement in Agriculture, such a link should be inferred since the

[175] Appellate Body Report on *Japan - Liquor Tax*, *op. cit.*, p. 14.
[176] *Ibid.*

SCM Agreement was part of the "context" of the Agreement on Agriculture. The definition of "subsidy" in the SCM Agreement was the only place a definition of "subsidy" appeared in the WTO agreements as a whole. As was well established, all of the WTO agreements were to be considered as part of a single integrated system and there was a particular relationship between the Agreement on Agriculture and the SCM Agreement with respect to export subsidies on agricultural products.[177] Given the very similar definitions of "export subsidies" in both the SCM Agreement and the Agreement on Agriculture and the fact that the definition of "subsidy" in Article 1 of the SCM Agreement formed part of the definition of "export subsidy" as found in the SCM Agreement, the "subsidy" definition in the SCM Agreement was also applicable to the Agreement on Agriculture.[178] Hence, Canada submitted that the definition of "subsidy" provided in Article 1 of the SCM Agreement was the applicable definition of "subsidy" for the purposes of the Agreement on Agriculture. . This was also consistent with the comments of the Appellate Body on the relationship of the SCM Agreement and the Agreement on Agriculture:

> "[W]ith respect to subsidies on agricultural products, the Agreement on Agriculture and the SCM Agreement reflect the latest statement of the WTO members as to their rights and obligations concerning agricultural subsidies."[179]

4.160 Canada further noted that the term "subsidy" was found in both the definition of "export subsidy" in Article 1 and in several items listed in Article 9.1, such as Article 9.1(a). The interpretation of this term had then to be the same in all these provisions. Accordingly, if the practices at issue did not constitute "subsidies" under the SCM Agreement definition, there could not be a subsidy for the purposes of either Article 1 or the relevant items in Article 9.1 of the Agreement on Agriculture.[180]

4.161 Moreover, Canada argued that pursuant to the customary principles of treaty interpretation, a treaty had to be interpreted and applied to reflect the underlying common *intention* of the parties. Parties had therefore to resist seeking through dispute resolution benefits that were not obtained from negotiation. A trade agreement, in particular, expressed a delicate and carefully achieved balance of economic rights and obligations between the parties within a specific historical context. This had been repeatedly acknowledged in GATT practice where, given equally plausible alternative interpretations, GATT panels had applied the interpretation that best maintained the intended balance of the agreement.[181] That approach, reflecting a long-standing principle of public international law, had been affirmed by the Appellate Body in its Reports in the *United States - Restrictions on Imports of Cotton and*

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[177] Appellate Body Report on *Brazil - Desiccated Coconut, op. cit.*, pp. 11-14.

[178] Canada noted that further linkage was found through Article 13 of the Agreement on Agriculture.

[179] Appellate Body Report on *Brazil - Desiccated Coconut, op. cit.*, p.14.

[180] Canada acknowledged that the Agreement on Agriculture would take precedence over the SCM Agreement in the event of any conflict between the two. However, there had been no suggestion by either of the Complainants that the two Agreements were in conflict.

[181] Canada referred to *United States - Measures Affecting Alcoholic and Malt Beverages* (1992) (hereafter "*US - Malt Beverages*"), adopted 19 June 1992, DS17/R, para. 5.79, BISD 39S/206 at 296.

Man-made Fibre Underwear and *United States - Measure Affecting Imports of Woven Wool Shirts and Blouses from India* cases.[182]

3. The Agreement on Agriculture

(a) Outline

4.162 **New Zealand** claimed that the case at issue was about subsidies provided to exporters of dairy products who were granted access to milk for processing into products for export at prices lower than those charged for milk sold for processing into products destined for the domestic market. New Zealand emphasized that the subsidy was financed, not by way of a rebate funded by a direct levy on producers, but under a scheme that *compelled* milk producers to accept a lower price for milk designated for that purpose. Producers were the source of the financing of the subsidy, but the subsidy itself was provided to exporters. Both New Zealand and the **United States** claimed that the Special Milk Classes Scheme were export subsidy practices listed in Article 9.1(a) and (c). As such, these practices were subject to reduction commitments under the Agreement on Agriculture.[183]

4.163 The **United States** noted that the Agreement on Agriculture, Article 1(e), defined export subsidies as "subsidies contingent on export performance, including export subsidies listed in Article 9 of this Agreement." Thus, two elements had to be shown to establish an export subsidy: (i) that a subsidy existed and (ii) that receipt of that subsidy was contingent on export performance. The United States claimed that the Special Milk Classes Scheme was a subsidy because it was a government mandated and controlled system that provided processors with milk at prices well below the comparable price for milk destined for the domestic market. In turn, these low prices allowed the processors to make export sales that would otherwise not be made and to earn "assured margins" on such sales pursuant to the CDC's calculation of the net return to the dairy producer. The subsidy was contingent on export performance because the lower prices could only be obtained for export sales.

4.164 **Canada** emphasized that Article 1 of the Agreement on Agriculture defined "export subsidies" to be "*subsidies* contingent upon export performance, including the export subsidies listed in Article 9 of this Agreement." (emphasis added) Hence, if there were either an export subsidy listed in Article 9 or a subsidy contingent on export performance, there was an export subsidy for the purposes of the Agreement on Agriculture. However, as the sales of milk at differing prices for domestic and export markets, and, in particular, sales of milk under Special Classes 5(d) and (e), did not constitute a "subsidy" pursuant to the definition of the SCM Agreement, it followed that these sales could not constitute a subsidy for the purposes of the

[182] Appellate Body Report on *United States - Restrictions on Imports of Cotton and Man-made Fibre Underwear* (hereafter "*US - Cotton Underwear*"), WT/DS24/AB/R, adopted 25 February 1997, DSR 1997:I, 11; Appellate Body Report on *United States - Measure Affecting Imports of Woven Wool Shirts and Blouses from India* (hereafter "*US - Wool Shirts*"), WT/DS33/AB/R, adopted 23 May 1997, DSR 1997:I, 323.

[183] The United States expressed its total agreement with the arguments presented by New Zealand regarding the applicability of Article 9 and 10 of the Agreement on Agriculture.

Agreement on Agriculture.[184] Therefore, by definition, such sales could not constitute an "export subsidy" within the meaning of the definition in Article 1 of the Agreement on Agriculture. Canada further claimed that the practices at issue did not constitute an "export subsidy" within the meaning of any of the export subsidy practices described in Article 9.1 of the Agreement on Agriculture and, in particular, not within any of the practices cited by the Complainants.

(b) Article 9.1(a)

(i) The Meaning of "direct subsidies, including payments-in-kind"

4.165 **New Zealand** argued that, interpreted in accordance with the ordinary meaning of the terms of Article 9.1(a), in their context, and in the light of the object and purpose of the Agreement on Agriculture, Classes 5(d) and (e) of the Special Milk Classes Scheme constituted the provision by a government agency of a direct subsidy to an industry contingent upon export performance. This direct subsidy was provided through the foregoing of revenue or through a payment-in-kind within the meaning of Article 9.1(a) of the Agreement on Agriculture.

4.166 New Zealand argued that Canada, in focussing on the word "subsidies" in Article 9.1(a) of the Agreement on Agriculture and interpreting it in isolation, removed it completely from its own context. The term used in fact in Article 9.1(a) was "direct subsidies, including payments-in-kind". There was no justification in the rules of treaty interpretation for taking words individually out of a phrase, giving them each a meaning and then reconstructing the phrase on the basis of those individual meanings. That was divorcing meaning from context completely.

4.167 New Zealand argued that the normal usage of the term "payments-in-kind" was in respect of a payment in a form other than money, such as goods or services.[185] The provision of a production input at no charge would clearly be a payment-in-kind. The provision of a production input (milk) at a reduced price was no less a payment-in-kind. New Zealand maintained that Article 9.1(a) referred specifically to "payments-in-kind" as included within the ambit of the concept of "direct subsidies". In the present case, government agencies made milk available to processors for export under Classes 5(d) and (e) at lower prices. This was the alternative Canada had chosen to providing a money sum to compensate processors for export for having to purchase milk at the higher domestic price. The benefit of access to lower-priced milk was provided through the combined actions of the CDC and the provincial marketing agencies. Their actions made the provision of milk by producers at these lower prices mandatory. Through the operation of Classes 5(d) and (e), the government agency provided a subsidy through a "payment-in-kind" within the meaning of Article 9.1(a).

[184] Canada noted that Classes 5(a) to (c) were not contingent on export and that no suggestion had been made that they were contingent on export.

[185] New Zealand noted that *The Dictionary of Canadian Law* (Toronto, 1991) at p. 755 provided that a "payment-in-kind" meant "remuneration in the form of goods or services".

4.168 New Zealand argued that the foregoing of revenue was well recognized as a form of subsidy,[186] a common example being the foregoing of revenue through the remission of taxes. Thus, the ordinary meaning of the term "subsidy" in Article 9.1(a) included "revenue foregone". New Zealand noted that this was further illustrated in Article 9.2 which provided that in determining export subsidy commitment levels in Members' Schedules "revenue foregone" was to be treated as a subsidy. Article 9.2 provided in sub-paragraph (a)(i) that the "budgetary outlay reduction commitments" made by Members in respect of the subsidies listed in Article 9.1 shall in any year constitute the maximum level of expenditure for such subsidies. Article 1(c) of the Agreement on Agriculture defined "budgetary outlays" as including revenue foregone. Since revenue foregone was to be included in calculating levels of reduction commitments, it also had to be included in the concept of a subsidy for which reduction commitments were to be made. Thus, Article 9.2 made clear that the concept of "revenue foregone" was included within the scope of the subsidies listed in Article 9.1.

4.169 New Zealand noted that this conclusion was confirmed by reference to the negotiating history of the export subsidy provisions of the Agreement on Agriculture. The de Zeeuw Text contemplated that states would table lists of "financial outlays and revenue foregone" in respect of subsidy practices.[187] Similarly, the Modalities for the Establishment of Specific Binding Commitments under the Reform Programme (the "Modalities document")[188] in the context of export subsidy reduction commitments stated that "the expressions 'outlays' or 'expenditure' shall, unless the context otherwise requires, be taken to include 'revenue foregone'."[189] There had therefore been no doubt that revenue foregone was contemplated as a subsidy that would be subject to export subsidy disciplines.

4.170 New Zealand maintained that its understanding of the interpretation of Article 9.1(a) was confirmed by reference to the preparatory work in the negotiation of that article. From the outset it had been understood that mechanisms to shield exporters from having to pay high domestic prices would be regarded as export subsidies. The text of the "Generic Criteria" produced as a basis for considering export competition issues in the negotiations spoke of any form of subsidy which resulted "in the sale of such products for export at a price lower than the comparable price charged for like products to buyers in the domestic market."[190] The "Illustrative List of Export Subsidy Practices", set out to give specific content to that Generic Criteria, included what subsequently became Article 9.1(a).

4.171 New Zealand argued that negotiating history made it clear that providing inputs at a lower price for export constituted a direct subsidy contingent upon export. The means by which the subsidized input was provided was not material. It could be through a transfer of money or it could be through revenue foregone. It could be

[186] New Zealand noted that Article 1 of the SCM Agreement included revenue foregone by a government within the definition of a subsidy (see Article 1.1(a)(1)(ii) for example).
[187] "The Framework Agreement on Agricultural Reform Programme" (MTN.GNG/NG5/W/170). (New Zealand, Annex 31)
[188] MTN.GNG/MA/W/24.
[189] The Modalities Document, para.2, Annex 8 (MTN.GNG/MA/W/24).
[190] MTN.GNG/AG/W/1/Add.10 at p. 1 (para. 2).

viewed simply as the foregoing of revenue or it could be viewed as a "payment-in-kind". Regardless of the characterization given, it constituted a direct subsidy captured by the terms of Article 9.1(a).

4.172 New Zealand argued that the ordinary meaning of the terms of Article 9.1(a), read in the particular context of Article 9 as well as in the broader context of the Agreement on Agriculture and the WTO subsidies regime as a whole, was that a government-mandated scheme whereby milk was made available by a government agency for the production of dairy products for export at prices that were lower than the prices for milk from the same agency for the production of comparable domestic products constituted a "direct subsidy" that was "contingent on export performance". Thus, the foregoing of revenue or the provision of a "payment-in-kind" by government agencies on milk provided to processors under Classes 5(d) and (e) was a subsidy within the meaning of Article 9.1(a) of the Agreement on Agriculture.

4.173 New Zealand argued that it was the lack of choice between supplying the domestic or the export markets which lead producers to forego revenue (addressed in paragraph 4.93 and following). The decision to place milk in one "market" rather than the other was not made by the producer. The decision that the domestic market was satisfied and that, accordingly, milk had to be classified into Special Class 5(d) or 5(e) was made by government. Rational, profit-seeking producers, however, would - if they had the choice - supply their milk to the higher-priced domestic market (even although the influx of more milk into that market may ultimately have the effect of lowering prices). But the decision that they may not do so was made for them. Hence, the distinction between domestic and export markets was government-created: it was, indeed, a legal fiction created by Canada. With regard to in-quota milk, producers collectively forewent revenue by being forced to accept a lower in-quota price by virtue of export sales being pooled with higher-priced domestic sales. With regard to over-quota milk, individual producers forewent revenue by having no choice other than to accept the export price for that portion of their production which was ultimately deemed to be over-quota. Under the Special Milk Classes Scheme, the government of Canada obliged milk producers to forego the revenue they would otherwise have received from sales of milk at domestic prices in order to create an economic incentive for exporters to export. Producers were compelled to forego revenue and the benefit of this revenue foregone was passed on to exporters. Since both in-quota and over-quota milk were allocated to Class 5(e), the foregoing of revenue under Class 5(e) applied as much to over-quota as it did to in-quota milk.

4.174 New Zealand noted that under the old producer levy-based system, producers received the same gross price for all milk produced (both in-quota and over-quota) but were forced, by government regulation, to forego revenue by virtue of a levy to subsidize the cost of exports. The situation was little different under the Special Milk Classes Scheme. Producers were forced to accept a lower price for milk that was subsequently exported. In the case of in-quota milk the revenue received by a producer was reduced by pooling. In the case of over-quota milk, revenue was not pooled and the price was determined by the CDC and the provincial milk marketing agency on the basis of world prices. New Zealand pointed out that the fact that world prices were the benchmark should not obscure the fact that the decision to place milk in one "market" rather than the other was not made by the producer.

4.175 The **United States** argued that the Government of Canada, whether through the CDC or through the provincial governments, played a clear role in the establish-

ment and administration of the Special Milk Classes Scheme. It was through the CDC that processors obtained a permit for preferentially priced milk for dairy products for export. In the absence of the federal and provincial government authority and legislation for the Special Classes, the processors would be paying the full price for milk.[191] The processors would not be receiving milk at an artificially reduced price tailor-made by the CDC to allow them to make export sales.[192] Thus the requirement under Article 9.1(a) that direct subsidies were provided by governments or their agencies was met.

4.176 The United States argued that Canada's construction of Paragraph 9.1(a) would make the reference to payments-in-kind meaningless. The Canadian argument was contrary to the principles of interpretation under customary international law and, in particular, those that required that the terms of an agreement be given effect, and that they be interpreted in good faith, in context and in light of their object and purpose.[193] Article 9.1(a) covered "direct subsidies, including payments-in-kind". The ordinary meaning of the phrase "payments-in-kind" in the context of Article 9.1(a) was that the provision of artificially low-priced goods was to be regarded in the same way as straight cash. Accordingly, as Classes 5(d) and (e) provided milk at a reduced price contingent on the export of the manufactured product, the measure fell within Article 9.1(a) of the Agreement on Agriculture. It would be inconsistent with the ordinary meaning of the phrase "payment-in-kind" to suggest that the provision of goods without payment would be a subsidy, but that any level of payment, even though less than adequate remuneration, would not be an export subsidy. Moreover, the frequent statements by both industry leaders and Members of Parliament that the Special Classes would allow milk producers to share the "costs" of exports confirm that indeed the government was transferring value from the milk producers to dairy processors.

4.177 The United States argued, in respect of revenue foregone, that the Canadian position was premised on the idea that under Canada's milk marketing system producers could not sell milk into the domestic market that was designated for export as surplus milk. Yet, this division of markets into domestic and export segments was an artificial one and completely a construct of Canada. As New Zealand had stated, there were separate "markets" only because Canada had created a "special milk class" scheme and assigned the export of dairy products to Class 5. The United States recalled that milk was declared surplus to the domestic market in Canada pursuant to the discretion of the Canadian Dairy Commission. This was not a determination based on the operation of a free market. For instance, there was no determination of demand elasticities at different price levels. Instead, prices were maintained at rigid levels in the domestic market and if the market could not be cleared at a particular price level, there was not much latitude to reduce price to sell additional product

[191] The United States noted that prior to the institution of the Special Milk Classes Scheme, dairy exporters paid full domestic prices for milk used in export, but were then rebated a portion of the purchase price to enable them to compete in world markets.

[192] The United States understood that the CDC determined the price paid to the milk producer under Special Class 5(d) and (e) by calculating backward from a "world" price, netting out an assured margin, *i.e.*, profit, for the exporting dairy product manufacturer.

[193] Appellate Body Report on *US - Reformulated Gasoline, op. cit.*, p.23, DSR 1996:I, 3.

domestically. Moreover, the declaration of a milk surplus was generally based on conditions within a province, usually without consideration of conditions in other provinces despite the fact that there was considerable movement of milk across provincial boundaries. The United States argued that Canadian consumers would use more milk if domestic prices were lower. Special Classes 5(a) through (c), offering lower priced milk to compete with certain imports, implicitly recognized this market principle. Milk sold at those lower Special Class prices allowed Canadian producers to capture additional sales. If that milk had instead been exported at the still lower Special Class 5(e) prices, there was no question but that the total revenue received by the milk producer would have been less, resulting in "revenue foregone".

4.178 The United States noted that the same principle was demonstrated by the controversy over the substitution of imported butter-oil for butterfat in products such as ice cream. The high domestic milk prices in Canada had caused processors to look for alternative products for inputs in fat-rich products such as ice cream. If milk were to be sold at lower prices in Canada, milk would retain such product markets. It was for this reason that a proposal had been made to create an additional Special Class to allow Canadian milk producers to be more price competitive with imports of butter-oil. The Canadian International Trade Tribunal, in its report relating to butter-oil imports, considered the possibility of Canadian milk producers simply selling the milk that was displaced by imports of butter-oil into world markets. In conducting an analysis of the impact of such action on Canadian milk producers, the Canadian Tribunal described the effects in terms of "revenue foregone" by the Canadian industry.[194] Thus, this concept was not unfamiliar to the CITT, with its considerable knowledge of the Canadian milk marketing system.

4.179 **Canada** reiterated that sales of milk at differing prices did not constitute a "subsidy" as it was defined in Article 1 of the SCM Agreement. As the Agreement on Agriculture and the SCM Agreement had to be taken together, the definition of "subsidy" in the SCM Agreement was applicable to the term "subsidy" as it was found in Article 9.1(a).[195] It followed that there was no "subsidy", whether direct or not, for the purposes of Article 9.1(a). (Canada's detailed arguments on the application of the SCM Agreement definition of "subsidy" to the measures in question are summarized beginning at paragraph 4.309.)

4.180 In respect of the matter of payments-in-kind, Canada noted that the United States argued that Canada's interpretation of Paragraph (a) would make the reference to payments-in-kind meaningless and New Zealand characterized a sale of dairy inputs at a reduced price as a payment-in-kind. Canada submitted that the Complainants had not clearly articulated what amounted to a payment-in-kind. Canada's position did not seek to make that expression meaningless but rather to give the expression its ordinary meaning. A payment-in-kind arose when a debt was satisfied by the provision of a good or a service rather than being paid for in money. For example, a government could impose a 5 per cent royalty with respect to a concession to drill for oil. If the government permitted that obligation to be discharged by the delivery to it

[194] United States, Exhibit 42.

[195] Canada noted the acknowledgement of the United States that the meaning of the word "subsidy" was substantially the same for the purposes of the Agreement on Agriculture and the SCM Agreement (paragraph 4.304).

of one barrel of oil for every twenty barrels extracted, that would be a payment-in-kind. In the case of the Canadian dairy system, payment was made for milk in the ordinary sense of the word. A market-based differential between payments was qualitatively different from a payment-in-kind.[196]

4.181 Canada noted that the Complainants sought to find a subsidy in Article 9.1(a) by claiming that there was "revenue foregone" (paragraphs 4.173 and 4.177). Canada submitted that even if the word "payments" were held to include "revenue foregone", there was no revenue for the producers to forego with respect to sales of milk for export use under Special Classes 5(d) and (e). In the context of commercial sales, revenue was foregone when the vendor chose to sell the product at a price lower than the price at which the vendor *could* have otherwise sold it. In other words, if a vendor chose to forego a sale into a higher-priced market in favour of a sale into a lower-priced market, then the vendor had chosen to forego revenue.[197]

4.182 Canada argued that "revenue foregone" implied a choice of markets, a choice foregone. Under the Canadian milk marketing system, milk *could not* be sold in the market for export uses if it was required for Canadian domestic requirements. Thus, sales of milk for export purposes at prices based on world market prices could not be made until there was no opportunity to sell milk into domestic markets at the *higher* domestic prices. This was a basic and rational approach in any commercial operation. Any milk sold for export uses was additional to the domestic demand. The sale of milk at world market prices - not always lower than domestic prices - therefore took place when milk producers in Canada could no longer place their products on the domestic market, and had therefore to try to obtain the highest prices possible in the alternative market, i.e., the market in Canada for milk for use in exports. Suggestions that Canadian milk producers somehow "forewent" revenue otherwise available to them in the domestic market demonstrated a serious misunderstanding of the Canadian milk marketing system.

4.183 Canada argued that rather than representing "revenue foregone", such sales represented revenue enhancement. Canadian producers could choose not to produce any milk in addition to domestic requirements. Accordingly, they could choose not to produce milk for use in export sales. They could choose to limit their revenues to the returns they would get from the domestic markets. Instead, by choosing to produce milk in addition to domestic needs, the returns from which would be based on world market prices, producers chose to try to enhance their total revenues. As a result, the only reasonable approach was indeed the approach adopted by the milk producers in Canada; to find a market in which the highest return was found for milk at any par-

[196] Canada noted that this explanation of its interpretation of the expression "payment-in-kind" was without prejudice to its position that there was no Article 9.1 export subsidy of any kind in this case.

[197] Canada noted that the United States had publicly stated that Canadian milk was sold to the international market at world market prices: *FAS Online*, "Dairy: World Markets and Trade - January 1998": "The US Challenges Canada's Dairy Export Subsidies and Import Protection", p. 2; "Dairy Trade by Selected Countries", p. 2. This was in contrast with the suggestions found in paragraph 40 of the United States Submission that Canadian exports were sold at prices "equal to or below world prices". Further, Canada noted again that since, under the Canadian dairy system, the ultimate decisions to produce for export lay with the dairy producers, they demanded that sales of such milk be made for the best available prices. To do otherwise would be irrational. (Canada, Exhibit 33)

ticular time. Thus, in the sale of milk at world market prices, revenue was not foregone but rather enhanced.

4.184 Canada argued that the fact that there was a domestic market and an export market was not a fiction but a fact of life. Canada rejected New Zealand's characterization that producers were "forced" by government to forego their own revenue. The record showed that the producers had collectively and individually chosen to market their product in the manner reflected by the present regime. New Zealand failed to explain how producers making these collective and individual decisions were "foregoing revenue" in the sense understood by Canada and the United States. In addition, it remained Canada's position that there was no revenue foregone, even to producers, when a person willingly sold a product in a market for the price that the market would bear for that product.

4.185 Canada noted that New Zealand built arguments on the basis of the Uruguay Round negotiating document entitled: Modalities for the Establishment of Specific Binding Commitments under the Reform Programme (paragraph 4.169). Canada pointed out that the following injunction was found on the cover sheet of the document:

> "The revised text is being re-issued on the understanding of participants in the Uruguay Round that these negotiating modalities shall not be used as a basis for dispute settlement proceedings under the WTO Agreement".

4.186 **New Zealand** argued - in respect of Canada's argument that the Special Milk Classes Scheme did not constitute a "payment-in-kind" within the meaning Article 9.1(a), because a payment-in-kind arose when a debt was satisfied by the provision of a good or a service rather than being paid for in money (paragraph 4.194) - that the suggestion that the existence of a debt was a prerequisite to any notion of payment-in-kind would render that concept, in the context of subsidies, completely redundant. If a debt was owed, the payment of it, or its discharge through a payment-in-kind, could not constitute a subsidy. It would simply be the *re*-payment of a debt. To the extent that Canada was suggesting that a payment-in-kind could never be a subsidy and could only be used in the context of the satisfaction of a debt, it was seeking to rewrite Article 9.1(a) to exclude the concept of "payment-in-kind" completely.

4.187 Since Canada's arguments that the Special Milk Classes Scheme did not meet the definition of the term "subsidy" and hence could not be a subsidy within the meaning of Article 9.1(a) of the Agreement on Agriculture were unfounded (paragraph 4.179), New Zealand's arguments on the applicability of Article 9.1(a) remained unanswered by Canada.

(ii) The Meaning of the Term "direct"

4.188 **New Zealand** argued that the term "direct" in relation to subsidization was used in a variety of senses and its meaning in any particular case had to be derived from the context in which it was used. In the context of subsidies under the GATT 1947, the word "direct" bore a particular meaning which was articulated in the negotiation of Article XVI of the GATT 1947. The term "indirectly" in Article XVI, it was explained, made it clear that "subsidization" could "not be interpreted as being

confined to subsidies operating directly to affect trade in the production under consideration."[198] In other words, a "direct" subsidy was one affecting trade in the product directly rather than one affecting trade incidentally or indirectly. In the present case, the subsidy provided was clearly "direct". Revenue was being foregone for the very purpose of affecting the trade in question - indeed of permitting its very existence. Without this foregoing of revenue no export trade would exist.[199] The objective of this foregoing of revenue was to secure export performance. It was not a subsidy that had other objectives with export performance as an incidental effect; it was a subsidy that provided only for products which were destined for export. It was a direct subsidy contingent on export performance, and thus fell within the ordinary meaning of the words of Article 9.1(a).

4.189 New Zealand argued that in Article 9.1(a) the term subsidies had to be interpreted in the light of the fact that this provision was referring to "direct" subsidies and in view of the fact that the category of direct subsidies had to be large enough to include "payments-in-kind." This alone was sufficient to demonstrate that a simple reliance on the definition of the term "subsidy" in Article 1 of the SCM Agreement was inadequate for the interpretation of Article 9.1(a). As this was ignored by Canada, Canada had failed to interpret Article 9.1(a) properly and thus had failed to show that the Special Milk Classes Scheme did not constitute an export subsidy within the meaning of Article 9.1(a). Accordingly, Canada had not discharged the burden of proof placed on it under Article 10.3 of the Agreement on Agriculture (paragraphs 4.290 and following refer).

4.190 **Canada** refuted the broad interpretation of the term "direct" in Article 9.1(a) given by the Complainants. Canada rejected any necessity to enter into such an exercise and referred the Panel to Article 1.1(a)(1) of the SCM Agreement where "direct" was used to qualify a "subsidy" implying a transfer of funds by a government. Canada reiterated that no direct export subsidy existed in Canada for dairy products.

(c) Article 9:1(c)

(i) The Meaning of the Term "payment"

4.191 **New Zealand** noted that the word "payment" was defined in the *Oxford English Dictionary* as: "1. the action, or an act of, paying; the remuneration of a person with money or its equivalent ... 2. a sum of money (or other thing) paid; ...".[200] The *Dictionary of Canadian Law* defined "payment" as "remuneration in any form."[201]

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[198] Report of the Drafting Committee of the Preparatory Committee of the UN Conference on Trade and Employment (20 January - 25 February 1947), E/PC/T/34/Rev.1 (29 May 1947), p. 26.

[199] New Zealand noted that Lyle Vanclief, then Parliamentary Secretary to the Minister of Agriculture and Agri-Food had told the Canadian House of Commons in 1995 that if the legislation which was to allow the CDC to implement "special milk classes" were not implemented by 1 August 1995 "dairy exports to the United States using producer-financed levies [would] be in jeopardy. Furthermore, while export subsidies by levies to other destinations could continue to grow for now, these subsidized shipments [would] also have to be reduced over time": House of Commons Debates, Volume 133 (No. 202), Tuesday 16 May 1995, p. 12668.

[200] *The Oxford English Dictionary* (2nd Edition) - Volume XI, Clarendon Press, Oxford, pp. 379-380.

[201] *The Dictionary of Canadian Law*, p. 755.

The term "remunerate" was defined in the *Oxford English Dictionary* as "1. To repay, requite, make some return for (services etc) … 2. To reward (a person) … to pay (one) for services rendered … 3. to give as compensation ... ".[202] New Zealand argued that the term "payments" covered both payments-in-kind and revenue foregone. The ordinary meaning of the term payment included a "payment-in-kind". Adding "in-kind" to the word "payment" simply described the *form* in which a payment was made. In respect of Article 9.1(a), the provision to exporters of lower-priced milk was a "payment-in-kind". It was the delivery of something of value in a form other than by way of a money transfer.

4.192 The **United States** argued that the common meaning of the word "payment" was "the action, or an act, of paying; the remuneration of a person with money or its equivalent; the giving of money, etc. in return for something in discharge of a debt". The word was also defined as "a sum of money (or other thing) paid; pay, wages; or price".[203] The verb "to pay," from which the noun "payment" was derived, was variously defined as "to give what is due, as for goods received; remunerate; recompense; to give or return as for goods, or services; to give or offer." However, "to pay" had also been construed as meaning "to give money or other equivalent value for; to hand over the price of a (thing); to bear the cost of; to be sufficient to buy or defray the cost of".[204] Thus, although the word payment often connoted an exchange of value for the provision of goods or services, or the provision of value on the occasion of a particular event or condition, it could also encompass bearing the cost. This latter meaning was perhaps the most consistent with the word's use in the context of a provision defining subsidies. Thus, the term payment could be used in Article 9.1 consistent with the concept of conferring a benefit through the bearing of a cost.[205]

4.193 In respect of the term "payment", **Canada** refuted that its ordinary meaning included "revenue foregone". The ordinary meaning of the term "payments" was straightforward - it meant "a sum of money."[206] Canada noted that, pursuant to Article 33 of the Vienna Convention, the French language version of the text of this provision provided additional support for its interpretation of the word "payment". The term used in the French text was "versement" which meant literally to remit money.[207]

4.194 Canada recalled that while the United States acknowledged that the common meaning of payment was "the action, or act of paying; the remuneration of a person with money or its equivalent; the giving of money, etc. in return for something in discharge of a debt" (paragraph 4.192), wishing to argue that the ordinary meaning of the word payment included "revenue forgone" and realizing that this "common meaning" was not supportive of their position, the United States had attempted to

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[202] *The Oxford English Dictionary* (2nd Edition) - Volume XIII, Clarendon Press, Oxford, p. 604.
[203] *The Oxford English Dictionary* (2nd Edition), Clarendon Press, 1989, pp. 379-80.
[204] *Ibid.*, p. 376, definition no. 11.
[205] The United States noted that this would be consistent with the requirement in the SCM Agreement that a subsidy involve a benefit.
[206] Canada noted that the *New Shorter Oxford English Dictionary* referred to; "1. an act, or the action or process, of paying. (Foll. by *of* the money etc. paid, the debt discharged, the payee; *for* the thing bought or recompensed.) ME. 2. (a sum of) money etc. paid. LME." (Canada, Exhibit 26)
[207] Canada referred *Le Petit Larousse*, 1994: "1. Action de verser de l'argent à qqn, à un organisme, sur son compte, etc.; 2. Somme versée." (Canada, Exhibit 28)

find an alternative meaning through the verb "pay", pointing to the eleventh listed definition which includes the phrase "bear the cost". This was a frail argument when it was considered that this was found within the eleventh definition of a related word, and did not appear at all the most recent *New Shorter Oxford English Dictionary*.[208] "Payments" had to be interpreted in its "ordinary meaning": i.e. to reflect an action of paying something of value.

4.195 Canada noted that New Zealand as well encountered difficulty in establishing that the "ordinary meaning" of the word "payment" included "revenue forgone". New Zealand noted that the *Oxford English Dictionary* definition of "payment" included "remuneration of a person with money or its equivalent" and suggested that the reference to "remunerate" indicated that the term was to be read broadly. Canada argued that there was a major difference between suggesting that payments could be made with a wide variety of items of value, i.e., from actual cash to payment-in-kind, to concluding that the ordinary meaning of "payment" included an indirect result such as "revenue foregone".

4.196 In **New Zealand's** view the dictionary definitions referred to above, indicated that the concept of "payment" had a wide ambit. New Zealand noted that in order to determine how the term payment was being used in the specific case of Article 9.1(c), reference had be made to the context in which the term was used and the object and purpose of the Agreement on Agriculture as a whole.[209] New Zealand noted that Article 9.1(c) was contained in a provision that identified the mechanisms that states had used to provide export subsidies and which were subject to reduction commitments. One mechanism the negotiators of Article 9.1(c) had in mind was the use of producer levies to fund payments to exporters to compensate for the high cost of a product purchased at domestic rather than at world prices. Such payments were referred to specifically as being included in the definition of "payments on the export of an agricultural product." The wording of Article 9.1(c) made clear that it had not been intended that its provisions be limited only to money paid from the proceeds of a producer levy.[210] An examination of the context in which the word "payments" in Article 9.1(c) appeared confirmed that in the light of the object and purpose of the Agreement on Agriculture as a whole, the term "payments" covered both revenue foregone and payments-in-kind.

4.197 New Zealand emphasized that as Article 9.2 included revenue foregone within the determination of budgetary outlay commitments to be made with regard to the subsidies listed in Article 9.1, the concept of "payments", in Article 9.1(c), had to include "revenue foregone" as they had to be quantified under the heading of "budgetary outlays", and this included, explicitly, revenue foregone. There was no need to provide specifically that "payments" included revenue foregone because the definition of "budgetary outlays" already carried that implication.

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[208] Canada, Exhibit 26.

[209] New Zealand noted that such an approach had been endorsed by the Appellate Body in *Canada - Certain Measures Concerning Periodicals* (hereafter "*Canada - Periodicals*"), WT/DS31/AB/R, adopted 30 July 1997, DSR 1997:I, 449, at 454, II 3, in seeking to interpret the meaning of the term "the payment of subsidies exclusively to domestic producers" in GATT Article III:8(b): p.34.

[210] New Zealand noted that Article 9.1(c) referred to "payments on the export of an agricultural product ... *including* payments that are financed through the proceeds of a levy ... "

4.198 The meaning of the phrase "payments on the export of an agricultural product" in Article 9.1(c) of the Agreement on Agriculture must, however, be distinguished from the term "the payment of subsidies exclusively to domestic producers" under Article III:8(b) of the GATT 1994. In *Canada - Certain Measures Concerning Periodicals* the Appellate Body stated that:

> " ... an examination of the text, context, and object and purpose of Article III.8(b) suggested that it was intended to exempt from the obligations of Article III only the payment of subsidies which involves the expenditure of revenue by a government."[211]

4.199 Accordingly, New Zealand noted that the Appellate Body concluded that a reduction in postal rates did not constitute a "payment of a subsidy exclusively to a domestic producer" within the meaning of GATT Article III:8(b). In reaching this conclusion the Appellate Body was influenced by the fact that Article III:8(b) was an exception to the national treatment obligation. In its view, it was never intended that exceptions to national treatment by way of subsidies based on tax reductions or other forms of revenue foregone were to be permitted under Article III:8(b).

4.200 In fact, New Zealand maintained that the rationale of the *Canada - Periodicals* decision reinforced the conclusion that the term "payments on the export of an agricultural product" in Article 9.1(c) had to include revenue foregone. The objective of the list in Article 9.1 was to bring agricultural export subsidies under WTO disciplines. An interpretation of Article 9.1(c) that narrowed the scope of the subsidies included therein to direct money transfers would defeat rather than serve the object and purpose of Article 9. It would expand the opportunity for Members to avoid their WTO obligations - precisely what the Appellate Body in *Canada - Periodicals* was seeking to avoid. Such a conclusion was strengthened when the object and purpose of the export competition provisions of the Agreement on Agriculture as a whole were considered. Revenue foregone, which was simply an alternative way of securing a benefit that could be obtained through the direct transfer of money, had to be included in the concept of "payment" under Article 9.1(c) if the progressive reduction of export subsidies through reduction commitments was to be successful.

4.201 New Zealand noted that under the old producer levy system, the CDC, acting in concert with provincial milk marketing boards or agencies, transferred money to exporters to compensate for the cost of processors purchasing milk for products for export at domestic rather than at world prices. Under Classes 5(d) and (e) of Special Milk Classes, processors were permitted to purchase milk for products for export at world rather than at domestic prices. The difference between the two approaches was one of form only. In each case, the processor for export was being shielded from the high domestic cost of milk. In each case, the processor for export was being provided with a subsidy that was captured by the phrase "payments on the export of an agricultural product" in Article 9.1(c) of the Agreement on Agriculture. Under Classes 5(d) and (e) revenue was foregone by provincial milk marketing boards or agencies

[211] Appellate Body Report on *Canada - Periodicals, op. cit.*, p.34, DSR 1997:I, 460, II B. New Zealand further noted that similar views were expressed in the Panels on *US - Malt Beverages, op. cit.* and *Indonesia - Certain Measures Affecting the Automobile Industry*, (hereafter "*Indonesia - Automobile Industry*"), WT/DS54/DS55/DS59/DS64/R, adopted 23 July 1998, p.340.

providing access to milk from producers to processors at "special class" prices. The provincial milk marketing board or agency forewent the revenue that it would have received if the milk had been sold at domestic prices.

4.202 New Zealand contended that although the provincial milk marketing board or agency was the vehicle for providing the special milk classes subsidy, it was the producer who bore the financial cost. The role of the provincial board or agency was one of a conduit - to pass on to the producer through the pooling arrangements the revenue that results from Special Milk Class sales. In fact, what the agency passed on to the producer were the *losses* that resulted from sales of milk at world market prices. It was the producer who forewent the revenue that would have been received if all milk was sold to processors at domestic prices. The Special Milk Classes Scheme shrouded in complexity the obvious fact that it was the producer who made the "payments on the export of an agricultural product" that brought the scheme within Article 9.1(c).

4.203 New Zealand claimed that, in substance, the revenue foregone by producers "on the export of an agricultural product" was the equivalent of a subsidy provided to such processors by a direct money transfer financed from the proceeds of a levy on "an agricultural product from which the exported product is derived" - a form of subsidy that Article 9.1(c) expressly enjoined. Hence, the Special Milk Classes Scheme involved an elaborate structure for a very simple subsidy. It consisted of the foregoing of revenue on the export of an agricultural product. That foregoing of revenue could be viewed as a foregoing by a provincial milk marketing board or agency, or it could be viewed as the foregoing of revenue by producers. The difference between the two was largely a matter of accounting. The form could differ, but the substance remains the same.

4.204 As noted under Article 9.1(a), New Zealand argued that Classes 5(d) and (e) of the Special Milk Classes Scheme could also be characterized as providing payments-in-kind - something that was equally encompassed in the ordinary meaning of the term "payment". A payment-in-kind involved remuneration through something other than, or something equivalent to, money. The provision of goods (milk) at a reduced price, instead of providing a money sum to compensate for the higher price that would be paid for milk for processing into products destined for the domestic market, was a payment-in-kind. It was a direct substitute for a payment by way of money transfer. And that, of course, was its intent. It should be seen as a substitute for the old "money-transfer" subsidies paid by Canada from producer levies. It was a "payment-in-kind" that fell within the concept of "payments on the export of an agricultural product" under Article 9.1(c).

4.205 The **United States** claimed that like the producer levy programme it replaced, the Special Milk Classes Scheme was an export subsidy within the meaning of Article 9.1(c) of the Agreement on Agriculture. By the express terms of that subparagraph, there was no requirement that an export subsidy be a charge on the public account. By way of example, the Article specified that payments subject to its coverage may be "financed from proceeds of a levy imposed on the agricultural product concerned or on an agricultural product from which the export product is derived." As argued under Article 9.1(a), the United States claimed that the term "payment" was broad enough to include instances in which value was given by some other means than the actual transfer of funds (paragraph 4.192). If this were the case, then

a fortiori "payment" included situations where value was given to another by means such as a product, in this case milk, at less than the market price.

4.206 The United States noted that the term payment was used twice in Article 9.1(c), but was not defined there or elsewhere in the Agreement on Agriculture.[212] The United States noted that the Vienna Convention counselled that the ordinary meaning of a term was to be given in light of its context, which, in this case, was the Agreement on Agriculture and, more specifically, that Agreement's provisions governing export subsidy disciplines. The meaning of the term "payment" had also to be fixed by considering the object and purpose of the pertinent treaty. Article 9.1, as a whole, broadly identified the subsidies, including payments within Article 9.1(c), that were to be taken into account in calculating the maximum level of expenditure for export subsidies that a Member could incur in a given year consistent with its Schedule of Concessions and Commitments and Articles 3 and 8 of the Agreement on Agriculture. This level constituted the Member's budgetary outlay reduction commitment. The term "budgetary outlays" was defined in Article 1(e) of the Agreement on Agriculture to include "revenue foregone." Thus, for example, not only direct subsidies, such as those described in Article 9.1(a), but also reduced charges, i.e., revenue foregone, as described in Paragraph 1(c), counted toward the budgetary outlays that were subject to the reduction commitments, whether or not charged to the public account.

4.207 The United States argued that in this context, and given that the purpose of Part V of the Agreement was to impose discipline on export subsidies, the term "payment" had to be construed consistently with the broad meaning given to budgetary outlays. If such outlays, and thus the applicable reduction commitments overall were expressly defined to include revenue foregone, then one consistent construction was to construe "payments" in a similar manner. Such an interpretation was consonant with the purpose of the Agreement to bring export subsidies under the transitional disciplines established by the reduction commitments. Considered from this perspective, if the total expenditures subject to reduction commitments were defined as total budgetary outlays and revenue foregone, then the individual expenditures had logically to comprise all payments, including price reductions that had the same economic effect as an export rebate. By mandating the sale of industrial milk at a discount, the Government of Canada was conferring a benefit to milk processors equivalent in its trade distorting effect to an export rebate. Moreover, the principle that an export subsidy could be accorded in the form of sales of products at a loss, or by offering goods or services for export at a more advantageous price than when offered for sales for domestic consumption, was not only inherent in the Agreement's definition of budgetary outlays, but was also reflected in the provisions of Article 9.1(a), (b) and (e) which defined "payments-in-kind," sales of non-commercial stocks, and discounted transport and freight charges as forms of subsidization.[213]

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[212] The United States noted that although the word "outlay" was used elsewhere in Article 9, it was defined in Article 1 of the Agreement to include revenue foregone, no definition of the word "payment" appeared in Article 1 with the other defined terms.

[213] The United States noted that the concept that subsidies that resulted in a price lower for export sale than for domestic consumption were export subsidies was, of course, a fundamental aspect of the export subsidy discipline contained in Article XVI of the GATT. Article XVI:4 stated, in rele-

4.208 In addition, the United States noted that the context of Article 9.1(c) also included the related subsidy reduction commitments contained in Articles 3, 8, and the remainder of 9 of the Agreement on Agriculture. These provisions were collectively intended to impose meaningful disciplines on the use of export subsidies. The Agreement on Agriculture thus narrowed the universe, and amount, of potential subsidies in several respects. First, Article 3 specified that no export subsidies were to be provided "in respect of any agricultural product not specified" in a Member's schedule. A Member could not introduce subsidies for products that were not identified in its schedule and which had not been subsidized during the pertinent base period. Furthermore, Article 9.1 referenced a broad cross-section of subsidy practices that were intended to capture the agricultural subsidies used by the Members at the time of negotiation of the Agreement. Such subsidies were made subject to reduction commitments pursuant to Articles 3, 8 and 9 of the Agreement, with significant reductions required in both subsidy outlays and the quantity of exports that benefitted from subsidies to occur during the transition period. In addition, Article 10, to protect Article 9 disciplines on export subsidies, prohibited the introduction of any subsidies not listed in Article 9 that either "results in, or which threatens to lead, to circumvention of export subsidy commitments ..." And finally, Article 3 of the SCM Agreement, when read in conjunction with Article 13 of the Agreement on Agriculture, provided that if a Member did not comply with the export subsidy disciplines contained in the Agreement on Agriculture, any offending export subsidy was to be subject to the terms of the SCM Agreement and its prohibition on export subsidies.[214]

4.209 Hence, the United States argued that given the Agreement on Agriculture's comprehensive treatment of export subsidies, which revealed the Members' intent to establish real and effective disciplines respecting export subsidies, a narrow construction of the term "payment" that would result in a weakening of the export subsidy reduction commitments and disciplines, would be contrary to the over-arching objective and purposes of the relevant treaty provisions as a whole.

4.210 In this regard, the United States noted that Professor Tangermann also compared the pernicious effect of producer-financed export subsidies with price pooling by state export agencies and concluded that the latter should be subject to the same export competition disciplines:

> "Where a state agency sells domestically at a price above the price charged for exports, while domestic producers are paid the average price, exports are implicitly subsidized. To see why, it is best to compare this policy to one of producer-financed export subsidies. In the

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vant part: "... contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market."

[214] Paragraph (c) of Article 13 of the Agreement on Agriculture, the so-called "Peace Clause", provided that export subsidies that conformed *fully* to the export subsidy disciplines contained in Part V of the Agreement were "exempt from actions based on Article XVI of GATT 1994 or Articles 3, 5, and 6 of the Subsidies Agreement." Article 3 of the SCM Agreement, which contained the prohibition on export subsidies, stated that the prohibition was inapplicable to the extent provided in the Agreement on Agriculture.

latter case, a levy is charged on the domestic sales, and the proceeds are then used to finance export subsidies. Under a price pooling regime, the same prices can result, and it is only the technical nature of financial flows which is different, but not the economic result. Hence, price pooling differs from producer-financed export subsidies only in form, not in substance. Countries should, therefore, not be allowed to escape their export subsidy commitments by using a price pooling regime."[215]

4.211 The United States argued that in construing the text of Article 9.1(c), it was clear that the reference to the levy financed export rebates was made for purposes of illustration, and did not limit the scope of Article 9. Thus, the language in Article 9.1(c) relating to the "payments that are financed from the proceeds of a levy" commenced with the introductory word "including", indicating that payments so financed constituted only one example of the types of payments which fell within the scope of the Article 9 subsidy disciplines. There was nothing in the text of the paragraph to provide a basis for concluding that other types of producer-financed funding for export payments, such as discounted prices, would be excluded from the subsidy constraints imposed by Article 9.1(c). To the contrary, subsidies that were the functional equivalent of producer-financed levies had to be assumed to be included in Article 9.1(c) disciplines.

4.212 The United States argued that Canada's Special Milk Classes Scheme differed from the producer levy programme that preceded it only in form, not substance. Revenue foregone (on export sales under the Special Classes) by the milk producers, which translated into discounted prices for dairy product manufacturers, was equivalent to the export rebates paid to such manufacturers under the levy system. To exclude such discounted milk from the coverage of Article 9.1(c) because the benefit or payment received by the dairy product exporter was in the form of a lower milk price, rather than in the form of an export rebate contingent on export of a product in which the milk had been used, would elevate form over substance. Hence, the Special Milk Classes Scheme, like the producer levy programme that it replaced, qualified as "payments on the export of an agricultural product" within the meaning of Article 9.1(c). First, the discounted milk prices provided for in Special Milk Classes 5(d) and (e) were available only in connection with the production of dairy products for export and, thus, were provided "on the export of an agricultural product". Second, the lower prices extended to milk processors, contingent on the use of the milk for production of dairy products for export, were the same both in substance and economic effect as the earlier levy-financed export rebates and, therefore, were likewise a "payment" within the meaning of that term as used in Article 9.1(c) of the Agreement.[216]

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[215] "A Developed Country Perspective of the Agenda for the Next WTO Round of Agricultural Negotiations," Stefan Tangerman, paper presented at the Graduate Institute of International Studies, p. 22-23. (United States, Exhibit 24)

[216] The United States noted that the Appellate Body considered the subsidy exception contained in Article III:8(b), which included the phrase "payment of subsidies exclusively to domestic producers," in *Canada - Periodicals, op. cit.* The meaning of that phrase had received consideration in a number of GATT disputes, *e.g.*, *US - Malt Beverages, op. cit.*, para. 5.8. The United States, however,

4.213 **Canada** submitted that the sales of milk under Special Classes (d) and (e) did not constitute an export subsidy within the meaning of Article 9.1(c) as it could not be shown that "payments" were made on the export of products from Canada.

4.214 Canada argued that, in accordance with the Vienna Convention, the interpretation of the text of WTO agreements had to proceed on the following basis: (i) the starting point was always the actual text and its ordinary meaning; (ii) the ordinary meaning of the terms of the agreement was to be read in their context; (iii) "context" had to comprise the text of the agreement, including other contemporaneous agreements reached by all the parties, as outlined in Article 31.2 of the Vienna Convention, and (iv) recourse could only be had to supplementary means of interpretation, such as negotiating history, in the event of ambiguity or to confirm a meaning.

4.215 Canada noted that New Zealand argued that support for the proposition that payment should include revenue forgone could be found the *Canada - Periodicals* case (paragraph 4.198 and following). In that case, the Appellate Body had ruled that the term "payment" as it appeared in Article III:8(b) of the GATT 1994 did not include a reduction of postal rates since Article III:8(b) was an exception and should be interpreted narrowly. New Zealand suggested that on the basis that Article 9.1 was a positive obligation the reverse should hold true: its terms should be interpreted *broadly*. Canada submitted that this misconstrued the proper interpretive approach. The fundamental rule was that of "ordinary meaning" under Article 31 of the Vienna Convention. In the case of an exception, the exceptional approach of a narrow approach was applied. Absent an exception, the interpreter had to revert to the fundamental rule of "ordinary meaning".

4.216 Canada argued that it was also noteworthy that in Article 1 of the SCM Agreement, the drafters were careful to add a provision covering "government revenue that is otherwise due is forgone", they had realized that the ordinary meaning of the preceding provision relating to "direct transfers of funds" would not be sufficient to cover "revenue forgone".

4.217 Canada refuted the allegations that the interaction between Article 9.2 and Article 9.1 implied that the defined meaning of "budgetary outlays", i.e., including "revenue forgone" was applicable to "payment" in Article 9.1(c). This would be to set aside the ordinary meaning of a word based on an indirect inference and notwithstanding the clear contextual confirmation provided by Annex 2.

4.218 Canada noted that in *United States - Reformulated Gasoline,* the Appellate Body undertook a comparison of the words used in different paragraphs of Article XX to determine the meaning of the test set out in Article XX(g). The Appellate Body noted that *different words* were used in the different paragraphs so as to properly describe the required relationship or degree of connection between the objectives in question and the measures implemented: "necessary" in certain paragraphs, "re-

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submitted that these decisions gave considerable weight in interpreting the phrase in Article III:8(b) to its context and the purpose of the treaty provision. That context and purpose, involving the construction of an exception to the principle of national treatment, was unquestionably different than that presented by Article 9.1(c) of the Agreement on Agriculture.

lating to" in certain others, "for the protection of" in another, and so on. Accordingly, the Appellate Body held that:

> "It does not seem reasonable to suppose that the WTO Members intended to require, in respect of each and every category, the same kind of degree of connection or relationship between the measure under appraisal and the state interest or policy sought to be promoted or realized."[217]

4.219 Hence, Canada argued that it could be presumed that specific words carried specific meanings and that the use of different words in a treaty text meant that the parties to the treaty intended different meanings to be applied to those differing terms. The approach to the interpretation of the term "payments" in Article 9.1(c) in the context of Article 9.1 as a whole should be no less rigorous. Canada argued that the choice of different terminology in each provision of Article 9.1 clearly indicated that negotiators had very precise and distinct concepts in mind with respect to each provision. In the light of the terms used in the other provisions, the selection of the word "payment" in Article 9.1(c) indicated an intention to apply a precise and limited ambit to the application of Article 9.1(c). Accordingly, the term "payment" had to be given its ordinary meaning and not be construed so as to encompass practices that could be covered by the use of broader terms such as "subsidies".

4.220 Canada argued that the negotiating history of Article 9.1 demonstrated that with respect to Article 9.1(c) in particular, the course of the agriculture negotiations had been to narrow the scope of that provision. Thus, the essential issue was what the parties agreed to at the end of the negotiations. In the context of the Agreement on Agriculture, this very point was made in one of the exhibits relied upon by the United States (paragraph 4.210).[218] Therein, Professor Tangermann identified production quotas with over-quota output sold at world market prices and price pooling arrangements as matters not presently covered under the Agreement on Agriculture and thus were subjects to be pursued in *future negotiations*.[219] Professor Tangermann recognized that the proper way to reconcile the divergent economic theories was by multilateral negotiation, not negotiation through litigation. Canada argued that it was apparent that Professor Tangermann viewed the results of the Uruguay Round in

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[217] Appellate Body Report on *US - Reformulated Gasoline, op. cit*, p. 18, DSR 1996:I, 16, III B.

[218] "A Developed Country Perspective on the Agenda for the Next WTO Round of Agriculture Negotiations", paper presented at the Graduate Institute of International Studies, Stefan Tangermann, contained in United States, Exhibit 24.

[219] *Ibid.*, p. 21: "Much effort was made in the Agreement on Agriculture to define export subsidies as precisely as possible, through appropriate wording in Article 9. However, there may be reasons to *consider some improvements*. In particular, there are policies which effectively may result in cross-subsidisation of exports and which may not be clearly enough outlawed by the current wording. Two cases in point are production quotas with above-quota output sold at world market prices, and price pooling arrangement." (emphasis added) Further at p. 23 Professor Tangermann wrote of the difficulty of getting countries to address this perceived problem and suggested two solutions: "However, *one could seek agreement* that new regimes of this type (ad (*sic*) new changes to old regimes resulting in the same type of effects on exports) established after the Uruguay Round are included in the definition of export subsidies. Alternatively, *one could agree explicitly* (*in some appropriate legal form*) that such regimes fall under Article 10 of the Agreement on Agriculture, i.e., that they amount to 'circumvention of export subsidy commitments'." (emphasis added)

agriculture as having an unsatisfactory economic result. While Professor Tangermann was entitled to his opinion as to the outcome he would consider to be desirable[220], the Agreement on Agriculture was not concerned with any particular economic theory but rather with specific legal obligations that were agreed to by Members.

4.221 Canada argued that if, indeed, the intention of the negotiators had been to stretch the meaning of "payment" beyond its ordinary meaning, this would have been provided for specifically. For example, the terms "budgetary outlay" and "outlay" had been defined in Article 1 of the Agreement on Agriculture as including "revenue foregone". Payment, however, which did not incorporate "revenue forgone" in its ordinary meaning, was not similarly defined. Confirmation of this could be found in the treatment of the word "payment" as it was used elsewhere in the Agreement on Agriculture. "Payment" appeared prominently in Annex 2 with respect to domestic support. In Article 5 of Annex 2 the reference was to "payments (or revenue forgone, including payments in kind)". Clearly, the drafters were aware that the ordinary meaning of payment did not include "revenue forgone" and specific provision for its inclusion would be required. The absence of any counterpart in Article 9.1 could only lead to the conclusion that in the case of Article 9.1(c) the drafters intended the ordinary meaning of "payment" to stand.

4.222 Canada further claimed that the negotiating history of the Agreement on Agriculture also supported Canada's submission that the term "payment" had to be construed precisely. Article 32 of the Vienna Convention permitted recourse to supplementary means, including the *travaux préparatoires*, to support the interpretation arrived at under Article 31.

4.223 Canada noted that Annex 7 to the Draft Dunkel Working Papers dated 21 November 1991 provided a proposed list of measures that would be deemed to be "export subsidies" for the purposes of reduction commitments.[221] As such, this list, which reflected earlier draft texts circulated in the summer of 1991[222], was a precursor to the eventual Article 9.1 in the Agreement on Agriculture. In particular, Article 3(k) of this draft was an early version of the text that would ultimately become Article 9.1(c). This paragraph referred to "subsidies", not "payments". The text of Paragraph 1(c) continued to refer to "subsidies" in the text of the 12 December Dunkel draft.[223] On 17 December 1991, Canada submitted to Arthur Dunkel a number of specific redrafting proposals on the agriculture text. Amongst these was an amendment to Paragraph 1(c) so as to substitute the word "payments" for the word "subsidies".[224] The text of Article 9(1) of the "Draft Final Act" of 20 December 1991 re-

[220] A Developed Country Perspective on the Agenda for the Next WTO Round of Agriculture Negotiations", paper presented at the Graduate Institute of International Studies, Stefan Tangermann, contained in United States, Exhibit 24, p. 21: "Such exports may, therefore appear *not to fall* under the export subsidy commitments under the Agreement on Agriculture. *From an economic point of view* this situation is not quite satisfactory." (emphasis added) Further at p. 22-23: "It is, therefore somewhat problematic, to say the least, that the Agreement on Agriculture so far does not include such indirect cross-subsidisation in its definition of export subsidies."

[221] Canada, Exhibit 29.

[222] Canada, Exhibit 30.

[223] Canada, Exhibit 53.

[224] Canada, Exhibit 31.

flected this change and referred to "payments".[225] This drafting history confirmed that the term "payments" was specifically and deliberately selected in place of a broader term. Accordingly, the word "payment" in Article 9(1)(c) had to be interpreted strictly in accordance with its ordinary meaning.

4.224 Moreover, Canada recalled its argument as set out under Article 9.1(a) that even if the word "payments" were held to include "revenue forgone", there was no revenue for the producers to forego with respect to sales of milk for export use under Special Classes 5(d) and (e) (paragraph 4.181 and following).

4.225 **New Zealand** noted that in the context of Article 9.1(c), Canada denied that the Special Milk Classes Scheme fell within the Agreement on Agriculture because (i) the word "payments" in Article 9.1(c) did not encompass revenue foregone and hence could not encompass what occurred under special milk classes, and (ii) even if the term "payments" did encompass revenue foregone, in fact no revenue was foregone under special milk classes. New Zealand refuted both contentions.

4.226 New Zealand maintained that in arguing for a restrictive meaning of the term "payments", Canada relied on both a contextual reading of the provision and negotiating history. In New Zealand's view, Canada had misread the context in which the term "payments" appeared and drawn inadmissible conclusions from the negotiating history.

4.227 New Zealand maintained that Canada sought to draw meaning for the word "payments" from the broad context of the Agreement on Agriculture, arguing that since in Article 5 of Annex 2 to the Agreement the terms "revenue foregone" and "payments in kind" were expressly included after the word payments, then the failure to mention either of these in Article 9.1(c) meant that they were excluded. New Zealand pointed out that Canada conveniently omitted to state that the term in Article 5 of Annex 2 was "direct payments" which in that context, given its connotation of money transfers, would have otherwise excluded "revenue foregone" or "payments-in-kind".

4.228 Furthermore, New Zealand argued that Canada had opted to explain the term payments by looking at the broader context of the Agreement on Agriculture, and focusing on domestic support disciplines, while ignoring the actual context of Article 9 itself. New Zealand emphasized that Article 9.2 made it clear that export subsidy reduction commitments were to include subsidies in the form of revenue foregone. It would thus defeat the purpose of Article 9 disciplines to read revenue foregone and payments-in-kind out of the definitions on which those commitments were based. The negotiators of Article 9 could not have intended such a result.

4.229 New Zealand argued that the express reference to revenue foregone and payments-in-kind in Article 5 of Annex 2, as well as the reference to revenue foregone in Article 9.2 (and other similar references in Annex 2, Articles 1(a), 2, 3 and 4; and Annex 3, Article 2), confirmed that subsidization by these particular means was specifically contemplated as being subject to the disciplines of the Agreement on Agriculture.

4.230 New Zealand noted that Canada further argued that the use of different terms to describe the export subsidy in question in each of the different sub-paragraphs of

[225] Canada, Exhibit 32.

Article 9.1 was evidence that different meanings for each of those terms was intended. However, the examples used all proved the opposite of Canada's contention. Each was an example of a subsidy, and thus it could not seriously be contended that only those sub-paragraphs where the word "subsidies" was used were, in effect, to be interpreted as referring to a subsidy or, as the Canadians stated, to be interpreted as broadly as express repetition of the word "subsidy" would require.

4.231 New Zealand noted the inference drawn by Canada from the fact that the word "payments" had been inserted in Article 9.1(c) of Article 9.1 in place of the word "subsidies" during the drafting phase - it appeared that Canada was of the view that this was done to *limit* the scope of the discipline in Article 9.1(c) so as not to include revenue foregone or payments-in-kind (paragraph 4.223). However, no negotiating history was cited by Canada to verify this assertion. In arguing that the change in wording indicated an intention to narrow the scope of Article 9.1(c), Canada overlooked the fact that at the same time as the change to the word "subsidies" was made, language was inserted aimed clearly at broadening the scope of that same sub-paragraph. The text was changed to make subsidies financed from the proceeds of a producer levy simply an example of the coverage of the provision rather than its specific referent.

4.232 New Zealand considered Canada's use of negotiating history in the context of Article 9.1(c) as problematic. Article 32 of the Vienna Convention permitted recourse to negotiating history as a *supplementary* means of interpretation to confirm a meaning or to resolve ambiguity or absurdity.[226] Canada claimed that it was using negotiating history simply to confirm a meaning. However, rather than showing a pattern of consistency in the use of the term, Canada was seeking to show that since the word "payments" differed from the word used in earlier drafts, that this confirmed the meaning Canada sought to ascribe to it. This was not using negotiating history to confirm a meaning. It was seeking confirmation by the drawing of a negative inference from the negotiating history. That was not, in New Zealand's view, what Article 32 contemplated.

4.233 Furthermore, New Zealand argued that given the nature of the negotiations in the Uruguay Round, the only negotiating history that could be referred to were the successive drafts of provisions. In the absence of negotiating records reflecting the intentions of the drafters, the meaning of changes in those successive drafts could be no more than conjecture. In the absence of records of the negotiators' discussions, there was no justification for choosing one explanation over another. New Zealand argued that in the present case, the use of the word "payments" could well have been designed to avoid the circularity that the word "subsidies" would have entailed. Para-

[226] New Zealand argued that the WTO Agreements, including the WTO Agreement on Agriculture, were to be interpreted in accordance with Articles 31 and 32 of the Vienna Convention on the Law of Treaties 1969 (the "Vienna Convention"). New Zealand noted that Article 31 of the Vienna Convention required that a treaty be interpreted in accordance with "the ordinary meaning to be given to the terms of a treaty in their context and in the light of its object and purpose". Article 32 provided that the preparatory work and the circumstances of the conclusion of a treaty could be referred to as a "supplementary means of interpretation" to confirm a meaning derived from the application of Article 31, or where the application of the approach set out in Article 31 produced a result that was "ambiguous or obscure," or was "manifestly absurd or unreasonable."

graph 9.1(c) was defining a subsidy; to have called it a subsidy at the outset - especially when no particular characterization, such as "direct" was needed - would have been tautologous. In short, the Canadian explanation of the meaning of the term "payments" on the basis of negotiating history proved nothing.

4.234 New Zealand noted that the issue of producer-financed export subsidies was the subject of considerable discussion in the negotiations on agriculture. The "conditions governing government participation in the operation of producer-financed subsidy schemes" was identified in the de Zeeuw Text as an issue to be resolved.[227] The negotiating document of 2 August 1991 identified, under the heading of "General Criteria", differential pricing arrangements as falling within the concept of an export subsidy.[228] The Illustrative List recognized specifically as an export subsidy, in Paragraph (k):

> "Subsidies on exports of agricultural products which are financed from the proceeds of a levy on producers of that product or on producers of the primary product from which the exported product is derived, under programmes in whose establishment, operation or financing governments are directly or indirectly involved."

4.235 New Zealand argued that this provision was clearly the precursor to Article 9.1(c) of the Agreement on Agriculture. New Zealand further argued that both the reference in the "General Criteria" to differential pricing and the terms of Paragraph (k) clearly treated schemes such as that now found in "special milk classes" as subsidies. Two changes were, however, made to Paragraph (k) before it found its way into Paragraph (c) of Article 9.1. First, the word "payments" was substituted for the word "subsidies" at the beginning of the sub-paragraph. Second, the provision was not limited to subsidies financed by producer levies. Producer levy-based subsidies became simply an illustration of producer-financed subsidies. Both of these changes confirmed the conclusion that Special Classes 5(d) and (e) of the Canadian scheme fell within Article 9.1(c). The word "payments" carried within it both the sense of revenue foregone and payment-in-kind. The change to make clear that producer-levy-financed subsidies were not the only producer-financed subsidies that were covered by the sub-paragraph, only reinforced the conclusion that subsidies, such as that provided under "special milk classes", were to be covered.

4.236 New Zealand noted that following Canada's approach, if the word "subsidies" had been used in Article 9.1(c), it would have had to have been interpreted in accordance with Article 1 of the SCM Agreement. This of itself would have qualified the scope of the subsidy under Article 9.1(c). Yet, as Canada had acknowledged (paragraph 4.127) that Article 9.1 provided an "illustrative list" of export subsidies and hence broadened the scope of the concept of export subsidies under Article 1 of the Agreement on Agriculture. By this analysis, in order to be consistent, Canada should be arguing that the use of the word "payments" in Article 9.1(c) was designed to expand the scope of the measures beyond that which would have been covered if the word "subsidies" had been used.

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[227] MTN.GNG/NG5/W/170, p.6 (para. 22).
[228] MTN.GNG/AG/W/1/Add.10, p.1 (para. 2).

4.237 New Zealand argued that whether it was viewed as revenue foregone by the provincial milk marketing board or agency, or revenue foregone by the producer - which was, in New Zealand's view, precisely the type of subsidization that Article 9.1(c) was designed to capture - or whether it was viewed as a payment-in-kind, the provision of lower-priced milk to the processors of dairy products for export, under Special Classes 5(d) and (e), was a "payment on the export of an agricultural product" within the meaning of Article 9.1(c).

4.238 The **United States** claimed that Canada had misrepresented the conclusions of Professor Tangermann regarding the applicability of the Agreement on Agriculture's disciplines on export subsidies to Canada's Special Milk Classes Scheme (paragraph 4.220). Canada had focussed on a discussion in the Tangerman article that related to quota systems that involved the export of the actual product subject to the quota, for example, sugar from the European Communities, a different situation than was represented by Canada's Special Milk Classes Scheme, where it was the export processor who benefitted from the low priced over-quota production. Canada failed to mention the more pertinent conclusions reached by Professor Tangerman later in his article, which specifically addressed the Canadian dairy regime: "Countries should, therefore, not be allowed to escape their export subsidy commitments by using a price pooling regime. It should be clear that an effective constraint on the extent of price pooling is established through the commitments on export subsidies."(footnotes omitted) United States, Exhibit 24, at p.33. In footnote 13 of his paper, Professor Tangerman said: "This may have serious implications for the new price pooling regime for milk established in Canada, which substituted for the producer-financed export subsidies used in Canada prior to the conclusion of the Uruguay Round."

4.239 **Canada** noted that New Zealand disputed the precision of "payment" by arguing that the expression "direct payment" would have been used if that precision had been intended (paragraph 4.227). This contradicted New Zealand's position on "direct subsidy" - New Zealand had argued that "… a 'direct' subsidy was one affecting trade in the product directly rather than one affecting trade incidentally or indirectly." (paragraph 4.188). In Canada's view, Article 9.1(c) export subsidies were not limited to direct payments (i.e., it did not exclude payments affecting trade incidentally or indirectly) but they were limited to "payments" in the ordinary meaning of the word. Canada argued that the negotiators had felt the need to clarify references to direct payment in Annex 2 by explicitly including the concept of "payment-in-kind." Had the negotiators intended to include that concept in Article 9.1(c) they would have explicitly included it in this provision as well. The fact that they did not was significant in interpreting the Agreement.

4.240 Canada further noted that the Complainants had suggested that the term "payment" in Article 9.1(c) included "revenue foregone". While "revenue foregone" was part of the definition of subsidy, it was not part of the ordinary meaning of "payment". For example, it was common for retail establishments in Canada to offer price discounts to persons over 60 or 65 years of age. It was not at all common for these discounts to be considered "payments" received by these shoppers. Canada further noted that the United States had acknowledged that the concept of revenue

foregone was generally associated only with circumstances involving a governmental treasury and public funds, such as where taxes were forgone.[229] Canada reiterated that even if "payment" were to include revenue foregone, there was no revenue foregone as producers received the best price available in either the domestic market or the xport market (paragraph 4.181 and following). Moreover, the only payment was the commercial payment made by the processor to obtain the product. In addition, there was no evidence of these payments being financed by virtue of government action.

(ii) Financed by Virtue of Governmental Action

4.241 **New Zealand** argued that the requirement of governmental involvement in subsidization under Article 9.1(c) was clearly met in the present case (see arguments set out in paragraph 4.41 and following). The government action concerned did not have to involve the government itself paying money or foregoing revenue because immediately after the phrase "financed by virtue of government action" were the words "whether or not a charge on the public account is involved." Moreover, the words "by virtue of" indicated that while the involvement of government had to be present, government action need not be the sole or exclusive agent in the financing of the subsidy.

4.242 In the specific context of export subsidies under the Agreement on Agriculture, the phrase "financed by virtue of governmental action" in Article 9.1(c) suggested that the intention of the drafters of the Agreement on Agriculture was *not* that there be a *high* threshold for government involvement in order to constitute subsidization. Canada's actions in respect of the Special Milk Classes Scheme met the appropriate threshold.

4.243 New Zealand noted that Canada had admitted that the government involvement in its dairy supply management system was sufficient to meet the requirement that any "payments" had been "financed by virtue of governmental action." In Annex B to its Second Written Submission, Canada stated:

> "Canada does not deny that the previous producer-funded levy/rebate scheme fell within the deeming provision in Article 9.1(c) of the Agreement on Agriculture. That scheme has been replaced."[230]

4.244 New Zealand maintained that what had been replaced was the way in which exporters were relieved from the high domestic price of milk; what was not replaced was the nature or level of government involvement in the system. According to the description that Canada had provided of its system, decisions were made by producers operating through dairy marketing boards and the CMSMC. The role of the CDC was simply to implement these producer-made decisions. That, presumably, was what the CDC was doing when the producer levy/rebate system was in operation, and that was what the CDC was, according to Canada, doing today. Hence, even accepting, for purposes of argument, the Canadian depiction of the role of government in the operation of the system, then an admission that the producer-levy scheme fell

[229] Canada referred to the US response to the Panel's Question 4 (p.5) to New Zealand and the United States.

[230] Annex B of Canada's Second Written Submission, p.7.

within Article 9.1(c) was an admission that the existing Special Milk Classes Scheme had to be "financed by virtue of governmental action".

4.245 In view of this admission by Canada, the only issue under Article 9.1(c) was whether the action of providing lower-priced milk to exporters constituted a "payment" within the meaning of that provision. New Zealand argued, in light of the discussion under Section (i) above, that since the term "payments" in Article 9.1(c) of the Agreement on Agriculture included the foregoing of revenue or payments-in-kind, the Special Milk Classes Scheme constituted a payment on the export of an agricultural product *financed by virtue of governmental action* within the meaning of Article 9.1(c) and hence constituted an export subsidy.

4.246 The **United States** noted, in respect of the second condition to the applicability of Article 9.1(c), i.e, that the export payment be "financed by virtue of governmental action", that as the term "governmental action" was not defined in the Agreement on Agriculture, resort to the Vienna Convention for assistance in interpreting that term was appropriate.

4.247 The United States maintained that the ordinary meaning of the phrase "financed by virtue of governmental action" reasonably included circumstances in which the financial underpinning of an export payment was fixed by the undertakings of a government entity. In this context, government action could include activity either at the federal level or provincial level, or by both, in a federal system. By the very terms of Article 9.1(c), its scope was not limited to export subsidies funded by charges on the public account. To the contrary, the section explicitly stated that a charge on the public account was not a prerequisite to its coverage. By inference, there had to be financing based on some form of contribution from private entities that was mandated by a government, whether national or local in jurisdiction. Article 9.1(c)'s specific inclusion of "payments that are financed from the proceeds of a levy," in this context, made clear that a levy imposed on an agricultural product to support either its export, or that of a product derived from it, and which was administered by a government, meant that government action to administer and enforce such producer levies satisfied the requirement that a payment be "financed by virtue governmental action". By logical extension, similar administrative and enforcement actions by a Member government of other forms of subsidies financed through joint, but not voluntary[231], producer actions had to be included within the scope of Article 9.1(c) as well. This construction of the phrase "financed by virtue of governmental action" was consistent with both the purpose and objective of the reduction commitment provisions of the Agreement, as well as the historical background against which the treaty was negotiated. As had been noted earlier, the inclusion of producer-financed subsidies within the listing of export subsidies subject to reduction commitments was the result of the view that such subsidies were no different from subsidies funded by a government's treasury in terms of the deleterious effect which they had on trade (paragraph 4.146).

[231] The United States noted that, as had been indicated, the participation of dairy farmers in the special milk class price system was not voluntary, nor was their participation in the predecessor producer levy/rebate programme.

4.248 The United States maintained that the concerted action of Canada's federal and provincial governments in establishing and enforcing the levy system and then introducing and administering the special milk class price system satisfied the Article 9.1(c) requirement that the export payments be financed by virtue of governmental action. Thus, the actions of the Canadian government pervaded virtually every aspect of the producer-financed export subsidies, which were now entirely dependent on the Special Milk Classes Scheme (see the United States' argument under paragraph 4.54 and following).

4.249 The United States contended that the Canadian government's involvement in every aspect of supply management, including the Special Milk Classes, and the pooling arrangements through which the Special Milk Class prices were made possible, demonstrated that the financing of the milk discounts, which constitute "payments on the export" of dairy products, was accomplished by virtue of action by the Government of Canada. Accordingly, all prerequisites for the applicability of Article 9.1(c) to the Canadian Special Milk Class system were satisfied, and this producer-financed export subsidy was, therefore, subject to the export subsidy reduction commitments set forth in Part V of the Agreement on Agriculture.

4.250 **Canada** maintained that the sales of milk under Special Classes 5(d) and (e) did not constitute an export subsidy within the meaning of Article 9.1(c). In order to show that Special Classes 5(d) and (e) were export subsidy practices within the meaning of Article 9.1(c), the Complainants had to show that (i) "payments" were made on the export of products from Canada; and (ii) that such "payments" were "financed by virtue of governmental action". Canada claimed that this test had not been met.

4.251 Canada contended, in respect of the differences in the nature of government involvement between the new Special Milk Classes Scheme and the old levy-based system (paragraph 4.242), that under the old system, the CDC had made payments directly to processors to rebate the price of milk already paid by the processors exporting dairy products. Such payments would only take place if exports were taking place. These payments were financed by levies imposed on all producers for every hectolitre of milk produced. The funds were held in an account by the CDC and could be used by it, at its own discretion, in any amount necessary to make any sale it felt to be appropriate. Producer boards were aware of CDC actions only as they were reported in accounting to the CMSMC for the overall cost of the surplus disposal programme. The boards exercised control by approving a levy rate, after which the operation of the programme passed to CDC. Individual producers were aware only of the levy rate on their production, and of the year-end adjustments that sometimes resulted if not all the levy funds were spent over the course of a dairy year. Levies were mandatory payments not unlike taxes. The payments were issued by the CDC under general direction of the CMSMC, not unlike government subsidies (although there was no government money involved). In addition, under the old system, over-quota production was discouraged and penalized. The discouragement of over-quota production was not merely a policy decision, but was a result of Canada's obligation under GATT Article XI:2(c)(i) to limit production and marketing as a condition of maintaining quantitative import restrictions.

4.252 Canada argued that the current Canadian dairy export arrangements were entirely different. No levies were imposed on producers any longer. The CDC did not have any pot of money with which to make payments to exporters, and in fact, no

payments were made to processors. For each transaction under Classes 5(d) and (e), processors and the CDC as the agent of producers commercially negotiated the price of milk. The producer boards reviewed each transaction and had the ultimate authority to reject or accept the CDC recommendation with respect to any particular Class 5(d) or (e) permit. The producer boards acted in this system as true commercial representatives of the producers, seeking to ensure that the terms of each sale were to their benefit. Producers were made aware on each milk cheque of the returns achieved for Class 5(e) transactions. They had the necessary information to make a decision whether to seek, through their producer boards, any adjustments to quota levels needed to minimize in-quota sales under Class 5(e). They were also in a position to assess clearly, on an individual basis, the attractiveness of over-quota production, which was no longer penalized. As Canada had demonstrated, significant numbers of them had decided that such production was worthwhile, and they had pursued it.

4.253 Accordingly, Canada contended that the practices in dispute did not constitute payments that were "financed by virtue of government action." The basis for the sale of milk for export purposes was through arm's length negotiations involving processors and agents acting for producers. This resulted in sales based on world market prices. Such conditions could not fall within the concept of "financed by virtue of government action".

(d) Article 10

(i) Outline

4.254 **New Zealand** argued that, in the alternative, the Special Milk Classes Scheme constituted an export subsidy within the meaning of Article 1 of the Agreement on Agriculture that operated to circumvent Canada's export subsidy commitments under Article 9 of that Agreement. Hence, Canada was in breach of its obligations under Article 10 of the Agreement on Agriculture.

4.255 The **United States** claimed that even if the Panel determined that neither Article 9.1(a) nor 9.1(c) encompassed the Special Milk Classes Scheme, it was nonetheless an export subsidy within the meaning of Article 10 of the Agreement on Agriculture. This conclusion followed from the treatment of producer-financed subsidies as export subsidies in the 1960 Working Party Report relating to the notification of export subsidies under Article XVI of the GATT 1947. This conclusion was also compelled by an analysis of the Special Milk Classes Scheme under the SCM Agreement (paragraph 4.301 and following).

4.256 The United States further claimed that the object and purpose of Article 10.1 of the Agreement on Agriculture was to prevent the circumvention of export subsidy commitments. This was reinforced by Article 10.3 which placed the onus on an exporting Member to demonstrate that any exports in excess of its scheduled commitments were not subject to export subsidies. Canada concurred in this construction of the Article 10.3 obligation. Hence, the United States claimed that that Special Milk Classes Scheme resulted in, and threatened to lead to, circumvention of Canada's WTO subsidy reduction commitments.

4.257 **Canada** submitted that Article 10 did not apply in the present case as it could not be established that there existed export subsidies other than the export subsidies listed in Article 9.1, nor could it be established that there was actual or threatened

circumvention of the export subsidy commitments. Canada noted that Article 10.1 consisted of three components. There had to be either:

(a) an export subsidy other than an export subsidy listed in Paragraph 1 of Article 9 (i.e., a subsidy contingent on export performance);

or

(b) a non-commercial transaction;

and

(c) components (a) or (b) or both had to be applied in a manner which resulted in, or threatened to lead to circumvention of the subsidy reduction commitments found in Article 9 as elaborated in each Members schedule.

4.258 Canada's position was that neither component (a) or (b) existed in the current case and thus it was not necessary to consider the application of component (c) in order to resolve the dispute. Canada claimed that neither the United States nor New Zealand relied upon component (b) in furtherance of their claims.[232] The only remaining possibility for the application of Article 10.1 was if the practices constituted export subsidies other than an export subsidies listed in Article 9.1. Canada submitted that the analysis applied by Canada demonstrated that no such export subsidy existed.

(ii) "Export subsidy" within the Meaning of Article 10

4.259 **New Zealand** argued that even if the export subsidy provided under the Special Milk Classes Scheme was not encompassed by the list of subsidies in Article 9.1, it would still constitute an export subsidy within the meaning of Article 10. The basic definition of an export subsidy for the purposes of the Agreement on Agriculture was found in Article 1(e). That provision defined "export subsidies" as "subsidies contingent upon export performance." There was no doubt that access to lower-priced milk under Special Classes 5(d) and (e) was contingent on the milk being used in the production of products for export and hence was "contingent upon export performance". Any measure not listed in Article 9 that came within this definition would thus meet the requirements of Article 10.1. This would include, for example, any measures that met the definition of subsidy under Paragraph (d) of the Illustrative List of Export Subsidies in Annex I to the SCM Agreement. The question was whether providing this lower-priced milk was a subsidy.

4.260 New Zealand noted that the Agreement on Agriculture did not define the concept of a subsidy; accordingly recourse had to be had to the broader context of the

[232] In response to a Panel question, the United States noted that it had not relied in its claims on the second part of Article 10.1, which directed that non-commercial transactions shall not be used to circumvent export subsidy reduction commitments. The United States argued that to the extent that transactions involving non-commercial dairy products had occurred, those transactions appeared to be included within the scope of the subsidies specifically enumerated in Article 9.1 of the Agreement and, therefore, reliance on the second part of Article 10.1, even if applicable, appeared to be unnecessary. New Zealand stated that it was not making a case in the context of non-commercial transactions in the context of Article 10.1 of the Agreement on Agriculture.

WTO Multilateral Trade Agreements in Annex IA to the WTO Agreement in order to determine what fell within the scope of a "subsidy". In this regard, guidance could be obtained from the SCM Agreement which provided both a definition of what constituted a "subsidy" for the purposes of that Agreement and an Illustrative List of Export Subsidies. New Zealand noted that Canada's arguments against the application of Article 10 of the Agreement on Agriculture were simply an extension of its argument that Article 1 of the SCM Agreement provided the definition of subsidy for the Agreement on Agriculture. Since, Canada argued, the Special Milk Classes Scheme did not provide a subsidy within the meaning of Article 1 of the SCM Agreement or of the Illustrative List of Export Subsidies in Annex I of that Agreement, then there was no export subsidy within the meaning of Article 10.

4.261 New Zealand claimed that the Special Milk Classes Scheme did come within the definition of Article 1 of the SCM Agreement, and also constituted a subsidy under Paragraph (d) of the Illustrative List (Section 4). Thus, even if the Panel were to conclude that the specific provisions of Article 9.1(a) or 9.1(c) had not been met, there would still be an export subsidy within the meaning of Article 10 that circumvented or threatened to lead to circumvention of Canada's export subsidy commitments. New Zealand argued that the scope of the concept of export subsidy under the Agreement on Agriculture was broader than the definition of subsidy under Article 1 of the SCM Agreement. Export subsidies under the Agreement on Agriculture included those subsidies listed in Article 9.1 of that Agreement. As Canada had acknowledged (paragraph 4.127) in addition to being an exhaustive list for the purposes of Article 9.1, the Article 9.1 list was an *illustrative* list of export subsidies for the purposes of Article 1 of the Agreement on Agriculture. Thus, in determining what constituted an "export subsidy" for the purposes of Article 10 of the Agreement on Agriculture, guidance could be sought from the types of measures included in Article 9.1.

4.262 New Zealand noted that in the present case, the Canadian scheme differed only from the previous levy-based system by virtue of a "book-keeping entry" (that is, milk was now being provided at a *reduced* price "contingent upon export", instead of being provided previously at *full* price with a *rebate* being subsequently paid). New Zealand had argued that such a change in book-keeping did not remove the scheme from the reach of Article 9.1. However, in the event that the Panel did not accept this, New Zealand believed that the "special milk class" scheme was, nonetheless, precisely the kind of circumventory measure that the negotiators of Article 10 would have intended to catch. It was a measure analogous to an Article 9.1 measure and thus one that fell within the scope of an "export subsidy" within the meaning of Article 1 of the Agreement on Agriculture and hence was an export subsidy under Article 10.

4.263 The **United States** noted that the Agreement on Agriculture defined export subsidies as "subsidies contingent on export performance, including subsidies listed in Article 9 of this Agreement." (Article 1(e)) The reference in Article 10.1 to "export subsidies" not listed in Article 9, was thus intended to capture all export subsidies within the meaning of Article 1(e) of the Agreement other than those specifically described in Article 9.1 of the Agreement on Agriculture. Because neither Article 10, nor any other provision of the Agreement on Agriculture, expressly defined the term "subsidy", it was necessary, consistent with "customary rules of interpretation of public international law", to consider the context, object and purpose of this particu-

lar treaty provision to give meaning to that term. The context of Article 10 included the remaining provisions of the Agreement on Agriculture, as well as the provisions of other relevant WTO Agreements, including the Agreement on Subsidies and Countervailing Measures. Both the Illustrative List of Export Subsidies contained in Annex I of the SCM Agreement and Article 1 of that Agreement informed the meaning of "subsidies" for purposes of the Agreement on Agriculture (Section 4). Therefore, measures that satisfied the requirements of either the Illustrative List or Article 1 of the SCM Agreement also would be subsidies for purposes of Article 10 of the Agreement on Agriculture.

4.264 **Canada** argued that it had shown that the sales of milk in question did not constitute an "export subsidy" under Article 1 of the Agreement on Agriculture. More specifically, Canada had shown that there was no "subsidy" as that term was defined in the SCM Agreement and that there was no practice that fell within the list of "export subsidies" in the Illustrative List attached to that agreement. As a result, there was no "export subsidy not listed in Paragraph 1 of Article 9". Therefore, Article 10.1 could not apply.

(iii) "Circumvention"

4.265 **New Zealand** noted that prior to the conclusion of the Uruguay Round, Canada disposed of its surplus milk through subsidized exports financed by producer levies. New Zealand argued that the essence of the producer levy-based subsidy scheme had been that exporters of dairy products would be compensated for the high domestic price of milk. Producers would pay the cost of this subsidy. Canada's new scheme achieved precisely the same result. In substance, nothing had changed under the Canadian system. The financial effects for the producer and the exporter were essentially the same. Under the old scheme the exporter of dairy products benefited from a subsidy that provided protection from the high domestic cost of inputs in the production of those products, and the producer paid the cost of this subsidy. Exactly the same situation existed today.

4.266 New Zealand argued that the export competition rules in the Agreement on Agriculture sought to discipline action by governments that shielded the exporters of dairy products from actual costs in the production of those products. Producer levy-based subsidies were expressly included in Article 9 for that reason. A scheme that in substance and effect achieved precisely the same result as the producer levy-based subsidy was circumvention. That this was the case was evident from the introduction of the Special Milk Classes Scheme. It came into effect on 1 August 1995, the day on which the export subsidy reduction commitments in Canada's WTO Schedule became effective. New Zealand noted that the objective of Canada's Special Milk Classes Scheme of avoiding the consequences of abolishing the producer levy-based subsidies and replacing them with a system that would have precisely the same economic effect, had been acknowledged openly by Canadian government and Canadian dairy industry officials. Lyle Vanclief, then Parliamentary Secretary to the Minister of Agriculture and Agri-Food, told the Canadian House of Commons Committee on Agriculture:

> "We're not changing; we're not changing anything in the price of the milk, just the way in which it's done… Rather than the levies being collected, being paid x number of dollars and then having a levy taken off that for that portion of the milk to meet these demands, the price is

being pooled and the bottom line, the net, is being paid to the producer in the first place."[233]

4.267 New Zealand contended that the effect of the Special Milk Classes Scheme was to circumvent Canada's export subsidy commitments under the Agreement on Agriculture. Canada's export subsidy commitment for butter by volume for 1995/1996 was 9,464 tonnes. Its actual exports for that year were 14,574 tonnes. For 1996/1997, its commitment in respect of butter was 8,271 tonnes. Its actual exports were 15,567 tonnes. Canada's export subsidy commitment in respect of cheese by volume for 1996/1997 was 11,773 tonnes. Its actual exports were 20,086 tonnes. Canada's export subsidy commitment for "Other Milk Products" by volume for 1996/1997 was 35,649 tonnes. Its exports of whole milk powder alone in 1996/1997 were 36,632 tonnes. New Zealand concluded that there was a pattern that showed that Canada's exports of major dairy products, with the exception of skim milk powder, had increased dramatically since the introduction of the Special Milk Classes Scheme. These exports of subsidized products completely undermined the export subsidy commitments made by Canada on becoming a Member of the WTO. The Special Milk Classes Scheme clearly constituted circumvention of Canada's export subsidy commitments and given Canada's rapidly expanding exports of dairy products on the basis of the incentives provided by "special milk classes", there was a threat of further circumvention of Canada's export subsidy commitments.

4.268 The **United States** noted that to determine the meaning of the term "circumvent", it was necessary to consider the ordinary meaning of the term.[234] The ordinary definition of the verb to circumvent (from which the noun "circumvention" was derived) was to overreach, outwit, avoid or evade.[235] Thus, Article 10.1's mandate that export subsidies, other than those listed in Article 9.1, were not to be used in a manner that resulted in, or threatened to lead to, circumvention of the export subsidy commitments had be construed to mean that such other export subsidies were not be used to evade or avoid the export subsidy disciplines contained in Article 9.1.

4.269 The United States argued that a broad construction of the term "export subsidy" was justified by the object and purpose of Article 10.1. Article 10.1 of the Agreement on Agriculture was an anti-circumvention provision. Its purpose was to ensure that reduction commitments on the export subsidies listed in Article 9.1 were not undermined. It recognized that Members might introduce export subsidies of a kind not listed in Article 9.1, but which would nevertheless achieve the same or similar results in practice. Pursuant to Article 10.1, those "other export subsidies" were subject to the same export reduction commitments.

4.270 The United States recalled that the reduction commitments entailed both a reduction in the amount of the outlays, and also a reduction in the quantity of exports subsidized.[236] The commitments specific to each Member were set forth in Section IV, Part II, of each Member's schedule. Thus, an export subsidy bestowed by a Member which subsidized exports of a specific product in excess of the quantity set forth

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[233] *House of Commons Committee on Agriculture Hearing* (30 May 1995) at p.9 of the material downloaded from www.parl.gc.ca on 27 March 1997. (New Zealand, Annex 2)

[234] Appellate Body Report on *Brazil - Desiccated Coconut, op. cit.*, p.15, DSR 1997:I, 180, IV E.

[235] *The Oxford English Dictionary*, 2nd Edition, Clarendon Press, 1989.

[236] Article 3.3, 8, Agreement on Agriculture.

in its Schedule for a specific year would constitute a circumvention within the plain meaning of Article 10.1, of that country's reduction commitments for that product.

4.271 The United States noted that this construction of the circumvention language in Article 10.1 was consistent with both the object and purpose of the export subsidy disciplines contained in Part V of the Agreement and the Agreement as a whole. As stated in the preamble to the Agreement,[237] the Members' objective in concluding the Agreement included the goal of establishing a fair and market-oriented agricultural trading system and specific binding commitments respecting export competition. Thus, the object and purpose of Article 10.1 required that a Member not use any export subsidies in connection with export quantities exceeding the levels to which commitments had been made in the Member's respective schedules.[238] To allow otherwise would significantly undermine those subsidy disciplines, and thereby permit evasion of the reduction commitments which represented a fundamental aspect of the reform in agricultural trade. In this connection, the language of Article 10.3 discussed was highly pertinent (paragraph 4.295 and following). This provision directed that if a Member exceeded its reduction commitment relating to the quantity of subsidized exports of a specific product, it had to demonstrate that no export subsidy had been granted with regard to those exports that exceed the volume commitment. The key operative language in this provision was that *no* export subsidy, *whether or not listed in Article 9*, was permitted with regard to that quantity of exports that exceeds the reduction commitments. Any subsidy of a quantity of exports that was greater than the reduction levels adopted in the pertinent Member's schedule was inconsistent with that Member's obligations under the Agreement in Agriculture.

4.272 Hence the United States argued that to the extent that a country provided an export subsidy that fell outside the export subsidy categories set forth in Article 9.1, that export subsidy could not be used to circumvent the subsidy reduction commitments. Consequently, an application of an export subsidy to a quantity of exports that was greater than that set forth in a Member's schedule would by definition constitute a circumvention of its obligations under Articles 3, 8 and 9 of the Agreement.

4.273 The United States maintained that Canada had transformed its producer-financed export levies by adopting a new subsidy regime in an apparent effort to evade any reduction commitment. This was precisely the action that Paragraphs 1 and 3 of Article 10 were designed to address. The drafters of Article 9.1 knew that the export subsidy disciplines would be undermined if Members were free to substitute different export subsidies from those listed in Article 9. Article 10.1 was simply intended to preclude such substitution if the export subsidies either resulted in, or threatened, circumvention of the reduction commitments contained in a Member's schedule.

4.274 The United States recalled that the officials of the Government of Canada and the Canadian dairy industry had stated that the special milk class price system was

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[237] The United States noted that the panel in *United States - Import Prohibition of Certain Shrimp and Shrimp Products* (hereafter "*US - Shrimp-Turtle*"), WT/DS58/R, adopted 6 November 1998, para. 7.42, had observed that the preamble of an agreement may assist in determining its object and purpose.

[238] The United States noted that Article 3.3 limited the use of export subsidies listed in Article 9.1 to the specific subsidy outlays and export quantities specified in each Member's schedule.

designed to support exports in the same manner that the pre-WTO levy/export rebate system had subsidized exports. Moreover, it was estimated by Canadian officials that the conversion to the special milk class price system would not alter the economic equation, in terms of revenue received and costs incurred, for either the dairy farmers or the dairy product producers.

4.275 In conclusion, the United States argued that Canada's special milk class price system was an export subsidy of dairy products in excess of the limits for Canada under the Agreement on Agriculture, whether they fall under Article 9 *or* Article 10 of that Agreement. As a result, those subsidies did not benefit from the exemption in Article 13(c)(ii) of that Agreement on Agriculture. Consequently, these export subsidies were also inconsistent with Canada's obligations under Article 3 of the SCM Agreement.

4.276 **Canada** argued that the Complainants were basing themselves more on rhetoric than on law, in arguing that Canada was circumventing the obligations of the Agreement on Agriculture because it was pursuing the same *objectives* (preserving the integrity of the Canadian milk supply management system) as it pursued prior to the entry into force of the WTO Agreement. The Complainants' arguments relied on statements made by Canadian officials to the effect that, in bringing Canada's measures into conformity with the WTO Agreement, Canada would continue to seek the same objectives as before. Yet, Canada argued that Article 10.1 manifestly did not regulate *objectives*. It simply stated that "*export subsidies* not listed in Paragraph 1 of Article 1" were not to be used in a way that would circumvent the commitments.

4.277 Canada argued that the statement made by the United States was unnecessarily broad in saying that an export subsidy, irrespective of whether it is covered by Article 9.1, in excess of the quantity set out in its Schedule "would constitute a circumvention within the plain meaning of Article 10.1" (paragraph 4.270). It was only "export subsidies" other than those covered by Article 9.1 that could possibly be subject to Article 10. An export subsidy covered by Article 9.1 that exceeded the quantity commitments was not a circumvention of Article 9 but rather a violation of Article 8. The United States was mistaken to the extent that they appeared to suggest that the use of export subsidies listed in Article 9 in excess of a Member's subsidy reduction commitments under that Article gave rise to a separate claim of circumvention under Article 10. Canada concurred that where export subsidies, other than those listed in Article 9.1, had been applied to a commodity subject to subsidy reduction commitments in excess of the reduction commitment level specified in a Member's schedule for that commodity, a presumption of circumvention pursuant to Article 10 would arise. The critical issue was whether any such "export subsidies" had been granted.

4.278 Canada stressed the importance of the exact nature of Article 10.1. It *did not* say that parties could not use mechanisms other than "export subsidies" in order to attain the general or political objectives for which "export subsidies" were previously used. To the contrary, it was drafted to have a very targeted and limited meaning: to limit the use of "export subsidies" defined in Article 1 of the *Agreement on Agriculture*, not listed in Article 9.1, to circumvent export subsidy reduction commitments. The drafters did not intend it to be used to limit the rights of Members to use measures that the negotiators of the Agreement on Agriculture did not agree should be restricted.

4.279 Canada argued that bringing measures into conformity with the WTO Agreements while trying to achieve the same policy objectives did not, in itself, constitute "circumvention" or an "evasion" of the reduction commitments. The Canadian statements quoted in the Complainants' submissions had to be viewed in that light. Canada did not dispute that following the entry into force of the WTO Agreement, it intended to preserve the integrity of the Canadian milk supply management system. Indeed, the continued preservation of certain domestic agricultural programmes within the legal framework established by the Agreement on Agriculture was the intention of almost every WTO Member. The special regime provided for in the Agreement on Agriculture made no sense seen in any other light.

4.280 Canada argued that the change from a levy system to the present system of individual and collective producer decisions based on market-based prices for exports was one of the many steps taken to bring Canadian measures into conformity with WTO commitments in the implementation process; the character and effect of the new system compared to the pre-Uruguay Round levy system was profoundly different. With the introduction of the Special Milk Classes Scheme, Canada moved from a penalty-based system designed to limit production closely to domestic requirements for GATT 1947 Article XI purposes, to a new market-driven opportunity system that offered producers the chance to take commercial risks and enter the export market. Presented with opportunity, rather than penalties, those producers who wished to enter the new environment could do so with a completely different attitude. However, since no one was forced to do so, producers also had the option to rely only on the domestic market. Hence, it was quite accurate to indicate to producers that, *if they so chose,* they could decide not to export and there would be no great impact on their positions.

4.281 Canada argued that it was inaccurate to suggest that there was circumvention because the Special Milk Classes Scheme were essentially the same and that in substance, nothing had changed. Canada noted that there had indeed been a significant increase in exports from Canada under the new Special Milk Classes Scheme, reflecting the fact that it was a different system. Hence, if the old and new systems were the same, as argued by the Complainants, then they had to explain why the current system was producing such different results. Those producers that did not wish to participate in export markets (beyond the limited amount included in-quota) could remain largely unaffected by the export market. Those who wished to do so could have an unlimited commercial opportunity to participate in export markets on the basis of actual world price signals. In practice, therefore, Canada's new export policies for dairy exports reflected the assurances of continuity provided to producers by Ministers in 1995, while at the same time opening up new opportunities, consistent with the new rules negotiated under the WTO. In summary, Canada submitted that the introduction of the new Special Milk Classes Scheme demonstrated Canada's *intention* to be consistent with its WTO obligations and not to circumvent them.

4.282 **New Zealand** stressed that the objective of Article 10 was to discipline circumvention. It was designed to capture measures which did not meet the particular definitions in Article 9.1, but which nevertheless had the same economic effect as a subsidy subject to Article 9 reduction commitments. Measures analogous to those listed in Article 9.1, although not technically meeting the strict letter of Article 9, clearly were in the minds of drafters seeking to avoid circumvention of Article 9

commitments. Hence, the illustrative role of Article 9.1 export subsidies in the definition of export subsidies under Article 1 of the Agreement on Agriculture.

4.283 New Zealand noted that Canada had also argued that even if there was an export subsidy there was still no "circumvention". The essence of the Canadian position was that there was no prohibition under the WTO against adopting measures that achieved the same objectives as were achieved by previously used export subsidies. However, New Zealand contended, that was not the issue. What was at issue in this case was whether it was permissible under the Agreement on Agriculture to introduce an export subsidy that had the same effect as an export subsidy for which reduction commitments have been made. Article 10 clearly proscribed such subsidies because they circumvented export subsidy reduction commitments. New Zealand believed that this was what had occurred in this case. Canada had introduced a measure that constituted an export subsidy. That subsidy achieved precisely the same effect as the export subsidy based on producer levies which Canada abandoned because it fell within Article 9.1 of the Agreement on Agriculture. Whether Canada intended or did not intend that the new measure comply with its WTO obligations was irrelevant. Article 10 did not require that there be any proof of intent to circumvent, it only required that there be actual or threatened circumvention of commitments.

4.284 New Zealand noted that Canada rested its response to the argument that the Special Milk Classes Scheme contravened Article 10 of the Agreement on Agriculture simply on the basis that the measure was not a subsidy within the meaning of the SCM Agreement, and hence did not fall within Article 10 of the Agreement on Agriculture. This approach to the interpretation of the Agreement on Agriculture was flawed. More specifically, in the context of Article 10, it constituted a denial of the object and purpose of that provision which was to prevent circumvention of export subsidy commitments. Interpreting the meaning of "export subsidy" under Article 10 had to involve looking at the term in its particular context and in the broader context of the Agreement on Agriculture as a whole. Thus, the broad scope of the concept of export subsidy under Article 1 of the Agreement on Agriculture, for which Article 9.1 provided an "illustrative list", and the object of preventing circumvention which lay at the heart of Article 10, provided an important part of the context for the interpretation of the meaning of "export subsidy" under Article 10.

4.285 New Zealand argued that the ambit of "circumventing" or simply of "threatening to lead to circumvention" was very broad and this gave some insight into the objective of Article 10. Article 10 was included in the Agreement on Agriculture because Members were concerned that the export subsidy commitments undertaken under Article 9 could be nullified by subsidies that did not fit the precise definition of Article 9 but equally had the effect of shielding exporters from the actual cost of production of goods destined for export. That object and purpose also had to be taken into account in determining what constituted an export subsidy for the purposes of Article 10.

4.286 New Zealand submitted that the broad scope of the definition of export subsidy in Article 1(e) of the Agreement on Agriculture, together with the circumvention objective of Article 10, lead to the conclusion that the Special Milk Classes Scheme was an export subsidy that was being applied in a manner that circumvented, or threatened to lead to circumvention, of Canada's export subsidy commitments under Article 10 of the Agreement on Agriculture.

4.287 Moreover, New Zealand argued that in Article 10 the term "export subsidies" was found in a context that was concerned with the prevention of actual or threatened circumvention of export subsidy commitments . The context, and object and purpose, of Article 10 argued for a flexible construction of the term "export subsidy" in order that Article 10 could live up to the intentions of its drafters. What would undermine, or threaten to undermine, a Member's reduction commitments would naturally vary according to the particular circumstances of each case. This meant therefore, that the determination of whether a measure constituted an export subsidy for the purposes of Article 10, had to be made on a case-by-case basis.

4.288 New Zealand argued that in this regard, an analogy could be drawn between the non-circumvention objective of Article 10 and the non-circumvention objectives of GATT Article XXIII:1(b) which was concerned with redressing actions that nullified or impaired a Member's legitimate expectations of benefits from tariff negotiations. In *Japan - Measures Affecting Consumer Photographic Film and Paper* the Panel took the view that in order to achieve this purpose, "it is important that the kinds of government actions considered to be measures covered by Article XXIII:1(b) should not be defined in an unduly restrictive manner."[239] Under the Agreement on Agriculture, the type of measure to which Article 10 applied had already been prescribed. It was an "export subsidy". Nevertheless, the importance of achieving the purpose of non-circumvention under Article 10 meant that the term export subsidy should not be interpreted in an "unduly restrictive manner". Indeed, seeking to draw a sharp line around the definition of "export subsidy" by means of an exhaustive and prescriptive definition could well encourage the adoption of measures that exhibited the same subsidization effects as Article 9.1 subsidies but which did not fall strictly within its terms. This could lead to evasion of the Agreement's export subsidy disciplines, and thereby fundamentally undermine Article 10's anti-circumvention purpose. The anti-circumvention provision itself would be circumvented.

4.289 New Zealand argued that in the present case, if the "special milk class" scheme was found not to constitute an export subsidy under Article 9.1(c) because the provision of lower-priced milk to exporters was, for instance, not regarded as a "payment", then the fact that the measure was not materially different in terms of its subsidization effect from an export subsidy listed in Article 9.1, and the actual or threatened circumventory nature of the measure, had to be relevant considerations in determining whether it constituted an export subsidy within the meaning of Article 10. Similarly, if the Special Milk Classes Scheme was not found to be an export subsidy under Article 9.1(a), the scheme could still nonetheless meet the definition of export subsidy in the context of Article 10. The circumventory nature of the scheme would again be a relevant factor to be taken into account. Taking account of these considerations, it was New Zealand's view that even if the "special milk class" regime failed to meet the test of Article 9, it would nevertheless constitute an export subsidy which circumvented, or threatened to circumvent, Canada's export subsidy commitments within the meaning of Article 10.

[239] Panel Report on *Japan - Photographic Film*, *op. cit.*, para.10.50.

(iv) Article 10.3 - the Burden of Proof

4.290 **New Zealand** noted that the Agreement on Agriculture contained, in Article 10.3, a provision which had implications for the burden of proof.[240] Article 10 was concerned with the prevention of circumvention of export subsidy commitments. A Member which claimed that quantities exported in excess of reduction commitment levels were not subsidized "must establish" that no export subsidy had been granted. The language was mandatory and unequivocal. New Zealand maintained that the fact that this obligation was intended to be a stringent one, and one applicable in the context of dispute settlement, was made clear from the preparatory work relating to Article 10. The negotiating Draft Text on Agriculture of 12 December 1991 provided as follows:

> " ... a *prima facie* case of circumvention of budgetary outlay commitments shall be deemed to exist where it is established that:
>
> (a) subsidies contingent on exports which are not subject to reduction have been or are being resorted to at the national or sub-national level; and
>
> (b) the volume of subsidized exports of the product concerned exceeds the volume of exports that could have been subsidized, or which can reasonably be expected to be subsidized … "[241]

4.291 New Zealand argued that the language of a "*prima facie* case" was the language used by the Appellate Body under the rules relating to burden of proof. In the *EC - Hormones*, the Appellate Body paraphrased the approach of the Panel:

> "The initial burden lies on the complaining party, which must establish a *prima facie* case of inconsistency with a particular provision of the *SPS Agreement* on the part of the defending party ... When that *prima facie* case is made, the burden of proof moves to the defending party, which must in turn counter or refute the claimed inconsistency. This seems straightforward enough and is in conformity with our ruling in *United States - Shirts and Blouses*, which the Panel invokes and which embodies a rule applicable in any adversarial proceedings."[242]

4.292 New Zealand argued that the effect of a rule deeming that a *prima facie* case had been made out, as the earlier drafts of Article 10 provided, was to reverse the burden of proof. Under such a rule, the normal obligation on the complaining party to establish a *prima facie* case was dispensed with. The burden started with the responding party. This was the explicit effect of the language used in the earlier drafts of Article 10. Although the wording of Article 10 had changed, and no explicit reference to a *prima facie* case was retained, the earlier draft provided guidance to the

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[240] Article 10:3 of the Agreement on Agriculture stated: "Any Member which claims that any quantity exported in excess of a reduction commitment level is not subsidised must establish that no export subsidy, whether listed in Article 9 or not, has been granted in respect of the quantity of exports in question."

[241] New Zealand, Annex 35.

[242] Appellate Body Reports on *EC - Measures Concerning Meat and Meat Products (Hormones)*, (hereafter "*EC - Hormones*"), WT/DS26/AB/R, WT/DS48/AB/R, adopted 13 February 1998, paragraph 98.

thinking of the negotiators of the rules on circumvention. The changes made to the wording of what became Article 10.3 were not incompatible with the express terms of the earlier draft. They simply stated, in a more general way, that there was an obligation on a Member whose exports of a product in respect of which reduction commitments had been made exceeded the volume of those commitments, to "establish" that no subsidy had been granted. In effect, once it had been "established" that the exports of a Member were in excess of its reduction commitments, the burden was then on that Member to "establish" that no subsidy had been granted. The burden of proof clearly shifted.

4.293 Hence, New Zealand argued that properly interpreted in its context, Article 10.3 spoke to dispute settlement situations. It imposed a specific obligation on Members that would usually arise only in a dispute settlement context. Where a Member was challenged in dispute settlement proceedings on the ground that the quantities of its exports exceeded its reduction commitment levels, then that Member "must establish" that no export subsidy had been granted in respect of those quantities. Such a rule could only have the effect of placing the burden on the Member against which the complaint had been made to establish that no subsidization has occurred.

4.294 New Zealand noted that Article 10.3 had important implications for the case at issue. Since the quantities of butter exported by Canada in 1995/1996 and 1996/1997 exceeded the reduction commitments made by Canada in respect of butter for both of those years, Article 10.3 required that Canada "must establish" that no export subsidy had been granted in respect of butter. Since the quantity of cheese exported by Canada in 1996/1997 was in excess of Canada's reduction commitment for cheese for that year, Article 10.3 required that Canada "must establish" that no export subsidy had been granted in respect of cheese. And since the quantity of whole milk powder exported by Canada in 1996/1997 exceeded Canada's reduction commitments in respect of "Other Milk Products", Article 10.3 required that Canada "must establish" that no export subsidy has been granted in respect of whole milk powder. In each case, the burden of proof lay on Canada. In this respect, New Zealand noted that Canada had acknowledged that the burden of proof was on Canada to establish that no export subsidy existed in respect of the Special Milk Classes Scheme.

4.295 The **United States** argued that Article 10.3, which complemented the prohibition on circumvention contained in Article 10.1, required the exporting Member to establish that export subsidies had not been provided with respect to those quantities of a product exported that were greater than the annual export quantities set forth in that Member's schedule for the product in question. The imposition of this requirement in Article 10.3, emphasized the seriousness which the Agreement attached to the possibility of circumvention of the export subsidy reduction commitments. Its application in the context at issue meant that Canada had to establish that no export subsidy had been granted in respect of the quantity of exports that were in excess of its reduction commitments. As the export quantities for butter, cheese, and dairy products in the "other dairy product" category exceeded the reduction commitments for those categories in Canada's Schedule, Canada had to show that such exports did not benefit from export subsidies.

4.296 The United States submitted that Canada could not meet the requirement of Article 10.3 because the quantities of the identified dairy products that were exported

exceeded the reduction commitments and the special milk class price system was an export subsidy.

4.297 **Canada** agreed that the wording of Article 10.3 had the effect of reversing the usual burden of proof rule as set out above. Thus, once it had been established that the exporting country had exported quantities of a product in excess of the level of the reduction commitment for that product, the burden lay on that exporting country to show a prima facie case that the exports in excess of the reduction commitment were not subject to export subsidies. Once such a prima facie case had been established, the burden of proof moved to the complaining party. Canada claimed that it had clearly surpassed any prima facie standard in demonstrating that no export subsidies had been granted with respect to the products in question.

(e) Other Relevant Provisions of the Agreement on Agriculture

(i) Article 8 and 3.3

4.298 **New Zealand** argued that Canada's provision of export subsidies under Article 9.1(a) and (c) of the Agreement of Agriculture in excess of its scheduled export subsidy commitments was a violation of Article 3.3 of that Agreement. Furthermore, Canada was in violation of its obligation under Article 8 of the Agreement on Agriculture not to provide export subsidies otherwise than in conformity with the Agreement on Agriculture.

4.299 The **United States** argued that as the Special Milk Classes Scheme was an export subsidy within the meaning of Article 9.1 of the Agreement on Agriculture, Canada was in breach of Article 3.3 of the Agreement on Agriculture not to provide export subsidies in excess of its quantity commitments levels specified in Section II of Part IV of its Schedule. Furthermore, Canada was in breach of Article 8 of the Agreement on Agriculture not to provide export subsidies otherwise than in conformity with the Agreement and with the commitments specified in its Schedule.

4.300 **Canada** argued that Article 8 did not apply. As Canada had shown that sales of milk at differing prices for domestic and export markets did not constitute an "export subsidy" as that term was defined in Article 1 of Agreement on Agriculture, the practice at issue did not fall within the scope of Article 8.

4. Agreement on Subsidies and Countervailing Measures ("SCM Agreement")

(a) Outline

4.301 **New Zealand** claimed that even on the basis of its own approach to the interpretation of the term "subsidy", under the SCM Agreement, Canada had not shown that the Special Milk Classes Scheme fell outside the definition of subsidy. New Zealand argued that the scheme constituted a subsidy within the meaning of Article 1 of the SCM Agreement in the following respects:

(a) it constituted the provision by government of a good within the meaning of Article 1.1(a)(1)(iii);

(b) or alternatively the government had entrusted a private body to perform the same function within the meaning of Article 1.1(a)(1)(iv); and

(c) it constituted a form of income or price support within the meaning of GATT Article XVI, under Article 1.1(a)(2).

4.302 New Zealand noted that Article 1 of the SCM Agreement provided that a subsidy shall be deemed to exist when there was a financial contribution by a government or any public body, or any form of income or price support in the sense of Article XVI of GATT 1994, and a benefit was thereby conferred. The Special Milk Classes Scheme consisted of a financial contribution by government. Alternatively, the Special Milk Classes Scheme might be viewed as a form of income or price support in the sense of Article XVI of GATT 1994. In either case, a benefit was conferred within the meaning of Article 1 of the SCM Agreement.

4.303 In addition, the Special Milk Classes Scheme constituted the provision of an export subsidy within the meaning of Paragraph (d) of the Illustrative List of Export Subsidies in Annex I of the SCM Agreement.

4.304 The **United States** considered that the definition of subsidy was substantially the same for purposes of the Agreement on Agriculture and the SCM Agreement. As the SCM Agreement was one of the other Agreements set forth in Annex 1A of the Marrakesh Agreement, the SCM formed part of the context of the Agreement on Agriculture.

4.305 The United States claimed that even if it were to be assumed that the SCM Agreement was dispositive of what constituted an export subsidy, solely for purposes of argument and without prejudice to the views of the United States concerning the applicability of Articles 9 and 10 of the Agreement on Agriculture, Paragraph (d) of the Illustrative List of Export Subsidies contained in Annex I lead directly to the conclusion that the Special Milk Classes Scheme was an export subsidy. Hence, the United States claimed that the Special Milk Classes Scheme, and specifically the provision of lower priced milk through Special Class 5(d) and (e) to exporters, constituted an export subsidy within the meaning of the Agreement on Agriculture as well as the SCM Agreement.

4.306 **Canada** claimed that the sale of milk for export purposes in Canada did not constitute a "financial contribution by a government or a public body" pursuant to Article 1.1(a)(1) of the SCM Agreement. Nor did it constitute "any form of income or price support in the sense of Article XVI of GATT 1994" . Nor did the sale of milk in Canada for export constitute a "benefit" for the purchaser over and above the normal commercial conditions that applied in such a market; there could be no "benefit" as the term should be interpreted under Article 1 of the SCM Agreement.

4.307 Hence Canada submitted that the sale of milk at differing prices did not constitute a "subsidy" within the meaning of Article 1 of the SCM Agreement. As noted, the term "subsidy" as it was used in the definition of "export subsidy" in the Agreement on Agriculture had to be interpreted in accordance with the definition of subsidy in Article 1 of the SCM Agreement. Accordingly, since there was no "subsidy", there could not be any "export subsidy" for the purposes of the Agreement on Agriculture.

4.308 Further, Canada claimed that the practices at issue were not "export subsidies" in the sense of Paragraph (d) of Illustrative List of Export Subsidies attached to

the SCM Agreement. Although Paragraph (d) was the only item on this list that was in any way relevant to the issue at hand, it was concerned with differences between internal domestic prices and export prices. Indeed, other than Article 9.1(b) of the Agreement on Agriculture, it was the only provision in either the Agreement on Agriculture or the SCM Agreement that touched on such price differentials. Canada had demonstrated that its Import for Re-Export Programme (paragraph 2.11) provided exactly the conditions that would exclude a measure from the application of Paragraph (d). This confirmed that the practices in question did not fall within the meaning of the term "export subsidy" for SCM Agreement or Agreement on Agriculture purposes. Accordingly, Canada claimed that not only was there no subsidy within the meaning of the Agreement on Agriculture and the SCM Agreement but, in particular, there was no prohibited export subsidy as set out in the Illustrative List of Export Subsidies found in Annex I of the SCM Agreement.

(b) Article 1

(i) Article 1.1(a)(1) - Financial Contribution

4.309 **Canada** claimed that there was no financial contribution by government pursuant to Article 1.1(a)(1) and, accordingly, the sale of milk for export purposes in Canada did not constitute a "financial contribution by a government or a public body" pursuant to Article 1.1(a)(1).

4.310 Canada submitted that under Article 1.1(a)(1), the term "financial contribution by a government or any public body" was defined exhaustively[243] and was limited to the circumstances described in the four sub-paragraphs (i) to (iv). Accordingly, if the practices at issue did not fall within any of the items in (i) to (iv), then the practices could not be considered to be "financial contributions by government or any public body". Moreover, there could be measures or practices which could arguably fall within the meaning of the term "financial contribution" but did not fall within one of the various descriptions in sub-paragraphs (i) through (iv). In such a case, the measure or practice was outside the scope of what was a "financial contribution" for the purposes of the subsidy definition.

4.311 Canada noted that the plain meaning of the term "financial contribution" was that something of value was being contributed to a recipient by the donor. In this case, "financial contribution by a government or any public body" meant that there was a transfer of something of value to a recipient from a government or other public body. In the absence of any evidence that there was any such transfer of resources, there could not be a "financial contribution". Each of the items set out in (i) to (iv) had to be interpreted as reflecting this basic concept. Canada submitted that an ex-

[243] Canada argued that the use of the term "i.e." indicated that the items that followed were intended to be an exhaustive, rather than an illustrative list. In this regard, Canada noted that the Uruguay Round negotiators agreed to replace the term "such as" in the Cartland I draft of the SCM Agreement, MTN.GNG/NG10/W/38 (18 July, 1990), with "i.e." in Cartland II, MTN.GNG/NG10/W/39/Rev.1 (4 September 1990), thus clearly indicating an intent to move from an illustrative definition to an exhaustive definition. (Canada, Exhibit 25) Canada also noted that "e.g." was also used within the subsidy definition in Article 1 to indicate an illustrative list. (Canada, Exhibit 25)

amination of each of the items set out in sub-paragraphs (i) to (iv) of Article 1.1(a)(1) demonstrated that none of them applied to the practices at issue.

Sub-paragraph (i)

4.312 **Canada** noted that sub-paragraph (i) included as "a financial contribution by government or any public body", "a government practice involv[ing] a direct transfer of funds (e.g. grants, loans and equity infusion), and potential direct transfers of funds or liabilities (e.g., loan guarantees)". This provision covered the most common form of financial contribution made in connection with subsidies, i.e., the direct payment to a recipient of funds from government treasuries. Canada argued that it was evident from the facts that the practices in dispute did not involve any direct grants or transfer of funds from governments to any recipient. There was nothing in the marketing of milk for export at world prices analogous to a government grant, loan or equity infusion were anything like a potential direct transfer of funds or liabilities such as a loan guarantee. No evidence or allegation to the contrary had been offered by the Complainants.

Sub-paragraph (ii)

4.313 **Canada** recalled that sub-paragraph (ii) included as "a financial contribution by government or any public body" circumstances where "government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)". This provision referred to any practice under which a government chose not to collect tax or other duties owing to it[244] and thus made financial contribution to the person owing the revenue to the government. It was clear that the practices at issue did not involve any such foregoing of government taxes, duties or other government monies owing. No evidence to the contrary has been offered by the Complainants.

Sub-paragraph (iii)

4.314 **Canada** noted that sub-paragraph (iii) included as "a financial contribution by government or any public body" a situation where "a government provides goods or services other than general infrastructure, or purchases goods". Canada argued that the various levels of government in Canada did not provide milk to anyone. As demonstrated in Part I, the Canadian dairy industry was composed entirely of privately-owned farms producing milk for sale to privately owned or co-operative dairy processors. While these sales took place within a framework established by legislation, it was the private actors that produced and sold the milk. The core of the system was operated on the foundation of the decisions by producers made on a strictly commercial basis.

4.315 Canada reiterated that the milk marketing boards were "producer-run". They did not constitute government or government agencies. To the contrary, they were established pursuant to referenda of dairy producers in each of the respective provinces and, in most provinces, they were controlled by the elected representatives of the dairy producers. While legislation required that the boards take into account a

[244] Canada argued that the intent of the negotiators to link the term "government revenue" to taxes or duties was made clear both by the reference to "tax credits" as the illustrative example provided in the provision and the discussion of "duties" in the footnote to the provision.

broader range of interests than those of the producers alone, the fact remained that the boards operated as an extension of the commercial operations of the individual dairy producers of Canada.

4.316 Canada argued that if the conduct of commercial operations by private producers and processors within a regulatory framework constituted Government provision of the good or service provided through the commercial transactions, then virtually all activities in a modern economy could be so characterized. For example, labour provided through collective agreements established under government labour laws or determined by minimum wage laws could be considered labour provided by government.

4.317 Furthermore, Canada argued that sub-paragraph (iii) had to be read in the context of the term "financial contribution". Thus, in order for government to be providing goods within the meaning of the provision, it had to be demonstrated that this provision of goods involved a contribution of a financial nature from public resources controlled by the government. The sale of milk to processors by producers collectively through or with the participation of producer-run marketing boards could in no way be construed as the provision of goods by government or any public body, nor was it the provision of goods that entailed a governmental financial contribution.

4.318 Canada contended that the participation of the milk marketing boards in providing milk sourced from producers to processors did not involve any "financial contribution" from the boards. The boards acted as agents for the producers in collecting and selling milk to the processors. With respect to exports, processors purchased the milk through or with the participation of the boards for prices based on the world market return being obtained by the processors. Thus, the producers only received for the milk a market price paid initially to the board as their agent. This was best illustrated by a counter-example. If the boards were purchasing milk at high domestic prices and then reselling the milk to the processors at low prices and absorbing the difference, then it might be open to argue that the boards would be making a "financial contribution", albeit of a non-governmental type. However, in the case of Canadian dairy exports, as agents of the producers the boards paid to the producers what the boards receive from the processors for the milk. As Canada had described, the price paid back to the producers was flowed entirely through the board and there was no "adjustment' or "contribution" by the boards to this revenue stream. This reinforced the conclusion that there was no "financial contribution" to the processors by the boards, and therefore Article 1.1(a)(1) could not apply.

4.319 **New Zealand** argued that the Special Milk Classes Scheme involved a financial contribution within the meaning of Article 1.1(a)(1)(iii). The Special Milk Classes Scheme involved the providing of goods by the combined action of governmental agencies - the CDC and the provincial milk marketing boards (Section 1. Canada's denial of this was based on its view that the Special Milk Classes Scheme involved producers operating collectively without significant government involvement. However, New Zealand held that role of government in the operation of the Special Milk Classes Scheme was integral and essential. The providing of lower-priced milk to exporters - which was the export subsidy in this case - was effected through the joint action of the CDC and the provincial milk marketing boards.

4.320 New Zealand further noted that Canada argued that in any event there was no financial contribution because the boards were simply agents of producers; what was passed on to exporters was the producer's milk. New Zealand noted that the boards

did not pass milk on to exporters because they were acting as agents of producers. Boards had a right to dispose of milk regardless of the wishes of producers. A producer could not deny the board the right to sell its milk - a producer could not revoke the "agency". Nor could this, according to New Zealand, be seen just as a matter of the decision of the provincial milk marketing board. The system under which milk - a good - was provided to exporters did not just involve that board. It was an operation involving both federal and provincial action.

4.321 The **United States** argued that where surplus milk was provided to processors/exporters under Classes 5(d) and (e), this involved the Canadian Government through its legislative arrangements providing goods (i.e. milk) at prices below those prevailing in the domestic market. Hence, the provincial milk marketing boards, on behalf of the milk producers in their respective provinces, provided milk at prices lower than available on the domestic market to processors. The processors used that low priced milk in manufacturing dairy products for export. Those same marketing boards, moreover, operated under the authority of powers delegated to them by the federal and provincial governments. The boards did not receive their authority and powers from the milk producers. Thus, their actions, together with those of the Canadian Government, acting through the CDC, provided goods, here milk, to processors. The United States claimed that this constituted a subsidy under Article 1.1(a)(1)(iii) of the SCM Agreement.

Sub-paragraph (iv)

4.322 **Canada** noted that the first part of sub-paragraph (iv) included as "a financial contribution by government or any public body" circumstances where "a government makes payments to a funding mechanism". This provision was intended to cover a situation where a government, rather than making direct payments from its treasury to the targeted recipients as described in sub-paragraph (i), provided bulk funding to some other body or mechanism for the subsequent re-distribution of the financial contributions. As previously noted with respect to sub-paragraph (i), there was no evidence that any level of government in Canada made any contribution, either directly (i.e., sub-paragraph (i)) or indirectly through a funding mechanism (i.e., sub-paragraph (iv)) of funds with respect to the sale of milk at differing prices.

4.323 Canada argued that none of the "functions" set out in sub-paragraphs (i) through (iii) in Article 1.1(a)(1) were carried out by government with respect to the practices at issue. Similarly, it could not be said that any government in Canada "entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments" as set out in the second part of Article 1.1(a)(1)(iv). In this regard, Canada stressed that to show that the practices of a private body fell within the terms of this provision, three elements had to be proven: (i) there had to be direction or entrustment of a function to a private body by government; (ii) the function had to be one listed in subclauses (i) to (iii); and (iii) that function had to be one that was *normally* carried out by government and "in no real sense differs from practices *normally* followed by governments".

4.324 Canada argued that its government did not "entrust or direct" any private body to carry out any of the functions detailed in (i) through (iii) with respect to sales of milk for export purposes in Canada. In particular, governments in Canada did not

so "entrust[245] or direct" the milk marketing boards in Canada to carry out such functions. Canada recalled that the boards were not directed by governments (Section 1. Boards had come into existence on a vote of the producers in a province. They were entrusted *by producers* who had elected them and to whom they were responsible to act on their behalf and to market their products; they were therefore not "entrusted" by governments to undertake any of the activities referred to in Article 1 of the SCM Agreement.

4.325 Canada argued that there could be no basis for suggesting that that the marketing of milk, whether for domestic or export sale, was one that was *normally* carried out by government and that in no real sense differed from practices normally followed by governments. A distinction had to be made between the regulatory functions of the boards and their commercial activities. In the exercise of certain regulatory functions, the boards might engage in activities that were governmental in nature and that could be considered "normally followed by governments." The establishment and enforcement of quality standards for milk delivered from farms and the establishment of quotas for domestic purposes, for example, could be argued to fall within the range of such activities. However, the marketing of milk, i.e., arranging the collection of milk from farms and its delivery to processing plants, negotiating payments with processors and remitting funds to producers, was not a function *normally* carried out by government. Indeed, the structure and the autonomy of the boards, indicated that governments had essentially no responsibility, direct or indirect, in this area, except that of general oversight in support of the public interest.

4.326 Canada noted that this was particularly true with respect to sales of milk for *export* purposes. Governments had not "entrusted" a private body, i.e., the milk marketing boards, with a mandate to sell inputs for products for export at a price lower than those destined for domestic consumption. The sale of milk to processors for export purposes was the result of arm's length bargaining between willing buyers and willing sellers without any government direction or expectation of the outcome. Thus, there had been no entrustment by government as required under the paragraph. In addition, what this provision manifestly did not capture, contrary to the contentions of the Complainants, was regulatory frameworks, stipulated by law, through which private interests had the opportunity of maximizing their returns in commercial markets and in accordance with commercial considerations. Moreover, since the milk marketing boards were selling milk through arm's length sales to processors at market prices, this practice could not be constructed to be a "financial contribution" to the processors under any common sense analysis.

4.327 **New Zealand** argued that even if the provincial milk marketing board was not a body with governmental attributes, and was indeed just an agent of producers, there would still be a "financial contribution" within the meaning of sub-paragraph (iv) of Article 1.1(a)(1) of the SCM Agreement, which applied to circumstances where a government "entrusts or directs a private body to carry out one or more of the type of functions" set out *inter alia,* in Paragraph (iii) of Article 1.1(a)(1). In the

[245] Canada noted that the meaning of "entrust" was related to the companion word "direct": see the *New Shorter Oxford English Dictionary on Historical Principles*, Lesley Brown (ed.), (Oxford: Oxford University Press, 1993) (the "*NSOED*"): "to invest with a trust; give the responsibility for a task; commit the… execution of (a task) to a person." (Canada, Exhibit 26)

present case, what would now be viewed as a private body, the provincial milk marketing agency, had been entrusted with providing the goods in question.

4.328 New Zealand further noted that sub-paragraph (iv) also stipulated that the practice that was alleged to constitute a subsidy "in no real sense, differs from practices normally followed by governments." On this ground, Canada denied the applicability of sub-paragraph (iv), arguing that no such function of providing goods had been entrusted by government to a private body and that the functions in question were not normally carried out by governments. The first aspect of this response was no more than a reiteration of Canada's denial of government involvement in the Special Milk Classes Scheme (Section 1, paragraph 4.41 and following). In respect of the second aspect, Canada argued that although the regulatory function of milk marketing boards could be viewed as functions normally carried out by governments, the marketing of milk was not. However, the effect of the Special Milk Classes Scheme was to reallocate income from producers to exporters, and the reallocation of income within society was a function normally carried out by government. Thus, contrary to Canada's claims, the Special Milk Classes Scheme did provide a financial contribution within the meaning of Article 1.1(a)(1) of the SCM Agreement.

4.329 Furthermore, in respect of Article 1.1(a)(1)(iv), and functions that "would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments", New Zealand drew the Panel's attention to Canada's own implementation of that provision in its own domestic legislation contained in the Special Import Measures Act.[246] Section 2(1.6) of that Act incorporated the terms of Article 1.1(a)(1)(iv) of the SCM Agreement by providing that a financial contribution that amounted to a subsidy existed where:

> "(d) the government permits or directs a non-governmental body to do any thing referred to in any of paragraphs (a) to (c) where the right or obligation to do the thing is normally vested in the government and the manner in which the non-governmental body does the thing does not differ in a meaningful way from the manner in which the government would do it."

4.330 In New Zealand's view, the language adopted by Canada in this legislative implementation of the definition of subsidy under the SCM Agreement reflected, presumably, what Canada understood the provisions of the SCM Agreement to mean. Thus, it was revealing that Canada used the phrase "*permits* or directs" in its implementing legislation for the phrase "*entrusts* or directs" in Article 1.1(a)(1)(iv). However, in the case at issue, Canada took the view that the legislative basis for the Special Milk Classes Scheme was enabling only. Canada argued that "enabling legislation" did not compel any action. Canada did not, it argued, "entrust or direct" milk marketing boards with any of the functions listed in sub-paragraphs (i) through (iii) of Article 1.1(a)(1) (paragraph 4.340).

4.331 In New Zealand's view it was clear that the Special Milk Classes Scheme would meet the requirements of Section 2(1.6)(d) of Canada's Special Import Measures Act and thus if it were a measure of another country would constitute a subsidy under Canadian law. However, Canada appeared to want to apply a different stan-

[246] Special Import Measures Act, S.C. 1984, c.25, s.2.

dard in this case and deny that the Special Milk Classes Scheme met the requirements of the provision of the SCM Agreement on which Section 2(1.6)(d) was based.

4.332 New Zealand argued, moreover, that the Canadian legislative incorporation of sub-paragraph (iv) precisely reflected the intent of the drafters of Article 1 of the SCM Agreement. The origin of the words that appeared in sub-paragraph (iv) was the 1960 Report of the Panel on Subsidies on Review Pursuant to Article XVI:[247] where the Panel took the view that the requirements of GATT Article XVI would be met in schemes where "the government took a part either by making payments into a common fund or by entrusting to a private body the functions of taxation and subsidization with the result that the practice would in no real sense differ from those normally followed by government." These words made clear that the "practice" was the practice of taxation or subsidization and that the manner in which it was being performed by the private body was in no real sense different from the way governments undertook such practices. This was the present day import of sub-paragraph (iv) and it had been identified correctly in Canada's Special Import Measures Act.

4.333 The **United States** argued, like New Zealand, that the Special Milk Classes Scheme provided a subsidy under Article 1.1(a)(1)(iv) of the SCM Agreement. Thus, even if the provincial milk marketing agencies were not considered to be acting as government bodies, there would still be a "financial contribution" within the meaning of sub-paragraph (iv) of Article 1.1(a)(1) because they were entrusted with government functions. The provincial milk marketing boards, together with the CDC, had been entrusted to price goods to allow their export at competitive levels. Furthermore, this was a function normally provided by government within the meaning of Paragraph (iv) since the Special Milk Classes Scheme operated to reallocate income from one group (the milk producers) to another class (the dairy processors), a common function of government. Indeed, the levy system that the Special Classes replaced, performed the same governmental function.

4.334 The United States argued that the applicability of Article 1.1(a)(1)(iv) of the SCM Agreement depended on the fulfilment of three conditions. More specifically, the existence of the financial contribution necessary to the finding of a subsidy under Paragraph (iv) required that: (i) a government entrusted or directs a private body to carry out one or more of the type of functions illustrated in Paragraphs (i)-(iii) of Paragraph (a)(1) to Article 1.1; (ii) such functions would normally be vested in the government; and (iii) the practice, in no real sense, differed from the practices normally followed by governments. The United States contended that Canada incorrectly concluded that none of the foregoing conditions were met by the Special Milk Classes Scheme.

4.335 In respect of the first factor, the United States argued that the Government of Canada together with the provincial governments made provision for milk producers, through their provincial marketing boards, to supply milk for export at prices that were below those available to manufacturers of dairy products for sale in the domestic market. By doing so, the government shifted certain costs from the processors to the milk producers, and also provided a good to the processors. Thus, a function provided for under Article 1.1(a)(1), was entrusted to a private entity. Both the Compre-

[247] Panel Report on *Review Pursuant to Article XVI:5, op. cit.*

hensive Agreement and the CDC Act provided specifically for the delegation of certain federal powers, including powers of the CDC, to the marketing boards to establish pools, set prices, and collect payments. There was no dispute that the boards exercised delegated government powers, including the power to set prices, to establish quotas, and to pool revenue. Thus, they had been entrusted with governmental powers.

4.336 The United States further argued, in respect of the first requirement, that Paragraph (d) of the Illustrative List Export Subsidies in Annex I of the SCM Agreement was relevant as it was part of the context of Article 1 of that Agreement. Thus, the language of Article 1 was informed by the practices identified as export subsidies in Annex I. As set out in further detail below (paragraph 4.385 and following), Paragraph (d) of the Illustrative List specified that the "provision by governments or their agencies either directly or indirectly through government-mandated schemes" of goods on more favorable terms for export was an export subsidy. Both Paragraphs (iii) and (iv) of Article 1 had to be interpreted with this in mind. Otherwise, a fundamental contradiction in meaning would result with that practice constituting an identified export subsidy for purposes of the Illustrative List, but not being a subsidy for purposes of Article 1. Therefore, a government-mandated scheme, such as Canada's Special Milk Classes Scheme, that resulted in the provision of goods within the meaning of the Illustrative List also satisfied the requirement of Paragraph (iii) of Article 1 of the same Agreement that the provision, directly or indirectly, of goods by a government, constituted a financial contribution. Hence, since the provision of a good was a government function specifically listed in Article1.1(a)(1)(iii) of the Agreement, the first requirement for the application of Article 1 was satisfied.

4.337 The United States argued that the Special Milk Classes Scheme also satisfied the second requirement because the subsidized provision of goods and the fixing of prices were functions normally vested in governments. Indeed, it was a common practice in the agricultural sector for governments to influence the price level for agricultural products, especially basic food articles such as milk. Whether the Special Milk Classes Scheme was viewed as providing goods at lower prices for exports or as fixing price levels for milk used for the manufacture of export products, the function involved was one normally vested or performed by governments. Canada's argument that there was no specific order from the federal or provincial government to producers to set prices for milk used in exports at a particular level was inaccurate and beside the point. First, over-quota milk could only be sold for export at the Special Class 5(e) price. The producer had no choice. In-quota milk was sold at prices negotiated by the CDC, that were rarely modified. Second, pursuant to Article 1.1(a)(1)(iv) of the SCM Agreement it was unnecessary for the government to set the price for the milk if it entrusted that function to the milk boards, which it had done. The entire rationale for Paragraph (iv) was that practices of private parties entrusted with government functions were to be treated as subsidies where the practice, "in no real sense, differs from practices normally followed by governments" and a benefit was thereby provided.

4.338 Furthermore, the United States argued the common governmental function of shifting costs and reallocating income from one private entity to another was the very function previously fulfilled by the levy/rebate system, which Canada had acknowledged was replaced with the Special Milk Classes Scheme. Further, the United States argued that the conclusions reached by the 1960 Working Party that consid-

ered, inter alia, whether producer-financed subsidies were to be notified pursuant to Article XVI:1 of GATT 1947 supported this construction of Paragraph (iv).[248] The United States emphasized, moreover, that the language in the SCM Agreement that was contained in Article 1.1(a)(1)(iv) respecting "functions normally vested in the government" and "which in no real sense, differs from practices normally followed by governments", first appeared in the 1960 Working Party report. Furthermore, the Working Party had found that producer-financed levy/rebates satisfied those requirements where there was sufficient government involvement in the programme.

4.339 Finally, the United States argued that the Special Milk Classes Scheme operated to establish prices for milk for export in a manner that was indistinguishable from practices normally followed by governments. The inclusion of this practice in the Illustrative List certainly supported the conclusion that it was a recognized, albeit unwelcome, government practice. That practice, moreover, was specifically subject to the export subsidy disciplines contained in both the Agreement on Agriculture and the SCM Agreement. Moreover, producer-financed subsidy schemes, in which governments performed a substantial function, were treated as export subsidies in the Agreement on Agriculture, and before that in the 1960 Working Party Report, precisely because they did not differ in any practical sense from the practices normally followed by governments. Thus, contrary to Canada's conclusions, each of the prerequisites to the applicability of Article 1.1(a)(1) of the SCM Agreement was satisfied by the Special Milk Classes Scheme.

4.340 **Canada** refuted the US argument that Canada made provision for milk producers, through their provincial marketing boards, to supply milk for export at prices that were below those available to manufacturers of dairy products for sale in the domestic market (paragraph 4.335) Canada claimed that the facts made it clear that there was no governmental requirement placed on milk producers, through their marketing boards to supply milk for export, let alone a governmental requirement to sell that milk for export at a prescribed price. Permitting producers to adopt a course of action did not amount to entrusting or directing a private body to carry out a government function.

4.341 Furthermore, Canada rebutted the United States claim that the government shifted costs from processors to producers (paragraph 4.338). The costs of production were always borne by the producers. Processors paid the highest price that producer boards could obtain given the externally-determined economic realities of the markets in which they sold the final products. Producers were not forced to provide milk at any given price but rather milk was supplied pursuant to negotiated agreements. Thus, there was no shifting of costs. Moreover, the United States' explanation also failed to address why a significant number of producers would choose to produce above their quotas if the effect was to shift costs to them from processors. The only rational explanation would be that producers were coerced to act against their own best interests but no such coercion existed. Canada noted that the United States also claimed that this alleged government action provided a good to the processors. This directly contradicted their own statement that producers, through their marketing boards supplied the milk.

[248] Panel Report on *Review Pursuant to Article XVI:5, op. cit.*

4.342 Moreover, Canada noted in respect to the requirement regarding functions normally vested in the government, that the United States characterized the government function in this case to be one of reallocation of wealth within society. Canada argued that sales of milk by milk producers at market prices did not "reallocate" income at all. A willing buyer purchased a good from a willing seller in an arm's length transaction at the market price. Although obviously money changed hands, the ordinary language to describe such a transaction was that the seller *earned* income, not that the transaction reallocated income from one party to the other. The redistribution of wealth that occurred through transactions at market prices was not a practice normally followed by governments when they sought to redistribute income. Government actions to reallocate income were generally achieved through government charges (taxes) and payments (subsidies) in which government forced one group in society to give up income which it either had or could otherwise obtain, and provided another group with income that would not be forthcoming in the market. Canada maintained that the key characteristic of sales of milk under Special Classes 5(d) and (e) was that governments did *not* control the sales prices, and they did not delegate to anyone else the power to control the sales prices. The implicit assumption in the US arguments was that any transaction at market prices, as opposed to controlled domestic prices, had to be considered a "reallocation of income." In fact, it was the absence of control over prices for export use that formed the basis of the Complainants' case. Canada was a small country on world dairy markets. It was a price taker. It would be the purest of nonsense for any Canadian government to claim to control the price at which Canadian dairy exports took place.

4.343 The drafters of the SCM Agreement in providing for a definition of "subsidy" were careful to distinguish in Article 1.1(a)(1) between the circumstances where governmental "financial contributions" referred to a government practice involving a direct transfer of funds, the foregoing of government revenue or a government making payments to a funding mechanism (sub-paragraphs (i), (ii) and (iii)) and the indirect provision of the governmental financial contribution through a "private body" (sub-paragraph (iv)). Accordingly, where the entity in question was a private body, as conceded in this circumstance (US reference in paragraph 4.335), the applicable provision was sub-paragraph (iv). Hence the drafters had carefully circumscribed the circumstances under which Paragraph (iv) could apply to a private body. The government had to "entrust or direct" the private body and the function must be "one which would normally be vested in the government and the practice, in no real sense, differs from the practices normally followed by governments." Thus, in the context of "subsidies", the drafters of the SCM Agreement appreciated that where private bodies were involved, careful limits had to be drawn against the implication of governmental activity.

(ii) Article 1.1(a)(2) - Income or Price Support in the Sense of Article XVI of GATT 1994

4.344 **Canada** argued that the practices at issue did not fall within the description of "any form of income or price support in the sense of Article XVI of GATT 1994". Article XVI:1 of GATT 1994 included as a subsidy "any form of price or income support, which operates directly or indirectly to increase exports from ... its territory". This clearly contemplated a system under which exports were encouraged independently of market forces. As described above, the practice under which milk was sold

for export purpose in Canada was exclusively linked to market forces. Dairy producers received a return on their sales of milk for export purposes based on actual sales into export markets. It was in response to these price signals that milk was produced for the export market.

4.345 Canada noted that it had been long established in GATT practice that supply management systems which relied on border measures to support domestic price levels were not to be considered "subsidies" under Article XVI. This view was reflected in the 1960 Report of the Panel on Subsidies on "Review Pursuant to Article XVI:5":

> "It was generally agreed that a system under which a government, by direct or indirect methods, maintains such a price by purchases and resale at a loss is a subsidy. Such purchases would need only to cover part of the production to involve a subsidy and, in determining loss on resale, such expenses as holding stocks should be taken into account. The Panel considered, however, that there could be other cases in which a government maintained a fixed price above the world price without resort to subsidy. *One such case might be that in which a government fixes by law a minimum price to producers which is maintained by quantitative restrictions or flexible tariff or similar charges. In such a case, there would be no loss to the government, and the measure would not be governed by Article XVI.*"[249] (emphasis added)

4.346 Canada argued that it was evident that the supply management system in Canada did not constitute a subsidy pursuant to the above comments. The exclusion in this passage from the subsidy concept of any system where higher domestic prices were supported by tariff measures was particularly noteworthy in the context of this dispute.[250]

4.347 In respect of GATT 1994 Ad Article XVI:B:3, Canada argued that in the case of systems for the stabilization of domestic prices for primary products[251], an export subsidy was not involved where two tests were met: (i) the system had resulted in, or

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[249] Panel Report on *Review Pursuant to Article XVI:5, op. cit.*, para.11.

[250] Canada noted that the fact that the Panel emphasized that their decision was based on the fact that there was "no loss to the government" had importance for the interpretation of Article 1 of the SCM Agreement as a whole, since the drafters of that Article expressly linked the definition of "subsidy" to Article XVI of the GATT 1994. There was an implication in this concept that there had to be some transfer of value from public sources to the recipients, resulting in a loss to treasuries in some way. This was also consistent with the analytical approach adopted by the Working Party Report in Australian Subsidy on Ammonium Sulphate, (GATT/CP.4/39) 3 April 1950 at paragraph 10: "The working party then examined the question of whether the Australian Government had complied with the terms of Article XVI on subsidies. It noted that, although this Article is drafted in very general terms, the type of subsidy which it was intended to cover was the financial aid given by a government to support its domestic production and to improve its competitive position either on the domestic market or on foreign markets".

[251] Canada noted that Ad Article XVI:B of GATT 1994 stated in part: "For the purposes of Section B, a "primary product" is understood to be any product of farm, forest or fishery, or any mineral, in its natural form or which has undergone such processing as is customarily required to prepare it for marketing in substantial volume in international trade."

was designed to result in, export prices higher than the domestic prices; and (ii) the system did not stimulate exports unduly or otherwise seriously prejudice the interests of other contracting parties. With respect to the first test, Canada contended that its system for the sale of milk for export purposes contemplated the possibility of export prices higher than the domestic price. Indeed, in recent months as certain domestic milk prices in the United States had exceeded domestic prices in Canada, price levels in Special Classes 5(a) through (c) (which were linked to price levels in US markets and could be used either for export or domestic purposes) had exceeded price levels in the domestic use classes. In addition, since Canada's system for sales of milk for export purposes was based on world market conditions, it could not be alleged that it stimulated exports unduly or otherwise seriously prejudiced the interests of other WTO Members. Thus, Canada's dairy supply management system did not involve an export subsidy pursuant to this provision.

4.348 Canada argued that the drafters of the SCM Agreement expressly incorporated the concept of "income and price support", as defined by Article XVI, into Article 1 of the SCM Agreement and that practices such as those used for the sale of milk in Canada for export purposes were clearly excluded from this definition. This suggested that the intent of the negotiators was that such programmes did not fall within the concept of "subsidy" in the Article 1 of the SCM Agreement.[252] Accordingly, Canada argued that the sale of milk in Canada for export purposes could not constitute "any form of income or price support in the sense of Article XVI of GATT 1994" as provided for in Article 1.1(a)(2). Hence, the practices at issue in this dispute did not correspond with either half of the first part of the two-part test in Article 1.1, and consequently, there could be no "subsidy" pursuant to that definition.

4.349 **New Zealand** noted that Article 1 of the SCM Agreement included within the definition of a subsidy "any form of income or price support in the sense of Article XVI of GATT 1994". Section A.1 of Article XVI of GATT 1994 included within its scope income or price support "which operates directly or indirectly to increase exports of any product". Section B.4 of Article XVI of GATT 1994 included subsidies which resulted "in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market." These definitions clearly encompassed a scheme under which the government ensures that milk was made available for the production of products for export at a price that was lower than that for milk available for the production of equivalent products for domestic consumption.

[252] Canada argued that the comments of the Appellate Body in *Brazil - Desiccated Coconut, op. cit.*, had to be noted in this context. At p. 14 they noted that "The Agreement on Agriculture and the SCM Agreement reflect the latest statement of WTO members as to their rights and obligations concerning agricultural subsidies." They went on to comment that these Agreements "represent a substantial elaboration of the provisions of the GATT 1994", and recognized that pursuant to Annex 1A, the other goods agreement prevail in the event of a conflict with GATT 1994. However, the Appellate Body cautioned that "this does not mean that the other goods agreements in Annex 1A, such as the SCM Agreement, supersede the GATT 1994" and cited with approval the comments of the panel that "Article VI of the GATT 1994 and the SCM represent an inseparable package of rights and disciplines that must be considered in conjunction." Canada argued that similar logic also applied to the relationship of Article XVI and the SCM Agreement and the Agreement on Agriculture.

4.350 New Zealand further noted that Canada denied that the Special Milk Classes Scheme constituted a form of income or price support within the meaning of Article XVI of GATT 1994. Article XVI:1, Canada argued, contemplated a system under which exports were encouraged independently of market forces (paragraph 4.344). Thus, Canada's reasoning here, too, was based largely on its argument that dairy exporters responded to market signals and not to any incentives provided through the Special Milk Classes Scheme. The reality was, in New Zealand's view, otherwise. The allocation of milk to domestic or export markets was not the decision of the producer (as argued under paragraph 4.93 and following). Milk was sold for export rather than domestically not in response to market signals but in response to the determination of federal and provincial representatives operating through the CMSMC. Moreover, it was not the incentive for the *producer* that was in issue. It was the *exporter* who received the support. Exporters were encouraged to export because they were shielded from domestic prices, precisely the incentive to export regardless of market conditions that Canada said was contemplated by Article XVI.

4.351 New Zealand further noted that Canada argued that its system met the requirements of Ad Article XVI:B:3 of GATT 1994 (and was not therefore a subsidy for the purposes of Article XVI of GATT 1994) because the system contemplated the possibility of export prices being higher than domestic prices. But Canada's argumentation in support of this related only to Special Classes 5(a) through 5(c) and did not deal at all with Special Classes 5(d) and (e), the provisions that were in issue in this case. Moreover, it was extremely unlikely that the prices for these latter classes would ever rise to such an extent that they would exceed Canadian domestic prices. World prices would have to rise over 300 per cent before the Special Class 5(e) price approached the Canadian domestic price. Thus, in respect of those sub-classes, the requirements of Ad Article XVI:B:3 could, realistically, never be met. Further, in New Zealand's view, the Canadian system *did* operate to "stimulate exports unduly" within the terms of Ad Article XVI:B:3 given that, absent special milk classes, Canadian dairy exports would be largely uneconomic and would be severely curtailed.

4.352 New Zealand noted Canada's attempt to deny the applicability of Article 1.1(a)(2) of the SCM Agreement which incorporated within the definition of "subsidy" any form of income or price support in the sense of Article XVI of GATT 1994. New Zealand noted that Canada cited, in paragraph 4.345, as authority for this, a passage from the 1960 Report of the Panel on Subsidies[253] where the Panel said that a situation where a government fixed a minimum price to producers and maintained it *simply* by "quantitative restrictions or flexible tariff or similar charges" "*might*" be a case where there was no subsidy. Canada then extrapolated from this qualified comment the absolute proposition that the Panel was of the view that *any* system where higher domestic prices were supported by tariff measures would not represent a subsidy. In New Zealand's view Canada had failed to make any allusion whatsoever to the Panel's key conclusion[254] regarding producer-funded subsidies: that the requirements of GATT Article XVI would be met in schemes where "the government took a part either by making payments into the common fund or by entrust-

[253] Panel Report on *Review Pursuant to Article XVI:5, op. cit.*
[254] *Ibid.*

ing to a private body the functions of taxation and subsidization with the result that the practice would in no real sense differ from those normally followed by government". New Zealand's conclusion that the Canadian scheme did indeed provide price or income support in the sense of GATT Article XVI, and that the requirements of Ad Article XVI:B:3 could never realistically be discharged by Canada, had not been rebutted.

4.353 The **United States** argued that even if Canada's supply management regime with its price classification system were found to be a system of stabilization of domestic prices within the meaning of Ad Article XVI, the Canadian Special Milk Classes Scheme *clearly* resulted in "the sale of the product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market." Because the special milk class price system did not result, and was not designed to result, in "the sale of the product for export at a price higher than the comparable price charged for the like product to buyers in the domestic market" it did not, and could not, satisfy the exception from treatment as a subsidy contained in Ad Article XVI. Thus, when Canada's special milk class price system was analyzed within the framework of Ad Article XVI, the result reached was the same as under the SCM and Agreement on Agricultures: the special milk class price system was an export subsidy.

4.354 **Canada,** in response to a question by the Panel as to why Canada felt there was not "price or income support in the sense of Article XVI" when Canada had a positive Aggregate Measurement of Support ("AMS") with respect to dairy products, argued that its *domestic support commitments* were not price or income support in the sense of Article 1.1(a)(2) of the SCM Agreement. The term "market price support", as it was used with respect to Domestic Support in Annexes 3 and 4 of the Agreement on Agriculture, was fundamentally different in content and purpose from the term "price or income support in the sense of Article XVI of GATT 1994".

4.355 Canada argued that Market Price Support"("MPS") was a term chosen to be one of the elements to be used in calculating a comprehensive measurement of domestic support through the AMS in the Agreement on Agriculture. AMS was intended to be a broad measurement of government support in favour of agricultural producers, for the purpose of developing reduction commitments. As such, it had been, and was, a very ad hoc measure, not a rigorous measurement of "subsidies" as they might be otherwise understood or defined. Thus, MPS was a negotiated measuring device adopted for a specific purpose in the Agreement on Agriculture negotiations. It bore no linkage or lineage with any other concept of "price support", and in particular, was quite distinct from the term "price or income support in the sense of Article XVI of GATT 1994", as it used in the SCM Agreement. In contrast, the purpose of the use of the term "price or income support in the sense of Article XVI of GATT 1994" in the SCM Agreement was to bring some price support systems within the ambit of the disciplines on export subsidies in that Agreement. This built on the similar purposes captured in the language of Article XVI of the GATT 1994 itself. In that case, the term was restricted to the specific circumstances as set out in Interpretative Note 2 ad Paragraph 3 of Article XVI and as discussed in the 1960 Report of the Panel on Subsidies. Accordingly, unlike MPS, this term was to be linked directly to the concept of "subsidies".

4.356 Canada noted that it had indicated (for 1995/96) - with respect to Canada's notifications of its AMS under the Agreement on Agriculture - that it had MPS with

respect to butter and skim milk powder. This notification was based on the gap between the fixed external reference price (the 1986-88 average export minimum prices agreed under the International Dairy Arrangement) and an "applied administered price" (the CDC support prices, as operated at that time). Canada emphasized that although the CDC continued to announce a "Support Price", this had become a misnomer - whereas the CDC used to use a "Support Price" as the basis for a standing offer to purchase programme, this had been terminated. The CDC "Support Price" was now essentially used as a reference price by the CMSMC and the provincial producer boards as a target in their negotiations with processors, with the objective that milk prices not be too far out of line in different provinces. As such, it no longer appeared to constitute an "applied administered price" for the purposes of MPS calculation.

4.357 Canada stressed that the issue before the panel was whether Special Classes 5(d) and (e) constituted "export subsidies" for the purposes of the Agreement on Agriculture. In that regard, the definition of "export subsidy", in the context of the definition of "subsidy" as it was found in Article 1 of the SCM Agreement, bore no relationship, textually or historically, to the formula used to calculate MPS or APS as a result of the Uruguay Round.

4.358 **New Zealand** did not accept the conclusion reached by Canada where it sought to distinguish the term "market price support", in the Agreement on Agriculture, from the reference to "any form of income or price support" in Article 1 of the SCM Agreement. The Aggregate Measurement of Support (which included specific provision for calculating market price support) as it was defined in Article 1 of the Agreement on Agriculture, would certainly catch all forms of income and price support within the meaning of GATT Article XVI. This was made very clear, for example, in Paragraph 6 of Annex 2 of the Agreement on Agriculture which defined the conditions when (decoupled) "*income support*" can be exempted from the Aggregate Measurement of Support. Conversely, in Paragraph 1(b) of the same Annex, "*price support* to producers" was specifically excluded from the category of exempt domestic support and thus must be included in the Aggregate Measurement of Support.

4.359 In New Zealand's view, the linkage between the two concepts was confirmed by Article 13 of the Agreement on Agriculture. That Article, setting out the applicability of certain provisions of other agreements to measures covered by the Agreement on Agriculture stated, in Paragraph (b), that "domestic support measures ... as reflected in each Member's Schedule" (i.e., the AMS commitments) shall be "exempt from actions based on Paragraph 1 of Article XVI of GATT 1994 ... ".

4.360 New Zealand noted that Canada stated that the support price no longer appeared to constitute an 'applied administered price' for the purposes of "[market price support] calculation" (paragraph 4.356). New Zealand disagreed with this on the basis that support prices were still used by the CDC to buffer domestic supplies seasonally and, to a very minor extent regionally and between processors[255] and they also assisted producer boards in "establishing domestic price levels.[256] Despite the fact that buffer stocks might represent only a small part of domestic production, the

[255] New Zealand referred to paragraph 57 of Canada's First Submission.
[256] New Zealand referred to paragraph 45 of Canada's Second Written Submission.

effect of the CDC, a government agency, purchasing and selling stocks on the basis of support prices meant that those support prices represented the market clearing level for the products concerned - applied administered prices remained, as did price and income support in the sense of Article XVI:1 of GATT 1994.

4.361 **Canada** emphasized that the reference in Article 1.1(a)(2) was to Article XVI as a whole and not just to the Paragraph 1 of Article XVI. The phrase "any form of income or price support" did not appear in Paragraph 1 of Article XVI; it did as a subset of the term "subsidy": i.e., "any subsidy, including any form of income or price support". The plain meaning of this was that the term "subsidy" was to include "any form of income or price support" and the notification obligations in Paragraph 1 attaching to "subsidies" had necessarily to apply to income or price support systems.

4.362 Canada noted that Paragraph 3 of Article XVI stated that "contracting parties should seek to avoid the use of subsidies on the export of primary products". The second sentence then set out stronger injunctions with respect to the use of "such subsidies" in certain circumstances. Thus, both Paragraph 1 and Paragraph 3 were concerned with "subsidies", with Paragraph 3 concerned with certain kinds of "subsidies": i.e., export subsidies on primary products. The fundamental principle of interpretation applicable in this circumstance was that the same term (e.g., "subsidy") should be interpreted consistently when it was used in the same agreement. Where the same term was used within a single article the presumption in favour of consistency in interpretation was all the stronger. Absent any direction to the contrary, there was no reason to consider the meaning of the term "subsidy" in Paragraph 1 to differ from the use of the term "subsidy" in Paragraph 3. Paragraph 1 referred to all "subsidies" and Paragraph 3 referred only to some of those "subsidies"; those "subsidies" that were export subsidies on primary products. However, any "subsidy" that fell within the parameters of Paragraph 3 was also a "subsidy" for the purposes of Paragraph 1.

4.363 Canada argued that the term "any form of income or price support" was expressly included in the term "subsidy" in Paragraph 1. Although this express inclusion was not repeated in Paragraph 3, if the term "subsidy" was to have a consistent meaning throughout Article XVI, then the term "subsidy" as it was used in Paragraph 3 had also to include "any form of price or income support", except to the extent that there was any express direction to the contrary. There was, in fact, such an express exclusion. It was found in Interpretative Note 2 to Paragraph 3 in Ad Article XVI. This note stated that "a system for the stabilization of the domestic price or of the return to domestic producers of a primary product independently of the movement of export prices", (i.e., price or income support), under certain specified conditions, "shall not be considered to involve a subsidy on exports within the meaning of paragraph 3". Thus, the term "subsidies on exports" as it appeared in Paragraph 3 shall not include these particular types of income or price supports. The carve-out in the Ad Article of certain kinds of price and income support systems served as confirmation that, as a first step, all income or price support systems were in fact implicitly included in Paragraph 3, mirroring the express inclusion in Paragraph 1.

4.364 Canada argued that the presumption had to be that the meaning of the term "subsidy" was consistent throughout Article XVI. Since the subsidies referred to in Paragraph 3, export subsidies, were a subset of all subsidies, any practices which were declared not to be "subsidies" in Paragraph 3 could not be considered to be

"subsidies" for the purposes of Paragraph 1 if the principle of consistency of interpretation was to be upheld. It was important in this context to note that the Ad Article referred to "within the meaning of paragraph 3", not "for the purposes of paragraph 3". The latter formulation might suggest that, notwithstanding the usual meaning of "subsidy", the provisions of Paragraph 3 did not apply to these particular income or price support systems. The choice of the word "meaning", however, directed the interpretative note to the meaning of the word, as it was used in Paragraph 3, but without restricting that application to Paragraph 3. Since the principle of consistency of interpretation presumed that the meaning that applied in one part of an Article, i.e., Paragraph 3, also had to apply in the rest of the Article, the application of the Ad Article flowed into the consistent interpretation of the term "subsidy" throughout Article XVI. Accordingly, the term "subsidy" in Paragraph 1 of the Article XVI had the same meaning as it had in Paragraph 3. It included all income or price support systems other than those specifically excluded by the Ad Article. Similarly, the term "all income or price support" as it was expressly used with respect to "subsidy" in Paragraph 1, had to have the same consistent meaning as the implied term "all income or price support" as it was necessarily implied with respect to "subsidy" in Paragraph 3.

4.365 Canada recalled that the reference in Article 1 of the SCM Agreement was to "any form of income or price support in the sense of Article XVI of the GATT 1994". If the application of the Ad Article was only to Paragraph 3 of Article XVI, and did not flow to Paragraph 1, then there would be a different meaning for "any form of price and income support" for each of the two paragraphs. The result would be that the reference in Article 1 of the SCM Agreement to "any form of income or price support" would be left in a state of confusion and therefore meaningless. Consequently, in Canada's submission, particularly in the context of this case, "any income or price support" as it was used in Paragraph 1 of Article XVI could not be interpreted without reference to Paragraph 3 or Ad Article XVI. In this respect, Canada noted that the GATT Analytical Index, 1995, at p. 445 directed the reader to "Interpretative Note 2 ad Paragraph 3 of Article XVI" for the interpretation of the phrase "including any form of income or price support", as it was used in Paragraph 1 of Article XVI. This clearly reflected an accepted interpretative approach to the provisions of Article XVI. The reference to "Article XVI" in Article 1 of the SCM Agreement, rather than any particular paragraph of the Article, provided confirmation and endorsement of this approach.

4.366 The United States noted that Canada did not explain why it maintained the obviously cumbersome and complex arrangements for milk exports, i.e., the Special Milk Classes Scheme, if sales of surplus production were not a necessary element of its milk price support system. Although it might be true that Canada's domestic support arrangements could survive without export sales, either its domestic prices would be lower or its domestic production levels would be forced to be lower to maintain the current price levels. It was to avoid these results that the levy system existed, and later was replaced by the Special Milk Classes Scheme when the levy system was explicitly defined to be an export subsidy. Even if Canada eliminated its planned export programme, Canada would still have a structural surplus of skim milk powder that would have to be exported if domestic prices levels were to be maintained.

4.367 The United States argued that Canada's analysis of Article XVI reflected a serious omission with respect to its application of Interpretative Note 2 to Paragraph 3 of Ad Article XVI. Canada stressed that the term "subsidy" as it was used in Paragraph 3 had also to include "any form of price or income support", except to the extent that there was any express direction to the contrary. Canada had then noted that such an "express exclusion" existed in Interpretative Note 2 to Paragraph 3 in Ad Article XVI. It referred to the "system for the stabilization of the domestic price" under certain specified conditions shall not be considered an export subsidy within the meaning of Paragraph 3. In the view of the United States, Canada had completely glossed over with oblique reference to "certain specified conditions" that Canada's system did not satisfy the criteria for such conditions. First, the system had to result only "at times" in the export sale of the product at a price lower than the comparable domestic price. For that reason, the Contracting Parties had to also determine "(a) the system has also resulted, or is so designed as to result, in the sale of the product for export at a price higher than the comparable price charged for the like product to buyers in the domestic market; and (b) the system is so operated, or is designed so to operate ... as not to stimulate exports unduly or otherwise seriously to prejudice the interests of other contracting parties." The Canadian regime failed in all respects. Canada's contention, moreover, that the rare instance in which Special Class 5(a) through 5(c) prices might be higher than domestic prices satisfied the criteria of the exception set forth in Ad Article XVI ignored the fact that Class 5(a) through 5(c) milk was sold at exactly the same price in both domestic and export markets. Canada, indeed, argued that access to Class 5(a) through (c) were not conditioned on export. Consequently, by Canada's own analysis, if the exception was not available, the system was a subsidy on exports within the meaning of Article XVI.3 and, in turn, a subsidy within the meaning of Article XVI as a whole.

(iii) Article 1.1(b) - "Benefit"

4.368 **Canada** argued that an analysis of whether the sale of milk through negotiated prices conferred a "benefit" had to begin with an understanding of what was meant by that word. The word "benefit" had not been defined in the SCM Agreement or in any of the other covered agreements. In the absence of a definition, recourse had to be made to the principles of treaty interpretation in customary international law, as expressed in Articles 31 and 32 of the Vienna Convention. Following this approach, Canada submitted that the word "benefit" as it was found in Article 1.1(b) of the SCM Agreement, could only be read as meaning a competitive advantage in trade. This conclusion flowed naturally from the ordinary meaning of "benefit", the context in which it was found and the object and purpose of the SCM Agreement read as a whole.

4.369 Canada argued that to establish ordinary meaning, some guidance could be obtained from authoritative dictionaries. In this respect, the New Shorter Oxford English Dictionary referred to "an advantage" or a "pecuniary profit".[257] Furthermore, Canada noted that WTO agreements were authentic in English, French and

[257] *NSOED,* Canada, Exhibit 26.

Spanish.[258] Under Article 33 of the Vienna Convention, the terms of each authentic text were presumed to be the same. If there was a difference of meaning, the meaning which "best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted."[259] Canada noted that in the French language text of the SCM Agreement, the word used for "benefit" was "*avantage*". Canada argued that this lent support to reading "benefit" in the English text as carrying the meaning of "advantage".

4.370 Canada argued that the SCM Agreement was about the maintenance of fair trade between producers. It was intended to discipline government contributions that resulted in a competitive advantage to certain producers. In this context, and in the light of the object and purpose of the provision, the expression "benefit" could only be interpreted to mean "competitive advantage". A broad reading of the word "benefit" would make governments liable for virtually any financial activity they undertook, regardless of whether or not that activity had a trade-distorting effect. In a commercial context, understanding "benefit" to mean "an advantage", meant that the transaction in question provided something to the recipient that would not be available in the ordinary course of business (for example, goods purchased at above market price or inputs provided at less than commercially prevalent prices). In either case, the action by government had provided something to the recipient over and above what was available in the market. Moreover, Canada argued that if "benefit" was to be read as carrying a broader meaning, this would have the effect of rendering the term meaningless and redundant since nearly any financial contribution could be said to provide a benefit in some aspect of that wider sense. This would be contrary to the basic rules of treaty interpretation.[260] Canada contended that the above confirmed that the term "benefit", as it was used in the SCM Agreement, was best understood to mean an "advantage". Canada contended that no "benefit" in the sense of some advantage outside of normal commercial returns can be found in the sale of milk in Canada at differing prices for domestic and export purposes.

4.371 Canada argued that the Complainants' submissions were premised on the assumption that there was only one market for dairy products in Canada. They argued that there were at least two distinct markets for the sale of dairy products. One market was the sale of dairy products for domestic consumption and the other was the sale of dairy products for export. In fact, there were sub-markets within each of these general markets. To find a "benefit", it had to be demonstrated that the ability of processors to obtain dairy products surplus to domestic requirements, on terms and conditions negotiated at arms length between producers (acting collectively) and processors, at the price that such products commanded in the international marketplace, conferred any assistance or advantage to the buyer. Canada failed to see how

[258] Marrakesh Agreement Establishing the World Trade Organisation, signature provisions.

[259] Vienna Convention, Article 33.

[260] Canada noted that in particular, in the Appellate Body Report on *US - Reformulated Gasoline*, *op. cit.*, p.23, DSR 1996:I, 16, IV, the Appellate Body stated: "One of the corollaries of the 'general rules of interpretation' in the Vienna Convention is that interpretation must give meaning and effect to all the terms of a treaty. An interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility."

neutrality with respect to the purchase and sale of products at the price that was normal and customary in a particular market, could be said to be a "benefit".

4.372 Canada submitted that the relevant market for any product was the market in which it would compete. Since Class 5(d) and (e) milk could not, by definition, be sold in the domestic consumption market, the relevant market in which the price of such milk had to be examined was the export market as this was the only market in which the product can be sold. There could be no "benefit" where products were sold into a market at prices that the market would bear. Thus, Canada argued that the sales of milk in Canada for export use did not in themselves constitute a "benefit" for the purchaser over and above the normal commercial conditions that applied in such a market. Accordingly, there could be no "benefit" as that term had to be interpreted under Article 1 of the SCM Agreement.

4.373 Canada argued that even if both a governmental "financial contribution" and a "benefit" were found, the word "thereby" in Article 1.1(b) required that there was no "subsidy" until a causal link was established between the two elements. In other words, it was necessary to show that the "benefit" was conferred from the "financial contribution".

4.374 **New Zealand** noted that Canada's denial that any "benefit" was conferred by the operation of the Special Milk Classes Scheme was based largely on its view that Special Classes 5(d) and (e) milk were sold on the basis of arm's length transactions engaged in by producers or their agents and not by governments. There could be no "benefit", Canada asserted, because the exporter was simply obtaining milk at the only price at which it was available. Milk was exported, Canada claimed, only when there was no further domestic demand, thus there was no alternative domestic market to which the price can be compared. New Zealand contended that such an explanation assumed that there were two markets, domestic and export, that operate without governmental restraint. However the domestic market was only "satisfied", to use Canada's term, because the government said it was. Even when the market was "satisfied" it would still be possible to release more product into the market. Left to their own devices, producers would do just that. They would make the rational commercial decision to sell their product on the domestic market. While this would ultimately bring prices down, equally, greater quantities would be sold. Thus, the decision to provide milk at a lower price for the "export market" was not the result of the normal operation of the marketplace. Offering milk to exporters at a price lower than the domestic price was a conscious decision taken by government under the Special Milk Classes Scheme. It was a decision that conferred a benefit because in the absence of the Special Milk Classes Scheme exporters would have to pay domestic prices to access milk and would then clearly sell any products on world markets at a loss. The recipient was indeed, even in the terms that Canada used, being provided with something that "would not be available in the ordinary course of business" (paragraph 4.370). Thus the requirement that a benefit be conferred in order to meet the definition of "subsidy" in Article 1 of the SCM Agreement was met.

4.375 New Zealand maintained that Canada's contention that the Special Milk Classes Scheme did not provide a subsidy within the meaning of Article 1 of the SCM Agreement could not, therefore, be supported.

4.376 The **United States** argued that for purposes of Article 1 of the SCM Agreement, the Special Classes provided a benefit to the dairy product export manufacturers. While the United States did not necessarily accept Canada's construction of the

term "benefit", the application of the term even as construed by Canada resulted in the conclusion that export processors received a benefit in the form of lower priced milk. Since those processors had no other source for such low priced milk[261] and they could not sell their dairy products into world markets if they were compelled to pay the much higher domestic prices in Canada for milk[262], the processors clearly received a competitive *advantage* that they would otherwise lack.

4.377 Canada's argument that there was no benefit, moreover, rested solely on its theory that milk producers sold for export at approximations of world price levels free of all government compulsion. This view entirely ignored the fact that milk subject to surplus removal had to be sold for export at the lower prices fixed by the CDC or not be sold at all. The United States claimed that data (set out in US Exhibit 57) clearly indicated that over-quota component prices set by the CDC often undercut world prices for butter and SMP. Given that milk was a highly perishable product, and the initiation of surplus removal meant that no other processors in a province had a need for the milk, the Special Class price under surplus removal constituted what was essentially a take it or leave it price to the milk producer. Mr. Doyle, from the Dairy Farmers of Canada, stated this concept most concisely:

> "From the producer standpoint, the revenue generated is what is reflected in 5-E and that is not a price setting as you use as an expression; its a price taking. It's the result of whatever the market provided for after costs."[263]

4.378 The United States submitted that a recent decision by Revenue Canada in a Canadian countervailing duty investigation involving refined sugar from the European Union was relevant to this issue. One of the subsidies that Revenue Canada examined was the payment of refunds to sugar processors selling their products onto the world market. Revenue Canada determined that those refunds constituted a benefit because the payments covered "the price difference between the EU price level and the world price level, thereby allowing the exporters to be competitive in export markets." Canada's Special Milk Classes Scheme also resulted in a price difference with lower priced milk available only to exporters to allow them to be competitive in world markets. Revenue Canada's conclusion that such price differentials constitute a benefit to exports compelled the conclusion that the Special Classes also conferred a benefit to Canadian processors.[264]

4.379 **Canada** refuted the US contention that processors received a benefit in the form of lower priced milk. Canada argued that there was no "benefit" conferred where products were sold into a market at prices that reflected the economic realities of that market. Likewise, the Canada refuted the US contention that what Canada called the market price was a "take it or leave it" price negotiated by the CDC. This

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[261] The United States noted that Canada reported that the Import for Re-Export Programme did not provide imported milk to its processors except in a form of more limited utility, e.g., as milk powder (the Import for Re-Export Programme is further addressed in the following Section of this report).

[262] United States, Exhibit 25.

[263] Excerpt from Mr. Doyle's testimony before the Canadian International Trade Tribunal in its examination of the butter oil blend issue.

[264] Final Determination of Subsidizing of Refined Sugar from the European Community, Statement of Reasons, Revenue Canada. See United States, Exhibit 55.

was factually inaccurate. The CDC negotiated as agent for the producers and, as the principals, the producers had the right to approve or reject the transaction. The negotiated price was a price at which a willing buyer was prepared to purchase from a willing seller. It was difficult to see how such commercially-based sales conferred a benefit.

4.380 Canada contested the methodology in which the United States had constructed Canadian dairy prices as set out in Exhibit 57 (referred to in paragraph 4.377). The United States had converted actual over-quota returns for the 1995/96 to 1997/98 dairy years to US dollars, and compared them to prices reported for New Zealand and Australia. The United States then selected milk component prices under Class 5(e) from different individual provinces and converted these to US dollars after which conversion factors were assigned to each component to calculate the alleged value of milk reflected by the component prices. Canada argued that this procedure was flawed. It was almost impossible to create an accurate per hectolitre milk price from milk component prices for use in cheese and other products. This was because the protein and other solids prices for cheese were very different than for other products. For cheese making, protein was more highly valued, while the other solids were lower-priced. In making skim milk powder, protein and other solids had the same value. Moreover, different products contained different proportions of the various components. Therefore, from month to month and from province to province, as the composition of production changed, a crude conversion from component prices to a hectolitre price using fixed coefficients yielded an incorrect number. This result was clearly displayed in the "Calculated Milk Price" line (first page of Exhibit 57) where the United States reported that its estimate of farm level over-quota returns based on the components conversion methodology were vastly different than the actual over-quota returns for each of the dairy years studied. In other words, the data manipulations had generated incorrect answers.

4.381 Furthermore, in the following panel of the table in Exhibit 57, the United States took estimated prices for butter and skim milk powder in Northern European ports, which it used as a proxy for world dairy prices, and converted these to an estimated world price for milk. Unfortunately, it used inappropriate conversion factors. Butter and skim milk powder were joint products produced in more or less fixed proportions from standard whole milk. Canadian dairy experts considered these proportions to be 4.365 kg. of butter and 8.51 kg. of skim milk powder per hectolitre of milk. The United States had assumed 4.875 kg. of butter and 8.51 kg. of skim milk powder, thus overstating the value of a hectolitre of milk, and biasing its world price estimate upward. In the last line of the table in Exhibit 57, the United States attempted a comparison between prices of raw milk to processors on one hand with retail-packaged milk on the other. This was a basic analytical error (paragraph 4.439).

4.382 Canada further argued that the graph in Exhibit 57 suffered from similar methodological errors as the table. First, the component prices achieved in sales under Class 5(e) as reported by "various [unidentified] provincial newsletters" reflected the values of these components in a broad range of dairy products, for which different components had different values. A simplistic conversion from reported component prices to butter and skim milk powder prices produced inaccurate results. Second, the United States appeared to be comparing component values of raw milk as paid for by processors at their plants, with a survey of prices for finished butter transported to Northern European ports. Any analysis that failed to make allowances

for processor margins, marketing costs and transportation before comparing these "constructed" plant-gate prices with finished goods prices obviously lacked credibility.

4.383 Canada noted that New Zealand argued that there was a benefit because the notion of a domestic market and an export market was an artificial construct designed by Canada. Canada argued that far from being an artificial construct, the differences between Canadian domestic and international dairy markets were a basic business reality to which producers and processors had to respond. Neither the Agreement on Agriculture nor the SCM Agreement required Members to eliminate all domestic and international pricing differences. Canadian dairy producers had simply adjusted themselves to the objective fact that these differences existed.

(c) Paragraph (d) of the Illustrative List of Export Subsidies

(i) Outline

4.384 **New Zealand** noted the Illustrative List in Annex I to the SCM Agreement made clear that the provision of inputs solely for use in exports on more favourable terms than for domestic production constituted an export subsidy. There was no doubt that what occurred under Classes 5(d) and (e) of the Special Milk Classes Scheme would constitute a subsidy within the meaning of Paragraph (d) of the Illustrative List. Under a government-mandated scheme, lower-priced milk was being made available to processors contingent upon export. The terms and conditions under which such milk was made available were more favourable than those commercially available on world markets since the existence of tariff restrictions on the importation of milk into Canada meant that the choice between domestic and imported products was not unrestricted within the meaning of the footnote to Paragraph (d). New Zealand claimed that the Special Milk Classes Scheme met the conditions set out in Paragraph (d) of the Illustrative List of Export Subsidies in Annex I of the SCM Agreement which made it clear that such differential pricing schemes fell within its scope.

4.385 The **United States** argued that Paragraph (d) of Annex 1 of the SCM Agreement was particularly germane to consideration of whether Canada's Special Milk Classes Scheme constituted an export subsidy as this paragraph specifically addressed the situation where a government provided inputs to exporters at a price which was below the price at which the same materials were made available to manufacturers in the domestic market. This, after all, was precisely the function and objective of the Special Milk Classes Scheme. The conclusion that a differential pricing system for products destined for export fell within the concept of an export subsidy under Article 10 of the Agreement on Agriculture, as well, was, thus, reinforced by reference to the Illustrative List of Export Subsidies in the SCM Agreement. The Illustrative List made clear that the provisions of inputs solely for use in exports on more favorable terms than for domestic production constituted an export subsidy.

4.386 The United States argued that there were essentially four conditions that had to be fulfilled to satisfy Paragraph (d): (1) the provision of goods had to be by governments or mandated by them, either directly or indirectly; (2) the goods had to be used in the production of exported goods; (3) the goods had to provided on terms or

conditions more favorable than for provision of like or competitive products in the production of goods for domestic consumption; and (4) the goods had to be made available on terms or conditions more favorable than those commercially available on world markets to the exporters. The United States argued that Canada's Special Milk Classes Scheme satisfied each of the requisite factors and, therefore, was an export subsidy within the meaning of the SCM Agreement.[265]

4.387 In conclusion, the United States argued that because the Special Classes had satisfied each of the criteria identified in Paragraph (d) of the Illustrative List, the Special Classes were deemed to be an export subsidy for purposes of the SCM Agreement. And as the SCM Agreement was part of the context of the subsidy provisions of the Agreement on Agriculture, the fact that the Special Classes comprised a subsidy under the Illustrative List argued for their treatment as a subsidy under the Agreement on Agriculture as well.

4.388 **Canada** argued that the facts demonstrated that the sale of milk in Canada for export use differed significantly from the practice described in Paragraph (d). This significant difference between the practices at issue and the practices *explicitly* described as export subsidy practices raised a clear implication that the Canadian practices did not fall within the conception of "subsidies" or "export subsidies" in the SCM Agreement or the Agreement on Agriculture. In Canada's view there were three elements that had to be met if a practice or measure relating to goods was to fall within the description provided in Paragraph (d):

(a) the raw materials for use in the production of exported goods had to be provided by government or their agencies, either directly, or indirectly through a *government-mandated* scheme;

(b) the raw materials were provided on terms or conditions more favorable that those that apply to raw material for use in goods for the domestic market; and

(c) those terms and conditions were also more favorable than those commercially available on world markets to exporters.

4.389 Canada claimed that none of the three criteria applied to sales of milk under Special Classes 5(d) and (e) and therefore such sales were not deemed to be an "export subsidy" under this provision. Moreover, given the careful delineation of this type of "export subsidy", it was highly suggestive that a reverse proposition was true: the practices at issue were *not* to be considered to be "export subsidies" for the SCM Agreement, or in turn, for the Agreement on Agriculture. It was Canada's position that the practices in question did not fall within Paragraph (d) of the illustrative List. This raised a strong presumption that the practices in question were not "export subsidies" for the purposes of the SCM Agreement and, in context, for the Agreement on Agriculture.

[265] The United States noted that it had already established that the Special Milk Classes Scheme was an export subsidy because it satisfied the criteria alternatively of Article 9.1 or 10 of the Agreement on Agriculture.

(ii) Government Mandated ...

4.390 **New Zealand** argued that the scheme could be viewed as either the provision by a government or its agency of products for the use in the production of exported goods, or it could be viewed as the provision of such products by producers through a government-mandated scheme. The role of the CDC and of the provincial milk marketing boards and agencies in providing lower-priced milk for the production of dairy products for export was one of implementing a government-mandated scheme.

4.391 The **United States** argued that the provision of milk at the Special Class prices was mandated by the federal and provincial governments and the Special Class prices were only available for milk used in production of export products. The United States submitted that the Panel consider at least two relevant factors in analyzing the mandatory nature of Canada's Special Class System: (i) the various GATT and WTO cases, including *Japan - Photographic Film*, *EEC - Dessert Apples*, and *Japan - Semiconductors*, which were each pertinent to a determination whether there was a government measure requiring compliance; and (ii) milk that was determined to be surplus by the CDC had to be sold at the Special Class 5(e) price when sold to processors for export.

4.392 **Canada** argued that milk for use in export markets was not provided by governments in Canada or their agencies. Nor was milk provided "indirectly" through "government-mandated schemes". Paragraph (d) required that the scheme in question be "mandated"[266] by government and not merely permitted or enabled. The distinction was critical. The ordinary meaning of the word "mandated" implied an act by government directing a certain outcome or course of action. This was confirmed by reference to dictionary definitions of "mandate" which confirmed that the term required a direction or order by superior body, not a mere empowerment. The New Shorter Oxford English Dictionary referred to a "mandate" as being: "a command, an order, an injunction"; "a legal command from a superior to an inferior"; and "instruction as to policy supposed to be given by the electors to a parliament". Canada pointed out that this also appeared to be the understanding of the United States who carefully distinguished "authorize" and "mandate", equating the latter with "require", with respect to their Uruguay Round implementing legislation.[267]

4.393 **New Zealand** refuted Canada's arguments that the requirements of Paragraph (d) of the Illustrative List of Export Subsidies had not been met because milk was not provided by a "government-mandated" scheme, and that the terms and conditions on which milk was sold were not more favourable than those commercially available on world markets to exporters. Canada derived a definition of "mandated" by choosing selectively from the dictionary definition of the word "mandate" in its noun form. But, the term "government-mandated" used the past participle of the verb "to mandate". Included amongst the Oxford English Dictionary definitions of the verb form of mandate were "to delegate authority to". The term "mandated" was defined to mean "permitted to act on behalf of a group".[268] The critical distinction that Canada

[266] In defining "mandate", the *NSOED* referred to: "a command, an order, an injunction"; "a judicial or legal command from a superior to an inferior". (Canada, Exhibit 26)

[267] Canada, Exhibit 27, p.213.

[268] New Zealand referred to the *Oxford English Dictionary*, Second Edition, Volume IX, p. 301.

wished to make dissipated in the face of a more accurate use of dictionary definitions.

4.394 New Zealand claimed that it had already been demonstrated that the Special Milk Classes Scheme *did* involve the provision of goods by government. Moreover, with regard to the alternative argument regarding the *indirect* provision of goods through government-mandated schemes, Canada's attempt to rely on dictionary definitions of the word "mandate" were not credible in light of definitions of the verb form of mandate, which was the form in which it was used in the term "government-mandated", were examined. The Oxford English Dictionary recorded that the term "mandated" in this form was frequently used to mean "permitted to act on behalf of a group".[269] The Special Milk Classes Scheme thus met this aspect of Paragraph (d).

4.395 **Canada** argued that the first listed definition of the verb form of "mandate" was "to command." The definition that New Zealand used was part of the last listed definition of the verb form of "mandate." The first part of this last listed definition read "To give a mandate to, to delegate authority to (a representative, group, organization, etc.)." As this definition began with giving "a mandate" to someone, an examination of the noun form of the word "mandate" was more than warranted. In looking at the noun form in the Oxford English Dictionary: "1. A command, order, injunction; 2.a. A judicial or legal command from a superior to an inferior." Canada maintained that the ordinary meaning connoted more than merely the sense of "permitted or enabled." In respect of "mandate", Canada further argued that the immediate context[270] of the words confirmed Canada's understanding that "government-mandated" means "government-ordered" or "government commanded." Item (c) of the Illustrative List of Export Subsidies of the SCM Agreement (the "Illustrative List") identifies as a subsidy the following:

> "(c) Internal transport and freight charges on export shipments, provided or mandated by governments, on terms more favourable than for domestic shipment."

4.396 Canada argued that the meaning of "mandated" in Item C of the Illustrative List was that of "commanded" or "ordered." That which made such discounted charges on export shipments an "export subsidy" was the government involvement requiring that they be given. For example, a private transport company that offered better rates for transport to some destination rather than to others, even if those destinations were foreign, would not be considered an export subsidy for the purposes of the WTO Agreements. To hold otherwise would require all Members to know and take responsibility for all transport charges on every shipment within their territory. Indeed, the mere fact that such companies were allowed to charge different rates to different clients, certainly could not mean to say that such private party practices were "government-mandated." The same logic would apply to Article 9.1(e) of the

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[269] New Zealand referred to the *Oxford English Dictionary*, Second Edition, Volume IX, p. 301.

[270] In respect of the term "mandate" Canada argued that the Appellate Body had noted that a treaty interpreter ought not to stop at the ordinary meaning of a word. The analysis had to continue to consider the context in which the word was found, as well as the object and purpose of the provision itself, and if necessary, of the agreement as a whole: Appellate Body Report on *United States - Import Prohibition of Certain Shrimp and Shrimp Products*, (hereafter "*US - Shrimp-Turtle*"), WT/DS58/AB/R, adopted 6 November 1998, pp. 41-42, para. 114-116.

Agreement on Agriculture. Hence, moving to Paragraph (d) of the Illustrative List then, it seemed natural to read "government-mandated" in the same fashion as "mandated by government." Truly, such a reading coincided with the very notion of governmental control with respect to a measure identified as being a "government subsidy." The measure had necessarily to be imposed by the government as this item itself added as a condition "... if (in the case of products) such terms or conditions are more favourable than those commercially available ...".

4.397 Canada further argued that its interpretation was consistent with the object and purpose of Paragraph (d). That was, to identify as a governmental export subsidy the provision of inputs for export purposes at artificially advantageous terms or conditions, whether by government or at the insistence of government. Furthermore, the Agreement as a whole did not purport to restrict private party actions but rather was concerned with constraining governments from providing subsidies or from entrusting or directing private parties to do so. Producer boards were private parties who were not directed by government to carry out subsidy functions and they were entrusted by their members to act on their behalf, not by government.

4.398 Canada argued that this approach to schemes or actions carried out by non-governmental entities was also reflected in the text of the definition of "subsidy" in Article 1 of the SCM Agreement and the use of the word "imposed" in Article 9(1)(c) of the Agreement on Agriculture. In Canada, milk producers and the marketing boards that represented producers were completely free to participate or not participate in export opportunities as they choose. Moreover, boards were not required by any government direction to establish or operate the Special Class export practices. This was entirely a matter of their own choice. The most that could be said was that governments made it possible for boards to put special class arrangements into place. The Complainants had provided no evidence that the goods in question were provided through a government-mandated scheme.[271]

(iii) Terms or Conditions more Favourable ...

4.399 **New Zealand** argued that the terms and conditions on which milk was made available were more favourable than for the provision of like or directly competitive products for the production of goods for domestic consumption. Milk was made available at the lower world price and not at the higher domestic price.

4.400 The **United States** argued that the Special Class 5(d) and (e) prices were uniformly lower than prices for the same milk components sold in the same market categories in the domestic market. Although Canada could dispute that the Special Class prices were fixed by the CDC, there was no question that the provincial marketing boards had to establish a price and that they did so through powers delegated to them by the federal and provincial government in their respective jurisdictions over provincial and inter-provincial trade and exports.

4.401 **Canada** noted that while milk could be sold in Canada for export purposes at prices which were lower than those for milk for use in products destined for the domestic market, this was not always so. In fact, as discussed with respect to Article

[271] Canada maintained that New Zealand's arguments with respect to this provision were flawed by their assumption that there was a "government-mandated scheme".

1.1(a)(2) of the SCM Agreement, recently the prices of some dairy components under Classes 5(a) and (b), which were linked to US domestic milk prices, had begun to exceed prices for milk classes in Canada for domestic use. Therefore, it was not always true that milk sold for export was sold on terms and conditions more favourable than those that apply to milk for domestic use.

4.402 The **United States** argued, in respect of prices for Special Classes 5(a), (b) and (c), that the only instances in which such prices could be argued to be higher than domestic prices, according to the data from the Canadian International Trade Tribunal, would be if prices to different end-use classes were compared. For example, by comparing the price of butterfat used in yoghurt with butterfat used in cheese. Such a comparison would be entirely inappropriate, however, as the Canadian system specifically differentiated among product markets in establishing price levels. Thus, the only appropriate comparison would be between prices for the same component in the same product market. This was the approach which the United States took, and using that approach, the resulting comparisons uniformly showed the Special Class prices to be lower than domestic prices for each of the three major milk components, i.e., butterfat, proteins, and other solids.

(iv) Terms and Conditions more Favorable than those Commercially Available ...

4.403 **New Zealand** further claimed that the requirement that the terms and conditions be more favourable than those commercially available on world markets were also met. A footnote to Paragraph (d) indicated that the term "commercially available" meant "that the choice between domestic and imported goods is unrestricted and depends only on commercial considerations." In the case of milk for processing into exported products, the choice between domestic and imported products was not unrestricted. Canada's tariff restrictions on the importation of milk meant that the terms and conditions on which milk was provided for processing into exported products under "special milk classes" were more favourable than those commercially available to Canadian processors on world markets.

4.404 The **United States** claimed that the terms and conditions for access to Special Class 5(d) and (e) were more favorable than those commercially available on world markets to Canada's dairy product exporters. The United States noted that Canada conceded that, in fact, "[w]ith respect to milk of HS 0401, no permits have been issued for milk for manufacturing purposes under the Import for Re-Export Programme".[272] Thus, the record was presently clear that Canadian exporters had no access to imported fluid milk under the Import for Re-Export Programme. Therefore, its exporters did have access to milk under the Special Milk Classes Scheme on terms and conditions that were more favorable than those commercially available to them within the meaning of Paragraph (d) of the Illustrative List.[273]

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[272] Canada's reply to New Zealand's Question 1(b).

[273] The United States noted that although Canada asserted that exporters had access to other dairy inputs, such as milk powder and evaporated milk, through the Import for Re-Export Programme, the United States in its response to the Panel's Question 5 had demonstrated that such products simply were not substitutable in any practical sense for the liquid milk that Canada's exporters receive through the Special Milk Classes Scheme.

4.405 **Canada** argued on this point that the requirement was essentially a requirement that inputs not be provided at prices lower than exporters obtained for similar inputs on world markets. Sales of milk for export purposes under Special Classes (d) and (e) were tied directly to sales of the resulting dairy products into world markets and producers sought to obtain the optimum return from such sales to processors. The result was that milk inputs were not provided to processors at less than world market levels.

4.406 Canada noted that the footnote to Paragraph (d) stated that the term "commercially available" meant that "the choice between domestic and imported products is unrestricted and depends only on commercial considerations". Canada claimed that processors seeking to use imported dairy inputs had unhindered access to inputs on the world market for use in re-exported dairy products from Canada. Canada operated an Import for Re-Export Programme under the provisions of the *Export and Import Permits Act* pursuant to which permits were freely issued to processors to access inputs on the world market, subject only to the condition that imported products met Canadian sanitary requirements and that all resulting manufactured products be re-exported from Canada. Canada argued that inputs imported under the Import for Re-Export Programme were not part of Canada's scheduled tariff quota commitments. Such imports entered under supplemental import permits issued by the Department of Foreign Affairs and International Trade. As such, these imports were not counted against Canada's TRQ commitments. Accordingly, processors had an unrestricted choice between domestic and imported inputs for exported dairy products that depended only on commercial considerations.

4.407 Canada argued that due to the perishable nature of the product and difficulty in shipping, there was little trade in fluid milk for manufacturing purposes. Trade in milk consisted largely of trade in the storable and tradeable milk derivatives, such as skim milk power, whole milk power and butter. The commercial availability of these substitutable dairy ingredients, through the Import for Re-Export Programme, provided effective international competition for sales of milk for processing purposes to Canadian customers. Canada noted the fact that the programme had been used in not insignificant quantities and that prices paid for imported dairy products under the Import for Re-Export Programme were negotiated between Canadian buyers and foreign suppliers. This supported Canada's position that processors made their choices based on commercial considerations.

4.408 **New Zealand** argued that the granting of permits under an Import for Re-Export Programme, to which Canada referred in passing, did not mean that the choice between imported and domestic products was "unrestricted" within the terms of the footnote to Paragraph (d). Paragraph (d) did not grant Members the right to provide each input into a product at lower prices for export than for domestic uses where tariff protection was provided as long as there happened to be a scheme in place that allowed the temporary import of those inputs for manufacture in bond. A duty draw-back mechanism was not sufficient justification for governments to provide car engines, wheels and other vehicle components at cheap prices solely for export use. In short, Canada had failed to provide any evidence that the choice between imported and domestic products was "unrestricted" within the meaning of Paragraph (d) of the Illustrative List.

4.409 New Zealand argued that it was clear that the prices of products derived from over-quota milk would be below domestic market prices in order that exports could

be commercially viable from the exporters' point of view[274]. New Zealand also believes that there was a risk that such prices would also be below world market prices. Although Canada argued that the CDC must negotiate vigorously with exporters in order to maintain the confidence of producers and the CMSMC, the reality was that the alternative to disposing of Class 5(e) milk by way of export was to pour it away. Accordingly, when pressure for effective surplus removal was added to the need for exporters to obtain a profit margin, the result could well be that prices paid by exporters were below world market prices.

4.410 New Zealand maintained that Canada's image of unhindered access was hardly in accord with the reality that permits were issued on a discretionary basis and goods were imported subject to the "within access" tariff. A tariff was a form of restriction. This in itself would be enough to render the Programme inconsistent with the requirement set out in the footnote to Paragraph (d). New Zealand also commented on the careful use of language in the Canadian submissions relating to the Import for Re-Export Programme by virtue of which Canada asserted that processors had unhindered access to "dairy inputs", rather than to "milk" on the world market. It had become clear that the shift in language that was used in preceding paragraphs which had referred to "milk" was anything but stylistic. It simply would not have been accurate for Canada to have said that processors had unhindered access to milk on the world market. Canada had admitted that "no permits have been issued for milk for manufacturing purposes under the Import for Re-Export Programme".[275] But the other dairy "inputs" to which Canada refered were simply not relevant to the current case, which was about the provision of lower-priced milk to exporters. Canada had further sought to ascribe this lack of trade to the "perishable nature" of milk and "difficulty in shipping", although it did not explain why shipping milk a short distance across the Canada-United States border was more "difficult" and likely to lead to a "perishing" of the product, than shipping it potentially much longer distances from within Canada.

4.411 Hence, New Zealand maintained that in practice, milk was not "commercially available" on world markets to Canadian processors under the Import for Re-Export Programme. Thus, the terms and conditions on which "special class" milk was made available were more favourable than those commercially available on world markets. Clearly, the requirements of Paragraph (d) of the Illustrative List were met.

4.412 The **United States** recalled that Canada had admitted in its response to the Panel's questions that milk in liquid form was *not* imported into Canada for use in manufacturing.[276] Thus, such milk was clearly not commercially available within the meaning of Paragraph (d). Canada sought to imply that phytosanitary barriers did not exist. The United States noted that in their argumentation on this context, Canada referred to *dairy products*, not milk. This statement did not alter the fact that milk

[274] For example, Figure 3 of New Zealand's First Submission provided a representation of the price of the butterfat component of butter manufactured from Class 4(a) milk and that manufactured from Class 5(e) milk.

[275] Canada's responses to New Zealand questions of 20 October 1998.

[276] Canada's Response to Question 1 from New Zealand: "With respect to milk of HS 0401, no permits have been issued for milk for manufacturing purposes under the Import for Re-Export Programme."

was not entering Canada. Also Canada sought to argue that the components of milk and milk itself were the same. This was not true as the ingredients had a much narrower range of applications, than the whole milk product. These other dairy products were not "like or directly competitive" products within the meaning of Paragraph (d). In addition, the other dairy products mentioned by Canada certainly could not be used by Canada's processors for many end-uses that were served by liquid milk. For example, a manufacturer of skim milk powder or butter could not import those same products to replace the milk that he received under the Special Milk Classes Scheme. This was a critical consideration because a considerable portion of Canada's dairy product exports consisted of butter and skim milk powder.

4.413 Furthermore, the United States argued that the very modest level of imports reported by Canada emphasized their lack of competitiveness with milk available through the Special Classes. The total volume of such imports, such as milk powder and evaporated milk, comprised less than 5 per cent of Canada's export volume of dairy products, and significantly less than 1 per cent of Canada's domestic consumption of milk. These volumes indicated that processors had decided that the other dairy products to which Canada referred were not available on as favorable terms and conditions as milk under the Special Milk Classes Scheme. Such paltry import volumes also provided unrefuted evidence that Canada's processors did not find such other dairy products to be directly competitive with the industrial milk provided by Canada's Special Milk Classes Scheme.

4.414 Furthermore, the United States claimed that Canada had failed to demonstrated that those other dairy products were available on terms and conditions as favorable as those provided by the Special Classes. For example, Canada admitted that milk in Special Class 5(e) was provided at world prices or an approximation of world prices, and also conceded that milk ingredients imported under the Re-Export Programme had to bear an in-quota duty rate. Even if the Panel accepted Canada's argument regarding the direct competitiveness of the milk ingredients (which the United States submitted misstated the competitiveness of such products), the imports had to be higher priced as they were subject to import tariffs and the underlying purchase price was a world market price. Thus, by definition such imports were available on less favorable terms and conditions than those provided by the Special Classes.

4.415 Hence, the United States concluded that the application of the Illustrative List of Export Subsidies resulted in a finding that the Special Milk Classes Scheme was an export subsidy. Consideration of the criteria regarding subsidies contained in Article 1 of the SCM Agreement only confirmed this result.

4.416 **Canada** argued, in respect of its sanitary requirements, that under Paragraph 26(1)(a), (b) and (c) of the Dairy Product Regulations[277], under the Canadian Agricultural Products Act, dairy products imported into Canada had to originate in a country that had "standards for dairy products that are at least equivalent to those set out in these regulations", and "a system for inspection for dairy products and establishments that are at least equivalent to that in Canada". The product had to also "meet the standards for a similar dairy product that is produced in Canada" and "has been prepared under conditions at least that equivalent to those required by these

[277] P.C. 1979 - 3088, as amended.

regulations".[278] These standards did not prevent US dairy products from entering Canada. As a matter of practice, the Canadian Food Inspection Agency (CFIA) routinely approved the import of dairy products into Canada from the United States on the basis that standards in the United States met the standards set out in the regulations. Once imported into a province, raw milk would be subject to the same provincial standards as milk produced in that province. These standards would not pose any barrier for milk sourced in the United States. Thus, while there were sanitary standards, these were normal routine matters and did not pose anything like the "effective prohibition" as suggested by the United States. Canada argued that although it was true that there had not been any imports of raw industrial milk in recent years under the Import for Re-Export Programme, this does not reflect any denial of access to the Canadian market. There had not been a *request* to the CFIA for approval of the import of industrial milk under their sanitary regulations. The reasons for no imports of industrial milk into Canada were commercial, not regulatory.

4.417 Canada noted that the United States had suggested that there was a qualitative difference for manufacturing purposes between liquid milk and milk components that limited the use of milk components to certain niche products. Canada argued that milk components were not different products - they were simply part of the same product. The quality of milk components such as skim milk powder, butter or other milk ingredients had greatly improved in recent years. This had now reached the point that it was argued that final product quality was actually enhanced by the use of specialized whey protein concentrates in place of skim milk in ice cream for example. Where components were competitive with liquid milk, questions of cost would come into play. Costs of transport of a product such as liquid milk were considerable when it was considered that up to 87 per cent of the product consisted of water. In addition, raw milk could be a less economically efficient input for a manufacturer than dairy products that supplied the components needed for a particular manufacturing process. Hence, Canada argued that the supposed barriers to liquid milk for Canadian processors from the United States did not exist. There was no commercial basis to suggest that liquid milk and tradeable milk components could not be used for the same manufacturing processes.

4.418 In sum, Canada argued that processors had unrestricted access to dairy product inputs through the Import for Re-export Programme, and they had access to those products at world market prices. Inputs sold to processors through Special Classes 5(d) and (e) were sold at world market prices. The use of the Import for Re-Export Programme indicated that these two sources of supply effectively competed. Processors had not shown any overwhelming preference for ingredients sourced under Special Classes 5(d) and (e). Hence, it could be concluded that Special Class prices were not more favourable than prices commercially available to Canadian exporters on world markets. Given that prices of dairy inputs were available to processors at internationally competitive prices, both through the Import for Re-Export Programme and through Special Classes 5(d) and (e), and both avenues were used, this suggested that Special Classes 5(d) and (e) could not be said to provide a "benefit."

[278] Canada, Exhibit 54.

4.419 Canada contended that the imports under the Import for Re-Export Programme in recent years had been of significant quantities.[279] Furthermore, these imports of dairy inputs from the United States entered Canada duty-free. For all products imported under the Programme in 1998, the average trade-weighted tariff was less than 1 per cent.

4.420 **New Zealand** noted that the Appellate Body had indicated that whether something was a "like" or a "directly competitive" product was to be determined on a case-by-case basis.[280] Applying the relevant factors, such as the product's end use, consumer tastes and preferences, and the product's properties, nature and quality, to skim and whole milk powder, New Zealand was of the view that skim milk powder and whole milk powder were not "like or directly competitive" products with fluid milk in the context of the production of the products that are exported from Classes 5(d) and (e). In other words, processors would not import skim milk powder or whole milk powder at world prices in order to export the same products - skim milk powder and whole milk powder - at the same world prices. Skim milk powder and whole milk powder were two important products exported from Special Class 5(d) or (e) milk. For other products (principally butter and cheese) exported from Special Class 5(d) or (e) milk, while it might be technically possible to substitute skim milk powder or whole milk powder for milk in their production, it was highly unlikely that this would be an economically viable approach given the resultant products had to be exported at world prices. In general, such a reconstitution of milk only occurred for sales of liquid milk in domestic markets where domestic production was insufficient to meet demand. As Canada had stated "there have not been any imports of raw industrial milk in recent years under the Import for Re-Export Programme".[281] New Zealand considered that this was further evidence that the choice between domestic and imported milk was not unrestricted and did not depend only on commercial considerations in the meaning of Paragraph (d) of the Illustrative List of Export Subsidies.

4.421 New Zealand contended that the primary reference of the term "products" in brackets in the last part of Paragraph (d) was to the term "imported or domestic products" in the second line of the paragraph. New Zealand understood the paragraph to mean that, in order to constitute a subsidy, the imported or domestic products in question had to be made available on terms more favourable than the terms commercially available on world markets for "like or directly competitive" products. The bracketed reference to "products" made clear that there was no such limitation in the case of services.

4.422 The **United States** argued that the express reference to "like or directly competitive" products in Paragraph (d) of the Illustrative List was made in connection with the discussion of products provided "for use in the production of goods for domestic consumption". However, because Paragraph (d) contemplated a comparison

[279] Statistics on imports under the Import for Re-Export Programme in recent years were attached to Canada's Second Oral Statement of 18 November 1998 ("Comments by Canada on Oral Statement of United States").

[280] Appellate Body Report on *Japan - Liquor Tax, op. cit.*, pp.20-21; Appellate Body Report on *Canada - Periodicals, op. cit.*, p.21, DSR 1997:I, 466, V A.

[281] Canada's Oral Submission of 17 November 1998, para. 74.

between the "terms or conditions" applicable to products used in the production of exported goods and those "commercially available" on world markets to exporters, that comparison could only be meaningful if the products themselves were comparable. Thus, any products available on the world market used in such comparison had to also be "like or directly competitive" with the products used in the production of exported goods. The United States emphasized that it did not consider milk powders to be "like or directly competitive" with fluid industrial milk within the meaning of that phrase as used in Paragraph (d) of the Illustrative List of Export Subsidies.

4.423 The United States argued that the natural starting point for construing the meaning of the phrase "like or directly competitive products" was the definition of "*like product*" contained in the SCM Agreement. Footnote 46 of that Agreement stated that "[t]hroughout this Agreement the term 'like product' shall be interpreted to mean a product which is identical, i.e., like in all respects to the product under consideration, or in the absence of such a product, another product which, although not alike in all respects, has characteristics closely resembling those of the product under consideration." Although the definition of like product appeared in Part V of the SCM Agreement, use of the clause "throughout this Agreement" made clear that this definition was equally applicable to the provisions of the Illustrative List of Export Subsidies contained in Annex I to the Agreement. The United States noted that the definition of "like product" contained in the SCM Agreement had been applied in only one WTO proceeding to date: *Indonesia - Certain Measures Affecting the Automobile Industry*.[282] There the Panel emphasized that the definition required not only that the characteristics of the products being compared resemble one another, but that the characteristics "closely" resembled one another.[283] The Panel had also found that an important element to be considered were the physical characteristics of the products involved, although its analysis need not be confined to physical characteristics alone.[284] In addition, the Panel had observed that tariff classification principles might be useful because they provided "guidance as to which physical characteristics between products were considered significant by Customs experts."[285]

4.424 In light of the above, the United States first observed that for customs classification purposes fluid milk and milk powders were classified in different categories. Fluid milk was classified in item 0401, whereas milk powders were classified in 0402. Second, there were obvious differences in the physical characteristics of fluid and powdered milk, the foremost being that one was in liquid form while the other

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[282] Panel Report on *Indonesia - Automobile Industry*, *op. cit.* The United States further noted that the term "like product" appeared in various provisions of the GATT 1994, as well as the WTO Agreements, and its meaning had been determined to depend on its precise usage in a particular agreement. Thus, the Appellate Body in *Japan - Liquor Tax, op. cit.*, p. 21, stated: "The concept of 'likeness" is a relative one that evokes the image of an accordion. The accordion of "likeness" stretches and squeezes in different places as different provisions of the *WTO Agreement* are applied. The width of the accordion in any one of those places must be determined by the particular provision in which the term "like" is encountered as well as by the context and the circumstances that prevail in any given case to which that provision may apply."

[283] Panel Report on *Indonesia - Automobile Industry, op. cit.*, para. 14.172.

[284] *Ibid.*, 14.172. 14.173.

[285] *Ibid.* The Appellate Body in *Japan - Liquor Tax, op. cit.*, also found the tariff classification of a good to be relevant to the determination of "likeness", p. 21.

has been dried to powdered form. In addition, fluid industrial milk contained butterfat, whereas skim milk powder contained no butterfat at all. These physical differences resulted in constraints on the use of milk powders in particular end-uses, and/or require additional processing steps for their use. Skim milk powder, because it lacked butterfat, could not alone be used for any of the multitude of dairy end-uses where butterfat was required. That butterfat had been added in any formulation using skim milk powder where butterfat was required underscored the lack of competitiveness of skim milk powder in such end-uses. Fluid industrial milk because it contained butterfat was not subject to a similar constraint. This fact, in itself, suggested that skim milk powder and fluid industrial milk did not "closely resemble" each other in terms of physical characteristics and, therefore, were not like products. The United States noted that the same conclusion, i.e., that it was not a like product, was warranted with respect to whole milk powder. Again, whole milk powder and fluid milk were not classified in the same tariff category, and differed in terms of their physical form, one being in a liquid form, the other being a powder. Although both fluid industrial milk and whole milk powder contained butterfat, the fact that all liquid had been removed from whole milk powder meant that in almost all instances before it can be used it had to be rehydrated. This process was both time consuming and required additional costs, as well as additional equipment. The US industry estimated this cost to be approximately US$70 per hundredweight.

4.425 The United States further noted that whether the powder was produced using high intensity heat or lower temperatures also would affect the nature of the powder produced and the range of products in which it could be used without alteration of the final processed dairy product. For example, powdered milk produced with high temperatures required a lengthier period, often as much as 24 hours, for rehydration. The high temperatures used also frequently imparted a taste to the powder which altered the flavour of the finished product from that which would be obtained by using fluid milk. In many instances, the powder, once rehydrated, was used only in products where its taste would be obscured by means of flavouring, such as in ice cream.

4.426 The United States further noted that the differences in physical characteristics also evidenced itself in the manner in which the respective products were used. In broad terms, in Canada 40 per cent of fluid milk was used for beverage purposes, 40 per cent was used in the production of cheese, and 20 per cent was used in all other dairy products. In comparison, relatively small amounts of milk powder were used for beverage purposes in Canada or the United States. Only comparatively small amounts of powder milk were used in cheese, and primarily for fortification, i.e., to increase the protein level. For example, in two of the primary cheese products, mozzarella and cheddar, milk powder normally represented no more than 3 per cent of the product by weight. Powder could be used to fortify cheese because of its relatively high protein level compared to fluid milk. Another physical difference was the high perishability of fluid milk. Whereas fluid milk would spoil within a period of days even when refrigerated, milk powder could be stored for lengthy periods of time, measured in months, if not years.

4.427 The United States noted that two separate GATT Panel reports had concluded that the differences between fluid milk and various products derived from milk were sufficient that they generally did not constitute like products or compete directly within the meaning of Article XI:2 of the GATT 1947. In *Japan - Restrictions on*

Imports of Certain Agricultural Products[286], a Panel examined a broad variety of dairy products, including processed cheese, prepared whey, skim milk powder, and whole milk powder and determined that "a product in its original form and a product processed from it could not be considered to be 'like products'" for purposes of Article XI:2.[287] In *Canada - Import Restrictions on Ice Cream and Yoghurt*[288], another Panel reached a similar conclusion, finding that neither ice cream nor yoghurt competed directly with raw milk.

> "The Panel considered that the term compete *directly* with ... 'imposed a more limiting requirement than merely 'compete with'.... The essence of direct competition was that a buyer was basically indifferent if faced with a choice between one product or the other and viewed them as substitutable in terms of their use. Only limited competition existed between raw milk and ice cream and yoghurt." (emphasis in original)[289]

4.428 The United States argued that the conclusions in the cited Panel reports were equally applicable in the present context. Although those Panels were interpreting the terms "like product" and "directly competitive" in the context of Article XI:2 of the GATT, the use of those terms in the SCM Agreement should be given an equally narrow meaning. In fact, the 1987 Panel Report on *Japan - Customs Duties, Taxes and Labeling Practices on Imported Wines and Alcoholic Beverages* stated that it was aware of the "very narrow definition" for the term "like product" for antidumping purposes.[290] Since the definition of like product in the Antidumping Agreement was identical to that currently found in the SCM Agreement, the *Alcoholic Beverages* Panel's observations regarding the narrow definition of "like product" were germane to this dispute. Given all of the foregoing, including the significant differences in physical characteristics described above, milk powders and fluid milk were not "like products".

4.429 The United States submitted that, for very similar reasons, milk powders and fluid industrial milk were not *directly competitive products*.[291] Because the phrase "directly competitive products" was not defined in the SCM Agreement, the ordinary meaning of the term in light of its context, and the object and purpose of the provision were our starting point, consistent with Article 31 of the Vienna Convention. The purpose of the requirements in Paragraph (d) that a product be "like or directly competitive" and that the product be provided on "terms and conditions" no less fa-

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[286] Report on *Japan - Certain Agricultural Products, op. cit.*

[287] *Ibid.*, p. 231, para. 5.3.1.4.

[288] Panel Report on *Canada - Yoghurt, op. cit.*

[289] *Ibid.*, p. 89, para. 73.

[290] Panel Report on *Japan - Alcoholic Beverages*, (hereafter "*Japan - Alcoholic Beverages*") L/6216, BISD 34S/83, adopted 10 November 1987, pp. 115-116, para. 5.6.

[291] The United States noted that in the different context of Article III:2 of the GATT 1994, the Appellate Body in *Japan - Liquor Tax, op. cit.*, indicated that the category of "directly competitive or substitutable products" may be broader than the class of "like products", but stated that this determination was "a matter for the panel to determine based on all relevant facts in that case" and had to be determined on a case-by-case basis (p.25). The Appellate Body further observed that consideration of such factors as physical characteristics, common end-uses, and tariff classifications were appropriate for this purpose. *Ibid.*

vorable than the product supplied by the government of the country of exportation were to allow a determination whether a benefit was conferred to an exporter when the government provided for a product to be received on more favourable terms for export than for production for domestic consumption. This determination necessitated a comparison between products that closely resembled each other, otherwise the risk of an apples to oranges comparison might result. A determination whether products were provided on the same favorable "terms and conditions" would be impossible unless the products closely resembled each other. Products that were materially different would not be comparable for purposes of determining the equivalence of the applicable terms and conditions. Therefore, to construe the phrase "directly competitive" to encompass products that while substitutable for certain purposes were not interchangeable for most end-uses, either because of differences in physical characteristics or other reasons, would appear to undermine the ability to determine whether the applicable terms or conditions were similar.

4.430 The United States noted that, as indicated above, the *Canada - Yoghurt* Panel found that to be "directly competitive" a buyer would have to be indifferent in its choice between the products in issue. In the view of the United States, a buyer would not be indifferent to the choice between fluid industrial milk and milk powders because of the differences in physical characteristics, limited substitutability in end-uses, and the additional processes associated with reconstituting powders prior to their use in further manufacture of dairy products. Consequently, milk powders were not "like or directly competitive" with industrial milk provided through the special class system.

4.431 The United States submitted that cheese imported by Canada in the Import for Re-Export Programme was not like or directly competitive with fluid industrial milk based on the significant and obvious physical differences between the products, as well as the inability to substitute cheese in most of the end-uses for milk. The United States also noted that beyond the question of whether milk powders were like or directly competitive products, there was the separate question of whether milk powder imports were available on the same favorable terms or conditions on which fluid milk was available to exporters under the special class system. The United States submitted that they were not. Import data supplied by Canada pertaining to the Import for Re-Export Programme indicated that virtually all such imports consist of various manufactured dairy products, *not raw milk*, as was available under Special Classes 5(d) and (e). Moreover, those dairy ingredients were on a "milk equivalent" basis priced higher than industrial milk provided pursuant to Special Classes 5(d) and (e).

4.432 The United States used Canada's data[292] on quantities and values of selected dairy products imported under the Import for Re-Export Programme to calculate the equivalent price, or cost, of "milk" imported for calendar years 1995, 1996, 1997 and 1998 to date.[293] The products selected included dry milk, not containing sweetening matter, with greater than 1.5 per cent fat, or whole milk powder (WMP), cheese of all

[292] The United States referred to the data attached to Canada's comments on the US Oral Statement at the Second Substantive Meeting of the Panel ("Comments by Canada on Oral Statement of United States, Second Panel Hearing, November 17-18, 1998").

[293] Contained in US Exhibit 65.

types, and fluid milk, not concentrated, containing no sweetening matter, with between 1 and 6 per cent fat. These three products accounted for approximately 75 per cent of the total value of 1997 dairy product imports for re-export.[294] Unit values of imports for re-export were computed in a straightforward manner (total value/total quantity), converted to US dollars per metric tonne, with international prices, as reported by the US Department of Agriculture, provided as a comparison. These unit values were then converted to a milk equivalent basis, using yield factors and manufacturing margins based on a combination of data from the CDC and factors used by the US Department of Agriculture, as shown in the immediately following table. Comparative data for Special Class prices 5(d) and (e) were computed for calendar year 1997 and for 5(e) for marketing year 1996/97.[295] The 1997 price data for Special Classes 5(d) and (e) were based on statistics from Agriculture and Agri-Food Canada[296], and were weighted-averages based on 71 per cent and 81 per cent, respectively, of the 1997 volume of milk sold under Special Classes 5(d) and (e) in Canada (calculations also attached). The 1996/97 marketing year price data for Special Class 5(d) and (e) were computed based on Class 5(e) component values for Quebec, which represented 64 per cent of total Class 5(e) milk sales in 1997, using milk composition factors of 3.9 per cent for butterfat, 3.3 per cent for protein, and 5.21 per cent for other milk solids.

4.433 The United States contended that, based on the above-described calculations, contrary to Canada's assertion, Canadian processors did not have access to dairy products under the Import for Re-Export Programme at prices comparable to prices for raw milk available under Classes 5(d) and (e). The "milk equivalent" prices for whole milk powder, cheese, and fluid milk imported through the Import for Re-Export Programme were in each instance higher than the corresponding prices for special class 5(d) and (e) milk.

4.434 **Canada** noted that the reference to "products", within brackets, in the last part of Paragraph (d) of the Illustrative List, included "like or directly competitive products". Paragraph (d) referred initially to both "products or services"[297] and then subsequently again to both "products and services"[298]. The second reference to "products and services" was modified by the phrase "like or directly competitive". The use of the word "product" in the final condition of Paragraph (d)[299] followed the reference to "like or directly competitive products and services". Thus, the word "product" referred back to the antecedent reference to "like or directly competitive products and services." Accordingly, the purpose of the use of the word "product" in

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[294] The United States claimed that imports of skim milk powder under the Import for Re-Export Programme were at such extremely low levels during the last two calendar years that their presence could not be considered to provide an alternative to milk provided through the Special Classes Scheme.

[295] The United States noted that the most complete and reliable data available was for 1997 and marketing year 1996/97.

[296] Attached to United States, Exhibit 56.

[297] " ... of imported or domestic products or services for use in the production of exported goods ... "

[298] " ... for provision of like or directly competitive products or services ... "

[299] " ... if (in the case of products) such terms or conditions are more favorable than those commercially available on world markets to their exporters."

the bracketed portion in the final condition in Paragraph (d) was to indicate that this final condition applied only with respect to "products"; not to both "products and services". Since the antecedent reference was to "like or directly competitive products and services", then the qualifying term "like or directly competitive" similarly applied to "products" in the final condition.

4.435 Canada argued that in the dairy industry in Canada, and abroad, skim milk powder and whole milk powder were considered to be like or directly competitive with whole milk. In addition, raw milk could be a less economically efficient input for a manufacturer compared to dairy products that supplied the components needed for a particular manufacturing process. Milk powder was, of course, much cheaper to transport due to the fact that raw milk is over 80 per cent water. Milk powders could be reconstituted for use in the manufacture of some dairy products. They could also be used to standardize for protein and butterfat for a variety of products. Indeed, to the extent that there was a cost advantage to do so, dairy product manufacturers would use milk powders instead of raw milk. Thus, to a certain extent, milk powders competed in the same markets and fulfilled the same needs and uses as fluid industrial milk. These products could be used interchangeably in many applications. The differences between fluid industrial milk and milk powders primarily related to storage and transportation, not end-use.

4.436 Canada drew the Panel's attention to the US Dairy Export Council website where the US dairy processing industry claimed: "U.S. powdered milk can be easily reconstituted into wholesome drinking milk or used as an ingredient in baked goods, dairy products, confections and other prepared foods".[300] Similarly, a study prepared by the United States Department of Agriculture (USDA) had stated, in respect of SMP that it "can be substituted for fresh skim milk or condensed skim milk in many manufactured products" and "converted easily back to milk, and with little formulaic adjustment…[and] can be substituted for condensed skim in many processing operations".[301] Canada further noted that the United States claimed that SMP normally represented no more than 3 per cent of (mozzarella and cheddar cheese products) by weight (paragraph 4.426). However, the same USDA study just referred to stated that, on a skim equivalent volume basis, skim milk powder usage had grown to "25.4% of the dairy ingredients in the manufacture of mozzarella and other Italian-cheeses in one region of the United States and 16.1% nationally".[302] Perhaps it was for this reason that the US Dairy Export council proudly proclaimed on its website that "the US milk powder industry is capable of unrestrained growth."[303]

4.437 Canada argued that the GATT Article XI Panel Reports relied on by the United States (paragraph 4.427 and following) had little to do with whether, for the purposes of Paragraph (d) of Annex I of the SCM Agreement, milk powders and fluid industrial milk were "like or directly competitive products." GATT Article

[300] http://www.usdec.org/cgi_win/usdec.exe/section24

[301] A Review of Class III - A Pricing under Federal Milk Marketing Orders, Dairy Division, Agricultural Marketing Service, United States Department of Agriculture, March 1995, pp.1-2.

[302] A Review of Class III - A Pricing under Federal Milk Marketing Orders, Dairy Division, Agricultural Marketing Service, United States Department of Agriculture, March 1995, at pp. 17 and 22, referring to the years 1992 to 1994.

[303] *Ibid.*, pp.1-2.

XI:2(c)(i) was concerned with restrictions on the importation of primary products "in any form". This expression was subject to the definition in Ad Article XI:2(c). Furthermore, GATT Article 2(c)(i) created an exception to the general prohibition created in Article XI:1, and thus had been construed narrowly.[304] The "like or directly competitive products" concept in Paragraph (d) of the Illustrative List of Annex I to the SCM Agreement was a defining part of that list and thus was to be given its full and ordinary meaning in accordance with the principles of treaty interpretation.

4.438 Canada argued that the United States had given scant attention to more authoritative and more relevant Appellate Body jurisprudence on concepts of "directly competitive or substitutable products"; jurisprudence that plainly supported the conclusion that milk powders directly competed with fluid industrial milk.[305] Apart from being of minimal relevance, the Panel Report in *Canada - Yoghurt* relied on by the United States was readily distinguishable on its facts. That Panel had considered whether, from the standpoint of the end-use consumer, ice cream and yoghurt competed directly with fresh milk. This was an entirely different issue from assessing, from the standpoint of processors, whether milk powders and fluid industrial milk were "like or directly competitive" products. In respect of the other GATT Article XI case cited by the United States (*Japan - Restrictions on Imports of Certain Agricultural Products*) seemed to lend support to the common-sense proposition that milk powders competed directly with fluid milk. What the United States failed to mention was that the Panel in that case appeared to accept that milk powders and certain other dried and condensed milk products "could compete directly with fresh milk for manufacturing use."[306]

4.439 Canada refuted the validity of the "milk equivalent" prices calculated by the United States as provided in US Exhibit 56 (paragraph 4.432). Canada argued that dividing the total reported trade value by the total reported trade volume in trade statistics was an unreliable guide to actual prices. Thus, the data submitted by the United States (the Dairy Market Review attached to Exhibit 36) showing the highest Canadian domestic milk price for Class 1 use was C$65.35/hl (US$48/hl), together with an estimate of import costs of US$116/hl. Canada argued that it was obvious that either the estimated unit import value was wrong, or the data was not comparable. The alternative was to assume that Canadian importers freely chose supplies that were twice as expensive as the most expensive domestic alternative. Canada noted that in the case at issue, much of the fluid milk imported under the Import for Re-export Programme was imported in retail packages for use on cruise ships. It was hence, clearly inappropriate to make price comparisons between retail packages on one hand and milk supplies from farmers to processors on the other.

4.440 Similarly, Canada argued that the United States estimates of unit import value for "cheese of all types" was simply an average of high and low value cheese of

[304] Panel Report on *Japan -Certain Agricultural Products, op. cit.*, para. 5.1.3.7; Panel Report on *Canada -Yoghurt, op. cit.*, para. 59.

[305] Canada referred to the Appellate Body Report on *Japan - Liquor Tax, op. cit.* and the Appellate Body Report of *Canada -Periodicals, op. cit.*

[306] Appellate Body Report on *Japan - Liquor Tax op. cit.*, para. 5.3.1.4. Canada noted that the Panel went on to find that milk powders did not meet the perishability requirements of Ad Article XI:2(c), which had no counterpart in Paragraph (d) of Annex I to the SCM Agreement.

vastly different types. These were average import values, together with unsubstantiated conversion factors were then used to generate a "milk equivalent cost of cheese imported for re-export". This approach was invalid because the yield of cheese from a hectolitre of milk varied widely between varieties of cheese. As the mix of varieties imported varied from year to year, a conversion using some "standard" yield of "generic" cheese from a hectolitre of milk would bear no consistent relationship to the actual value of milk used in the production of imported cheeses. In the case of whole milk powder, which was a much more uniform commodity product for which it may be valid to use a simple conversion formula, the United States data showed that, the US estimated average Class 5(e) price was very similar to the estimated "milk equivalent cost of WMP imported for re-export" in 1997 and 1998. While the problems noted above with respect to the use of unit import values remained, this gave an indication that, in the one situation in Exhibit 56 where the construction of milk equivalent prices on the basis of formulae was most defensible, the resulting data supported Canada's argument.

4.441 Canada further noted that on page four of Exhibit 56 the United States estimated milk prices in Classes 5(d) and (e) on the basis of prices estimated for individual provinces (except Ontario). The resulting estimated prices were incorrect. The actual Canadian average return for Class 5(d) sales in the 1997 calendar year was $26.22/hl. For Class 5(e), the return was $22.98/hl.[307] Canada argued that the discrepancy between these real figures and the values constructed by the United States was partly explained by the fact that the United States included a Class 5(d) price of $11.98/hl for Manitoba, although it was self-evident that this was a data error in the 1997 Dairy Market Review. (For the record, the correct datum should have read $22.01). This should have been obvious from the fact that the Class 5(d) prices reported in the Review for all other provinces were between $31.31/hl and $21.66/hl. It was questionable statistical practice to simply use what was clearly an anomalous figure without verifying from other sources. In addition, the data set used by the United States did not include prices from Ontario. The flaws in the data presented by the United States meant that no weight can be attached to them.

4.442 The **United States** noted that Canada carefully qualified its statement in respect of the "like or directly competitive" nature of milk powders with fluid milk (paragraph 4.435). Canada stated that milk powders could be used in the manufacture of *some* dairy products. Similarly, Canada stated that to a *certain extent* milk powders competed in the same markets. The United States argued that direct competition contemplated more than a *certain* degree of competition or the ability to substitute for fluid milk in *some* uses.

[307] Canada noted that as dairy farmers in Canada were actually paid based on the butterfat, protein and other solids components of milk, it was possible to generate differing estimates of the price of a hectolitre of milk depending whether one used the average composition of milk delivered or a standard milk composition. At the individual farm level, payment was based on the components delivered by the farmer, so, while the problem of translating to hectolitres of milk complicated life for analysts, it had no impact on the farm-level economics of the system.

(d) Article 3

4.443 The **United States** argued that once a violation of Part V of the Agreement on Agriculture had been found, Canada had to bring the operation of its export subsidies into conformity with its obligations, particularly those establishing its export reduction commitments respecting the quantity of subsidized exports. This was true, regardless of whether a separate violation of the SCM Agreement was also found.

4.444 The United States noted that Article 3 of the SCM Agreement was addressed by Article 13 of the Agreement on Agriculture. That provision directed that only export subsidies that conformed with Part V of the Agreement on Agriculture were exempt from challenges pursuant to Article 3 of the SCM Agreement. Furthermore, the United States claimed that Article 3 of the SCM Agreement was within the Panel's terms of reference. Consequently, the United States requested that the Panel make separate findings respecting the consistency of the Special Class system with the SCM Agreement, including a finding whether the Special Class system provided a prohibited export subsidy within the meaning of Article 3.

4.445 The United States claimed that as Canada's Special Milk Classes Scheme was an export subsidy of dairy products in excess of the limits for Canada under the Agreement on Agriculture, whether they fell under Article 9 *or* Article 10 of that Agreement, as a result, those subsidies did not benefit from the exemption in Article 13(c)(ii) of that Agreement on Agriculture. Consequently, the United States claimed that these export subsidies were also inconsistent with Canada's obligations under Article 3 of the SCM Agreement.

5. Protected Markets and Export Subsidies

4.446 **Canada** did not deny that its milk production sector enjoyed a level of protection through tariffs. That was a right negotiated and set out in its WTO Schedules, Schedules which had been accepted by the Complainants. Nor did Canada deny that such protection could lead to higher prices for milk which benefited milk producers, but only with respect to the *domestic* market. The very purpose of tariffs was that the targeted domestic industry would enjoy higher domestic prices. This was accepted as a basic feature of the WTO system and was true for all WTO Members that maintained tariffs, including the two Complainants. Canada argued that the submissions of the Complainants failed, in particular, to recognize: (i) that sales of milk for export use in Canada were based on the commercial practices of producers and their reactions to world market signals; (ii) that the logical conclusion of their arguments would be to deem the existence of export subsidies wherever exported products were subject to tariff protection in their home market, thus prohibiting most such exports and undermining one of the most fundamental features of the WTO system; and (iii) that the selling of products at differing prices for domestic and export markets was a common international practice that had never been treated as an export subsidy for GATT/WTO purposes.

4.447 Canada argued that nothing in the WTO Agreements revealed a common intention to treat sales of a product in different markets at differing prices as implying the existence of a subsidy for the lower-priced good. Canada maintained that if the Complainants' arguments were to succeed, the basis of the consensus on the negotiated use of tariff protection for sensitive sectors, as captured in the GATT 1947 and the WTO Agreements, would be undermined. In character, a tariff was simply a tax

and, as such, represented an incontestable government intervention in support of a domestic industry. The result of accepting the Complainants' line of reasoning would be that an export subsidy would be found every time a product was exported at its world market price from a market protected by tariffs *at any level,* since the very point of any tariff was to raise by government intervention the price of a good from its world market level. Given the absolute prohibition in the SCM Agreement on export subsidies, the Complainants' arguments, taken to their logical conclusion, would lead to an absolute prohibition on the exportation of any product at world market prices from a domestic market protected by tariffs. This could not have been the intention of the drafters of the WTO Agreements.

4.448 Moreover, Canada argued that the right to export while maintaining tariffs was clearly built into the "tariffication" decision incorporated in the results of the Uruguay Round. WTO Members agreed that all non-tariff barriers, including quantitative restrictions maintained under *GATT 1947* Article XI(2)(c)(i), would be converted into equivalent tariffs. The condition under Article XI for the maintenance of such quantitative restrictions was that domestic production of the product in question had to be restricted. This limited any potential for production for export purposes. By converting Article XI quantitative restrictions into tariffs under Article II of the GATT 1994, this condition was removed. Thus, WTO Members had agreed that under the new WTO regime, Members maintaining the new equivalent tariffs would not have to restrict their domestic production. Canada argued that this shift clearly contemplated new production in addition to domestic needs, e.g., production for export while maintaining Article II tariffs. Thus, the new "tariffied" tariffs were to be treated in exactly the same way as all other tariffs had been since 1947 - there was a common expectation that the product subject to the tariff could be exported.

4.449 Canada argued that far from an anomaly, the sale of goods into domestic and export markets at differing prices was a common practice for many WTO Members. For example, the peanut market in the United States had a structure similar to the Canadian milk market. The United States peanut market was protected from external competition by high tariffs (155 per cent *ad valorem* on shelled peanuts and 192.7 per cent *ad valorem* for peanuts in shell) and domestic competition was limited through quotas.[308] There was no quota for production for export of peanuts. Any additional quantity produced by a farmer above the specified quota had to be "sold

[308] American Peanut Coalition (APC) testimony before the Trade Subcommittee of the Ways and Means Committee of the US House of Representatives, 12 February 1998 p. 3 (Exhibit 23): "Congress moved to decouple farm income support from production decisions in the Federal Agriculture Improvement and Reform Act of 1996 (the "FAIR" Act). This 'freedom-to-farm' bill eliminated deficiency payments and marketing loans and replaced them with transition payments for virtually all farm commodities. This was in keeping with the concept of 'decoupled income support' in the 'green box' of permitted policies that were exempt from reductions in the Uruguay Round. As a result of the 1996 Farm Bill, farmers now have the freedom to farm almost everything, except peanuts. Only farmers who own or lease a production quota can legally grow peanuts to be sold for edible use." The APC further noted at p. 4: "In spite of the peanut programme, the US is a significant exporter of peanuts, having a 25% share of the world market. This occurs as a result of the fact that US peanuts grown outside of the peanut quota are required to be exported or put to non-edible uses."

for whatever can be obtained on the international market".[309] As a result, the United States had a 25 per cent share of the world peanut market. The domestic prices for peanuts for edible use were about twice as high as the world market price.[310]

4.450 Canada recalled that the use of differing prices for export sales of dairy products was also part of the marketing system used in California. At the November 1997 meeting of the Committee on Agriculture, Canada had asked the United States whether it could confirm that milk marketing plans established by the State of California provided lower prices for dairy components to be used in the manufacture of yoghurt, soft fresh cheese (fromage frais), uncreamed, creamed, or partially creamed cottage cheese, sour cream, sour half-and-half, or light sour cream which was sold for use outside the boundaries of the United States, than for dairy components to be used for manufacturing similar products for sale within the United States. The United States confirmed Canada's understanding of the matter.

4.451 Canada argued that even if the enabling authority of the producer boards were to be eliminated, producers would operate on the basis of economic differences between the domestic market and the world market. As a matter of very simple economic reality, so long as there was a level of border protection maintained by Canada, dairy product prices in Canada would continue to exceed world price levels. Such differences in pricing were linked to the level of border protection maintained and other general economic conditions in the Canadian market. In these circumstances, producers would seek to exploit these tariff-generated differentials in their commercial relations with Canadian processors. This would occur independently of any legislative framework.

4.452 **New Zealand** argued that compliance with export subsidy commitments by a Member whose domestic market was protected by tariffs did not prohibit it from exporting at world market prices. A Member that protected its domestic market by high tariffs could export in accordance with its export subsidy commitments. It could also, of course, export without the use of export subsidies. In this respect, New Zealand noted that Canada's export data indicated that Canada did export dairy products: in 1997/98, 4 per cent of cheese and 21 per cent of "other milk products" exports were exported from outside Special Classes 5(d) and (e).[311]

4.453 New Zealand argued that there was no blanket prohibition under the WTO of differential pricing between domestic and exported agricultural products. What the WTO required was that any such difference result from private and not from government action. The objection of New Zealand in this case was that through the actions of governments and their agencies Canada was using export subsidies to bridge the gap between its high domestic prices and lower world market prices in excess of its scheduled allowance. The subsidy existed because, in accordance with the relevant definitions of export subsidy, a government was involved in a scheme which

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[309] The United States Government Accounting Office GAO/RCED-93-18, *Making the Peanut Programme Responsive to Market Forces*, "Appendix II: GAO's, Technical Economic Analysis of the Peanut Programme", p.60. (Canada, Exhibit 24)

[310] *Ibid.*, pp.62-63. In 1989, the quota support price for peanuts was $0.3318 per pound (in 1991 dollars). The world price for US peanuts was $0.1853 per pound (in 1991 dollars). In 1998, those prices were in the order of $0.45 per pound on world markets and $0.65 on US domestic markets.

[311] Canada's answer to Question No. 1 by the Panel, 20 October 1998.

required milk producers to supply lower priced milk to exporters of dairy products as an incentive for them to undertake exports which would, in the absence of the export subsidy, be unlikely. The removal of government from such a scheme, and not just the pretence of removal of the kind Canada asserted in this case, would mean that the Agreement on Agriculture would not apply. Exporters would be free to export without limit based on commercial considerations rather than export subsidies.

4.454 New Zealand emphasized that it was not indeed suggesting that Canada did not have the right to export dairy products. Canada, like any Member, was perfectly free to export dairy products provided that it did so in accordance with its WTO obligations. It could export up to its export subsidy commitment levels. And it could export whatever quantity it wanted without the use of subsidies at all. What New Zealand *was* denying was Canada's claim that it was allowed to use export subsidies which came within Article 9.1 of the Agreement on Agriculture in excess of its export subsidy commitments or to use export subsidies not covered by Article 9.1 that had the effect of circumventing or threatening to circumvent those commitments.

4.455 In respect of Canada's arguments on Article XI (paragraph 4.448), New Zealand noted that it was not surprising that Canada cited no authority for what it claimed the WTO Agreements "contemplated" as a result of tariffication, nor could it. Tariffication was not concerned with whether a country was an exporter or an importer or both. Tariffication was not about the right to export. It was concerned with market access barriers. However, it certainly was not within contemplation that having liberalized agricultural trade with the converting of quotas into tariffs, Members would now be free to use export subsidies inconsistent with the express requirements of the Agreement on Agriculture. New Zealand argued that Article XI did not in fact prevent producers from producing any quantity of product and it did not prevent that product from being exported. What Article XI did do was to require that in those countries which chose to put in place quantitative restrictions on imports, the proportion of imports could not fall below the level which would have pertained had the quantitative restrictions not existed.

4.456 The **United States** submitted that this broader question, raised by Canada, went beyond the scope of the case, and need not be addressed by this Panel. The United States was not contesting in this dispute either Canada's right to set tariffs or to pursue supply management in its dairy sector. The question presented by the Complainants was not only a different one, but was also much narrower, i.e., whether Canada's Special Milk Classes Scheme constituted an export subsidy subject to the reduction commitments contained in the Agreement on Agriculture. The question whether, in the absence of any other governmental action, exports at prices below tariff protected domestic prices constituted an export subsidy, was not before the Panel.

4.457 The United States contended that Canada was confusing the issue by suggesting that the position of Complainants meant that a country with high tariffs and high domestic prices necessarily engaged in differential pricing and therefore bestowed an export subsidy. Canada asserted that such price differences were simply a result of existing tariff protection. Although this, in part, could be the case, it would be unreasonable to assume that the WTO Members were unaware of protective tariffs or supply management systems when they concluded the SCM Agreement and the Agreement on Agriculture or when they adopted GATT 1994. The United States argued that there could be many circumstances where a WTO Member could have a

lower price for export of agricultural products and a higher price for domestic use without implicating any of a Member's WTO obligations. The answer to this question depended in substantial part on the level and nature of government involvement in the export of the agricultural products. Canada was wrong in assuming that the price differential occasioned by the existence of a tariff barrier necessarily resulted in both a financial contribution and a benefit to the exporter. The situation where merely a protective tariff existed stood in sharp contrast to one where in addition to a tariff, a Member had constructed a scheme, such as the Canadian Special Milk Classes Scheme, where both the quantities exported and the export prices were determined largely by the intervention of governments.

4.458 The WTO Agreements on Agriculture and Subsidies imposed specific disciplines on export subsidies. What was noteworthy was that none of the relevant Agreements provided an exemption from the export subsidy disciplines when differential pricing resulted from government action. The only provision that implicitly addressed this issue was Paragraph (d) of the Illustrative List of Export Subsidies in the SCM Agreement. Paragraph (d) provided an exemption from its coverage where any benefit that would otherwise result from the provision of a good at a lower price by the government was negated by the availability of such goods on as favorable terms and conditions on the world market. Canada did not satisfy the requirements of that exemption. Moreover, even if Canada did meet those requirements, it would only be exempted from the disciplines of that provision, not the additional restrictions on export subsidies included in the Agreement on Agriculture and the SCM Agreement.

4.459 If Canada merely maintained tariff protection for its milk producers and the Canadian federal and provincial governments otherwise were not involved in the regulation of prices and exports of dairy products, the United States would not have requested the formation of this Panel. A situation in which tariff protection alone resulted in differential pricing for domestic and export manufacturers involved no financial contribution or benefit in the sense of the SCM Agreement. The mere imposition of tariffs, including any price differential that might result, had never been considered to constitute an export subsidy. In addition, where only tariffs existed, there was always the possibility that the world markets into which the goods were sold could reflect either prices at a higher or lower level than existed domestically. This was because domestic prices were not simply a function of the level of tariffs. The extent of competition within the domestic market, including the number of producers, the availability of alternative products, the level of production, the elasticity of demand, and other economic factors also had a direct bearing on domestic price levels. Thus, the existence of a price differential could not be assumed to exist and even where a differential existed it could not be assumed to result solely from the imposition of a tariff on imported goods.

4.460 The United States argued that Canada could not isolate the Special Milk Classes Scheme from the environment in which it operated, and particularly from the supply management system. It was convenient, but not convincing, for Canada to argue that the Special Classes did not provide for the establishment of domestic prices at levels higher than those applicable to exports, when the supply management system clearly established those prices. This was not a particularly pertinent issue. What was dispositive respecting the existence of the subsidy was that the governments in Canada had set in place a mechanism through which processors were pro-

vided lower priced milk. Whether the higher price for domestically-sold milk was fixed under the Special Classes or by some other government intervention was simply not relevant.

B. Importation of Milk

1. Outline

4.461 The **United States** recalled that in implementing its Uruguay Round market access commitments, Canada established a tariff-rate quota for fluid milk and cream (hereinafter "fluid milk") with an in-quota level of 64,500 tonnes. Part I, Section IB of Canada's Schedule, provided that fluid milk encompassed in tariff item number 0401.10.10, which entered within the tariff-rate quota at the MFN rate of 17.5 per cent, beginning in 1995.[312] The rate of duty applicable to entries within the tariff-rate quota receiving MFN treatment would decline to 7.53 per cent at the end of the six-year implementation period. Fluid milk imports outside of the 64,500 tonne tariff-rate quota bore an initial rate of duty equal to 283.3 per cent, declining to 241.3 per cent in 2001. The United States claimed that for all intents and purposes, the over-quota tariff rate precluded imports of fluid milk outside of the tariff-rate quota.[313]

4.462 The United States maintained that Canada, in addition, imposed unjustified constraints on access to the tariff-rate quota that impeded market access at even the lower, in-quota tariff rate. Canada only permitted cross-border retail purchases of C$20, or less, by residents of Canada for their own personal use to qualify for entry within the tariff-rate quota. By confining the scope of fluid milk entries that were eligible for the lower in-quota rate, Canada granted imports of fluid milk treatment less favorable than that provided for in the appropriate Part of Schedule V and, thus, had acted inconsistently with its obligations under Article II:1 of the GATT 1994. Because Canada administered the tariff-rate quota through a general permit restricting any single import entry to a value of C$20 and subjected such entries to a personal use restriction, Canada's licensing procedures introduced additional trade impediments that were inconsistent with its obligations under Article 3 of the Agreement on Import Licensing Procedures ("the Import Licensing Agreement").

4.463 The United States claimed that it was clear that Canada imposed unjustifiable limitations, including both a dollar value and personal use restriction, on fluid milk imports under its General Permit for dairy products. The United States submitted that those restrictions were not justified by the language in Canada's schedule and were inconsistent with its obligations under Article II:1(b) of the GATT 1994 and Article 3 of the Import Licensing Agreement.

4.464 **Canada** claimed that its current treatment of fluid milk imports was fully consistent with the terms and conditions of the tariff item for fluid milk (HS 0401.10.10) in its Schedule. Canada noted that the United States did *not* argue that it had not received the level of access that it had negotiated. Rather, it was a particular

[312] The United States noted that imports from the United States within the tariff-rate quota received preferential duty rates under terms of the North American Free Trade Agreement.

[313] "The Canadian Dairy Industry: Institutional Structure and Demand Trends in the 1990s". (United States, Exhibit 25)

type of access that was now the subject matter of this dispute. Canada denied that the continuation of its limited concession on *consumer imports of packaged fluid milk*, granted in respect of its residents who engaged in cross-border shopping, was a general concession on fluid milk including *commercial and bulk trade in fluid milk*.

4.465 Canada stressed that the agreed record of negotiations between Canada and the United States throughout the Uruguay Round of negotiations conclusively proved that the United States was well aware of the nature and meaning of Canada's concession and the terms and conditions under which it had been granted. The claims of the United States were in conflict with the clear and common understanding of the negotiators from both Canada and the United States of Canada's offer in the Uruguay Round negotiations with respect to access to fluid milk.

4.466 Canada further denied that the Import Licensing Agreement required Canada to impose import controls where none were required. Such controls would only cause inconvenience to cross-border shoppers.

4.467 Canada claimed that in making this claim, the United States was seeking to obtain through dispute settlement a broader and different type of access for trade in fluid milk than that agreed upon in negotiations.

2. Article II:1 of GATT 1994

4.468 The **United States** argued that Canada's administration of its TRQ was inconsistent with Article II:1 of the GATT 1994. Article II:1(b) required that a Member provide tariff treatment no less favorable than was provided for in its Schedule of Concessions to imports from the territories of other WTO Members and exempt such imports from any customs duty in excess of the rate bound in the importing Member's Schedule. The Appellate Body had recently elaborated on the requirements of Article II:1(b) in its Report in *Argentina - Footwear*:

> "In accordance with the general rules of treaty interpretation set out in Article 31 of the Vienna Convention, Article II:1(b), first sentence, must be read in its context and in light of the object and purpose of the GATT 1994. Article II:1(a) is part of the context of Article II:1(b); it requires that a Member must accord to the commerce of other Member's "treatment no less favourable than that provided for" in its Schedule. It is evident to us that the application of customs duties in *excess* of those provided for in a Member's Schedule, inconsistent with the first sentence of Article II:1(b), constitutes "less favourable" treatment under the provisions of Article II:1(a). A basic object and purpose of the GATT 1994, as reflected in Article II, is to preserve the value of tariff concessions negotiated by a Member with its trading partners, and bound in that Member's Schedule, a reduction in its value by the imposition of duties in excess of the bound tariff rate would upset the balance of concessions among Members."[314]

[314] Appellate Body Report on *Argentina - Measures Affecting Imports of Footwear, Textiles, Apparel, and Other Items* (hereafter "*Argentina - Footwear*"), adopted 22 April 1998, WT/DS56/AB/R, para.47.

4.469 The United States noted that Canada allowed only fluid milk entries that were made pursuant to a general permit by a resident of Canada making retail purchases for the person's own, or their household's, personal use to qualify for the lower rate of duty under the tariff-rate quota. The language of Canada's Schedule, however, did not justify that limitation. By denying access for all other entries under the tariff-rate quota, and thereby imposing duties on those other entries in excess of those provided for in its Schedule, Canada was granting tariff treatment less favorable than was provided for in its Schedule of Concessions.

4.470 The United States noted that Canada justified its ban of entries other than small purchases for the personal use of the Canadian resident from the tariff-rate quota on the language in column seven of its Schedule, which Canada claimed constituted a "term, condition, or qualification" within the meaning of Article II:1(b).[315] Canada asserted that this language properly limited the scope of eligibility for the lower in-quota duty rate to imports of fluid milk made in cross-border trade by retail customers for their own personal use. However, the text which appeared in Schedule V relating to tariff item number 0401.10.10 did not warrant Canada's interpretation. The pertinent language was as follows "This quantity represents the estimated annual cross border purchases imported by Canadian consumers".

4.471 The United States argued that for the text relied on by Canada to create a condition on the applicability of the lower in-quota tariff rate, that language had to clearly establish the limitation that Canada had imposed on the scope of the concession.[316] The language in Schedule V, however, did not permit the interpretation that Canada had adopted. First, there was no basis to conclude that the language on which Canada relied constituted a "term, condition, or qualification." The language that the quantity of the tariff-rate quota "represents the estimated annual cross border purchases" simply described the manner in which the size of the tariff-rate quota was determined. The language in Canada's Schedule could not be construed to constitute a limitation on the access under the tariff-rate quota; there was no indication from the language contained in the Schedule that any type of limitation, other than the quantitative limitation to 64,500 tonnes, was provided for.

4.472 Second, the United States maintained that contrary to principles of treaty interpretation, Canada's construction of the language in its Schedule imputed words that were not there.[317] The words "cross-border purchases" contained in the Schedule

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[315] Canada's answers to questions posed during consultations with the United States. (United States, Exhibit 34)

[316] The United States noted the relevance of the Appellate Body's findings in the Appellate Body Report on *European Communities, United Kingdom, and Ireland - Customs Classification of Certain Computer Equipment*, (hereafter *EC - Computer Equipment*"), WT/DS62/67/68/AB/R, adopted 22 June 1998, "[t]he security and predictability of tariff concessions would be seriously undermined if the concessions in Member's Schedules were to be interpreted on the basis of the subjective views of certain exporting Members alone." While this referred to the views of exporting Members, it would be even more true for importing Members, who by drafting the text of their tariff concessions were in the best position to specify clearly the scope of the concessions.

[317] The United States noted the statement of the Appellate Body noted in *India - Pharmaceuticals, op. cit.*, para. 45: "The duty of a treaty interpreter is to examine the words of the language of the treaty itself. This should be done in accordance with the principles of treaty interpretation set out in Article 31 of the Vienna Convention. But these principles of interpretation neither require nor con-

could not be construed to limit eligibility to the in-quota rate to retail purchases valued at C$20, or less, for the personal use of the purchaser. All imports that were the result of a sales transaction of some type were "cross-border purchases". These words could not be read to differentiate between retail purchases for personal use and other types of purchases. Similarly, the phrase "imported by Canadian consumers" did not limit the scope of eligibility in the manner suggested by Canada. The ordinary meaning of the word "consumer" was "one that consumes" or "a person who acquires goods or services; a buyer."[318] The word "consumer" did not distinguish between retail purchases for personal use and other types of transactions. Purchasers who consumed milk in their business endeavours, whether it be manufacturing or some other pursuit were also "consumers". Therefore, Canada lacked any textual support in its Schedule for the limitations that it had imposed on access to the in-quota rate. Absent language in its Schedule that constituted a "term, condition, or qualification" within the meaning of Article II:1 of the GATT 1994, Canada acted in derogation of its obligations under Article II when it provided treatment less favorable to any imports than was provided for in its Schedule.

4.473 Furthermore, the United States argued that Canada's manner of administering the tariff-rate quota through the use of a general permit also resulted in treatment less favorable than provided for in its Schedule and, thus, was also inconsistent with its obligations under Article II:1. More specifically, Canada conditioned use of the general permit on each import entry of dairy products being valued at less than C$20 and for the personal use of the importer. Neither of these restrictions appeared as a "term, condition, or qualification" in Canada's Schedule of Concessions. Yet, Canada denied the in-quota duty rate to any entries which did not meet the requirements of the general permit. By doing so, Canada denied all entries which could otherwise qualify for the 64,500 tonne tariff-rate quota the lower duty rate under the in-quota rate that was provided for in Canada's Schedule. As a result such entries were subjected to duties in excess of those provided for in Canada's Schedule.

4.474 **Canada** argued that it had the right, under Article II, to set terms and conditions on the application of customs duties. Canada had the obligation, under Article II of the *GATT 1994*, not to impose "ordinary customs duties in excess of those set forth and provided" in its Schedule. Article II further provided that such obligation was "subject to the terms, conditions or qualifications set forth in that Schedule."

4.475 Canada noted that prior to the entry into force of the WTO Agreements, GATT 1947 panel practice had interpreted this "qualification" provision in two ways. First, each Contracting Party had the right to impose conditions on the concessions granted in the form of bound tariffs, so long as those conditions were not, in themselves, inconsistent with GATT 1947. Second, each Contracting Party could, *in addition to* making concessions in the form of bound tariffs, set down other conces-

done the imputation into a treaty of words that are not there or the importation into a treaty of concepts that are not intended."

[318] Webster's II, New Riverside University Dictionary, 1994.

sions ("terms") in its Schedule. Canada noted that in *European Economic Community - Imports of Beef from Canada*,[319] the Panel held that:

> "... the European Economic Community had, by virtue of the footnote in the Schedule, reserved its right to set conditions for the entry under the levy-free tariff quota in question. *The Panel further found that the right to set conditions was presupposed in Article II:1(b) of the General Agreement.*"[320] (emphasis added)

4.476 Canada further noted that in *United States - Restrictions on Imports of Sugar*[321] the Panel noted that Article II:1(b) "permits contracting parties to qualify the obligation to exempt products from customs duties in excess of the levels specified in the Schedule."[322] The Panel found, however, that Contracting Parties could not, in their Schedules, qualify their obligations under *other* Articles of the GATT.[323] In *United States - Restrictions on the Importation of Sugar and Sugar Containing Products Applied under the 1955 Waiver and under the Headnote to the Schedule of Tariff Concessions* (hereafter "*US - Sugar II*")[324], the Panel found that "the General Agreement does not oblige contracting parties to make concessions and specifically allows them in Article II:1(b) to subject to conditions the concessions they decide to make."

4.477 Canada noted that, in the recent report on *Computer Equipment*[325], the Appellate Body made a number of observations about the interpretation of tariff schedules and Article II of the GATT 1994 that were relevant to this dispute. As a first principle, the Appellate Body stated that items in tariff schedules to the GATT 1994 were to be considered to be integral parts of a treaty and as such to be subject to the customary principles of treaty interpretation, as set out in the Vienna Convention. As such, they were to be interpreted on the basis of the common intention of the parties :

> "The security and predictability of tariff concessions would be seriously undermined if the concessions in Members' Schedules were to be interpreted on the basis of the subjective views of certain exporting Members alone.
>
> (...)
>
> The purpose of treaty interpretation under Article 31 of the *Vienna Convention* is to ascertain the *common* intentions of the parties. These *common* intentions cannot be ascertained on the basis of the subjec-

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[319] Panel Report on *European Economic Community - Imports of Beef from Canada* (hereafter "*EEC - Beef*"), L/5099, BISD 28S/92, adopted 10 March 1981.

[320] *Ibid.*, para. 4.5(a).

[321] Panel Report on *United States - Restrictions on Imports of Sugar* (hereafter "*US - Sugar*"), L/6514 BISD 36/S331, adopted 22 June 1989.

[322] *Ibid.*, para. 5.2. Canada noted that in paragraph 5.3, the Panel concluded that: "... Article II gives contracting parties the possibility to incorporate into the legal framework of the General Agreement commitments additional to those already contained in the General Agreement and *to qualify such additional commitments*, not however to reduce their commitments under other provisions of that Agreement." (emphasis added)

[323] *Ibid.*, para. 5.3

[324] Panel Report on *US - Sugar II*, L/6631, 37S/228, adopted on 7 November 1990.

[325] Appellate Body Report on *EC - Computer Equipment, op. cit.*

> tive and unilaterally determined "expectations" of *one* of the parties to a treaty. Tariff concessions provided for in a Member's Schedule - the interpretation of which is at issue here - are reciprocal and result from a mutually-advantageous negotiation between importing and exporting Members. A Schedule is made an integral part of the GATT 1994 by Article II:7 of the GATT 1994. Therefore, the concessions provided for in that Schedule are part of the terms of the treaty. As such, the only rules which may be applied in interpreting the meaning of a concession are the general rules of treaty interpretation set out in the *Vienna Convention.*"[326] (emphasis in the original)

4.478 Canada further noted that to determine that common understanding, the Appellate Body then referred to Articles 31 and 32 of the Vienna Convention :

> "Pursuant to Article 31(1) of the *Vienna Convention*, the meaning of a term of a treaty is to be determined in accordance with the ordinary meaning to be given to this term in its context and in the light of the object and purpose of the treaty"
>
> (…)
>
> "The application of these rules in Article 31 of the *Vienna Convention* will usually allow a treaty interpreter to establish the meaning of a term. However, if after applying Article 31 the meaning of the term remains ambiguous or obscure, or leads to a result which is manifestly absurd or unreasonable, Article 32 allows a treaty interpreter to have recourse to:
>
> > ... supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion.
>
> With regard to 'the circumstances of [the] conclusion' of a treaty, this permits, in appropriate cases, the examination of the historical background against which the treaty was negotiated."[327]

4.479 Canada recalled that on the point of the circumstances under which the treaty interpreter should examine the "historical background against which the treaty was negotiated," the Appellate Body quoted Sir Ian Sinclair:

> ".. the reference in Article 32 of the Convention to the circumstances of the conclusion of a treaty may have some value in emphasizing the need for the interpreter to bear constantly in mind the historical background against which the treaty has been negotiated."[328]

4.480 Canada noted that the Appellate Body had also specifically rejected the idea, as suggested by the Panel in the *EC - Computer Equipment* case, that the burden of clarifying the scope of a tariff concession rested solely on the importing Member. Returning to its view that the key issue in treaty interpretation was one of determin-

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[326] Appellate Body Report on *EC - Computer Equipment, op. cit.*, paras. 82, 84.
[327] Appellate Body Report on *EC - Computer Equipment, op. cit.*, paras. 85-86.
[328] I. Sinclair, the *Vienna Convention on the Law of Treaties*, 2nd ed., (Manchester University Press, 1984), p.141.

ing the *common intention,* the Appellate Body made the question one of common burden:

> "We consider that any clarification of the scope of tariff concessions that may be required during the negotiations is a task for *all* interested parties."[329] (emphasis in original)

4.481 In this context, the Appellate Body commented on the burden this placed on the exporting member :

> "Tariff negotiations are a process of reciprocal demands and concessions, of "give and take". It is only normal that importing Members define their offers (and their ensuing obligations) in terms which suit their needs. On the other hand, exporting Members have to ensure that their corresponding rights are described in such a manner in the Schedules of importing Members that their export interests, as agreed in the negotiations, are guaranteed. There was a special arrangement made for this in the Uruguay Round. For this purpose, a process of verification of tariff schedules took place from 15 February through 25 March 1994, which allowed Uruguay Round participants to check and control, through consultations with their negotiating partners, the scope and definition of tariff concessions.[330] Indeed, the fact that Members' Schedules are an integral part of the GATT 1994 indicates that, while each Schedule represents the tariff commitments made by *one* Member, they represent a common agreement among *all* Members."[331] (emphasis in original)

4.482 Canada noted that the United States acknowledged the application of the *EC - Computer Equipment* dispute. However, the brief quotation selected from the case and accompanying comment found in the submission of the United States did not reflect the full opinion of the Appellate Body as set out above. The United States attempted to suggest that the case stood for the proposition that a greater burden lay on the importing Member in matters regarding the interpretation of a tariff item. In fact, as noted above, the Appellate Body had expressly rejected this idea which had been suggested in the Panel Report and had pointed emphatically to the determination of the common intention of the Parties as being the central purpose of treaty interpretation. Moreover, in this context, the Appellate Body made it clear that if a greater burden lay anywhere, it was with the exporting Member.

4.483 Canada argued that it had a right, under Article II of the GATT 1994, to impose such terms and conditions on its tariffs as set out in its Schedule. Furthermore, in respect to the level of clarity and "notice" needed to ensure that other Members were aware of the value and the nature of the concession they were receiving, terms and conditions were to be treated without distinction from specific tariff items.

4.484 Canada argued that where, in the course of a new tariff regime, a term or condition was introduced and, in particular, where that condition had been the spe-

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[329] Appellate Body Report on *EC - Computer Equipment, op. cit.,* para. 110.

[330] Footnote in the original report: "MTN.TNC/W/131, 21 January 1994. See also *Marrakesh Protocol to the General Agreement on Tariffs and Trade 1994*, para. 3.".

[331] Appellate Body Report on *EC - Computer Equipment, op. cit.*, para.109.

cific subject of on-going negotiations over many months, it was indeed the responsibility of the exporting country to seek clarification if that country considered that there was any uncertainty or ambiguity in the term or condition. Canada had informed the United States at all material times about the terms of access that it proposed to grant to imports of fluid milk in Canada's tariff Schedule. This condition was not novel and posed no surprise for US negotiators as it simply represented a continuation in tariffied form of the long-standing regime in place for fluid milk imports into Canada. The fact that the US side in the negotiations had been seeking greater access than that being offered by Canada did not affect the central question of what had been the nature of Canada's offer. The United States were fully aware of not only the existence of a term or condition, but also the nature of the specific condition on access to the Canadian fluid milk market. The United States could therefore not have had any legitimate expectation that Canada would make any additional concession for the import of commercial shipments of milk in bulk into Canada and thus, there could be no common understanding between the parties to the negotiations in that regard. Indeed, the bilateral negotiating history - the best evidence of what the parties understood - clearly indicated that this issue had been expressly negotiated and that the United States had failed to get additional access because of its failure to provide for practical access with respect to its own fluid milk market.

4.485 Canada recalled that at the conclusion of the Uruguay Round, pursuant to Article 4 of the Agreement on Agriculture, Canada converted its existing quantitative restrictions on the importation of fluid milk into a bound tariff on fluid milk.[332] In view of the volume of cross-border trade in consumer-packaged fluid milk, Canada incorporated an additional concession in its Schedule, subject to a condition. The qualified concession, a TRQ for the importation of consumer-packaged fluid milk by Canadian consumers (64,500 tonnes), was set out in Canada's Schedule V and reflected the estimated volume of cross-border trade in fluid milk in the period 1989-91.

4.486 Canada noted that since the implementation of the TRQ, Canada had, in accordance with its qualified concession under Article II, permitted the importation of consumer-packaged fluid milk by Canadian consumers at the lower tariff rate. Such imports were made under the authority of the General Import Permit No.1 under the Export and Import Permits Act.[333] General import permits operated to provide standing authority for imports made within the parameters of the terms and conditions set out in the permit. No additional specific permit or other formality was required for qualifying imports.

4.487 Canada noted that in current circumstances, Canada had not deemed it necessary to impose any monitoring of quantities being imported at the border. The result was that the Canadian border was now effectively open and unrestricted to cross border imports of consumer packaged milk by Canadians for personal use. Canada reserved the right to limit quantities to the 64,500 tonnes stipulated in its Schedule at some future date if circumstances change. In accordance with its qualified conces-

[332] Canada, Exhibit 34.
[333] R.S.C. 1985, Chap. E-19. (Canada, Exhibit 35)

sion, Canada had applied the over-quota tariff to fluid milk shipments in commercial containers or in bulk.

4.488 Canada noted that the United States claimed that the words appearing in the "other Terms and Conditions" column had to be read as not stating any term or condition but rather as being no more than a historical note to indicate the source of the TRQ quantity. In short, the United States asked this Panel to ignore or render ineffective a part of Canada's Schedule that Canada had expressly stated to be a "term and condition" of access. Canada argued that this was inconsistent with the principles of interpretation under customary international law and, in particular, those that required that the terms of an agreement be given effect, and that they be interpreted in good faith, in context and in the light of their object and purpose.

4.489 Canada refuted the attempt by the United States to argue that the terms "cross-border purchases" and "consumer", as they appeared in the terms and conditions to the tariff item, had to be read as including commercial bulk purchases was not sustainable. First, it was straining the ordinary meaning of the language to suggest that the term "consumer" embraced large commercial enterprises. A further examination of reference sources did not support such a view. In ordinary legal usage in Canada and the United States the word "consumer" connoted acquisitions by individuals for personal usage. This meaning was evident from legal dictionaries[334] and statutory usage in both Canada and the United States.[335] It was also used in the sense of an individual who purchased a good or service for personal use, as opposed to a purchase made in the course of his trade or profession is also used in several international treaties.[336] Canada submitted that its interpretation of the word "consumer" was the one that was consistent with the ordinary meaning of that word. In fact, Canada argued that at all relevant times, throughout Uruguay Round negotiations the United States had been thoroughly conscious that the distinction between imports for personal use and commercial imports was at the heart of discussions between Canada and the United States on this issue. Accordingly, the claims by the United States in this regard lacked credibility.

4.490 Canada recalled that the Appellate Body had stressed[337], that a treaty had to be read so as not to render a part of the text redundant or meaningless. The construc-

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[334] Canada, Exhibit 36. Therein, see *Black's Law Dictionary,* 6th ed., (West Publishing Co.: Minneapolis Minn., 1990): "*Consumer* Individuals who purchase, use, maintain, and dispose of products and services... Consumers are to be distinguished from manufacturers (who produce goods) and wholesalers and retailers (who sell goods). A buyer (other than for the purpose of resale) of any consumer product." See also *The Dictionary of Canadian Law,* 2nd ed., (Carswell: Toronto, 1995): "*Consumer* A natural person. An individual. *Consumer Goods* Goods that are used or acquired for use primarily for personal, family or household purposes.

[335] Canada, Exhibit 37. Therein, see *Uniform Commercial Code*, Article 9-109: *Goods* are (1) "consumer goods" if they are used or bought for use primarily for personal, family or household purposes.

[336] Canada, Exhibit 38. Canada noted that examples of such usage included Article 5.1 of the European Communities Convention on the Law Applicable to Contractual Obligations (Rome 1980): "1. This Article applies to a contract the object of which is the supply of goods or services to a person ("the consumer") for a purpose which can be regarded as being outside his trade or profession, or a contract for the provision of credit for that object."

[337] Appellate Body Report on *US - Reformulated Gasoline, op. cit.,* p.23, DSR 1996:I, 3, at 21, IV: "one of the corollaries of the 'general rule of interpretation' in the *Vienna Convention* is that inter-

tion that the United States would seek to place on the words in the column entitled "Other Terms and Conditions" ("This quantity represents the estimated annual cross border purchases imported by Canadian consumers.") would leave it without purpose or meaning. The United States argued that the words in question did not indicate any term or condition but merely constituted a historical note explaining the source of the 64,000 tonnes figure. Since there was no need for Canada to set out the source for TRQ figure in the Schedule, the United States suggested that Canada had thrown in redundant words, without purpose or need, into its tariff schedule. This was clearly untenable. To the contrary, the implication of the words in the terms and conditions column was that they established a condition of within-quota access for fluid milk: importation by the consumer in consumer packages.

4.491 Canada noted that the context of a provision included its place in the agreement and the other parts of the agreement that may be of relevance.[338] The most obvious and fundamental contextual elements of the words in question had to be the heading under which they appeared, in the case at issue: "Other Terms and Conditions". This context clearly indicated that a term or condition affecting the TRQ was to be found in the words that fell thereunder. Therefore, contrary to the assertions of the United States, a premise was established that there was a term or condition in Canada's TRQ entry on fluid milk beyond mere quantity. That term and condition was that fluid milk had to be imported by the consumer in consumer packages to benefit from the lower tariff. Any other interpretation would have to explicitly ignore the context in which the words in question appeared and would therefore be inconsistent with the customary principles of international law, codified in part in the Vienna Convention. Canada noted that the legal principle of in *dubio mitius*, may also apply with respect to the interpretation of the terms and conditions in Canada's Schedule regarding fluid milk.

4.492 Canada argued that to the extent that there was any ambiguity, or that the terms persisted in remaining obscure, recourse could be had to the negotiating history of the agreement.[339] Following the Report of the Appellate Body in *Computer Equipment,* with respect to tariff issues, such recourse to negotiating history could be particularly appropriate. To exclude any consideration of negotiating history from the interpretation of the tariff line at issue, the United States had to establish that the text of the tariff line was, in fact, *unambiguous.* Canada was of the view that the meaning of the term and condition in the tariff line was clear on its face and in context. If the Panel considered that the meaning was not entirely clear, then, at the very

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pretation must give meaning and effect to all the terms of the treaty. An interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility." This passage was repeated by the Appellate Body in *Japan - Liquor Tax, op. cit.,* p.12.

[338] Canada recalled that Article 31.1 of the Vienna Convention stated: "The context for the purposes of the interpretation of a treaty shall comprise, *in addition to the text*, including its preamble and annexes ... " (emphasis added)

[339] Canada recalled that Article 32 of the Vienna Convention states: "Recourse may be had to supplementary means of interpretation, including preparatory work of the treaty or the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31: (a) leaves the meaning *ambiguous* or obscure; or (b) leads to a result which is manifestly absurd or unreasonable."

least, the text was raising some element of uncertainty. Accordingly, in accordance with the rules of interpretation under the Vienna Convention, there could be reference to the negotiating history to find the common understanding of the Parties.

4.493 Canada recalled that prior to the conclusion of the Uruguay Round, Canada had maintained a quantitative restriction on fluid milk under the Export and Import Permits Act (the "EIPA"). Fluid milk was originally included as "butterfat in any form" for *EIPA* purposes. Butterfat was listed on the *Import Control List* beginning in 1958, pursuant to the *EIPA*. Accordingly, fluid milk was permitted to enter Canada only under the authority of import permits issued under the *EIPA*. A general import permit (*General Import Permit No.1*)[340] was issued in 1970 providing authority for the importation of fluid milk in consumer packaging up to the value of C$10.00 per entry.[341] Individual permits for the commercial importation of milk were not issued. As such, this import regime had been a long-established feature of Canada-United States trade, as was well understood by officials on both sides of the border. For reasons of geography and the perishable nature of the product, imports of fluid milk into Canada originated almost exclusively in regions of the United States close to the Canadian border and were described at the time as "cross-border shopping". Canada argued that at all times, the United States *was well aware* of the details of Canada's pre-Uruguay Round regime for fluid milk. It was understood that any successor regime implanted in the context of tariffication at the conclusion of the Uruguay Round would reflect Canada's then-existing regime for fluid milk. Canada might agree in the process to enhance the access it provided but such enhancement would start with the premise of the existing regime. Thus, the United States could not argue that a reference to "cross-border shopping by Canadian consumer" was novel or isolated or that its meaning was obscure to its officials. Hence, the circumstances of the Uruguay Round negotiations made it crystal clear that United States officials fully understood that it was Canada's intention to limit access to the TRQ for fluid milk to cross-border purchases.

4.494 Canada argued that its item on fluid milk in its Schedule fully reflected the position that Canada took through negotiations with the United States and its contents posed no questions for those US officials that were party to those discussions. Only after the Uruguay Round negotiations were over had the United States tried to gain access for what it was unable to negotiate. Canada argued that the following points emerged from the record of the Uruguay Round Negotiations[342]:

(a) Canada was prepared to discuss with the United States in the closing days of the Uruguay Round the possibility of new additional access for fluid milk but Canada had made it clear throughout these discussions that any such additional access would be contingent on having effective equivalent access to the US market. The chief barrier to access to the US market was, and remained, the non-recognition of Canadian sanitary inspection standards for US purposes, the so-called "equivalency" issue.

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[340] Canada drew the Panel's attention to the attached copy of amendment to *General Import Permit No. 1* C.R.C. 1978, c. 613, expanding butter to include dairy products. (See Exhibit 39)

[341] Canada noted that this had been increased to C$20.00.

[342] Canada made reference to Exhibits 40 - 50.

(b) Canada had advised the United States that at a minimum it would maintain the then-existing access to Canada for consumer purchases of fluid milk, i.e., cross-border shopping.

(c) Canada had made it explicit that the treatment of existing cross-border shopping access and the creation of additional access of a non-consumer variety were separate and distinct matters.

(d) It was evident not only in Canada's own records, but more crucially, by *jointly drafted documents* exchanged by Canadian and US officials, US officials were fully aware that Canada was treating consumer imports of fluid milk as a distinct matter from any consideration of additional access for non-consumer imports, and that any such new non-consumer access was to be contingent on a resolution of the "equivalency" problem.

(e) The failure of Canada and the US to reach an agreement with respect to a resolution of the equivalency problem meant that, as Canadian officials had advised throughout, Canada's offer on fluid milk was to maintain access for consumer imports but not to give any access for non-consumer shipments.

4.495 Canada submitted that its concession of a TRQ for cross-border trade in consumer-packaged fluid milk was fully consistent with Article II. Canada asserted that, read in good faith and in context, and in view of the rich record of negotiations between the two countries, the conditions in question could not mean anything other than stated at the outset by Canada: that the TRQ remained open to consumer-packaged fluid milk in cross-border trade, but not to bulk or commercial fluid milk.

4.496 The **United States** noted that in the recent report on *Computer Equipment*[343], the Appellate Body had stated that items in tariff schedules to the GATT 1994 were to be considered to be integral parts of a treaty and as such to be subject to the customary principles of treaty interpretation, as set out in the Vienna Convention. Accordingly, pursuant to Article 31.1 of the Vienna Convention, the meaning of a term in a treaty was to be determined in accordance with the ordinary meaning to be given to the term in its context and in the light of the object and purpose of the treaty. The language in Canada's Schedule stating that the quantity provided for under the tariff-rate quota "represents the estimated annual cross-border purchases imported by Canadian consumers" failed to limit market access in the manner Canada now asserts it intended. The indicated language did not in its ordinary meaning allow an interpretation that permitted the actual constraints imposed by Canada on eligibility of imports for the in-quota rate. Because the language did not create the "term, condition, or qualification" which Canada now claimed it intended to establish at the time of its inclusion, Canada was providing treatment less favorable to imports of fluid milk than was provided for in its Schedule. Canada, therefore, was acting inconsistently with its obligations under Article II:1(b) of the GATT 1994.

4.497 The United States noted that Canada raised three arguments in response to the US complaint. First, Canada contended that the words in its Schedule would be ren-

[343] Appellate Body Report on *EC - Computer Equipment*, *op. cit.*

dered meaningless if they were not construed to limit the scope of market access as Canada had intended. Second, Canada argued that the meaning of the word "consumer" was so clear that its use obviously confined imports under the in-quota rate to small, retail purchases for the personal use of Canadian residents. Third, Canada asserted that the meaning of the words in the Schedule was agreed between the United States and Canada. Each of Canada's contentions was without merit.

4.498 The United States did not agree that the language in Canada's Schedule was made meaningless by denying those words the meaning that Canada now attributed to them. While the United States agreed with the principle of treaty interpretation, articulated by the Appellate Body, that words were to be given effect, here the question was what was the operative word to which effect was to be given. The only operative word in Canada's Schedule relating to fluid milk was the word "represents". However, the schedule statement that the quantity of the tariff-rate quota "represents" an estimated amount of trade did not operate to limit access in the manner Canada contended. It was simply a narrative statement explaining the basis for arriving at the in-quota quantity. Canada's choice of language was not at all the same as saying "access is limited to", or "this quantity is available only for." Canada attempted to read into the language in its Schedule a meaning and effect that were not there. The starting point for any treaty interpretation was the plain text of the treaty, which was also the best statement of the intent and agreement of the parties. That text was unambiguous and, therefore, Canada had failed to demonstrate any basis for examination of the negotiating history between the United States and Canada respecting market access for milk. Indeed, resort to such an examination would contravene the very principles of treaty interpretation which Canada cited in its argument.

4.499 The United States argued that this language remained from Canada's efforts to comply with certain specific modalities for market access set forth in the Agreement on Modalities for the Establishment of Specific Binding Commitments under the Reform Programme, which were Part B of the Draft Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations.[344] The modalities required "minimum access opportunities" for products for which there were "no significant imports." The modalities required that such opportunities would "represent in the first year of the implementation period not less than 3 per cent of corresponding domestic consumption in the base period ... and shall be expanded to reach 5 per cent of that base figure by the end of the implementation period." Canada had no significant imports of milk during the relevant period and was consequently faced with the prospect of a requirement to import milk in volumes equal to 5 per cent of domestic consumption. Canada's trade statistics showed no imports of milk, because milk was subject to an absolute quantitative restriction under its Import Control List. Faced with this stark reality, Canada had seized upon the idea of demonstrating the existence of some "current access". The imports that Canada relied on were unrecorded imports entered by returning Canadian shoppers. Such milk was not subject to formal customs entry. Consequently, no trade data was compiled. In creating a tariff-rate quota for milk as part of the required tariffication process, Canada sought to dress up this unknown quantity of trade as "current access" within the meaning of the

[344] Canada Exhibit 32: MTN.TNC/W/FA, p. L.19 (20 December 1991).

modalities. Paragraph 11 of Section B of Part B[345] provided that "current access opportunities on terms at least equivalent to those existing shall be maintained as part of the tariffication process." In the absence of any official trade statistics to justify a current access concession, rather than the more onerous minimum access concession, Canada had to place in its schedule an ostensible basis for this lesser concession. There had been various estimates concerning the volume of this unreported trade. Estimates ranged as low as approximately 35,000 tonnes and as high as 80,000 tonnes. When Canada reported in its Schedule that it would permit access for 64,500 tonnes at in-quota duty rates, it was appropriate that Canada stated how this level of "current" access was determined. The explanatory note in its Schedule that the volume represents the estimated amount of cross-border purchases by Canadian residents explained the derivation of the quantity adopted for in-quota market access. Contrary to Canada's contention, the ordinary meaning of the language served a purpose and was not meaningless.

4.500 The United States argued that Canada's attempt to demonstrate that the word "consumer" could only refer to a retail customer, purchasing small quantities of a product was also flawed. Canada sought to give a special meaning to that term, but Article 31.4 of the Vienna Convention permitted a special meaning only when it could be established that the parties so intended. Canada had not met this burden. The United States noted that the facts did not support Canada's assertion that language in its Schedule, and Canada's current interpretation of that language, was agreed to by the United States and Canada. At most Canada had shown that it had used the language in the schedule in its own internal memoranda. None of the exhibits tendered by Canada showed that the United States had shared a common understanding of the words or, more importantly, that the United States had agreed to the limitations that Canada now reads into that language. Unless Canada could demonstrate a common intent of the parties to give a special meaning to the term "consumer", its ordinary meaning was the only basis for interpretation of Canada's Schedule under the Vienna Convention.

4.501 The United States argued that Canada could have clearly established the limitation on access to the tariff-rate quota that it now claimed to have intended. For example, Canada could have instead specifically stated that the quantity eligible for the in-quota rate was limited to purchases by its residents for their personal use. Canada could have said that access under the tariff-rate quota was limited to milk entered under its General Permit No. 1 for dairy products. Or Canada could have used the same language which it used in the case of yoghurt and ice cream, and indicated, as it did for each of those products, that eligible entries were limited to access in "retail sized containers only".[346] Canada did not use the same limiting language that it used for yoghurt and ice cream for fluid milk. In such circumstances, the United States questioned how could it be understood that Canada sought to impose the same restriction on fluid milk access.

4.502 The United States noted that the United States used the term "ultimate consumer" in its Schedule for a related purpose.[347] The term there was defined to exclude

[345] Canada Exhibit 32: MTN.TNC/W/FA, p. L.26 (20 December 1991).
[346] Canada's Schedule V. (United States, Exhibit 51)
[347] The United States referred to excerpts from Schedule XX. (United States, Exhibit 52)

institutions that could prepare, but did not consume food articles, such as hospitals, prisons, restaurants, hotels and bakeries. Furthermore, the US schedule was very precise in identifying equivalent limitations on imports into the United States. Thus, the United States schedule specifically stated that the words "prepared for marketing to the ultimate consumer" means "that the product is imported in packaging of such sizes and labeling as to be readily identifiable as being intended for retail sale to the ultimate consumer without any alteration in the form of the product or its packaging".[348] The United States argued that in light of this very distinct use of a related term by the United States in the US Schedules Canada could not arrive at the conclusion that the United States shared Canada's intended construction of the word "consumer". The US use of the modifying adjective "ultimate" indicated that the United States believed it necessary in its Schedule to distinguish between the more narrow category encompassed by the words "ultimate consumer" and a broader category that includes all consumers. Indeed, there was no basis for Canada's arguments that the United States understood Canada's poorly communicated intent. Yet, despite Canada's failure to offer any explanation, Canada insisted that the two countries agreed on a common meaning for the term.

4.503 The United States refuted Canada's efforts to establish the ordinary meaning of the term "consumer". Specifically, Canada relied to a major extent on the meaning given to a phrase, in fact, a term of art under the Uniform Commercial Code - "consumer goods" - that did not appear in Canada's Schedule and which possessed a connotation of its own, distinct from the word "consumer". The attempt to attribute the meaning of an entirely distinct phrase to the words in the Schedule was entirely inappropriate. Furthermore, entirely missing from Canada's argument regarding the meaning of the word "consumer" was any reference to the New Shorter Oxford English Dictionary on Historical Principles,[349] that it regularly cited for a variety of definitions. The New Shorter Oxford English Dictionary defined "consumer" to mean "a person who or thing which squanders, destroys, or uses up; a user of an article or commodity, a buyer of goods or services". Clearly, this definition was at odds with the more restricted definition of the term "consumer" offered by Canada. In fact, there was nothing in the New Shorter Oxford English Dictionary definition to limit the meaning of the word "consumer" to individuals purchasing goods for their own personal use in small, retail packages.

4.504 The United States further refuted the Canadian contention that the negotiations between the United States and Canada at the end of the Uruguay Round regarding market access lent support to Canada's argument. Canada's assertion that its market access offer for dairy was always in the form of "current" access was entirely unfounded. Canada was fixated on the idea of modifying Article XI of the GATT to allow quantitative restrictions on imports to remain inviolate. Canada had resisted the concept of tariffication of quantitative restrictions to the very end of the Uruguay Round. Thus, to suggest that Canada had any long-held position regarding any level of market access for fluid milk was misleading. Canada's first offer relating to market access, moreover, had been based on the Dunkel modalities, with access initially

[348] The United States referred to excerpts from Schedule XX. (United States, Exhibit 52)
[349] Lesley Brown (ed.), (Oxford: Oxford University Press, 1993).

set at 3 per cent of its market, increasing to 5 per cent at the end of the implementation period.[350] The United States acknowledged that Canada indicated that this offer would only remain on the table if enhanced access to the US market for dairy products was provided. Negotiations between the two countries through the end of 1993 and the beginning of 1994 were aimed at reaching agreement on how such improved market access for a variety of products could be achieved. The negotiations were unsuccessful. Then in February 1994, Canada had submitted its final schedule to the WTO, including the 64,500 tonne tariff-rate quota for fluid milk. There had never been any agreement between the United States and Canada relating to either the size or nature of this tariff-rate quota, or the language used in Canada's Schedule.

4.505 The United States noted that given that Canada had commenced discussions of tariffication and market access at such a late date, resolution of the differences in position were not resolved by the time Canada was compelled to submit its Schedule. When it did so in February 1994, there certainly was no agreement between the United States and Canada on either the content of its concessions respecting fluid milk or the meaning of the terms used to describe the concession. Thus, Canada's selection of 64,500 tonnes as the quantity which represented so-called cross-border trade, was a number that it reached independently. Moreover, its choice of language to describe what that 64,500 tonnes represented was also made unilaterally.

4.506 **Canada** stressed that it did not claim that the United States agreed with Canada's action - what it claimed was that the United States' negotiators understood it. The United States had accepted Canada's Schedule, including the tariff item at issue, in the full knowledge of the meaning and implications of the terms and conditions placed in that Schedule with respect to fluid milk. Canada argued that under the interpretation advanced by the United States, everything but the purely grammatical sense of the words was ignored. This rendered an analysis incomplete. The Appellate Body, in *United States - Import Prohibition of Certain Shrimp and Shrimp Products*[351], had recently reaffirmed the importance of examining each element of Article 31.1 of the Vienna Convention. In particular, regarding the interpretation of the chapeau of Article XX of the GATT 1994, the Appellate Body noted that the Panel "...did not expressly examine the ordinary meaning of the words...",[352] that it had "... failed to scrutinize the *immediate* context of the chapeau,"[353] and finally, that it "...did not look into the object and purpose of the *chapeau*."[354] (emphasis in original).

4.507 Canada noted that in support of its interpretation, the United States asserted that the only operative word in the Schedule was the word "represents" and claimed that this was merely a narrative statement explaining the basis for arriving at the in-quota quantity. However, the United States had not examined of the meaning of that term. Canada submitted that even at this initial stage of analysis, there were two potential meanings of the term "represents" as it was used in the Schedule. First, the word was defined as meaning to "...bring clearly and distinctly to mind, esp. by de-

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350 United States, Exhibit 53.
351 Appellate Body Report on *US - Shrimp-Turtle, op.cit.*
352 *Ibid.*, p. 42, para. 115.
353 *Ibid.*, pp.42-43, para. 116.
354 *Ibid.*, p. 43, para. 116.

scription or imagination."[355] Thus, the word operated to more precisely identify the 64,500 tonnes found under the "Initial Quota" and "Final Quota" columns as being cross-border purchases of fluid milk by Canadian consumers. A second definition could be "… of a quantity: indicate or imply another quantity." The TRQ dealt with quantities. The figure of 64,500 tonnes was found in the "Initial Quota" and "Final Quota" columns of the Schedule. Thus, the word "represents," in its ordinary meaning, instructed the reader to have in mind cross-border purchases of fluid milk by Canadian consumers when reading 64,500 tonnes under the initial/final quota columns of Canada's Schedule.

4.508 Canada noted that a single dictionary meaning did not exhaust the search for ordinary meaning and that the dictionary meaning of "consume" also included the concept of "eat up, drink down, devour". This definition carried with it the concept of a person actually ingesting the article in question. Thus, in the context of an agricultural product, this definition was part of the ordinary meaning.

4.509 Canada further argued that, continuing with the analysis expounded by the Appellate Body, it was evident that the United States had, at the outset, failed to consider the context of the Canadian terms and conditions attached to its TRQ for fluid milk. The immediate context of these words was that they were found in the column entitled "Other Terms and Conditions," which in itself followed the columns entitled "Initial Quota" and "Final Quota." The inescapably logical conclusion was that the words found under "Other Terms and Conditions" were just that: terms and conditions that applied to the quantity described as the initial/final quotas. Had these words merely represented "a narrative statement explaining the basis for arriving at the in-quota quantity," they would not have found a place in the Schedule. Turning to the object and purpose of the "Other Terms and Conditions" column, this was evidenced by the very words describing the function of the column. This column had been provided to allow Members to describe the terms and conditions that they had attached to the TRQ applicable to the product in question, not to describe how they had arrived at the TRQ itself.

4.510 In respect of the negotiating history, Canada recalled that it had clearly indicated to the United States, as set out in jointly drafted documents, that it intended to continue its access for US milk imported by Canadian consumers while non-consumer utilization would continue to be blocked until equivalency was established. Canada's intentions had been clear. Canada maintained that if the United States had had any doubt about whether or not Canada's Schedule provided access consistent with their interpretation of the negotiations and resulting treaty terms, it would have been their responsibility to verify the meaning of the term and condition. It had been their responsibility to ensure that their interpretation of what access was agreed to in the negotiations was ensured.[356]

4.511 Canada did not concede, in respect of the US references to other language used by both Canada and the United States in their respective schedules, that such other language would necessarily have any adverse bearing on the language it had chosen with respect to its obligations. Indeed, the use of different words with respect

[355] The *New Shorter Oxford English Dictionary on Historical Principles*, Lesley Brown (ed.), (Oxford: Oxford University Press, 1993).

[356] Appellate Body Report on *EC - Computer Equipment, op. cit.*, para. 82, 84.

to different categories of products merely illustrated that the terms and conditions applicable thereto were formulated in their own differing contexts, and thus had to be examined accordingly. Again, this illustrated the importance of heeding the guidance provided by the Vienna Convention when interpreting the terms of a treaty,[357] particularly when faced with interpreting tariff schedules.[358]

3. Article 3 of the Agreement on Import Licensing Procedures

4.512 The **United States** argued that Canada administered the tariff-rate quota on fluid milk through general import permits provided for under Canada's Export-Import Permit Act.[359] By virtue of the general permit, residents of Canada were confined in any single import entry to C$20 worth of dairy products, limited to their personal or household use.[360] The two limitations, i.e., personal use and a specific dollar value, were imposed in addition to both the requirement for a general permit and the quantitative limit on the volume of fluid milk eligible for the in-quota rate under Canada's WTO Schedule. These additional constraints on imports were inconsistent with the requirements of Import Licensing Agreement. Specifically, Article 3.2 of the Import Licensing Agreement provided that:

> "Non-automatic licensing shall not have trade-restrictive or -distortive effects on imports additional to those caused by the imposition of the restriction."

4.513 The United States argued that the obligation encompassed in Article 3.2 reflected the Import Licensing Agreement's objectives that the flow of international trade not be "impeded by the inappropriate use of import licensing procedures" and that "licensing procedures should be no more administratively burdensome than absolutely necessary to administer the relevant measure".[361] Hence, the general permit, by imposing two conditions on entry that were additional to the licensing requirement itself, added another impediment to fluid milk trade between the United States and Canada and resulted in procedures that were more administratively burdensome than necessary to administer the measure. By limiting entries to the personal use of the importer, the general permit restricted trade beyond those constraints that would result from the mere act of licensing imports. By confining the value of imports, the general permit further impeded trade and was also inconsistent with Article 3.5(i) of the Agreement, which directed Members to "take into account the desirability of issuing licenses for products in economic quantities." The limitation on imports to C$20 appeared to eliminate all but individual consumer retail purchases of milk.

4.514 Finally, the United States argued that Canada had failed in its obligation under Article 3.5(iv) to provide information respecting the value and volume of fluid milk within the tariff-rate quota. This data was requested by the United States during consultations in November 1997, and Canada advised that such information had not

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[357] Appellate Body Report on *US - Shrimp-Turtle, op. cit.*, 50, p. 42.
[358] Appellate Body Report on *EC - Computer Equipment, op. cit.*, para. 82, 84.
[359] Responses to Questions from the US on Fluid Milk TRQ, Letter, dated 24 November 1997 (Answer to Question 31. United States, Exhibit 34)
[360] United States, Exhibit 34.
[361] Preamble, WTO Import Licensing Agreement, paras. 8 and 9.

been developed despite assurances in earlier consultations that the data would be made available.[362]

4.515 **Canada** argued that Article 1.1 of the Import Licensing Agreement defined import licensing as being administrative procedures used for the operation of import licensing regimes requiring the submission of an application or other documentation to the relevant administrative body as a prior condition for importation. Canada did not require Canadian residents to apply for or acquire import permits for the importation of less than C$20 worth of dairy products. There were no administrative procedures associated with the general import licensing regime in respect of such import. Therefore, that Agreement did not apply.

4.516 Canada further argued that its administration of the fluid milk tariff quota was consistent with the Import Licensing Agreement. Imports of fluid milk for personal use into Canada were freely made by Canadians under the terms of General Import Permit No.1. Individual permits were not required. Further, in the current circumstances, Canada had not considered it necessary to monitor the flow of such milk imports into Canada. Any such inspection regime would not be practicable, since it would, in effect, require the stopping of all returning Canadians at the many Canada-US border crossing points to inspect and record the contents of their grocery bags. Moreover, it would introduce an unwanted and unneeded interference in such import trade. No restrictions were placed on imports that were additional to the terms and conditions incorporated in Canada's tariff concession. Accordingly, this regime was in complete compliance with the requirements of Article 3.2 of the Import Licensing Agreement. Since any monitoring regime for such imports was neither realistic nor practicable, the provisions of Article 3.5(iv), cited by the United States did not apply.

4.517 The **United States** claimed that there could be no dispute that the Import Licensing Agreement applied to tariff-rate quotas. The Appellate Body in two separate disputes resolved the question by affirming that the Agreement's scope includes tariff-rate quotas.[363] Despite this clear statement by the Appellate Body, Canada argued that the Import Licensing Agreement did not apply in this instance because Article 1.1 limited the scope of import licensing to "the operation of import licensing regimes requiring the submission of an application or other documentation to the relevant administrative body as a prior condition for importation" (paragraph 4.515). Hence, Canada asserted that because its General Permit for dairy imports did not require any administrative procedures for imports of less than C$20, the Import Licensing Agreement was inapplicable.

4.518 The United States noted that Canada chose to ignore the fact that under Canada's Export and Import Permits Act administrative procedures existed for obtaining import licenses in situations in which the General Permit was inapplicable, e.g., where the desired dairy imports were valued at more than C$20.[364] While Canada

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[362] Consultations on 19 November 1997. Answers to question 24. (United States, Exhibit 34)

[363] In the proceedings involving *European Communities - Regime for the Importation, Sale, and Distribution of Bananas*, WT/DS27/AB/R, adopted 25 September 1997, para. 194, DSR 1997:II, 591 and *European Communities - Measures Affecting the Importation of Certain Poultry Products*, WT/DS69/AB/R, adopted 23 July 1998, paras. 120-122.

[364] The United States noted that Canada described the nature of the applicable procedures in its answer to question 5 from the United States. Specifically, Canada stated that pursuant to paragraph

rarely, if ever, granted licenses under those procedures for fluid milk imports, it presumably did grant licenses for other dairy products. For example, the United States assumed that Canada issued licenses for dairy imports under Canada's Import for Re-Export Programme.[365] More importantly, Canada had administrative procedures in place for licensing such imports. The fact that Canada elected not to grant such licenses did not negate the existence of those licensing procedures. It would be a most curious result for a country to establish licensing procedures, but then be able to avoid the disciplines of the Import Licensing Agreement simply because it refused to grant any licenses. Canada's procedures, thus, remained within the scope of the Import Licensing Agreement.

4.519 The United States argued that Canada could not be allowed to use GATT inconsistent measures to argue that the Import Licensing Agreement was inapplicable. Canada maintained procedures under its Import-Export Permits Act to permit dairy imports, including fluid milk, that did not qualify under the General Permit. Canada's refusal to grant licences under that authority did not diminish the reality of those procedures. Moreover, these procedures were precisely the subject of the Import Licensing Agreement's disciplines. Canada could not deny the Agreement's applicability by simply disclaiming the existence of any relevant procedures.

4.520 **Canada** recalled its position that the Import Licensing Agreement did not apply to the General Import Permit system. The United States understood this statement as being a claim by Canada that the Agreement did not apply to tariff quotas generally. Canada could not understand how the United States could have read its statement in this way and affirmed that the Import Licensing Agreement applied to any tariff quota administration regime falling in the description of Article 1.1 of that Agreement.

V. SUMMARY OF THIRD PARTY SUBMISSIONS

A. Australia

1. Introduction

5.1 Australia stated that as an agricultural exporter, and in particular, as a major exporter of dairy products Australia had a direct commercial interest in the outcome of the dispute at issue. As the export subsidy provisions of the Agreement on Agriculture were of major systemic importance to Australia, Australia's submission focussed on the question whether the delivery of cheap in-quota milk to manufacturers

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8.3(3) of the Act, "where goods have been included on the Import Control List and the Minister has determined an import access quantity for the goods pursuant to subsection 6.2(1), the Minister may issue (a) a permit to import those goods in a supplemental quantity to any resident of Canada who applies for the permit ...".

[365] The United States noted that Canada stated in its response to the questions from the Panel and from New Zealand that the Import for Re-Export Programme had not allowed the importation of fluid milk classified in tariff item 0401.10. (Response to Question 1(b) from New Zealand)

for export under Classes 5(d) and (e) provided export subsidies under the Agreement on Agriculture.[366]

5.2 Australia claimed that the Special Milk Classes Scheme delivered export subsidies within the meaning of the Agreement on Agriculture. As a result Canada was in breach of its export subsidy quantity reduction commitments for butter, cheese and other milk products under the Agreement on Agriculture. It followed that Canada was in breach of its commitments under Articles 3, 8, 9 and 10 of the Agreement on Agriculture and Article 3 of the SCM Agreement.

5.3 Australia disagreed with the United States line of argument regarding the functional equivalence of Canada's new dairy regime with its former system of producer-financed levies, which appeared to fall under Article 9.1 of the Agreement on Agriculture. Australia contended that this was not a trade impact issue but one of rules and so such a line of argument was not relevant. The WTO Agreement did not prevent a Member from bringing itself into conformity with the rules by measures that could have similar trade and production impact. In Australia's view the new regime provided export subsidies under the WTO rules regardless of the status of previous arrangements.

2. Discussion

(a) Relationship between the Agreement on Agriculture and the SCM Agreement

5.4 Australia noted that the Agreement on Agriculture itself did not contain a definition of "subsidy". Accordingly, the context of the Agreement on Agriculture needed to be examined for guidance, i.e. the WTO Agreement, in particular Annex 1A. The generic agreement on subsidies in the goods sector was the SCM Agreement. In the absence of any other indication, normal rules of interpretation suggested that that definition should be taken for other agreements in Annex 1A of the WTO Agreement. Moreover, there were explicit legal linkages between the Agreement on Agriculture and the SCM Agreement. In particular Article 13 of the Agreement on Agriculture provided a temporary derogation from aspects of the SCM Agreement provided that the conditions set out therein were fulfilled. Article 3.1 of the Agreement on Agriculture specifically referred to commitments limiting subsidization. The SCM Agreement was the vehicle by which the subsidy was defined for goods under the WTO Agreement. Article 31 of the Vienna Convention underlined that the Panel needed to interpret the meaning of "subsidy" in its context which included the WTO Agreement as a whole and the SCM Agreement in particular.

5.5 On the issue of the relationship between Article 1(e) of the Agreement on Agriculture[367] (which provided guidance for what constituted an export subsidy under that agreement) and Article 3.1(a) of the SCM Agreement[368], the ordinary mean-

[366] Australia's submission was limited to the issue of measures affecting dairy exports.

[367] Article 1(e) of the Agreement on Agriculture: "'export subsidies' refers to subsidies contingent upon export performance, including the export subsidies listed in Article 9 of this Agreement;"

[368] Article 3.1(a) of the SCM Agreement: "subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I;" [footnote in original omitted]

ing of these terms in the context of Annex 1A of the WTO Agreement would imply that the definitions were the same. If there were measures that fell under Article 3.1(a) of the SCM Agreement but not the definition of export subsidy under Article 1(e) of the Agreement on Agriculture, then they would not be covered by Article 13(c) of the Agreement on Agriculture. That would appear to lead to a result other than the intention of Article 13 of the Agreement on Agriculture and so be ruled out under Articles 31.1 and 32(b) of the Vienna Convention.

(b) Classes 5(d) and (e) under the Special Milk Classes Scheme Constitute Export Subsidies

5.6 Where in-quota milk was provided to processors/exporters under Classes 5(d) and (e), this involved the Government, through its legislative arrangements, providing goods (i.e. milk) at prices below those prevailing in the domestic market. Thus the measure provided a subsidy under Article 1.1(a)(iii) of the SCM Agreement. In the alternative, this was a subsidy under Article 1.1(a)(iv) of the SCM Agreement. The measure provided a benefit to the processor/exporter concerned, since it received the raw material (milk) at a price that enabled it to export the processed product concerned. This supply of milk was contingent upon the export of the processed dairy product. Accordingly, the measure constituted a subsidy that conferred a benefit on the recipient and was contingent upon export performance. Thus it fell under Article 3.1(a) of the SCM Agreement. Accordingly, it was an export subsidy within the meaning of the Agreement on Agriculture (as well as the SCM Agreement) and so came under Canada's obligations under Articles 3, 8, 9 and 10 of the Agreement on Agriculture. In the alternative, if the Panel found that this measure fell under Article 3.1(a) of the SCM Agreement but was not an "export subsidy" within the meaning of the Agreement on Agriculture, then it would be prohibited under Article 3 of the SCM Agreement, since it would not receive cover from Article 13(c) of the Agreement on Agriculture.

5.7 Paragraph (d) of the Illustrative List of Export Subsidies in Annex I of the SCM Agreement underscored that the provision of low priced inputs could be an export subsidy. In addition, while the calculation issue was in respect of countervail, Article 14(d) of the SCM Agreement indicated that such a measure would be a countervailable subsidy. Article 9.1(a) of the Agreement on Agriculture through its reference to "payments-in-kind" made it clear that cheap inputs in lieu of cash were regarded as direct subsidies.

5.8 Australia noted that given that Canada's exports exceeded the commitments in its Schedule, it was irrelevant whether the measure fell under the types of export subsidies listed in Article 9.1 of the Agreement on Agriculture, since Article 10.3 of the Agreement on Agriculture placed the onus on Canada to show that it had not breached its commitments whether or not it fell under Article 9.1 of the Agreement on Agriculture.

5.9 Classes 5(d) and (e) of the Special Milk Classes Scheme were designed to make products for export competitive through the supply of cheap milk based on the export price of the exported product. The "world price" of the milk, which was calculated by the CDC (whether product was exported by the CDC or where there were exporter-initiated proposals for export), was below the price of the milk that would be commercially available to processors/exporters without the operation of the scheme. The "world price" was negotiated by the CDC with the processor or ex-

porter. The prices in Class 5 were in fact on the individual components of milk (butterfat, protein, other solids). The CDC was constructing what it termed a "world price", which would appear not to be commercially available to producers without the operation of the Special Milk Classes Scheme. Australia noted that while Canada argued that processors/exporters conceptually had access to milk at world market prices under its Import for Re-Export Programme, the price of obtaining and using such milk was not taken into account when the price of the Class 5(d) or (e) milk to the processor/exporter was determined and was more favourable. There appeared to be no connection between the price of imported milk conceptually available at the factory under the Import for Re-Export Programme and the prices charged for milk under Classes 5(d) and (e). Accordingly, the measure provided milk at a price below an adequate level of remuneration contingent upon the export of the manufactured product and therefore would constitute an export subsidy, under both the Agreement on Agriculture and the SCM Agreement.

(c) Export Subsidies under Article 9.1 of the Agreement on Agriculture

(i) "Provision by governments or their agencies"

5.10 The Canadian Government, whether through the CDC or through the provincial marketing boards, played a clear role in the establishment and administration of the Classes 5(d) and (e) in the Special Milk Classes Scheme. The CDC was mandated under the CDC Act[369] to establish and operate the pooling of revenues from milk sales, to determine the percentage of total production represented by Classes 5(d) and (e) including in each province, and to calculate the "world price" for the purposes of Classes 5(d) and (e). Moreover, it was through the CDC that processors/exporters obtained a permit for cheap milk for dairy products for export. The requirement under Article 9.1(a) that the direct subsidies were provided by governments or their agencies was thereby met.

5.11 Australia did not agree with Canada's argument that in effect the Canadian dairy export regime was in some way not governmental. The regime for exports from in-quota milk under Classes 5(d) and (e) were an integral part of the Canadian dairy regime, which operated under legislative authority at both the Federal and Provincial levels. In the absence of legislative backing the scheme would not be able to operate.

5.12 In respect of Canada's claim that the permits issued by the CDC were recommendations to the marketing boards and that the CDC was not mandated to decide whether processors/exporters obtained product at world prices for export, Australia noted that the processor/exporter could not receive milk products at world prices without the permit issued by the CDC.

(ii) "Direct subsidies, including payments-in-kind"

5.13 Article 9.1(a) covered "direct subsidies, including payments-in-kind". The ordinary meaning of this phrase was that the provision of cheap goods was to be re-

[369] Australia noted that Paragraph 9(1) of the CDC Act indicated the delegation of the CDC powers, by agreement with a province or a Board, of the Commission's powers under paragraphs 9(1)(f)-(i).

garded in the same way as straight cash. Accordingly, since for Classes 5(d) and (e) the cheap milk was provided by the Government contingent on the export of the manufactured product, the measure fell under Article 9.1(a) of the Agreement on Agriculture. It would be inconsistent with the ordinary meaning of the phrase to suggest that the provision of goods without payment would be a subsidy but that any level of payment, even though less than adequate remuneration, would convert the measure from being a subsidy.

5.14 Processors/exporters accessed cheap milk under Classes 5(d) and (e) for the export of dairy products, compared with access to milk to produce the same product for the domestic market, and so the measure met the requirement of Article 9.1(a) that the provision of direct subsidies was "to a firm, to an industry, to producers of an agricultural product ...".

5.15 Processors/exporters requested a permit to export product under the Special Milk Classes Scheme. Milk destined for Classes 5(d) and (e) for processing into export product had been determined by the CDC. Classes 5(d) and (e) had been established solely for the export of dairy products and the provision of lower priced industrial milk was related specifically to the export of that product. Processors/exporters did not have access to the lower priced industrial milk unless the dairy product was to be exported. The subsidy provided through the Classes 5(d) and (e) was therefore "contingent upon export performance".

5.16 Accordingly, the measure satisfied the definition in Article 9.1(a) of the Agreement on Agriculture.

(d) Article 3 of the Agreement on Agriculture

5.17 Australia argued that since the Special Milk Classes Scheme was an export subsidy within the meaning of Article 9.1 of the Agreement on Agriculture, Canada was in breach of Article 3.3 of the Agreement on Agriculture not to provide export subsidies in excess of its budgetary outlay and quantity commitments levels specified in Section II of Part IV of its Schedule and in breach of Article 8 of the Agreement on Agriculture not to provide export subsidies otherwise than in conformity with the Agreement and with the commitments specified in its schedule.

(e) Article 10 of the Agreement on Agriculture

5.18 In the alternative, even if it were found that the export subsidies provided under Classes 5(d) and (e) were not captured within the meaning of Article 9.1 of the Agreement on Agriculture, Australia argued that Canada would appear to be in breach of Article 10.1 of the Agreement on Agriculture. The object and purpose of Article 10.1 of the Agreement on Agriculture was to prevent the circumvention of export subsidy commitments. This was reinforced by Article 10.3 which placed the onus on an exporting Member to demonstrate that any exports in excess of its scheduled commitments were not subject to export subsidies. As noted above, in Australia's view the measure provided an export subsidy and so the onus was on Canada to demonstrate that it was not in breach of its export subsidy commitments.

(f) Article 3 of the SCM Agreement

5.19 The measure in question fell under Article 3.1(a) of the SCM Agreement. Since Canada was in breach of its export subsidy commitments under the Agreement

on Agriculture, it did not receive cover through Article 13(c) of the Agreement on Agriculture, and so was in breach of Article 3 of the SCM Agreement. In the alternative, if the Panel found that the measure was not an export subsidy within the meaning of the Agreement on Agriculture but was an export subsidy under Article 3.1(a) of the SCM Agreement, then again Canada would receive no cover from Article 13(c) of the Agreement on Agriculture, and so would be in breach of Article 3 of the SCM Agreement.

B. Japan

1. Introduction

5.20 Japan, as both a producer and major importer of dairy products[370], expressed concern in respect of the effect of Canada's measures on international prices of dairy products. Such measures could give rise to inappropriate competition within the global dairy market, which in turn would bring about negative effects on the domestic markets. Hence, Japan considered that it had a substantial trade interest in the current matter.

5.21 Japan considered that the export subsidies were highly trade-distortive and had therefore argued for their termination. As a result of the Uruguay Round Negotiations, the WTO Agricultural Agreement provided that the Members had to phase out export subsidies and prevent the circumvention of such subsidies.

5.22 In Canada, a gap between export prices of dairy products and the domestic prices was created by the Special Milk Classes Scheme. Japan noted that the exportation of Canada's dairy products had been expanding under this Scheme. Japan considered that Canada's Special Milk Classes Scheme was an export subsidy, or, in the alternative, resulted in or threatened to lead to the circumvention of Canada's export subsidy reduction commitments.

2. Legal Arguments

(a) Canada's Special Milk Classes Scheme Provided an Export Subsidy within the Meaning of Article 9.1(c) of the Agreement on Agriculture

5.23 Japan considered that Canada's Special Milk Classes Scheme fell into the category of an export subsidy within the meaning of Article 9.1(c) of the Agreement on Agriculture, and that the actual amount of dairy products exported from Canada exceeded the level set forth in its Schedule. Consequently, Japan believed that the measures at issue were inconsistent with Articles 3.3 and 8 of the Agreement on Agriculture.

5.24 Article 9.1(c) provided the following two conditions for export subsidies: (i) "payments on the export of an agricultural product"; and (ii) payments that were "fi-

[370] Japan noted that, for example, Japan was the largest importer of trade in cheese: 24 per cent of the total imports in the world was shared by Japan (as reported in 1996 in the "Dairy Compendium" by the Australian Dairy Corporation) and Japan's imports of Canadian cheese amounted to 283 tonnes in FY1995 and 1,236 tonnes in FY1996.

nanced by virtue of governmental action". Concerning the first condition of Article 9.1(c), the price reduction provided by the Special Class 5(d) was available only for the milk destined for the production of dairy products for export purposes. Indeed, this was in practice and economically-speaking nothing else but "payments on the export of an agricultural product". With regard to the second condition of Article 9.1(c), the Special Milk Classes Scheme was founded through the Comprehensive Agreement on Special Class Pooling, which was an Agreement between the federal and provincial governments and operated by the CDC, whose authority to do so was given by the CDC Act and which was amended in 1995. This meant that the system was operated "by virtue of governmental action". Therefore, Japan considered that the price reduction under the Special Milk Classes Scheme was an export subsidy within the meaning of Article 9.1(c) of the Agreement on Agriculture, and accordingly had to be subject to reduction commitments under that Agreement.

5.25 Japan further noted that under Article 3.3 and Article 8 of the Agreement on Agriculture, Members were obliged not to provide export subsidies on agricultural products in excess of the budgetary outlay and the quantity commitment levels specified in their Schedule, and not to provide export subsidies "otherwise than in conformity with" the commitments in their Schedule. Japan noted that the volume of Canadian exports had exceeded the level of its export subsidy commitments under the Agreement on Agriculture in respect of most of the dairy product categories.[371] Hence, Japan claimed that the Canadian measure at issue, being an export subsidy provided for in Article 9.1(c), was not consistent with Article 3.3 and, accordingly, not consistent with Article 8 of the Agreement on Agriculture.

(b) By Operating the Special Milk Class System, Canada Circumvented or Threatened to Circumvent its Export Subsidy Commitments

5.26 Japan argued that even if the Panel were not to find that the Special Milk Classes Scheme provided an export subsidy within the meaning of Article 9.1(c) of the Agreement on Agriculture, Japan still believed that Canada's Special Milk Classes Scheme was inconsistent with Article 10.1 of the Agreement on Agriculture. Article 10.1 provided that the export subsidies not listed in Article 9.1 were not to be applied in a manner which resulted in, or threatened to lead to, circumvention of export subsidy commitments. If the Panel did not find the Scheme was an export subsidy as provided for in Article 9.1(c), Japan considered that the Scheme constituted an export subsidy within the meaning of Article 1(e) of the Agreement on Agriculture. This was because access to lower-priced milk under Class 5(d) was permitted exclusively for the purpose of processing dairy products for export and was "contingent upon export performance".

5.27 Under Class 5(d) of the Special Milk Classes Scheme, processors of dairy products benefitted from the price reduction instead of foregoing revenue by the provincial government agencies. Such price reduction, within the meaning of Article

[371] Japan noted that, for example, the volume of exports for butter in 1995/96 was 14,845 tonnes from Canada, the ceiling volume of which was 9,464 tonnes for the same period.

1(e), constituted a "subsidy", the interpretation of which was supported by the negotiating history on export subsidies.

5.28 Japan noted, in addition, that the apparent purpose of the Special Milk Classes Scheme was to avoid the consequences caused by the termination of the producer levy-based subsidies and to replace them with a system that would have precisely the same economic effect. In this regard, Japan believed that this system was "applied in a manner which results in, or which threatens to lead to, the circumvention of their export subsidy commitments" within the meaning of Article 10.1 of the Agreement on Agriculture.

(c) Canada was Requested to Bring the Measures at Issue into Conformity with the Agreement on Agriculture.

5.29 Japan argued that while it was understandable that the Government of Canada needed to establish certain domestic measures for a stable supply of dairy products through a sound development of dairy farming, the policy objectives in themselves could not justify the introduction of export subsidies which, in the case at issue, were highly trade-distortive and inconsistent with the Agreement on Agriculture.

5.30 Japan respectfully requested Canada to realize its domestic policy purposes through measures consistent with the WTO Agreement, and, also requested the Panel to recommend to the DSB that Canada bring its measure into conformity with its obligations under the Agreement on Agriculture.

VI. INTERIM REVIEW

6.1 On 5 February 1999, the Panel issued its interim report to the parties. On 18 February, Canada and the United States requested the Panel to review precise aspects of the interim report, in accordance with Article 15.2 of the DSU. New Zealand did not seek review of any aspect of the interim report. Neither of the three parties requested the Panel to hold a further meeting. We subsequently allowed the parties to comment on the comments we received on 18 February. On 26 February, all three parties submitted such comments.

6.2 Canada suggested that certain corrections and additions be made to the descriptive part of our report. The complainants did not object to these corrections and additions. Where appropriate, we redrafted the relevant sections accordingly. Canada also noted that Table 2 in paragraph 2.41 of our report contains confidential data. We deleted the relevant data from the last column of Table 2, inserted an appropriate footnote regarding the availability of this data in any appeal proceedings, and expressed the indications we derived from this column in paragraph 2.41. We kept the remaining columns in Table 2 since the data contained therein was already made public by Canada in its notifications under the Agreement on Agriculture.

6.3 On the basis of factual comments received by Canada we also redrafted paragraphs 7.54 and 7.59.

6.4 We incorporated certain US suggestions in the descriptive part of our report. Other suggestions had already been taken into account as a result of US comments on the descriptive part of our report. In the light, *inter alia*, of Canada's objections to

other US requests for review, we did not add language to paragraphs 7.10, 7.48 and 7.152 of our report.

6.5 The United States further suggested deleting the reference made in the interim report to the concept of "obiter dicta" in respect of our examination under Article 10 of the Agreement on Agriculture. We followed this suggestion (to which Canada did not object and with which New Zealand agreed) in order to clarify the matter. We stress, however, that our examination and findings under Article 10 are made in the alternative, i.e., in the event our findings under Article 9.1 should not be adopted and the DSB decides the dispute based on the alternative claims of violation of Article 10. Accordingly, we redrafted paragraphs 7.119, 7.136 and 8.1 and footnote 530

VII. FINDINGS

A. Claims of the Parties

1. The Special Milk Classes Scheme

7.1 New Zealand and the United States claim that the volume of Canadian exports of certain dairy products, under a scheme known as "Special Milk Classes", exceeds Canada's export subsidy commitments. Pursuant to this scheme, milk is classified into five Classes according to its end use and market destination. Classes 1 to 4 cover milk for use on the domestic market. Class 5 - the so-called "Special Class" - applies to milk intended for export as well as milk for use in products which face import competition in the domestic market. Class 5 is further subdivided into five sub-classes. Classes 5(d) and (e) apply exclusively to milk for use in exported products. Class 5(d) consists of the so-called "traditional planned exports". Class 5(e) covers milk that is to be exported for surplus removal purposes.[372]

7.2 Both complainants focus on Classes 5(d) and (e) of the Special Milk Classes Scheme.[373] They consider that these Classes in the context of Canada's supply and price management system constitute:

(a) an export subsidy in the sense of Article 9.1 of the Agreement on Agriculture which should be counted against Canada's export subsidy reduction commitments; or, in the alternative,

(b) an export subsidy not listed in Article 9.1 which is applied in a manner which results in, or threatens to lead to, circumvention of Canada's export subsidy commitments, contrary to Article 10.1 of the Agreement on Agriculture.

The complainants conclude that under both alternatives the scheme results in export subsidies granted contrary to the Agreement on Agriculture (in particular, Article 3.3, Article 8 and/or Article 10.1 thereof).

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[372] See paras. 2.38-2.40.

[373] New Zealand's claims only cover Classes 5(d) and (e). The United States, on the other hand, submits that subsidized exports are made under each of the Special Classes but - as it states in its answer to Panel Question 1 to the complainants - "places particular emphasis on the subsidized exports occurring as a result of the operation of Special Classes 5(d) and (e)". Below, the Panel also addresses Classes 5(a) to (c) which cover milk for domestic use as well as milk for export. See para. 7.41 and footnotes 453 and 496.

7.3 The United States further claims that, to the extent that the scheme is an export subsidy contrary to the Agreement on Agriculture, it also violates Article 3 of the Agreement on Subsidies and Countervailing Measures ("SCM Agreement") which prohibits export subsidies.

7.4 The dairy products in question are: butter, cheese and "other milk products". The relevant marketing years are: 1995/1996 and 1996/1997.[374] Both complainants also refer to marketing year 1997/1998 which ended on 31 July 1998 and for which data only became available - and was submitted to us - after our first substantive meeting. However, in doing so neither of the complainants explicitly incorporated this marketing year under its claims. Since, moreover, marketing year 1997/1998 only ended some four months *after* the establishment of this Panel (on 25 March 1998), we are not called upon to make findings in respect of that marketing year.[375]

7.5 In response Canada argues that the Special Milk Classes Scheme does not constitute an export subsidy either:

(a) in the general sense covered by the Agreement on Agriculture (in so doing Canada refers in particular to Article 1 of the SCM Agreement, arguing that the scheme is not a "subsidy" and can therefore *a priori* not be an "export subsidy"); or

(b) in the specific sense stipulated in any of the six sub-paragraphs of Article 9.1 or in Article 10.1 of the Agreement on Agriculture.

Canada submits that since the exports subject to this scheme are, therefore, not generated by export subsidies, they do not have to be counted against its scheduled reduction commitments, nor can they constitute a circumvention of these commitments in the sense of Article 10.1. Canada concludes, therefore, that the Special Milk Classes Scheme fully conforms to both the Agreement on Agriculture and to the SCM Agreement.

2. The Tariff-Rate Quota for Fluid Milk

7.6 The United States also claims that access to the tariff-rate quota for fluid milk - which Canada granted in the Uruguay Round negotiations - is being restricted contrary to Canada's obligations under Article II of GATT 1994 and Article 3 of the Agreement on Import Licensing Procedures. The restrictions referred to are as follows: (i) entries are only allowed for consumer packaged milk for personal use by Canadians; and (ii) entries are limited to those valued at less than C$20.

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[374] See Table 1 in para. 3.1 above. The US claims only cover marketing year 1996/1997 but this for all three products (US answer to Panel Question 2 to the complainants). The claims by New Zealand cover both marketing years 1995/1996 and 1996/1997 and this in both cases for all three products at issue, except that "other milk products" are not included for marketing year 1995/1996 (New Zealand answer to Panel Question 2 to the complainants).

[375] Our terms of reference, set out in document WT/DS103/5 and WT/DS113/5, only mandate us to "examine, in the light of the relevant provisions of the covered agreements cited by the United States in document WT/DS103/4 and by New Zealand in document WT/DS113/4, *the matters referred to the DSB respectively by the United States and New Zealand in these documents*" (emphases added). These documents, the requests for this Panel, were submitted to the DSB and incorporated in our terms of reference on 25 March 1998. The matters referred to therein, and thereby subjected to our review, do not include within their scope marketing year 1997/1998.

7.7 To this claim, Canada responds that in its Schedule it limited access to the tariff-rate quota to cross border imports of consumer packaged milk by Canadians for personal use. Canada claims that this is clear from the "terms and conditions" attached to this concession in its Schedule, as well as from the negotiating history that led to this concession.

3. Other Claims Raised in the Requests for this Panel

7.8 We note that the requests by the United States and New Zealand for the establishment of this Panel also alleged violations of Articles X, XI and XIII of GATT 1994. However, neither the United States nor New Zealand further pursued any of these claims during the Panel proceedings.

B. The Special Milk Classes Scheme

1. Summary of Claims and Arguments of the Parties

(a) New Zealand and the United States

7.9 New Zealand and the United States claim that under Classes 5(d) and (e), processors of dairy products for export are given access to milk at prices lower than those applying to milk for the manufacture of the same products for domestic consumption. In their view, this is done in order to remove surpluses of milk in a way that allows Canadian processors/exporters of dairy products to compete in export markets.

7.10 With respect to milk produced within the limits of the allocated producer quotas ("in-quota milk"), the Complainants argue that making milk available for use in exports at lower prices - under either Class 5(d) or (e) - can only be sustained because of the government's involvement, in particular the governmentally-imposed pooling of the relatively low returns from these exports with the higher returns obtained from milk sold for use on the domestic market. On these grounds, New Zealand and the United States submit that Classes 5(d) and (e) constitute an export subsidy whereby, as a result of extensive governmental involvement, *producers* are required to share the cost of selling milk at lower prices for export use and *processors/exporters* benefit from the cheaper milk made available to them to be competitive on export markets. In their view, the mechanism stimulates the removal of milk surpluses by way of exports.

7.11 In response to questions put to them by the Panel, the complainants clarified that their claims also cover exports generated under Class 5(e) from milk produced *in excess of* the allocated producer quotas ("over-quota milk"). This milk, as well, is sold for export at a lower price than the domestic milk price. However, as opposed to in-quota milk sold for export, the relatively low revenues from over-quota milk for export are generally *not* pooled with the higher revenues from milk used domestically. Nevertheless, for the complainants, the extent of federal and provincial governmental involvement in the arrangements under which milk is made available for export at lower prices - irrespective of whether the returns are pooled - suffices to conclude that the dairy products produced with over-quota milk are being exported with the help of export subsidies. According to the complainants, it is irrelevant for the processor producing for export - who can buy the milk at a cheaper price - whether the milk was produced in- or over-quota. The complainants submit that the

competitive benefit thereby granted to processors/exporters could not exist without the governmentally established and enforced Special Milk Classes Scheme and that this benefit thus constitutes an export subsidy.

(b) Canada

7.12 Canada argues that the Special Milk Classes Scheme is producer driven and not directed by the government. Canada submits that milk producers producing for export follow commercial considerations and react to world market signals, not to government directions. According to Canada, the government does play a role in the scheme but one that is limited and essentially responsive to the initiatives of the industry. For Canada, the government only has an oversight function to protect the public interest.

7.13 With respect to in-quota milk sold for export, Canada argues that producers are free to collectively determine whether and to what extent they wish to provide in-quota milk for export purposes. According to Canada, the lack of government control, direction or coercion in exporting milk at a lower price is even more apparent with respect to over-quota milk. Canada submits that any qualified dairy producer in Canada is free to produce as much milk as it chooses. Milk produced over-quota is sold for export at a price based on actual world prices. According to Canada, that is also the price the producer receives since the returns from over-quota milk are not pooled with higher domestic milk returns.

7.14 Canada further argues that under the Agreement on Agriculture it was required to replace earlier quantitative restrictions on imports of milk with tariffs. Under the former quantitative restrictions regime, Canada had an obligation to also impose domestic restrictions on the production of milk (in accordance with Article XI:2(c)(1) of GATT). Under the new regime, no such domestic restrictions are required. As a result, Canada was free to produce more, including milk for export. According to Canada, the fact that it imposes tariffs leads to higher domestic prices. For exports, however, lower prices have to prevail in order to compete on world markets. A system of sales at differing prices for domestic and export markets is the consequence. Upholding the complainants' claims would, according to Canada, mean that any such two-tiered system would constitute an export subsidy. This would, according to Canada, in effect mean that a Member imposing tariffs on imports of a product (e.g., milk) can no longer export that product (e.g., milk domestically produced) without being considered to be granting export subsidies.

2. The Panel's Decision of 16 December 1998

7.15 We submitted three sets of questions to the parties. The first set was submitted subsequent to our first substantive meeting; the second set after our second substantive meeting; and the third set after receipt of the answers to the second round of questions. We gave ample opportunity to each of the parties to comment on each others' answers.

7.16 After receipt of the US answers to our second set of questions, Canada raised an objection. In a letter dated 8 December 1998, Canada requested us to disregard US Exhibits 56 and 57 - containing data comparing milk prices under Classes 5(d) and (e) to milk equivalent prices under the Import for Re-Export Programme (Exhibit 56) and to so-called international prices for milk, butter and skim milk powder (Exhibit 57) - which had been submitted by the United States together with its answers to the second

round of Panel questions (in particular, Panel Questions 13 and 14 to the complainants[376]). Canada made this objection on three grounds. First, Canada argued, these Exhibits contain substantial new factual information that is not required to respond to the Panel's questions. Second, according to Canada, the Exhibits are not relevant to the Panel questions at hand. Third, Canada submitted, the figures have been developed using a highly suspect and very opaque methodology that resulted in some glaring inaccuracies in the numbers. In response, the United States, in a communication dated 14 December 1998, noted that its Exhibits 56 and 57 are directly responsive to the Panel's questions and that, even if the methodology used in these Exhibits were to be flawed, this would not be a basis to disregard the data; at most, the weight to be given to this evidence could be affected.

7.17 Paragraph 7 of our Working Procedures provides as follows:

> "Parties shall submit all factual evidence to the panel no later than during the first substantive meeting, except with respect to evidence necessary for purposes of rebuttal submissions or answers to questions. Exceptions to this procedure will be granted upon a showing of good cause. In such cases, the other party shall be accorded a period of time for comment, as appropriate".

In a letter sent to the parties on 16 December 1998 the Panel decided the following:

> "First of all the Panel would like to thank the parties for their considered and thorough replies to the Panel's questions, which have helped to clarify both the specific matters in respect of which questions have been raised as well as related issues before the Panel.
>
> In the Panel's view the data submitted by the United States is both relevant and responsive in the general context in which the Panel's questions were raised, including, in the case of question 13, the competitive relationship between the products in question.
>
> In these circumstances the Panel, whose responsibility or task it is to decide what ultimately is or is not relevant and material in this case, does not consider that it would be appropriate at this stage to exclude from consideration this or any other generally relevant information or data that has been submitted to it.
>
> However, the Panel notes the concerns expressed by Canada regarding the volume and complexity of the data submitted by the United States and in the circumstances extends to Canada an additional week (until

[376] Question 13 reads: "The Import for Re-Export Programme - a) Does the reference to 'products', within brackets, in the last part of Paragraph (d) of the Illustrative List, include 'like or directly competitive products'? - b) Do you consider that skim or whole milk powder are 'like or directly competitive' with fluid industrial milk?". Question 14 reads: "Please comment on Question 18 to Canada below". Question 18 to Canada reads: "If sales of products under special class 5(e) are to be competitive in world markets, the price at which products derived from out of quota milk are made available to exporters will have to be below market prices, in order for the transactions to be commercially viable from the exporters' point of view. Is there a risk or threat of such prices for particular transactions being below world market prices? Please comment in detail on this matter taking into account your replies to question 17 above. New Zealand and the United States are also invited to comment on this matter".

23 December) to provide the Panel with more extensive or additional comments on the United States replies than was possible within the previously established time limits".

3. The Agreements Referred to and the Sequence in which the Panel will Address the Claims

(a) The Agreement on Agriculture and the SCM Agreement

7.18 Both complainants invoke the Agreement on Agriculture. Article 2 of this agreement provides that it applies to the agricultural products listed in Annex I. The "agricultural products" set out in Annex I include the products at issue in this dispute (butter, cheese and "other milk products"), all of which fall under HS Chapter 4. We thus find that the Agreement on Agriculture applies to the issue at hand.

7.19 The United States also invokes Article 3 of the SCM Agreement, which contains, *inter alia*, a general prohibition on export subsidies. However, according to its own terms, Article 3 of the SCM Agreement is qualified in its application to agricultural export subsidies by the provisions of the Agreement on Agriculture. Article 3.1 provides as follows:

> "Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited ...".

In this respect, Article 21 of the Agreement on Agriculture also provides that:

> "[t]he provisions of GATT 1994 and of other Multilateral Trade Agreements in Annex 1A to the WTO Agreement [including the SCM Agreement] shall apply subject to the provisions of this Agreement".

7.20 The general position under the Agreement on Agriculture is that a Member is permitted to use export subsidies but only within the limits of the budgetary outlay and quantity commitment levels, if any, that are specified in that Member's WTO Schedule. The use of agricultural export subsidies beyond such scheduled limits is in effect prohibited by Article 3.3, Article 8 and Article 10 of the Agreement on Agriculture.

7.21 The use of export subsidies beyond such scheduled limits is, in principle, also actionable under the prohibition in Article 3 of the SCM Agreement. However, by virtue of Article 13 (c) (i) of the Agreement on Agriculture, export subsidies that conform fully to Part V of the Agreement on Agriculture are exempt from actions based on Article 3 of the SCM Agreement for the duration of the "implementation period" (*in casu*, up to 31 December 2003).

7.22 Accordingly, our conclusion with respect to whether the Special Milk Classes Scheme constitutes an export subsidy within the meaning of the Agreement on Agriculture that fully conforms with Part V of that Agreement (which includes Articles 8 to 11 as well as, by reference, Article 3.3), may be dispositive of the US claim for breach of Article 3 of the SCM Agreement.

7.23 On these grounds[377], the Panel will first examine the claims made under the Agreement on Agriculture. At the same time we note that the parties do not disagree that the SCM Agreement is important to the contextual interpretation of the provisions of the Agreement on Agriculture dealing with export subsidies. As stated by the Appellate Body in its report on *Brazil - Measures Affecting Desiccated Coconut*:

> "[W]ith respect to subsidies on agricultural products ... [t]he *Agreement on Agriculture* and the *SCM Agreement* reflect the latest statement of WTO Members as to their rights and obligations concerning agricultural subsidies".[378]

(b) The Agreement on Agriculture

(i) General Outline

7.24 As this is the first case brought before a panel which involves the substantive provisions of the Agreement on Agriculture relating to export subsidies, we consider it appropriate to provide an outline of these provisions. They form part of the context within which the specific provisions invoked by the complainants and the related claims must be addressed. They also reflect the object and purpose of the Agreement on Agriculture, another element we need to take into account when examining the issues before us.[379]

7.25 As enunciated in the preamble to the Agreement on Agriculture, the main purpose of the Agreement is to "establish a basis for initiating a process of reform of trade in agriculture"[380] in line with, *inter alia*, the long-term objective of establishing "a fair and market-oriented agricultural trading system".[381] This objective is pursued in order "to provide for substantial progressive reductions in agricultural support and protection sustained over an agreed period of time, resulting in correcting and preventing restrictions and distortions in world agricultural markets".[382]

7.26 The general aim of the Uruguay Round negotiations on agriculture was to "achieve greater liberalization of trade in agriculture and bring all measures affecting import access and export competition under strengthened and more operationally effective GATT rules and disciplines".[383] In the case of export competition this was to be achieved by "improving the competitive environment by increasing discipline on the use of all direct and indirect subsidies and other measures affecting directly or indirectly agricultural trade, including the phased reduction of their negative effects and dealing with their causes".[384] The results of these negotiations take the form of: (i) the specific binding reduction commitments on both export subsidies and domestic support which have been incorporated in Members' Schedules pursuant to Article

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[377] See paras. 7.19-7.22.
[378] Appellate Body Report on *Brazil - Desiccated Coconut*, *op. cit.*, p. 14, DSR 1997, 97.
[379] In accordance with the principles of treaty interpretation contained in the Vienna Convention on the Law of Treaties (Article 31).
[380] Preambular paragraph 1.
[381] Preambular paragraph 2.
[382] Preambular paragraph 3.
[383] Punta del Este Declaration, Ministerial Declaration on the Uruguay Round, MIN.DEC, 20 September 1986, p. 6.
[384] *Ibid.*

3.1 of the Agreement on Agriculture as constituting "commitments limiting subsidization"; and (ii) the rules set out in the Agreement on Agriculture itself, which are designed to protect the scheduled commitments and provide a new framework to govern the use of agricultural export subsidies and domestic support.

7.27 The fundamental general provision of the Agreement on Agriculture concerning export subsidies is Article 8:

> "Each Member undertakes not to provide export subsidies otherwise than in conformity with this Agreement and with the commitments as specified in that Member's Schedule".

Article 1(e) of the Agreement defines the term "export subsidies" ("unless the context otherwise requires") as referring to: "subsidies contingent upon export performance, including the export subsidies listed in Article 9 of this Agreement". This listing of export subsidies and the related base period for subsidized export quantities and budgetary outlays served as the basis for the establishment of the scheduled Uruguay Round reduction commitments. Under Article 9.1 the following export subsidies are subject to reduction commitments under the Agreement:

> "(a) the provision by governments or their agencies of direct subsidies, including payments-in-kind, to a firm, to an industry, to producers of an agricultural product, to a cooperative or other association of such producers, or to a marketing board, contingent on export performance;
>
> (b) the sale or disposal for export by governments or their agencies of non-commercial stocks of agricultural products at a price lower than the comparable price charged for the like product to buyers in the domestic market;
>
> (c) payments on the export of an agricultural product that are financed by virtue of governmental action, whether or not a charge on the public account is involved, including payments that are financed from the proceeds of a levy imposed on the agricultural product concerned or on an agricultural product from which the exported product is derived;
>
> (d) the provision of subsidies to reduce the costs of marketing exports of agricultural products (other than widely available export promotion and advisory services) including handling, upgrading and other processing costs, and the costs of international transport and freight;
>
> (e) internal transport and freight charges on export shipments, provided or mandated by governments, on terms more favourable than for domestic shipments;
>
> (f) subsidies on agricultural products contingent on their incorporation in exported products".

7.28 By virtue of Article 3.3 of the Agreement, the list in Article 9.1 lays the foundation for the core rules of the Agreement relating to export subsidies. Article 3.3 provides:

> "Subject to the provisions of paragraphs 2(b) and 4 of Article 9, a Member shall not provide export subsidies listed in paragraph 1 of

> Article 9 in respect of the agricultural products or groups of products specified in Section II of Part IV of its Schedule in excess of the budgetary outlay and quantity commitment levels specified therein and shall not provide such subsidies in respect of any agricultural product not specified in that Section of its Schedule".

7.29 The Article 3.3 prohibition relates exclusively to the export subsidies listed in Article 9.1. All other subsidies contingent upon export performance as defined in Article 1(e) of the Agreement are subject to the provisions of Article 10 relating to the prevention of circumvention of export subsidy commitments. Article 10.1 provides as follows:

> "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".

Thus, a Member may use export subsidies not listed in Article 9.1 within the limits of its scheduled reduction commitments. However, as stipulated by Article 10.1, such subsidies may not be applied so as to circumvent these and other export subsidy commitments under the Agreement on Agriculture.

(ii) The Specific Provisions Relied upon by the Parties

7.30 Both complainants invoke Articles 3.3, 8, 9.1 and 10 of the Agreement on Agriculture, quoted above.

7.31 Since Article 9.1 sets out the explicit reduction commitments entered into by Canada, as opposed to Article 10 which deals with circumvention of those commitments, we shall first examine whether the Special Milk Classes Scheme involves an export subsidy listed in Article 9.1. Both complainants also first address Article 9.1. We prefer this sequence to Canada's approach of first examining whether the scheme is a "subsidy" more generally with particular reference to the SCM Agreement. What needs to be examined here in the first place is whether an "export subsidy" is provided for quantities of exports of agricultural products in excess of the reduction commitments made by Canada under the Agreement on Agriculture. In our view, the most specific and appropriate language provided to make this determination is found in Article 9.1 of the Agreement on Agriculture - setting out specific practices as "export subsidies" explicitly made subject to Canada's reduction commitments -; not in Article 1 of the SCM Agreement pursuant to which certain practices are deemed to be a "subsidy" for purposes of the SCM Agreement.

4. Burden of Proof as a Consequence of Article 10.3 of the Agreement on Agriculture

7.32 We note, prior to our analysis of Article 9.1, that Article 10.3 provides as follows:

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

7.33 This provision shifts the burden of proof from the complainant to the defendant. A defending party (i.e., the exporting country) alleging that exports in excess of its reduction commitment level are not subsidized must demonstrate that no export subsidy in respect of this excess has been granted. All parties in dispute agree that the wording of Article 10.3 has this effect of reversing the usual burden of proof.[385]

7.34 In this dispute, all parties agree that the actual exports of butter, cheese and "other milk products" made by Canada, exceed Canada's reduction commitment levels and this for both marketing years at issue (1995/1996 and 1996/1997).[386] Canada claims that these quantities exported in excess of its reduction commitment levels are *not* subsidized. It is thus for Canada to establish that the quantity of exports exceeding its commitment levels has *not* been made subject to "export subsidies". In other words, for purposes of the claims before us, it is for Canada to present evidence sufficient to establish a presumption that the Special Milk Classes Scheme does *not* involve an "export subsidy, whether listed in Article 9 or not". Once such presumption is established, it is for New Zealand and the United States to present evidence to rebut this presumption.[387] New Zealand and the United States responded *in extenso* to the claim that the export quantities in question are not subject to export subsidies. Thus, our task is essentially to weigh the evidence and determine whether Canada has met the burden imposed by Article 10.3.

5. Article 9.1(a) of the Agreement on Agriculture

7.35 The complainants rely on Article 9.1(a) and (c). Both provisions define a type of export subsidy that is subject to Canada's reduction commitments. The parties do not disagree that there may be some degree of overlap between various subparagraphs of Article 9.1. The complainants submit that the provision of milk under Classes 5(d) and (e) of the Special Milk Classes Scheme involves export subsidies under both Article 9.1(a) and Article 9.1(c).

7.36 We first examine whether there is an Article 9.1(a) export subsidy at issue. Article 9.1(a) subjects the following type of action to Canada's export subsidy reduction commitments:

> "the provision by governments or their agencies of direct subsidies, including payments-in-kind, to a firm, to an industry, to producers of an agricultural product, to a cooperative or other association of such producers, or to a marketing board, contingent on export performance".

7.37 The complainants submit that in this case Canadian government agencies - in particular, the Canadian Dairy Commission ("the CDC") and the provincial milk marketing boards acting under delegated authority - make milk available to processors/exporters under Classes 5(d) and (e) at prices lower than the prevailing domestic milk price. In their view, this constitutes an export subsidy under Article 9.1(a).

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[385] See, in particular, Canada's answer to Panel Question 14 to Canada.

[386] See Table 2 in para. 2.41 above.

[387] See Appellate Body report on *United States - Measures Affecting Imports of Woven Wool Shirts and Blouses from India*, adopted on 23 May 1997, WT/DS33/AB/R, DSR 1997:I, 323.

7.38 Under Article 9.1(a), an export subsidy exists if the following conditions are fulfilled:

(a) the presence of "direct subsidies, including payments-in-kind";

(b) provided "by governments or their agencies";

(c) "to a firm, to an industry, to producers of an agricultural product, to a cooperative or other association of such producers, or to a marketing board"; and

(d) which are "contingent on export performance".

7.39 The record shows that milk is made available to *processors/exporters* under Classes 5(d) and (e). We consider that Article 9.1(a) applies to processors and exporters as either "a firm", "an industry" or "producers of agricultural products". We note that no party argued that producers or exporters were to be excluded from the application of Article 9.1(a). We thus find that the third condition under Article 9.1(a) is met in the instant case.

7.40 The record also shows, and Canada does not argue otherwise, that lower priced milk under Classes 5(d) and (e) is only available to processors for the processing of *dairy products which will be exported*. Accordingly, access to milk at a discounted price under Classes 5(d) and (e) is "contingent on export performance" in the sense of the fourth condition under Article 9.1(a). Milk for the production of *dairy products to be sold on the Canadian market* is only available at a higher price under one of the other milk classes (Classes 1 to 5, excluding 5(d) and (e)). A processor that buys milk under Classes (d) or (e), but subsequently uses the milk for domestic purposes, has to pay the price differential up to the level of the domestic milk price, plus interest calculated on the price differential starting from the time of transaction to the date of payment.[388]

7.41 The United States also makes claims under milk classes other than Classes 5(d) and (e). In this regard, we note that milk under such other classes is also available (often exclusively) to processors which produce for the domestic market. Accordingly, access to milk under such other classes is not "contingent on export performance". We therefore find that such other milk classes do not involve an export subsidy under Article 9.1(a).

7.42 The question is then whether the availability of milk under Classes 5(d) and (e) also meets the first and second conditions of Article 9.1(a): (i) does it provide "direct subsidies, including payments-in-kind"; and (ii) are such direct subsidies provided "by governments or their agencies"?

(a) "direct subsidies, including payments-in-kind"

(i) General Criteria

7.43 The plain language of Article 9.1(a) makes clear that "payments-in-kind" are a form of direct subsidy. Hence, a determination in the instant matter that "payments-in-kind" exist would also be a determination of the existence of a direct subsidy.

7.44 We first note that, when referring to subsidies (as Article 9.1(a) does), the ordinary meaning of the term "payment" cannot reasonably relate to a "payment" as the term

[388] See Canada's answer to Panel Question 23 to Canada. In Quebec, the processor will also have to pay a penalty of $12/hL.

is understood in contract law (e.g., pay for labour or the price of a good). Rather, it connotes a gratuitous act, a bounty or benefit provided, for example, in pursuit of a policy objective (e.g., in the area of export subsidies, the stimulation of exports to dispose of surpluses in the domestic market). A reading of Article 9.1(a) to the effect that a "payment" exists only if a benefit is granted, is further mandated by the general context of this provision which includes Article 1 of the SCM Agreement.[389] That provision explicitly requires that a "benefit" be conferred for there to be a "subsidy" under the SCM Agreement.[390]

7.45 Secondly, the term "payments-in-kind" in Article 9.1(a) must be ordinarily construed to include payment in goods or labour as opposed to payment of money.[391] We agree with the complainants that both the provision of a good at no price and the provision of a good at a price lower than the normal price (whatever this normal price may be) can be considered as a payment in kind.

(ii) Milk Sales under Special Milk Classes 5(d) and (e): the Provision of Milk for the Processing of Dairy Products for Export at a Lower Price

7.46 In the present case, no money is given gratuitously to processors/exporters. However, the complainants submit that under the Special Milk Classes Scheme processors/exporters receive a payment in kind, namely *milk at a price which is lower than that of milk sold for use on the domestic market* .

7.47 We noted above that a benefit must be conferred for a payment in kind to exist in the sense of Article 9.1(a).[392] In this case, the question thus arises whether the provision of milk to processors/exporters under Classes 5(d) or (e) confers a benefit to these processors/exporters. This, in turn, raises the question of what the appropriate benchmark is for determining whether the provision of a good at a certain price confers a benefit.[393] Does it suffice, as the complainants argue, that milk for export use is provided to processors at a price below the *domestic milk price* for there to be a benefit conferred to these processors (hereafter referred to as "the first benchmark", namely the domestic milk price)? Or, does one need to establish that processors/exporters receive milk under Classes 5(d) and (e) at a price which is not only lower than the domestic milk price, but also lower than the price of milk these processors/exporters can obtain from any other source, in particular the price of milk they can source from the world

[389] See para. 7.23.

[390] Article 1.1(b) of the SCM Agreement provides: "For the purpose of this Agreement, a subsidy shall be deemed to exist if: ... (b) a benefit is thereby conferred".

[391] The *New Shorter Oxford English Dictionary* defines "in kind" as "in goods or labour as opp. to money; (b) in a similar form, likewise" (Ed. Brown, L., Clarendon Press, Oxford, Volume 1, p. 1489).

[392] See para. 7.44.

[393] We note, in this respect, that Article 1.1(b) of the SCM Agreement - to which we referred when noting the requirement of a "benefit" being conferred in paragraph 7.44 above - only requires that there be a benefit in the general sense and that the benefit in fact be conferred by the measure or arrangement which is alleged to be a subsidy.

market (hereafter referred to as "the second benchmark", namely the lowest milk price to be obtained from any other source)?

7.48 If milk were provided below the lowest milk price to be obtained from any other source (i.e., below the second benchmark), it would *a fortiori* be provided below the domestic milk price (i.e., below the first benchmark). In other words, if we were to find that milk is provided below the second benchmark, there would be no need to further examine whether it is also provided below the first benchmark. Without making a finding on the issue of the appropriate benchmark we shall, therefore, in the first instance, proceed on the assumption that the second benchmark, although more favourable to Canada, is appropriate in the circumstances. In our view, if the price of milk under Classes 5(d) and (e) is lower than the price at which processors/exporters can obtain milk from any other source, a bounty or benefit - i.e., something they would otherwise not have obtained - would, indeed, be conferred. If this were the case, we consider that processors/exporters would be receiving "payments-in-kind" in the sense of Article 9.1(a).

7.49 We therefore next examine whether processors/exporters can access milk from any other source on terms and conditions, in particular prices, as favourable as those offered under Classes 5(d) and (e).

7.50 We note, first, that under Classes 5(d) and (e) milk is made available to processors for export at a significantly lower price than the price of milk *for domestic use*.[394] Canada does not contest this. Classes 5(d) and (e) thus make available milk at prices that are clearly below the first benchmark we referred to above.[395] Moreover, referring to the second benchmark, it is not disputed that sourcing milk from any of the other milk classes for use mainly on the domestic market (Classes 1 to 5(c)) would not offer processors/exporters the same favourable price as that of milk available under Classes 5(d) or (e).[396]

7.51 Second, given the high tariffs applied by Canada to imports of fluid milk[397] (283.8 per cent, declining to 241.3 per cent in 2001), the price of milk under Classes 5(d) and (e) is not only significantly lower than the domestic milk price, it is also significantly lower than the duty paid price of imported fluid milk. Canada does not dispute this nor does it contest that for all intents and purposes the over-quota tariff rate it imposes on imports of fluid milk effectively precludes such imports. For purposes of the second benchmark, importing fluid milk cannot therefore be considered as a source of milk at the same favourable price as that of milk offered under Classes 5(d) or (e).

7.52 Canada submits that processors for export can access their milk inputs on equally favourable terms and conditions as those under Classes 5(d) and (e) under its special Import for Re-Export Programme.[398] With respect to imports of fluid milk under this Programme Canada acknowledges that "there have not been imports of raw indus-

[394] See Table 3 in para. 2.51.
[395] See para. 7.47.
[396] See Table 3 in para. 2.51.
[397] Other than the fluid milk falling under the 64,500 tonnes tariff-rate quota which Canada restricts to cross border imports by Canadians of consumer packaged milk for personal use, valued at less than C$20 per entry.
[398] See para. 2.11.

trial milk in recent years under the Import for Re-Export Programme".[399] Canada argues, however, that under the Import for Re-Export Programme processors/exporters can nonetheless import milk derivatives, such as skim milk powder, whole milk powder, butter and butter derivatives. According to Canada, these milk components are not different from milk, but part of the same product and can be used for the same manufacturing processes as milk.

7.53 We note that under the Import for Re-Export Programme the decision as to whether fluid milk or milk derivatives may enter the Canadian market depends, first and foremost, on the discretionary authority of the Department of Foreign Affairs and International Trade. The statutory authority for the Programme is contained in paragraph 8 of the Export and Import Permits Act. Paragraph 8 (1) allows the Minister responsible for the Act to "issue to any resident of Canada applying therefor a permit to import goods included in an Import Control List, in such quantity and of such quality, by such persons, from such places or persons and *subject to such other terms and conditions as are described in the permit or in the regulations*".[400] Canada states that the authority of the Minister to set these terms and conditions is not subject to any specified regulations. Therefore - even if imports of fluid milk and milk derivatives under the Import for Re-Export Programme could in theory be made at an equally favourable price to the one offered under Classes 5(d) and (e) - the fact that the Minister has to issue a permit before such imports are allowed and that the Minister disposes of a wide discretion in doing so, is proof that these imports are not effectively available under equally favourable terms and conditions as those offered under Classes 5(d) and (e). After all, whether or not processors for export access fluid milk or milk derivatives under this Programme depends, in the first place, not on commercial considerations (i.e., price), but on the discretion of Canadian authorities.

7.54 We further note that processors for export have so far never accessed *fluid milk* for commercial use under this Programme.[401] Canada argues that no such imports of fluid milk are made due to commercial reasons, namely, the high costs of transport of fluid milk. Canada also refers to the fact that fluid milk is of a perishable nature and thus of limited tradability. We note, however, that fluid milk could be imported from the United States (given its proximity to Canada). In view of the US claim before this Panel to have wider access to the Canadian market for fluid milk (under Canada's tariff-rate quota)[402], one can assume that imports of fluid milk are, in principle, technically and commercially viable. Nonetheless, under the Import for Re-Export Programme no such imports are made. In our view, this indicates that the specific sales terms and conditions under the Programme are clearly not commercially attractive relative to those offered under Classes 5(d) or (e).

7.55 In addition, with respect to access to *milk derivatives* under the Import for Re-Export Programme, we note the Complainants' arguments that there are inherent differences between fluid milk - available under Classes 5(d) and (e) - and milk derivatives

[399] Canada's oral statement at the second substantive meeting, para. 74. In its comments on US Exhibit 56, Canada clarified that "much of the fluid milk imported under the Import for Re-export Programme is imported in retail packages for use on cruise ships".

[400] Emphasis added.

[401] See para. 7.52 and footnote 399.

[402] See paras. 7.142 ff.

which can be imported under the Programme. Skim milk powder, for example, does not contain any butterfat, thus requiring additional processing for its use in certain dairy products. Because fluid milk contains butterfat it is not subject to a similar constraint. Whole milk powder, on the other hand, does contain butterfat but since all liquid has been removed from it, for most end-uses it has to be rehydrated before it can be used. The same constraint applies to skim milk powder, but not to fluid milk. In both instances, additional time and cost are involved when using milk powder as an input rather than fluid milk. The United States further submits that the use of milk powder might also alter the flavour of the finished product from that which would be obtained by using fluid milk. Canada seems to acknowledge some of these elements when it states that "milk powders can be reconstituted for use in the manufacture of *some* dairy products … Thus, *to a certain extent*, milk powders compete in the same markets and fulfil the same needs and uses as fluid industrial milk".[403]

7.56 In our view, even if such milk derivatives were directly competitive with fluid milk, we note that (i) figures submitted by the United States indicate - albeit in general terms only - that the milk equivalent prices for the milk derivatives imported under the Import for Re-Export Programme were, over the last four years, *higher* than the price of fluid milk provided under Classes 5(d) and (e)[404]; and (ii) processors for export have revealed an overwhelming preference for Classes 5(d) and (e) milk, as opposed to sourcing inputs from the Programme (exports generated with Classes 5(d) and (e) milk account for approximately 95 per cent of total actual exports).[405] Indeed, in our view, the fact that fluid milk and milk derivatives surplus to Canadian domestic requirements are regularly disposed of (without accumulation of stocks) raises a presumption that the terms and conditions available under Classes 5(d) and (e) are more favourable than those under the Import for Re-Export Programme. The elements outlined above indicate that milk derivatives cannot, for all practical purposes, be sourced under the Programme on equally favourable terms and conditions as those under Classes 5(d) or (e).

7.57 For the above reasons[406], we find that Canada, in relation to Classes 5(d) and (e), has *not* met its burden[407] of establishing that the Import for Re-Export Programme provides processors for export with access to milk - or even milk derivatives for that matter - on equally favourable terms and conditions as those available under Classes 5(d) or (e).

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[403] Canada's answer to Panel Question 28(f) to Canada, emphasis added.

[404] See US Exhibit 56. In our decision of 16 December 1998, outlined above in para. 7.17, we decided that we can take cognizance of the figures contained in this Exhibit. We carefully considered Canada's objections to these figures set out in Canada's comments of 23 December 1998. Although these figures seem to include certain inaccuracies and can therefore only provide a general indication, we do not consider that Canada's objections are so serious that no weight at all should be attached to Exhibit 56. We note, moreover, that Canada did not provide figures or indications to effectively rebut the general tendency shown by the US figures. Moreover, in the view of the Panel, the fact that some of the data supplied by Canada on exports under the Import for Re-Export Programme related to imports and re-exports of dairy products by visiting cruise ships, casts doubt on the relevance of this data and of the Programme itself.

[405] See Canada's answers to Panel Questions 1 and 3(b) to Canada.

[406] See paras. 7.52-7.56.

[407] See para. 7.34.

7.58 More generally - and for all the reasons outlined above[408] - we find that the provision of milk to processors/exporters under Classes 5(d) and (e) at a price significantly lower than the domestic milk price (i.e., below the first benchmark) and on terms and conditions which are more favourable than those under any other alternative source, including under the Import for Re-Export Programme (i.e., below the second benchmark) - confers a "benefit" (in terms of both the first and second benchmarks we set out earlier[409]) to these processors/exporters and, for that reason, constitutes a payment in kind - namely, the provision of a good at a discounted price - in the sense of Article 9.1(a).

(iii) Milk Sales under Special Milk Classes 5(d) and (e): the Provision of Milk for the Processing of Dairy Products for Export by the CDC with an Assured Margin for the Processor

7.59 In addition to milk being offered at a discounted price otherwise not available, we note that with respect to the export sales conducted by the CDC itself - for which the CDC engages a processor to make dairy products with milk sourced under Classes 5(d) or (e) - there is another element which indicates that processors for export receive special treatment (i.e., a benefit) under Classes 5(d) and (e) which is otherwise not granted on commercial grounds. That is, no matter how low the world price is for the dairy product that a processor is requested to produce - and thus no matter how low the milk price should be in order for the processor to be able to produce the dairy product at such a low price - a Canadian processor for export is always sure to obtain a certain "margin".[410] This processor "margin" covers the cost of transforming milk into, e.g., butter or skim milk powder, and a return on investment for the processors.[411] This margin ensures that, in respect of exports by the CDC, processors are able to access milk at a price which enables the CDC to sell the processed dairy products on the world market at a competitive price. But for the Special Milk Classes Scheme, this guarantee offered to processors/exporters would not be commercially available.

7.60 In our view, this assured processor margin for certain exports generated with milk sourced under Classes 5(d) and (e) confirms the finding we made in paragraph 7.58, namely that the provision of milk to processors/exporters under Classes 5(d) and (e) on the reported favourable terms and conditions confers a benefit to these processors/exporters and, for that reason, constitutes a payment in kind in the sense of Article 9.1(a).

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[408] See paras. 7.53-7.56.

[409] See para. 7.47.

[410] See Section 1 (vii) and 2 (v) of Annex B to the Comprehensive Agreement on Special Class Pooling stating, respectively, "the processor will receive a reduced margin" and "[p]rocessors will receive full margin for the product sold".

[411] See Canadian International Trade Tribunal, Profile of the Canadian Dairy Industry, Staff Report, reference No. GC-97-001, New Zealand Exhibit 8, p. 36.

(iv) Concluding Remarks on the Payment in Kind Offered to Processors/Exporters

7.61 But for Classes 5(d) and (e), processors for export under the current Canadian milk regime would have to pay a significantly higher price for milk. By accessing this milk, these processors/exporters are effectively shielded from the high domestic milk price, the high import tariffs on fluid milk and - at least in respect of those exports made by the CDC itself - the risk of having to sell dairy products for sale on the world market at a reduced margin or at a loss.

7.62 We want to stress, however, that the existence of this "payment in kind" to processors does not in and of itself establish the existence of an export subsidy within the meaning of Article 9.1(a). In our view, in particular the existence of parallel markets for domestic use and for export with different prices does not necessarily constitute an export subsidy.[412] Whether or not the "payments-in-kind" to processors in this dispute constitute an export subsidy depends on the government's involvement in providing it.[413] This relates to the second condition under Article 9.1(a).

(b) Provided "by governments or their agencies"

7.63 Under this condition, we need to examine whether the milk made available to processors for export at a discounted price under Classes 5(d) and (e) - which we found earlier to constitute a payment in kind - is provided by the Canadian governments or their agencies.

(i) The Provision of Milk under Classes 5(d) and (e) is not Financed by Governmental Funds

[412] The price differential may, for example, be a consequence of high - but WTO consistent - import tariffs that can cause domestic prices to be higher than the world market price. In such scenario, efficient producers may take the decision - based on their own profitability - to also produce and sell milk for export, albeit at a lower price than the domestic price. If the decision to sell in either the domestic market or the export market is one made by the individual producer and based on commercial grounds only (e.g., on an allocation of sales to the two markets with a view to obtaining a maximised total revenue, taking into account the inherently limited domestic demand for milk and the lower price for export) - not a decision by the government or its agencies taken on behalf of the producers - such scenario would, in our view, not appear to be an export subsidy in the sense of Article 9.1.

[413] In this respect, we note the Panel Report on *Review Pursuant to Article XVI:5* (of GATT 1947), addressing the question of when subsidies are notifiable under Article XVI of GATT. There, the Panel stated the following:

> "The Panel examined the question whether subsidies financed by a non-governmental levy were notifiable under Article XVI. The GATT does not concern itself with such action by private persons acting independently of their governments except insofar as it allows importing countries to take action under other provisions of the Agreement. In general terms there was no obligation to notify schemes in which a group of producers voluntarily taxed themselves in order to subsidize exports of a product ... the Panel feels that the question of notifying levy/subsidy arrangements depends upon the source of the funds and the extent of government action, if any, in their collection. Therefore ... the Panel feels that CONTRACTING PARTIES should ask governments to notify all levy/subsidy schemes affecting imports or exports which are dependent for their enforcement on some form of government action" (adopted 24 May 1960, BISD9/188, p. 192).

but by Milk Producers Either Collectively (in-quota) or Individually (over-quota)

7.64 All parties agree that under Classes 5(d) and (e) no governmental funds are directly involved.[414] Neither the Canadian government nor its agencies buy milk at the high domestic price to sell it subsequently, at a loss, at a lower price for export, whereby the cost would be covered by governmental funds. It is undisputed that only the milk producers finance the sales of milk for export. For milk produced within a producer's quota and subsequently exported, the price differential between the price for export and the higher domestic price is collectively borne by all Canadian milk producers. This is so because all in-quota export revenues are pooled with all other in-quota milk returns. This pooling results in an average or pooled milk price - lower than the domestic price - which is the same for all in-quota milk produced by a given producer. Any milk produced over-quota necessarily obtains the lower price for export. However, in principle, only the individual producer who produces the over-quota milk bears the cost of such lower returns. This is so because returns of over-quota milk by one producer are generally not pooled with in-quota returns obtained by other producers.[415]

7.65 In our view, the fact that the government does not grant governmental funds to *finance* the payment in kind does not prevent this payment in kind from being *provided* by the government or its agencies in the sense of Article 9.1(a). The ordinary meaning of the word "provide" is not restricted to a financial contribution. The dictionary meaning of the word "provide" is rather:

> "1. foresee. 2. take appropriate measures in view of a possible event; make adequate preparation ... 4. prepare, get ready, or arrange (something beforehand) 5. equip or fit out with what is necessary for a certain purpose; furnish or supply with something 6. ... make available; yield, afford".[416]

(ii) The Degree of Government Involvement Required for there to be a "provision by governments or their agencies" under Article 9.1(a)

7.66 Canada does not argue that governments are not involved in providing milk under Classes 5(d) and (e). Rather, its position is that governments only have an implementing and oversight role to play in the establishment and efficient operation of the system. According to Canada, such government intervention does not approach the level required by Article 9.1(a). The complainants contend that the system would not exist without governmental intervention and that none of the provisions at issue requires that governments dictate every aspect of a measure for an export subsidy to exist. The

[414] In any event, the complainants did not contest the extent to which the full costs associated with the administration of the scheme for exporting milk surplus to Canadian domestic requirements, are effectively recovered by the CDC and the provincial governments or agencies.

[415] See, however, para. 7.112.

[416] The *New Shorter Oxford English Dictionary*, Ed. Brown, L., Clarendon Press, Oxford, Volume 2, p. 2392.

complainants conclude that in this case the government involvement in the Special Milk Classes Scheme does meet the level required by Article 9.1(a).

7.67 The question of government involvement required under Article 9.1(a) is one of degree that must be addressed on a case-by-case basis. In this dispute, we need to examine first how milk is made available under Classes 5(d) and (e). Thereafter, we need to assess the extent to which Canadian governments or their agencies are involved in this process. On that basis - and applying the ordinary meaning of the term "provision by governments or their agencies" referred to above[417], in its context and in light of the object and purpose of the Agreement on Agriculture[418] - we will then decide whether or not the payment in kind made under Classes 5(d) and (e) can be said to be provided by Canada's governments or their agencies.

(iii) How Milk for Export is Made Available under Classes 5(d) and (e)

Sales of Milk for Export under Class 5(d)

7.68 Class 5(d) covers so-called "traditional" export sales. These traditional sales - which are calculated into the national quota and thus constitute in-quota milk - are linked to certain trade opportunities, such as tariff-rate quotas of third countries that are traditionally made available to Canadian exporters, as well as sales arising out of longer term trading relationships. The volume of Class 5(d) is a set amount annually fixed by the Canadian Milk Supply Management Committee ("the CMSMC").

7.69 Exporters with access to these traditional markets approach the Canadian Dairy Commission ("the CDC") with proposals to purchase milk under Class 5(d). The CDC negotiates the transaction, including the milk price, and issues a permit which will allow the exporter to obtain the required milk for use in the planned exports from one of the provincial marketing boards. The permits issued by the CDC under Class 5(d) specify the dairy products to be exported.

Sales of Milk for Export under Class 5(e)

7.70 Both in-quota milk - mainly the so-called "sleeve" or safety margin which is finally not used in domestic markets[419] - and over-quota milk can be exported under Class 5(e). The removal of surplus milk by means of exports under Class 5(e) is composed of two operational elements: a CDC-initiated and a processor-initiated surplus removal element.

7.71 A first possibility is that the CDC itself initiates "preemptive surplus removal". In doing so, it "will be guided by an advisory group established by the CDC for that purpose".[420] This advisory group, the Surplus Removal Committee ("SRC"), decides whether surplus milk is available in the system. If so, the CDC can activate the preemptive surplus removal programme. To do so, the CDC does not have to seek further agreement from the provincial marketing boards that milk surplus to

[417] See para. 7.65.
[418] See paras. 7.24 ff.
[419] See para. 2.40.
[420] Section 1(i) of Annex B to the Comprehensive Agreement on Special Class Pooling.

domestic requirements is available. If the CDC decides to activate the programme, it will actively remove surplus by contracting with processors for the manufacture of products suitable for export. At this stage, two possibilities arise: either (i) the CDC, acting in its own right, purchases the dairy products and exports them through transactions it negotiates with state importers in other countries, or (ii) the CDC issues permits to processors which will allow these processors to buy milk under Class 5(e) from one of the provincial marketing boards, whereafter these processors themselves, or through traders, export the dairy products produced. The permits issued by the CDC under Class 5(e) specify the dairy products to be exported. In both instances, it is the CDC which negotiates the milk price with the processor. In the event of exports by the CDC itself, it is also the CDC which negotiates and grants the processor margin.[421]

7.72 A second possibility arises during the period in which the CDC initiated surplus removal programme is inactive. In these circumstances, "access to CDC contracts to dispose of surpluses will be available when requested by individual processors".[422] In practice, a processor wanting to produce for export first negotiates the terms of a potential sale of dairy products with a foreign buyer. The processor then needs to access milk, in order to produce the dairy product, at a price which will allow it to make the transaction. To do so, the processor has to obtain a permit from the CDC, allowing it to buy milk under Class 5(e). This permit also specifies the dairy products to be exported. The CDC can only issue such permit "when all demand for milk by processors in the province in harmonized Classes 1 to 5(d) is met". It is the CDC which negotiates the milk price with the processor. Once the processor obtains a Class 5(e) permit from the CDC, it approaches the local marketing board which in practice provides the processor with the milk at the negotiated price. Under this second possibility, the CDC itself can also buy the processed dairy products - produced with Class 5(e) milk - and export them in its own right. In that event, processors receive "full margin for product sold", a margin negotiated and granted by the CDC.[423]

(iv) The Extent to which Canada's Governments or their Agencies are Involved in the Making Available of Milk under Classes 5(d) and (e)

Canada's Governments and their Agencies

7.73 Canada is a federal state with a federal government and ten provincial governments. Regulatory jurisdiction over trade in dairy products is divided between the federal government and the provinces. The federal government has constitutional authority over interprovincial and international trade. All other aspects of production and sale of milk are under provincial jurisdiction. Both the Canadian federal gov-

[421] Section 1 (vii) of Annex B to the Comprehensive Agreement on Special Class Pooling.
[422] Section 2 (i) of Annex B to the Comprehensive Agreement on Special Class Pooling.
[423] Section 2 (v) of Annex B to the Comprehensive Agreement on Special Class Pooling.

ernment and provincial governments are "governments" for the purposes of Article 9.1(a).[424]

7.74 Three bodies play a direct decision-making role under Classes 5(d) and (e): the CDC, the provincial marketing boards and the CMSMC.

7.75 First, the CDC is a Canadian Crown Corporation. That the CDC is an "agency" of Canada's federal government in the sense of Article 9.1(a) is undisputed.[425]

7.76 Second, the provincial milk marketing boards are established and operate within a legal framework set up by federal and provincial legislation.[426] These boards exercise powers in respect of inter-provincial and external trade delegated to them by the federal government through the CDC, as well as powers delegated to them by provincial authorities. Three of these boards (Alberta, Nova Scotia and Saskatchewan) are, according to Canada, agencies of the provincial government. Orders or regulations issued by the provincial marketing boards can be enforced before the Canadian courts. In most provinces, individual decisions by the boards are subject to appeal to a provincial supervisory board or commission (of which Canada recognizes the governmental nature).

7.77 While we acknowledge that producers play an important role in the provincial marketing boards, we also note that these boards act under the explicit authority delegated to them by either the federal or a provincial government. Accordingly, they can be presumed to be an "agency" of one or more of Canada's governments in the sense of Article 9.1(a).[427] In this respect, we refer to paragraph 2 of the *Ad* note to

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[424] Article XXIV:12 of GATT 1994, part of the context of Article 9.1(a), provides as follows: "Each contracting party shall take such reasonable measures as may be available to it to ensure observance of the provisions of this Agreement by the regional and local governments and authorities within its territory". The Understanding on the Interpretation of Article XXIV of GATT 1994, under Article XXIV:12, explicitly provides that "[t]he provisions of Articles XXII and XXIII of GATT 1994 as elaborated and applied by the Dispute Settlement Understanding may be invoked in respect of measures affecting its observance taken by regional or local governments or authorities within the territory of a Member". These provisions imply that all GATT provisions apply to "regional and local governments and authorities" within a WTO Member, in accordance with the general principle of public international law that a party to a treaty "may not invoke the provisions of its internal law as justification for its failure to perform a treaty" (set out in Article 27 of the Vienna Convention on the Law of Treaties). Article XXIV may act to limit the obligation of a WTO Member, which is a federal State, to secure the *implementation* of its GATT obligations. However, in our view, it does not limit the *applicability* of the provisions of GATT 1994 (see Panel Reports on *Canada - Measures Affecting the Sale of Gold Coins*, L/5863, unadopted, dated 17 September 1985, paras. 53-54 and 63-64; *Canada - Import, Distribution and Sale of Alcoholic Drinks by Canadian Provincial Marketing Agencies*, adopted on 22 March 1988, 35S/37, p. 91, para. 4.33; and *Canada - Import, Distribution and Sale of Certain Alcoholic Drinks by Provincial Marketing Agencies*, adopted on 18 February 1992, 39S/27, p. 86, para. 5.35).

[425] See paras. 2.12-2.15.

[426] See paras. 2.16-2.20.

[427] In this respect, we refer to Article 7:2 of the Draft Articles on State Responsibility of the International Law Commission (ILC) - which might be considered as reflecting customary international law - which states: "The conduct of an organ of an entity which is not part of the formal structure of the State or of a territorial governmental entity, but which is empowered by the internal law of that State to exercise elements of the governmental authority, shall also be considered as an act of the State under international law, provided that organ was acting in that capacity in the case in question"

Article XVII:1 of GATT 1994[428] as well as to Article XXIV:12 of GATT 1994[429], both constituting part of the context of Article 9.1(a). That the provincial marketing boards cannot issue orders or regulations without the backing of provincial or federal authority was confirmed by the Canadian courts in the so-called *Bari II* case.[430] In that case, it was found that the provincial marketing boards could not act at the inter-provincial or international level since they did not have the necessary federal authority. This shortcoming has now been rectified by amending the CDC Act.

7.78 In our view, the fact that most of the provincial boards are not formally incorporated as government agencies and that all or most of them are composed, completely or partially, of individuals which are also dairy producers, does not alter our conclusion. When - and to the extent that - these boards act under explicit delegated governmental authority, they can be presumed to act as an agency of the government.[431] Nor is our conclusion altered by the fact that the authority thus delegated to the boards offers the boards a certain discretion. It is precisely *because* the boards receive the authority from the governments to regulate certain areas themselves that their actions become governmental. What is important though is that Canadian governments maintain the ultimate control and supervision of most, if not all, of the boards' activities.[432] These governments define, and approve changes to, the boards' mandates and functions.[433]

(Report of the ILC on the Work of its 48th Session, General Assembly, Official Records, 51st Session, Supplement No. 1 (A/51/10), under Chapter III).

[428] Paragraph 2 of the *Ad* note to Article XVII:1 of GATT 1994 states: "The activities of Marketing Boards which are established by contracting parties and which do not purchase or sell but lay down regulations covering private trade are governed by the relevant Articles of this Agreement". Since, accordingly, GATT 1994 applies to such activities of "marketing boards" - and the Canadian provincial milk marketing boards are, in our view, such "marketing boards" - one can assume that most of the activities of the Canadian milk marketing boards are governmental in nature.

[429] Provincial marketing boards acting under the authority explicitly delegated to them by federal or provincial governments are, in our view, "regional" or "local" authorities in the sense of Article XXIV:12 of GATT 1994, outlined above in footnote 424. See, in this respect, the 1988 Panel Report on *Canada - Import, Distribution and Sale of Alcoholic Drinks by Canadian Provincial Marketing Agencies*: "The panel noted that there was no dispute that the provincial liquor boards were 'regional authorities' within the meaning of Article XXIV:12" (adopted on 22 March 1988, 35S/37, p. 91, para. 4.33) and the 1992 Panel Report on *Canada - Import, Distribution and Sale of Certain Alcoholic Drinks by Provincial Marketing Agencies*: "The Panel noted that the parties to the dispute agreed that the provincial liquor boards were 'regional authorities' within the meaning of Article XXIV:12 of the General Agreement and that this Article was therefore applicable to all provincial practices at issue" (adopted on 18 February 1992, 39S/27, p. 86, para. 5.35).

[430] *B.C. Milk Marketing Board v. Bari Cheese et al.* (11 August 1993), Vancouver C912303 (B.C.S.C.); (14 August 1996), (B.C.C.A.), unreported.

[431] If we were to accept Canada's argument - namely, that the provincial marketing boards are not governmental agencies because they are composed mainly of milk producers and producer-driven - it would mean that also a decision by a government minister - being, for example, also a farmer or having his or her electoral base in the agricultural sector - which favoured farmers would, for that reason, no longer constitute a governmental action but a private action by farmers.

[432] In the *Bari III* case, for example, the Supreme Court of British Columbia found that the sub-delegation by the Governor in Council (of certain governmental powers granted to him under the CDC Act) to the CDC, the CMSMC and the provincial boards constitutes valid sub-delegation. The Court found that the functions sub-delegated are administrative, not legislative; that the sub-

7.79 The third body which plays a decision-making role under Classes 5(d) and (e) is the CMSMC.[434] The CMSMC was established by the National Milk Marketing Plan (NMMP) which, in turn, is "a federal-provincial agreement in respect of the establishment of a National Milk Marketing Plan for the purposes of regulating the marketing of milk and cream products relating to Canadian domestic requirements and for any additional industrial milk requirements in Canada".[435] The NMMP was entered into by nine provinces[436] and the CDC. The bodies signing on behalf of each province are typically the provincial milk marketing board, the provincial supervisory board (which provides oversight of the operations of the provincial marketing board and is recognized by Canada as a provincial authority) and the provincial Minister for Agriculture. These two entities and the provincial Minister for Agriculture select a single "designated representative" who casts the vote on behalf of the province concerned. The CDC chairs the CMSMC and also has the right to vote. Decisions by the CMSMC are taken by consensus. In certain cases, disagreement is resolved by decision of the CDC. The CMSMC is also "the supervisory body which will oversee the implementation"[437] of the Comprehensive Agreement on Special Class Pooling. This agreement was concluded by the same bodies that are signatories to the NMMP and prevails over the NMMP. Decisions by the CMSMC under the Comprehensive Agreement on Special Class Pooling are taken by consensus. Instead of the CDC resolving disagreements, under the Comprehensive Agreement on Special Class Pooling a specific dispute settlement procedure is provided for.[438]

7.80 We have found that all of the signatories to the NMMP and the Comprehensive Agreement on Special Class Pooling - i.e., the provincial governments and provincial supervisory boards, the CDC and the provincial marketing boards - may be considered as "agencies" of Canada's governments or are effectively Canada's provincial governments. Hence, we must presume that actions taken by these "agencies"

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delegation was done out of "administrative necessity"; and that "*sufficient direction has been provided ... as to how [the CDC, the CMSC and the boards] are to perform these functions*" (*British Columbia Milk Marketing Board and Canadian Dairy Commission v. Luigi Aquilini et al.*, Reasons for Judgment of the Hon. Mr. Justice Wong, 12 September 1997, para. 117).

[433] This delegation of governmental authority to the boards should be distinguished from the government's involvement in creating a legal framework for, e.g., private banks (an example referred to by Canada). The boards are not only provided with a framework within which they can operate; they receive the authority to themselves regulate certain aspects of the milk market. Private banks, on the contrary, are legally recognized and subject to certain rules and thus operate within a framework set by the government. However, they do not - like the boards - receive the power to regulate themselves, e.g., the financial markets.

[434] See paras. 2.27-2.33.

[435] Introduction (A) to the NMMP. On the NMMP, see paras. 2.21-2.26.

[436] All Canadian provinces are parties to the NMMP except for Newfoundland which is, according to Canada, not a party to the NMMP because its milk producers produce almost exclusively for the local fluid milk market and because Newfoundland has not traditionally contributed to the industrial milk supply that is the subject of the NMMP.

[437] Schedule I, Section 1 of the Comprehensive Agreement on Special Class Pooling.

[438] Annex D to the Comprehensive Agreement on Special Class Pooling, according to which the CMSMC first acts as the Supervisory Body in an attempt to resolve the dispute prior to arbitration by an arbitration Panel. The CDC acts as secretariat for all dispute settlement purposes.

or governments through the CMSMC are, in turn, actions taken by an "agency" of Canada's governments. We recognize the influential role played by producers in the CMSMC. At the same time, however, and considering the structure, delegated powers and responsibilities of the CMSMC as outlined above[439], the concrete government involvement in the CMSMC is more than obvious. The NMMP itself states that "the participation of the Federal and Provincial authorities is required to assure the adoption and implementation" of the NMMP.[440] Most decisions by the CMSMC require the agreement of both the CDC (an agency of the federal government) and the provincial governments signatories to the NMMP (the provincial government is one of the three bodies appointing the "designated representative" of a province). In some instances, the CDC may even decide alone when there is a disagreement between the signatories of the NMMP.

The Concrete Government Involvement in Making Milk Available under Classes 5(d) and (e)

7.81 Given our earlier considerations that the CDC is a government agency and that most of the actions taken by the provincial milk marketing boards and the CMSMC can also be regarded as taken by an "agency" of the government, the answer to the question of whether the milk made available under Classes 5(d) and (e) - which we found earlier to be a payment in kind - is provided by Canada's governments or their agencies, becomes more apparent.

7.82 *Under both Classes 5(d) and (e) processors/exporters can only access milk if they obtain a permit from the CDC, a government agency.* It is not the individual producer who decides what milk it thus sells for export. It is the CDC, acting on the advice of the Surplus Removal Committee ("SRC")[441], the CMSMC or the provincial marketing boards, which decides whether domestic requirements are met and whether, therefore, milk should be considered as "surplus" and be exported. Such exports are made, not necessarily because no more milk could be sold on the domestic market at a higher price, but mainly in order to maintain the high domestic price.[442] As noted by the current President of the CDC, Mr. Guy Jacob:

> "… the [CDC] is the organization that issues permits whereby secondary processors or exporters can purchase milk at lower prices. In other words, in order for an exporter to be able to buy milk at a lower price, he must first obtain a permit from the [CDC]. It is also the [CDC] that has the ultimate responsibility to ensure that secondary

[439] See para. 7.79.

[440] Preamble (B) to the NMMP, fourth paragraph.

[441] See para. 7.71.

[442] In the Standing Committee on Agriculture and Agri-Food of 17 March 1998, US Exhibit 45, p. 5, one Member of Parliament (Mr. Jean-Guy Chrétien) argued that many processors are willing and could produce far more dairy products for the domestic market but that they cannot access the required milk; whereas other processors, producing for export, have a much wider access to milk given that "there is no danger of flooding the domestic market". In reply, Mr. Guy Jacob, President of the CDC, stated: "Yes, we are hearing the same message from processors and producers … Processors are saying that they would have markets and could process more milk if the raw material were available".

processors or exporters that purchase milk at a lower price do in fact use that milk for the purpose for which the permit was issued".[443]

7.83 *Under both Classes 5(d) and (e), once a processor/exporter has obtained the required permit from the CDC, it has to appeal to the provincial marketing board to actually obtain the milk*. Although the board is not under an obligation to provide such milk, Canada submits that in practice it always does so. It is, again, not the individual milk producer which independently allocates part of its production to export sales, but rather the provincial marketing board which makes such milk available at the request of the CDC. All milk sales in Canada necessarily have to pass through the provincial marketing board. An individual producer only decides how much it *produces*; it has no control over what part of its production will be exported. The producer only knows that for over-quota production, a lower export return will be obtained.

7.84 It is the CMSMC which sets and periodically adjusts the quota level and thereby decides what share of a producers' milk production is labelled as over-quota and thus obtains lower export returns.[444] It is also the CMSMC which annually sets the amount of milk allowed for export under Class 5(d). For both Classes 5(d) and (e) it is the CDC which, finally, takes the decision whether milk actually gets exported by issuing the required permit. No link exists between what is over-quota for an individual producer and what actually gets authorized for export by the CDC. Indeed, the CDC can even decide that over-quota milk should in fact not be exported but sold domestically to make up a shortfall.[445]

7.85 We recall, in addition, that the CDC negotiates the milk price for transactions under Classes 5(d) and (e), as well as - for exports made by the CDC itself - the processor margin; that the large majority of export sales under these Classes are initiated by the CDC[446]; and that the CDC itself is a major exporter of processed dairy products.[447]

(v) The Panel's Finding on whether the Milk is Provided by Governments or their Agencies

7.86 As outlined above, the CDC, advised by other bodies acting under the authority delegated to them by governments, decides whether or not any and how much milk can be exported. The CDC then - in a very direct way, by providing a permit - makes milk

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[443] Standing Committee on Agriculture and Agri-Food of 17 March 1998, US Exhibit 45, p. 2.

[444] The quota level can vary considerably year by year and can even be adjusted during the year, so that it may be difficult for the producer to adjust production to its quota. In 1995/1996 and 1996/1997 the national quota for industrial milk (Market Sharing Quota or MSQ) was 44.2 million hL. In 1997/1998 it was decreased by 3 per cent to 43.3 million hL. In 1998/1999, on the other hand, it was increased by 4 per cent to 44.7 million hL.

[445] This over-quota milk then obtains the higher domestic price, the benefit of which does not go directly to the individual producer (who only gets the lower Class 5(e) return) but is shared among all producers.

[446] In 1995/1996, 96.6 per cent of surplus removal was initiated by the CDC; in 1996/1997, 91.49 per cent; in 1997/1998, 70.61 per cent.

[447] See statement by Mr. Guy Jacob, President of the CDC, Standing Committee on Agriculture and Agri-Food of 17 March 1998, US Exhibit 45, p. 4: "The [CDC] remains a major exporter. Last year [1997] its direct exports totalled some 200 million dollars".

available under Classes 5(d) and (e). Finally, the provincial milk marketing boards, acting under delegated authority, physically offer the milk to processors. We find, therefore, on the basis of the specific circumstances of this case, that the milk made available to processors for export under Classes 5(d) and (e) at a discounted price, is provided by Canada's governments or their agencies in the sense of Article 9.1(a).

(c) The Panel's Finding under Article 9.1(a)

7.87 We found earlier that the provision of lower priced milk to processors for export under Classes 5(d) and (e) constitutes a payment in kind to processors/exporters contingent on export performance.[448] We also found that this milk is provided by Canada's governments or its agencies.[449] On these grounds[450], we find that the making available of milk under Classes 5(d) and (e) constitutes an export subsidy within the meaning of Article 9.1(a).

6. Article 9.1(c) of the Agreement on Agriculture

7.88 We have found that the Special Milk Classes Scheme involves an export subsidy as listed in Article 9.1(a). The complainants submit that this scheme also constitutes an export subsidy as listed in Article 9.1(c). This provision subjects the following type of action to Canada's export subsidy commitments:

> "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".

7.89 In our view, the first part of Article 9.1(c) - "payments on the export of an agricultural product that are financed by virtue of governmental action" - includes the core elements of an export subsidy as listed in that provision. The subsequent part provides further clarification - in an illustrative way - as to the meaning of these core elements. We, therefore, consider that there are two conditions that have to be met for there to be an export subsidy as provided in Article 9.1(c):

(a) the presence of "payments on the export of an agricultural product";

(b) which are "financed by virtue of governmental action".

We next examine whether these two conditions are met in this case.

(a) "payments on the export of an agricultural product"

7.90 We found earlier that the provision of milk at a discounted price under Classes 5(d) and (e) involves "payments-in-kind" in the sense of Article 9.1(a) to processors/exporters that are "contingent on export performance".[451] Under Article 9.1(c) we need to examine whether such provision of milk involves a "payment on

[448] See para. 7.61.
[449] See para. 7.86.
[450] See also paras 7.39 and 7.40.
[451] See paras. 7.40 and 7.58.

the export of an agricultural product". In our view, if the word "payment" in Article 9.1(c) were to include "payments-in-kind", we would have to conclude that the provision of milk at a discounted price under Classes 5(d) and (e) also constitutes a "payment" in the sense of Article 9.1(c). Since, as we saw earlier[452], the provision of this cheaper milk is only available in case the dairy products produced with it are actually exported, we would then also need to conclude that it constitutes a payment "on the export of an agricultural product".[453] In our view, the term "payment on the export of an agricultural product" means, indeed, that the payment is conditional or contingent on the export of such product (*in casu*, the processed dairy products that are specified in the CDC permits issued under Classes 5(d) or (e)). Our finding as to whether or not the Special Milk Classes Scheme also involves "payments on the export of an agricultural product" in the sense of Article 9.1(c) thus only depends on whether or not the word "payment" in this provision covers not only payments in money but also "payments-in-kind". This is the issue we examine next.

7.91 We recall that according to the rules of treaty interpretation set out in Article 31 of the Vienna Convention on the Law of Treaties, the meaning of a term is to be determined by reference to its ordinary meaning, read in its context, and in the light of the object and purpose of the treaty.

7.92 As to the ordinary meaning of the word "payment", we note that the *Oxford English Dictionary* defines "payment" as

> "1. the action, or an act of, paying; the remuneration of a person with money *or its equivalent*; the giving of money, *etc.* in return for something in discharge of a debt".[454]

This indicates that the ordinary meaning of the word "payment" includes both the act of remunerating a person with money and the act of remunerating a person with its equivalent in kind, a so-called "payment in kind". Indeed, benefits available under the export rebate system in place before the Special Milk Classes were introduced[455] and the provision of *more milk for the same price* under this scheme are, in our view, both captured by the ordinary meaning of the word "payment".

7.93 The validity of this interpretation is confirmed when taking into account the context of the word "payment" as it is used in Article 9.1(c). The immediate context to turn to is, in our view, the second part of Article 9.1(c) which further defines the kind of "payment" required. It refers to a "charge" on the public account (an element *not* required for there to be an Article 9.1(c) export subsidy). We consider that a "charge" can arise both as a consequence of a transfer of money and of the provision

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[452] See para. 7.40.

[453] Referring to para. 7.41, to the extent that the US claims also cover any of the milk classes other than Classes 5(d) and (e), we note that all of these other milk classes can also (often exclusively) be accessed by processors which produce for the domestic market. Nothing offered under these other milk classes can thus constitute a payment "on the export of" an agricultural product. We therefore find that these other milk classes do not involve an export subsidy as listed in Article 9.1(c).

[454] *The Oxford English Dictionary* (2nd Edition) - Volume XI, Clarendon Press, Oxford, pp. 379-380 (emphasis added).

[455] We note in this respect that Canada, during our proceedings, acknowledged that its previous levy system - where levies were imposed on all milk producers and pay backs were made to processors/exporters with the proceeds of these levies - involved "payments" in the sense of Article 9.1(c).

of a good at a discounted price. The second part of Article 9.1(c) also provides an example of an export subsidy as listed in that provision. In so doing, it refers to payments "*financed* from the proceeds of a levy". "Financing" a "payment" can, in our view, be done by way of a transfer of money but also by means of charging a discounted price for a good. Therefore, the second part of Article 9.1(c), in our view, implicitly confirms that the notion of "payment" in Article 9.1(c) also covers payments-in-kind, such as the provision of milk at a reduced price.

7.94 We consider that the other provisions of the Agreement on Agriculture also form part of the context of Article 9.1(c). Article 9.1 identifies certain practices as export subsidies subject to the reduction commitments made by WTO Members. These commitments take the form of a ceiling imposed on "budgetary outlays" and on the quantity of exports for which export subsidies can be granted. They are specified for each year of the implementation period in the Schedule of the WTO Member concerned. According to Article 9.2(a), the export subsidy commitment levels represent "*with respect to the export subsidies listed in [Article 9.1]*: (i) in the case of budgetary outlay reduction commitments, the maximum level of expenditure for such subsidies that may be allocated or incurred in that year in respect of the agricultural product, or group of products, concerned".[456] In principle, the ceiling on "budgetary outlays" thus applies to *all* export subsidies listed in Article 9.1, including the Article 9.1(c) export subsidies. The concept of "budgetary outlay", however, is defined in Article 1(c) as including "revenue foregone". Since, therefore, the notion of "payment" in Article 9.1(c) would also include "revenue foregone", it can be implied that "payment" thereby not only includes payment in money terms but also payments-in-kind, i.e., "revenue foregone" by providing milk for use in exports at a discounted price (whereby, *in casu*, higher returns to be obtained on the domestic milk market are "foregone" by producers). In other words, since "revenue foregone" is to be taken into account in calculating the *levels* of reduction commitments - including the level of export subsidies as listed in Article 9.1(c) - it should, implicitly, also be included in the *definition* of the export subsidies for which these reduction commitments are made, including the definition of export subsidies under Article 9.1(c). In our view, this consideration confirms our interpretation that "payment" in the sense of Article 9.1(c) includes "payments-in-kind".

7.95 The idea that the export subsidies identified in Article 9.1 generally, and Article 9.1(c) in particular, also include payments-in-kind and, specifically, the provision of a good at a reduced price, is also confirmed in other sub-paragraphs of Article 9.1. Article 9.1(a) refers to "direct subsidies, *including payments-in-kind*". Article 9.1(b) mentions the sale or disposal for export of non-commercial stocks "*at a price lower* than the comparable price charged for the like product to buyers in the domestic market". Article 9.1(d) refers to a *reduction in the costs* of marketing exports. Finally, Article 9.1(e) is directed at *reduced* internal transport and freight *charges* on export shipments. None of the provisions under Article 9.1 - not even Article 9.1(a) which deals with "direct subsidies" - seems to be limited to contributions in money terms only; all of them, in one way or another, explicitly or implicitly, include reference to payments-in-kind such as lower prices or a reduction in costs or charges. In

[456] Emphasis added.

our view, this consideration further confirms our interpretation that "payment" in the sense of Article 9.1(c) includes payment in kind.

7.96 Canada argues that if the drafters of the Agreement on Agriculture had intended the word "payment" in Article 9.1(c) to include payment in kind they would have explicitly added such language. Canada refers to other provisions where such language was added. It refers, in particular, to paragraph 5 of Annex 2 of the Agreement on Agriculture which mentions "direct payments (or revenue foregone, including payments in kind)". However, in our view, this inclusion of "payments in kind" does not qualify or add to the meaning of the word "payment", but to the meaning of the word "*direct* payment". Moreover, if another provision, part of the context of Article 9.1(c), defines "*direct* payments" as including "payments in kind", we consider that it can be presumed that the more general word "payments" in Article 9.1(c) *a fortiori* includes "payments in kind". Nowhere in the Agreement on Agriculture is the word "payment" as such explicitly qualified as excluding or including payment in kind. Article 9.1(a), for example, refers to "*direct subsidies* [not "payments"], including payments-in-kind". As we noted earlier, the ordinary meaning of the word "payment" as well as the context in which it is used in Article 9.1(c), on the contrary, indicate that "payment" includes not only payment in money terms but also payment in kind.[457]

7.97 In the same vein, Canada refers to the Appellate Body report on *Canada - Periodicals* where the term "payment of subsidies exclusively to domestic producers, including payments to domestic producers derived from the proceeds of internal taxes or charges" in Article III:8(b) of GATT 1994 was interpreted as only including "the payment of subsidies which involve the expenditure of revenue by a government".[458] A reduction of postal rates granted by Canada Post for the distribution of certain publications was thus found to be excluded from the exemption under Article III:8(b). In our view, however, one needs to distinguish the term "payments" as used in Article III:8(b), from that in Article 9.1(c) and this because of the different context in which it is set and the different object and purpose it serves. First, Article III:8(b) only provides a specific *exemption* to the national treatment provisions in Article III for the payment of *certain production* subsidies, namely "the payment of subsidies exclusively to domestic producers".[459] It does not in any way provide a general definition of what a subsidy - let alone an export subsidy - is for purposes of GATT 1994 (and even less so for purposes of the Agreement on Agriculture). Article 9.1(c), on the other hand, provides a concrete example of an export subsidy, not constituting an exemption to any other provision, but part of a positive list of export subsidies made

[457] We are not convinced either by Canada's argument that the French text of Article 9.1(c) uses the word "versement" which, according to Canada, connotes only payments in money terms. We note, in this respect, that the French text of Article 9.1(a), when addressing "payments-in-kind", uses the term "versements en nature". This, in our view, confirms that also the meaning of the French term for "payment", namely "versement", does not exclude payment in kind, i.e., "versement en nature".

[458] Appellate Body report on *Canada - Certain Measures Concerning Periodicals*, adopted on 30 July 1997, WT/DS31/AB/R, p. 36, DSR 1997:I, 460, II B 2.

[459] Article III:8(b) states: "*The provisions of this Article shall not prevent* the payment of subsidies exclusively to domestic producers ..." (emphasis added).

subject to reduction commitments under the Agreement on Agriculture.[460] Second, Article III:8(b) exempts the "payment of subsidies exclusively to domestic producers" from Article III obligations and provides certain "payments" as an example of such subsidies. In other words Article III:8(b) when giving the example of certain "payments" does not define or further clarify the broader term "subsidy" or "payments" - the latter term being the only one provided in Article 9.1(c) and the term we have to interpret here - but the more narrow term "payment of subsidies exclusively to domestic producers". Recalling also the textual and contextual elements proper to Article 9.1(c) set out above[461] - and not to be found under Article III:8(b) - we thus consider that Canada's reference to Article III:8(b) of GATT 1994 does not alter our interpretation that "payment" in Article 9.1(c) also includes payment in kind.

7.98 Canada further claims that there is no revenue for the producers to forego with respect to sales of milk for export use under Classes 5(d) and (e) and, therefore, no payment in kind made by these producers. It submits that under the Canadian milk marketing system, such milk *cannot* be sold in the market for export uses if it is required for Canadian domestic requirements. Thus, sales of milk for export purposes at prices based on word market prices cannot be made until there is no opportunity to sell milk into domestic markets at the higher domestic prices. According to Canada, "revenue foregone" implies a choice of markets, a choice foregone and in this case producers do not have a choice.

7.99 In response to Canada's argument, we agree that the milk producer - with respect to Classes 5(d) and (e) milk - does *not* have a choice to make between selling its milk at a higher price for domestic use or at a lower price for export. However, we do so for reasons different from those put forward by Canada. As we noted earlier, it is not the milk producer that takes the decision where to allocate its milk production.[462] It is the CDC (acting on the advice of the SRC), the CMSMC and the provincial marketing boards, that decide whether domestic requirements are met and whether, therefore, milk should be considered as "surplus" and be exported. Such exports are made, not necessarily because no more milk could be sold on the domestic market at a higher price, but mainly in order to maintain the high domestic price.[463] If it is thus decided - by means of the issuance of a CDC permit under

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[460] In this respect, we note the Panel Report on *Indonesia - Certain Measures Affecting the Automobile Industry*, adopted 23July 1998, WT/DS54/R, which highlights the special and different context and object and purpose of Article III and Article III:8(b) in particular, when it states in para. 14.33: "As was the case under GATT 1947, we think that Article III of GATT 1994 and the WTO rules on subsidies remain focused on different problems. Article III continues to prohibit discrimination between domestic and imported products in respect of internal taxes and other domestic regulations, including local content requirements. It does not "proscribe" nor does it "prohibit" the provision of any subsidy *per se*"; and in para. 14.43: "We consider that the purpose of Article III:8(b) is to confirm that subsidies to producers do not violate Article III, so long as they do not have any component that introduces discrimination between imported and domestic products. In our view, the wording "payment of subsidies exclusively to domestic producers" exists so as to ensure that only subsidies provided to producers, and not tax or other forms of discrimination on products, be considered subsidies for the purpose of Article III:8(b) of GATT".

[461] See paras. 7.92-7.96.

[462] See paras. 7.82 ff.

[463] See para. 7.82 and footnote 442.

Classes 5(d) or (e) - that in-quota milk is to be exported, the milk producer *has to* accept a lower price. Through the pooling of all in-quota milk returns, this lower price is reflected in a lower average pooled price granted to milk producers for all of their in-quota milk. With respect to *over-quota* milk, it is again because of Canada's governments or their agencies - through the CMSMC - that a certain quantity of milk is labelled as over-quota. Once so labelled, milk necessarily obtains a lower price based on the world market price. Therefore, whenever producers produce milk over-quota, as defined by Canada's governments or their agencies, they *have to* sell it at a lower export related price.

7.100 Canada is, therefore, correct that producers do not have a choice to make with respect to the allocation of Classes 5(d) and (e) milk. However, in our view, this is so (i.e., the producers' choice is predetermined) *not* - as Canada implies - because of commercial reasons (e.g., because of a lower domestic demand the producer - depending on its profitability - decides, in order to maximize its total revenue, to allocate a certain share of its production to lower priced export markets), but because of governmental actions. Under the Canadian system, selling milk for use in the domestic market is no longer an option (i.e., the choice for a higher return is taken away) mainly because the quotas - set by Canadian governments or their agencies - are met; *not* because there is no more domestic demand for milk. As noted earlier, producers would likely be able to sell more milk domestically if they were allowed to do so, albeit probably at a somewhat lower price.[464] In conclusion, we consider that producers do forego a choice or revenue - albeit through governmental action - and, therefore, make a payment in kind to processors/exporters in the sense of Article 9.1(c).

7.101 In conclusion, a careful examination of the ordinary meaning of the term "payment" in Article 9.1(c), in its context and in light of the object and purpose of the Agreement on Agriculture, leads us to the conclusion that it does include payment in kind and thus, *in casu*, the provision of milk at a reduced price. Recalling our considerations in paragraph 7.90, we thus find that the provision of milk to processors/exporters under Classes 5(d) and (e) involves a "payment on the export of an agricultural product" in the sense of Article 9.1(c).

(b) Payments "financed by virtue of governmental action"

7.102 We recall that it is not in dispute that the payments-in-kind made under Classes 5(d) and (e) do *not* directly involve a charge on the public account.[465] The cost of selling milk at a reduced price for export is not borne by the government. It is borne by the milk producers either *collectively* (by means of pooling the lower in-quota export returns with the higher domestic returns and paying out an average pooled price for all in-quota milk to all producers) or, at least in principle, *individually* (with respect to over-quota milk, revenues of which are generally not pooled with higher returns from other milk producers). However, in our view, it is clear from the language of Article 9.1(c) that producer-financed payments can in principle be covered by this provision. "[W]hether or not a charge on the public account is in-

[464] See para. 7.82 and footnote 442.
[465] See para. 7.64.

volved" is explicitly stated to be irrelevant for purposes of Article 9.1(c). Moreover, Article 9.1(c) explicitly provides an example of a producer-financed payment, covered by Article 9.1(c), namely "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". The word "including" indicates that such payments financed from levies on agricultural products constitute only one example of a producer-financed export subsidy as listed in Article 9.1(c). In order to decide whether or not the scheme at issue here is another example of such export subsidies, we need to determine next whether or not this scheme involves payments "financed by virtue of governmental action".

7.103 We found earlier that the type and degree of government involvement in the making available of milk to processors/exporters under Classes 5(d) and (e) is such that the payment in kind involved is "provided by" Canada's governments or their agencies in the sense of Article 9.1(a).[466] We recall, in particular, that Canada's governments or their agencies through the Special Milk Classes Scheme decide when milk is to be exported, negotiate the price for such milk and actually provide the milk to processors/exporters.

7.104 We note, in addition, that it is the provincial milk marketing board, assisted by the CDC and operating under federal and/or provincial authority delegated to it, that (i) calculates the monthly pay cheque to be sent to each milk producer according to the relevant pooling arrangements and the specific rules or regulations the province concerned applies with respect to payments for over-quota milk; and (ii) eventually pays the milk producers a monthly income based on their production and the milk returns obtained through the scheme during a certain period. All milk necessarily passes through the intermediary of the provincial milk marketing boards which, together with the CDC and the CMSMC, arrange all milk sales, cash the returns obtained from processors/exporters for the milk sold and, finally, re-route these returns - including, in particular, the returns from milk sold under Classes 5(d) and (e) - to the individual milk producers on the basis of complex calculations.

7.105 We further note that, by virtue of the CDC Act, the CDC is, *inter alia*, authorized to (i) "distribut[e] money to producers of milk or cream received from the marketing of any quantity of milk or cream"[467]; (ii) "establish the price, or minimum or maximum price, paid or to be paid to the Commission, or to producers of milk or cream, the basis on which that payment is to be made and the terms and manner of payment that is to be made in respect of the marketing of any quantity of milk or cream"[468]; and (iii) "collect the price paid or to be paid to the Commission, or to any producer in respect of the marketing of any quantity of milk or cream … or recover that price in a court of competent jurisdiction".[469] The CDC also calculates the returns received by each province for Special Milk Classes sales, based on data provided by provincial marketing boards, and may audit the books of processors/exporters to ensure that they have used Classes 5(d) and (e) milk for export purposes.

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[466] See para. 7.86.
[467] CDC Act, Subsection 9(1), paragraph (f), (i).
[468] CDC Act, Subsection 9(1), paragraph (g).
[469] CDC Act, Subsection 9(1), paragraph (h).

7.106 On these grounds[470], we find that the payment in kind offered under Classes 5(d) and (e), namely the provision of milk at a discounted price to processors/exporters, although it is not financed directly with governmental funds, is, nevertheless, "financed by virtue of governmental action" in the sense of Article 9.1(c).

Additional Considerations with Respect to Sales of In-Quota Milk

7.107 We find additional support for our finding in the previous paragraph, in so far as it relates to *in-quota* milk sold under Classes 5(d) or (e), in the fact that the returns of in-quota milk are pooled with all other in-quota milk returns.[471]

7.108 At the national level, a system which pools all returns from in-quota milk in Special Class 5 was set up in the Comprehensive Agreement on Special Class Pooling. This agreement was concluded by the same bodies that established the CMSMC. Its implementation is overseen by the CMSMC, a body we considered earlier to be (at least to some extent) an agency of Canada's governments.[472] Moreover, in order to allow the CDC to administer this pooling system, the federal CDC Act was amended. Subsection 9(1), paragraph (f) of the Act, as amended, grants federal authority to the CDC to "establish and operate a pool or pools in respect of the marketing of milk or cream".

7.109 At an inter-provincial level, one pooling agreement was concluded between six eastern provincial boards ("the P6 Agreement"), another between four western provincial boards ("the P4 Agreement"). Both of these agreements pool all in-quota milk returns other than Special Class 5 returns (which are pooled nationally). These agreements were typically concluded by the relevant provincial governments, marketing boards and supervisory boards, all of which we presumed earlier to be agencies of Canada's governments.[473] Also the CDC itself is a signatory to both of these agreements. An example of how pooling of in-quota milk actually occurs is provided in paragraphs 2.59 to 2.63 above.

7.110 The authority vested in the provincial marketing boards to conclude, operate and enforce any of these three pooling agreements was delegated to them either by federal authorities (to the extent inter-provincial and international trade is involved, e.g., by the CDC[474]) or by provincial authorities (which have constitutional authority over all other aspects of production and sale of milk). The orders and regulations of the boards in respect of pooling - established pursuant to federal and provincial ena-

[470] See paras. 7.103-7.105.

[471] In this respect, we note that New Zealand and the United States have argued that Classes 5(d) and (e) constitute an export subsidy to milk *processors/exporters* financed by milk producers contingent on the export of the processed *dairy product*. Neither complainant suggested that the pooling of in-quota milk returns represents a payment to some *milk producers* financed by other milk producers contingent on the export of *milk*.

[472] See para. 7.80.

[473] See paras. 7.73 ff.

[474] In Schedule II to the Comprehensive Agreement on Special Class Pooling, the CDC, subject to the approval of the Governor in Council, authorizes the provincial boards "insofar as it is necessary to enable the Boards to fully carry-out the programme as set out in [the Comprehensive Agreement on Special Class Pooling] and its Annexes, to exercise all the powers of the [CDC] set out in paragraphs 9(1)(f) to (i) of the [CDC Act]".

bling legislation - can be enforced by the provincial boards before the normal courts by means of, e.g., a request for civil injunction or civil damages.

7.111 On these grounds, we consider that each of the three pooling arrangements are imposed on milk producers by virtue of governmental action. The pooling agreements are compulsory. Individual producers cannot opt-out of these pooling systems with respect to their in-quota milk.[475] It is this pooling mechanism that "finances" the payment in kind provided by the producers to the processors/exporters under Classes 5(d) and (e) with respect to in-quota milk. The pooling ensures that the producer which sells in-quota milk for export at a discounted price, does not have to bear the *total* cost of the "payment" thus provided to the processor/exporter. *All* milk producers share this cost by putting their higher returns from milk sold for domestic use in the same pool. The net result is that all producers obtain one average pooled price for all their in-quota milk. This pooling system confirms our finding that the provision of in-quota milk under Classes 5(d) and (e) is a payment in kind "financed by virtue of governmental action".[476]

Additional Considerations with Respect to Sales of Over-Quota Milk

7.112 We note, finally, that even though returns of *over-quota* milk sold under Class 5(e) are *generally* not pooled with other *in-quota* milk returns, over-quota milk returns are also, at least to some extent, pooled. This again occurs, we consider, by virtue of governmental action. First, any over-quota milk return is pooled annually with all other over-quota milk returns. On a monthly basis, the individual milk producer receives, from its provincial marketing board, a price for its monthly over-quota share. This price is *not* the actual return for the transaction made, but a three-month moving average of all returns achieved nationally for over-quota milk. Moreover, at the end of the dairy year, an adjustment is made to ensure that the total monthly payments made to individual producers correspond, on an averaged basis, to the total returns generated nationally that year by all over-quota milk sales. Therefore, even though each export transaction may - and mostly does - generate a different price (depending on the competitive conditions in the export market concerned, the dairy product in question and the delivery terms and timing of the transaction), at the end of the year an individual milk producer is not affected by this spectrum of variables, but receives a nationwide average pooled return for all of its over-quota milk.[477] Second, depending on the applicable provincial regulations, some degree of pooling also takes place between over-quota returns and in-quota returns. This is achieved, in some provinces, by offsetting over-quota production of some producers against under-quota production of others.[478] These so-called "flexibility" provisions or "fall incentives" essentially excuse over-quota production in certain months. This variable determination of what is labelled as over-quota milk in each province by virtue of provincial regulations, not only results in a shared financing of certain over-quota sales

[475] See Canada's answer to Panel Question 4(d) to Canada.
[476] See para. 7.106.
[477] See Canada's answer to Panel Question 34 to Canada.
[478] For example, in the provinces of Alberta, Manitoba and Saskatchewan, according to Canada's answer to Panel Question 20(b) to Canada and US Exhibits 39 and 58.

(including by those producers which did not produce over-quota); it also confirms that it is not the individual producer but Canada's governments or their agencies that essentially determine when milk receives the lower export return. In our view, this pooling of over-quota returns confirms our finding in paragraph 7.106 that the provision of over-quota milk under Class 5(e) is also a payment in kind "financed by virtue of governmental action".

(c) The Panel's Finding under Article 9.1(c)

7.113 We found earlier that the provision of lower priced milk to processors for export under Classes 5(d) and (e) constitutes a "payment" to these processors/exporters "on the export of an agricultural product".[479] We also found that this "payment" is "financed by virtue of governmental action".[480] On these grounds, we find that the making available of milk under Classes 5(d) and (e) constitutes an export subsidy within the meaning of Article 9.1(c).

7. Article 3.3 of the Agreement on Agriculture

7.114 We have found that the provision of milk to processors/exporters at a reduced price under Classes 5(d) and (e) constitutes an export subsidy as listed in Article 9.1(a)[481] and Article 9.1(c).[482] We recall that Article 3.3 provides as follows:

> "Subject to the provisions of paragraphs 2(b) and 4 of Article 9, a Member shall not provide export subsidies listed in paragraph 1 of Article 9 in respect of the agricultural products or groups of products specified in Section II of Part IV of its Schedule in excess of the budgetary outlay and quantity commitment levels specified therein and shall not provide such subsidies in respect of any agricultural product not specified in that Section of its Schedule".

7.115 We further note that, according to figures submitted by Canada, the total amount of exports generated through Classes 5(d) and (e) exceeds Canada's quantity reduction commitment levels as set out in Section II of Part IV of its Schedule and this (i) for all of the dairy products in dispute (butter, cheese and "other milk products") and (ii) during both marketing years at issue (1995/1996 and 1996/1997).[483] The relevant figures are reflected in the table below:

Product	Marketing Year	Canada's Export Quantity commitment level	Total exports generated through Classes 5(d) and 5(e)
Butter	1995/1996	9,464	9,527
	1996/1997	8,271	10,312
Cheese	1995/1996	12,448	13,751
	1996/1997	11,773	20,409

[479] See paras. 7.90 and 7.101.
[480] See paras. 7.103 ff.
[481] See para. 7.87.
[482] See para. 7.113.
[483] See Table 2 in para.2.41.

Other milk products	1995/1996	36,990	37,358
	1996/1997	35,649	60,300

7.116 On these grounds[484], we find that Canada provides export subsidies as listed in Article 9.1 in respect of the three dairy products at issue, and this for both marketing years in dispute, in excess of the quantity commitment levels specified in its Schedule, contrary to its obligations under Article 3.3.

8. Article 10 of the Agreement on Agriculture

7.117 We have found that the Special Milk Classes Scheme involves an export subsidy as listed both in Article 9.1(a) and in Article 9.1(c). In the alternative - i.e., in the event we would have found that the scheme does *not* involve an export subsidy as specified in either Article 9.1(a) or Article 9.1(c) - the Complainants submit that this scheme, nevertheless, constitutes an export subsidy contrary to Article 10.1 of the Agreement on Agriculture. This provision reads as follows:

> "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".

7.118 The Complainants only invoke the first phrase of Article 10.1. We note that this phrase only applies to "export subsidies *not* listed in paragraph 1 of Article 9". Export subsidies listed in Article 9.1 cannot, therefore, be found to contravene Article 10.1.[485] Having found that Canada's Special Milk Classes 5(d) and (e) involve export subsidies as listed in Article 9.1, we thus decide this dispute on the basis of Article 9.1. None of the complainants requested the Panel to make concurrent findings on both Article 9.1 and Article 10.1. In our view, the text of Article 10.1 and our findings based on Article 9.1 exclude such concurrent findings in respect of the same export subsidies. If our findings under Article 9.1 are adopted by the DSB, we consider that making additional findings under Article 10.1 would not be warranted in the light of the mutually exclusive relationship between Article 9.1 and Article 10.1.

7.119 However, in our examination of the claims relating to violations of Article 9.1 *or* Article 10.1, we also noted the following elements:

(a) both complainants requested a finding on Article 10.1 in the event that Article 9.1 were found not to be applicable;

(b) the complainants and Canada disagree on how Article 10.1 should be construed and on the consistency of Canada's Special Milk Classes Scheme with Article 10.1;

(c) both Article 9.1 (referring to Article 3.3) and Article 10.1 prohibit specified export subsidies and, in so doing, complement

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[484] See paras. 7.114-7.115.

[485] However, in our view, the mutual exclusiveness of Article 9.1 and Article 10.1 does not prevent that one element or aspect of a given scheme may constitute an export subsidy as listed in Article 9.1, while another element or aspect of the same scheme may be covered by Article 10.1 and that, as a result, the factual elements to be considered under both provisions might well be closely related if not the same in certain respects.

each other by focusing on different subsidy elements. As a result, the precise borderline between Article 9.1 and Article 10.1 export subsidies may not always be clear-cut. Indeed, so far this borderline has never been clarified in WTO legal or dispute settlement practice;

(d) if our findings under Article 9.1 were to be reversed, the Appellate Body could be called upon to examine the claims made under Article 10.1. This examination would require a complex factual assessment and the weighing of evidence submitted by the parties to this dispute, an exercise which could go beyond the jurisdiction of the Appellate Body and make it impossible for the DSB to provide recommendations and rulings on all legal claims within the time-frame prescribed by the DSU;

(e) if the DSB adopts our findings on Article 9.1, the DSU's declared objectives of "prompt settlement" of disputes (Article 3.3 of the DSU), of a "satisfactory settlement of the matter in accordance with the rights and obligations under [the DSU] and the covered agreements" (Article 3.4 of the DSU), of "a positive solution to a dispute" (Article 3.7 of the DSU) and of "effective resolution of disputes to the benefit of all Members" (Article 21.1), may be facilitated if the parties would have at their disposal the Panel's examination of the matter under Article 10.[486] On this point, we recall the following statement by the Appellate Body:

> "The principle of judicial economy has to be applied keeping in mind the aim of the dispute settlement system. This aim is to resolve the matter at issue and 'to secure a positive solution to a dispute'.[487] To provide only a partial resolution of the matter at issue would be false judicial economy. A panel has to address those claims on which a finding is necessary in order to enable the DSB to make sufficiently precise recommendations and rulings so as to allow for prompt compliance by a Member with those recommendations and rulings 'in order to ensure effective resolution of disputes to the benefit of all Members'[488]".[489]

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[486] In this respect, we also note Article 19.1 of the DSU providing that a panel "[i]n addition to its recommendations ... may suggest ways in which the Member concerned could implement the recommendations".

[487] A footnote refers to DSU, Article 3.7.

[488] A footnote refers to DSU, Article 21.1.

[489] Appellate Body report on *Australia - Measures Affecting Importation of Salmon*, WT/DS18/AB/R, adopted 6 November 1998, para. 223.

On these grounds, and in particular in order to (i) enable the Appellate Body and the DSB to make findings on Article 10.1 in the event that it considers it necessary[490] and (ii) avoid a continuation of the dispute over Canada's obligation to bring its dairy products marketing regime into conformity with its obligations under the Agreement on Agriculture, we have decided to proceed with our examination under Article 10.1 and to include that examination in our report as one on which no recommendation or ruling by the DSB would be necessary if our findings under Article 9.1 are adopted. We emphasize that our examination of Article 10.1 is made in the alternative only, i.e., assuming that Classes 5(d) and (e) do not involve export subsidies as listed in Article 9.1.

(a) The Two Elements under Article 10.1

7.120 In our view, for there to be a violation of Article 10.1, two elements need to be established:

(a) the presence of "export subsidies not listed in paragraph 1 of Article 9";

(b) which are "applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments".

7.121 Article 10.1 - in particular the second condition thereunder - has to be read together with Article 10.3, which provides:

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

7.122 Reading the second element of Article 10.1 together with Article 10.3, we note that all parties to this dispute agree that one example of applying export subsidies "in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments" is a situation where export subsidies other than Article 9.1 export subsidies are granted to a product subject to subsidy reduction commitments in excess

[490] In this respect, we refer to the dispute on *Australia - Measures Affecting Importation of Salmon* (WT/DS18/AB/R, adopted 6 November 1998), where the Appellate Body, after having reversed certain Panel findings, was "unable to come to a conclusion on [the claim under Article 5.6 of the SPS Agreement] due to the insufficiency of the factual findings of the Panel and of facts that are undisputed between the parties" (para. 213; see also para. 241). See also the Appellate Body Report on *Canada - Certain Measures Concerning Periodicals* (WT/DS31/AB/R, adopted 30 July 1997, p. 22: "We note that, due to the absence of adequate analysis in the Panel Report in this respect, it is not possible to proceed to a determination of like products [under Article III:2, first sentence, of GATT 1994]"). In this respect, see also the Panel Report on *India - Patent Protection for Pharmaceutical and Agricultural Chemical Products* (WT/DS50/R, adopted 16 January 1998) where the Panel decided to continue its examination under Article 63 of the TRIPS Agreement after it had found a violation under Article 70.8 of that Agreement (para. 7.44: "Although the United States formulates it [the Article 63 claim] as an alternative claim in the event that the Panel were to find that India has a valid mailbox system in place, and we have, as stated above, found that the current mailbox system in India is at variance with Article 70.8(a) of the TRIPS Agreement, we believe it necessary to make our findings clear on the issue of transparency in order to avoid a legal vacuum in the event that, upon appeal, the Appellate Body were to reverse our findings on Article 70.8").

of the reduction commitment level.[491] We see no reason, in the circumstances of this case, to disagree with this interpretation of Article 10. In our view, Article 10.3 does, indeed, address both (i) the question of who bears the burden of proving whether or not an export subsidy is at issue in a specific instance[492], and (ii) the question of when certain export subsidies can be said to be applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments.

7.123 We recall that, in this case, figures submitted by Canada show that for all of the dairy products in dispute and this during both marketing years at issue, the total amount of exports generated through Classes 5(d) and (e) exceeds Canada's reduction commitment level.[493] We also recall our consideration above that granting export subsidies "other" than those listed in Article 9.1 in excess of the relevant reduction commitment level for the subsidized product concerned, is sufficient to conclude that Article 10.1 is violated.[494] Therefore, in the circumstances of this dispute, whether or not Article 10.1 is violated depends on whether or not Classes 5(d) and (e) involve an "other" export subsidy in the sense of Article 10.1. In other words, in this dispute, we only need to further examine whether the first element of Article 10.1 is met.

(b) An "other" Export Subsidy under Article 10.1

7.124 The Article 10.1 concept of "[e]xport subsidies not listed in paragraph 1 of Article 9" is not further defined in Article 10 itself. Article 1(e) states, however, that:

> "[i]n this Agreement, unless the context otherwise requires: … 'export subsidies' refers to *subsidies contingent upon export performance*, including the export subsidies listed in Article 9 of this Agreement".[495]

For purposes of Article 10.1, we thus need to examine whether Classes 5(d) and (e) involve "subsidies contingent upon export performance" in the sense of Article 1(e) other than those listed in Article 9.1. Since we assumed earlier - in the alternative and for purposes only of our examination under Article 10.1 - that Classes 5(d) and (e) do *not* involve export subsidies as listed in Article 9.1, we need to examine next whether they do, nevertheless, constitute export subsidies in the sense of Article 1(e).[496]

7.125 In our view, Article 1(e) covers a wider range of "export subsidies" than the specific practices listed in Article 9.1. Article 1(e) explicitly states that it "includes" - and is thus not limited to - export subsidies listed in Article 9.1. We consider, therefore, that any subsidy contingent upon export performance other than one listed in Article 9.1 is covered by Article 10.1. Accordingly, measures which meet some but not all of the definitional elements of the individual export subsidy practices listed in Article 9.1 would be covered by Article 10:1, provided that they meet the basic re-

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491 See, in particular, Canada's answer to Panel Question 16 to Canada.

492 See paras. 7.32-7.34.

493 See para. 7.115, referring to Table 2 in para. 2.41.

494 See para. 7.122.

495 Emphasis added.

496 With reference to para. 7.41 and footnote 453, to the extent that the US claims also cover any of the milk classes other than Classes 5(d) and (e), we note that all of these other milk classes can also (often exclusively) be accessed by processors which produce for the domestic market. Nothing offered under these other milk classes is thus "contingent upon export performance". We therefore find that these other milk classes do not involve an export subsidy in the sense of Article 10.1.

quirement of Article 1(e) that they are "subsidies contingent upon export performance". However, neither the wording of Article 9.1, Article 10 nor Article 1(e) explicitly indicates which of the Article 9.1 limitations are no longer valid under Article 10.1. The guidance that *can* be derived from Article 9.1, as part of the context of Article 1(e) and Article 10.1, is that Article 10.1 must include certain payments-in-kind and producer-financed schemes which do not fully meet all elements under, respectively, Article 9.1(a) or Article 9.1(c). In this respect, it could, for example, be argued that where Article 9.1(a) addresses the provision by governments or their agencies of "direct subsidies, including payments-in-kind" contingent on export performance, Article 10.1 can be presumed to cover the indirect version of such subsidies.

7.126 We find further guidance to interpret the meaning of a subsidy contingent upon export performance for the purposes of Article 1(e) and Article 10.1, *inter alia*, in the SCM Agreement which is, we consider, part of the general context of Article 1(e) and Article 10.1. Article 1 of the SCM Agreement, for example, includes as a subsidy "any form of income or price support in the sense of Article XVI of GATT 1994" whereby a benefit is conferred. However, since in this case we need to interpret the meaning of certain "export subsidies", we consider it more appropriate, without prejudice to the scope of Article 10.1, to examine what practices are considered under the SCM Agreement to be "export subsidies", rather than to examine how that Agreement defines the more general concept of a "subsidy" in its Article 1. Annex I to the SCM Agreement - the Illustrative List of Export Subsidies - identifies practices which are, under Article 3 of the SCM Agreement, "subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance". Both complainants invoke Paragraph (d) of the Illustrative List which provides that the following action is an "export subsidy" for purposes of the SCM Agreement:

> "The provision by governments or their agencies either directly or indirectly through government-mandated schemes, of imported or domestic products or services for use in the production of exported goods, on terms or conditions more favourable than for provision of like or directly competitive products or services for use in the production of goods for domestic consumption, if (in the case of products) such terms or conditions are more favourable than those commercially available on world markets to their exporters".

A footnote added to the term "commercially available" states:

> "The term 'commercially available' means that the choice between domestic and imported products is unrestricted and depends only on commercial considerations".

7.127 Given that Paragraph (d) deals with the provision of products at different prices for, on the one hand, use in the production of *exported goods* and, on the other hand, use in the production of goods *for domestic consumption*, we agree with the parties that Paragraph (d) under the Illustrative List is the most relevant one to this case. We next examine whether the provision of milk at a lower price for export under Classes 5(d) and (e) falls within the scope of Paragraph (d).

7.128 In our view, Paragraph (d), applied to the facts of this case, requires the presence of three elements:

(a) the provision of "imported or domestic products … for use in the production of exported goods, on terms or conditions more favourable than for provision of like or directly competitive products … for use in the production of goods for domestic consumption";

(b) such provision of products for use in the production of exported goods is provided "by governments or their agencies either directly or indirectly through government-mandated schemes"; and

(c) the more favourable terms or conditions for such products for use in the production of exported goods are also "more favourable than those commercially available on world markets to their exporters"; these terms or conditions will only *not* be more favourable than those commercially available on world markets when the choice to be made by processors/exporters between buying either domestic products or imported products "is unrestricted and depends only on commercial considerations".

7.129 As to the first element under Paragraph (d), it is undisputed that through Classes 5(d) and (e) domestically produced milk is provided for use in the production of exported goods (processed dairy products) on terms and conditions more favourable than for provision of the same domestically produced milk for use in the production of dairy products for domestic consumption.[497] As we found earlier, the price differential between milk for use in exports and milk for use on the domestic market is significant.[498] We thus find that the first element under Paragraph (d) is met.

7.130 Examining the second element under Paragraph (d), we recall our analysis under Article 9.1(a) on the basis of which we found that under Classes 5(d) and (e) milk for export at a discounted price is "provided by" Canada's "governments or their agencies".[499] Even if we would have found that such lower priced milk is *not* "provided by" Canada's "governments or their agencies" - something we could assume here given that our examination under Article 10.1 is one in the alternative, i.e., on the assumption that the scheme is *not* an Article 9.1(a) export subsidy - we still consider that the evidence of record, outlined in paragraphs 7.68 to 7.85, is conclusive for us to find that such milk is, nevertheless, "provided by" Canada's "governments or their agencies either directly *or indirectly through government-mandated schemes*"[500] in the sense of Paragraph (d). Indeed, in the event milk were not directly provided by Canada's governments or their agencies under Classes 5(d) and (e), in our view, it is at least indirectly provided through government-mandated schemes. For there to be such schemes we do not consider it necessary, as argued by Canada, that the federal or provincial governments specifically direct a certain outcome or course of action to be achieved or taken by the CDC, the provincial marketing boards or the CMSMC. In our view, the ordinary meaning of the term "government-mandated" scheme - in its imme-

[497] See Table 3 in para. 2.51.
[498] See para. 7.50.
[499] See paras. 7.63-7.86.
[500] Emphasis added.

diate context of products being provided "*indirectly* through government-mandated schemes" - also includes the delegation of authority by the government to its agencies which, in turn, set up a "government-mandated" scheme.[501] We thus find that in this case the second element under Paragraph (d) is met.

7.131 Finally, referring to the third element under Paragraph (d), we recall our examination of whether or not the provision of milk to processors/exporters under Classes 5(d) and (e) confers a benefit to these processors/exporters, in such a way that one can conclude that a payment in kind is made to them in the sense of Article 9.1(a).[502] We recall, in particular, those paragraphs where we applied the benchmark of whether processors/exporters can access milk, or for that matter milk derivatives, from any other source - in particular the world market - on terms and conditions equally favourable to those offered under Classes 5(d) and (e).[503] There we found that "the provision of milk to processors/exporters under Classes 5(d) and (e) at a price significantly lower than the domestic milk price … and *on terms and conditions which are more favourable than those under any other alternative source, including under the Import for Re-Export Programme* … - confers a "benefit" … to these processors/exporters and, for that reason, constitutes a payment in kind - namely, the provision of a good at a discounted price - in the sense of Article 9.1(a)".[504] Even if we had found that Classes 5(d) and (e) do *not* involve the payment in kind referred to in Article 9.1(a) - something we could assume here given that our examination under Article 10.1 is one in the alternative, i.e., on the assumption that the scheme is *not* an Article 9.1(a) export subsidy - we nevertheless consider that the evidence of record is conclusive for us to find that the provision of milk under Classes 5(d) and (e) is made on "terms or conditions … more favourable than those commercially available on world markets" in the sense of Paragraph (d). We refer, in particular, to paragraphs 7.52 to 7.56 which, in our view, provide sufficient proof that the choice to be made by processors/exporters between accessing milk under Classes 5(d) or (e) and sourcing milk, or for that matter milk derivatives - in the event these milk derivatives could be considered to be directly competitive with fluid milk (an issue which is in dispute[505]) and assuming that the availability of a directly competitive product is relevant in cases where the like product is not available - is not a choice which is "unrestricted and depends only on commercial considerations" in the sense of the footnote to Paragraph (d). We recall, in particular, the discretion granted to the Minister of Foreign Affairs and International Trade who has to issue a permit for imports to be allowed[506]; the fact that to date commercial imports of fluid milk cannot, for all practical purposes, enter Canada[507]; and the figures submitted to us which indicate - albeit in general terms only - that under Classes 5(d) and (e) milk can be sourced on more

[501] The *New Shorter Oxford English Dictionary* (Ed. Brown, L., Clarendon Press, Oxford, Volume 1, p. 1683) defines "mandate" as follows: "1. Command, require by mandate; necessitate … 4. Give a mandate to, delegate authority to (a representative, group, organization, etc.)".
[502] See paras. 7.46 ff.
[503] See paras. 7.49-7.58.
[504] Para. 7.58, emphasis added.
[505] See para. 7.55.
[506] See para. 7.53.
[507] See para. 7.54.

favourable terms and conditions than under, e.g., the Import for Re-Export Programme, an indication reflected also in the overwhelming preference of processors/exporters for milk under Classes 5(d) and (e).[508]

7.132 For the above reasons[509], we find that Classes 5(d) and (e) involve an export subsidy as listed in Paragraph (d) of the Illustrative List of Export Subsidies annexed to the SCM Agreement. We do not consider it necessary in this case to decide whether the fact that a scheme involves an export subsidy under the SCM Agreement necessarily means that it also constitutes an export subsidy under Article 1(e) of the Agreement on Agriculture. We are not called upon - and do not intend here - to decide whether the scope of the concept of export subsidy under the SCM Agreement is the same as, or different than, that under the Agreement on Agriculture. We do find, however, that in the circumstances of this case and on the grounds outlined above[510], Classes 5(d) and (e) - assuming, in the alternative, that they do *not* constitute an export subsidy as listed in either Article 9.1(a) or Article 9.1(c) - nevertheless involve an "other" export subsidy in the sense of Article 10.1.

7.133 Given our finding in the previous paragraph and recalling: (i) our consideration above that granting export subsidies "other" than those listed in Article 9.1 in excess of the relevant reduction commitment level for the subsidized product concerned, is sufficient to conclude that Article 10.1 is violated[511]; and (ii) the fact that for all of the dairy products in dispute and this during both marketing years at issue, the total amount of exports generated through Classes 5(d) and (e) does exceed Canada's reduction commitment levels, we find that Canada - in the alternative, i.e., only in the event Classes 5(d) and (e) do not involve export subsidies as listed in either Article 9.1(a) or Article 9.1(c) - has acted inconsistently with its obligations under Article 10.1 with respect to all three dairy products at issue and during both marketing years in dispute.

9. Article 8 of the Agreement on Agriculture

7.134 Recalling that Article 8 of the Agreement on Agriculture provides that "[e]ach Member undertakes not to provide export subsidies otherwise than in conformity with this Agreement", we also find that as a consequence of the violations of either Article 3.3 (through Article 9.1) or Article 10.1 we found earlier[512], Canada has acted inconsistently with its obligations under Article 8.

10. Article 3 of the SCM Agreement

7.135 The United States also claims that the provision of milk under Classes 5(d) and (e) is inconsistent with Canada's obligations under Article 3 of the SCM Agreement which contains, *inter alia*, a general prohibition on export subsidies.

7.136 We have found that the Canadian scheme is inconsistent with: (i) Canada's obligations under both Article 3.3 and Article 8 (through Article 9.1(a) and Article

[508] See para. 7.56.
[509] See paras. 7.129-7.131.
[510] See paras. 7.124-7.131.
[511] See para. 7.122.
[512] See, respectively, in paras. 7.116 and 7.133.

9.1(c))[513]; or (ii) in the alternative, Canada's obligations under both Article 10.1 and Article 8[514], of the Agreement on Agriculture. Therefore, the exemption provided for in Article 13(c)(i) of the Agreement on Agriculture from actions under Article 3 of the SCM Agreement for "export subsidies that conform fully to the provisions of Part V" of the Agreement on Agriculture, does not apply. In principle, the scheme could therefore also be subjected to an examination under Article 3 of the SCM Agreement.

7.137 Article 3 is identified in the US request for this Panel and could thus, in principle, be presumed to fall within the Panel's terms of reference.[515] The question then arises whether we could and, as the case may be, should apply the principle of judicial economy and decide *not* to examine the US claim under Article 3. We recall the Appellate Body's statement in *Australia - Salmon*, quoted earlier[516], which provides the most recent statement on when judicial economy can be exercised.

7.138 We note, firstly, that although the United States extensively referred to the SCM Agreement as *context* of its claims under the Agreement on Agriculture, the US arguments on its *claim* under Article 3 of the SCM Agreement are minimal.[517] The US' only argument under Article 3 is effectively that because Canada violated its export subsidy commitments under the Agreement on Agriculture, it thereby automatically violates its obligations under Article 3 of the SCM Agreement.[518]

7.139 Secondly, we note that Article 4 of the SCM Agreement (entitled "Remedies") provides for "special or additional rules and procedures on dispute settlement" (as referred to in Article 1.2 of the DSU) in respect of claims made under Article 3. Article 4 sets out rights and obligations which may benefit either party to a dispute. It obliges panels to give recommendations that differ from those generally made under the DSU, a right which may be beneficial to complaining parties. Pursuant to Article 4.7, a panel *has to* recommend to the DSB that the subsidy be withdrawn without delay and *has to* specify the time-period allowed for such withdrawal. However, Ar-

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[513] See paras. 7.116 and 7.134.

[514] See paras. 7.133 and 7.134.

[515] The question arises, however, whether we can examine the Article 3 claim at all (even though Article 3 is mentioned in the US Panel request) given that in the US request for consultations and for establishment of this Panel, the United States only invoked - as a legal basis for consultations and a Panel on its SCM claim - Article 30 of the SCM Agreement, i.e., the general provision on "Dispute Settlement" (together with Articles 4 and 6 of the DSU), and *not* the more specific Article 4 of the SCM Agreement which sets out certain special and additional dispute settlement procedures for cases involving prohibited subsidies. We note that - given the multiple claims submitted in this dispute (both under the Agreement on Agriculture and the SCM Agreement) - the United States could, for example, have invoked Article 4 as a legal basis to obtain recommendations with respect to its Article 3 claim, while at the same time waive its right to, *inter alia*, those elements of the accelerated procedure under Article 4 that are at odds with the usual timetable applicable under the DSU. However, as further discussed below, we do not consider it necessary to answer these questions in this case.

[516] See para. 7.119.

[517] The only US argument is, indeed: "Consequently, these export subsidies are also inconsistent with Canada's obligations under Article 3 of the SCM Agreement" (US first submission, para. 125).

[518] In this respect, we note, however, that as opposed to our examination of this dispute under the Agreement on Agriculture (where Canada was found to bear the burden of proof, see para. 7.34), under Article 3 of the SCM Agreement, the usual rules on burden of proof apply.

ticle 4 also requires, in paragraph 2, that a request for consultations "include a statement of available evidence with regard to the existence and nature of the subsidy in question", a provision which may work to the advantage of the defending party. The same is true, in our view, in respect of Article 4.5 which states that "[u]pon its establishment, the panel may request the assistance of the Permanent Group of Experts … with regard to whether the measure in question is a prohibited subsidy". Article 4 also imposes a time-frame that is stricter than the usual DSU time-frame for the settlement of disputes. These shorter time periods may also be advantageous to defending parties in that their situation will need to be clarified more rapidly.

7.140 However, in this case the United States never invoked or even referred to the rules and procedures contained in Article 4. It did not do so in its request for consultations, in its request for a panel or in any of its submissions before the Panel, nor did it at any stage in this dispute pursue the matter within the framework of Article 4. Given that the United States - and, as a result, also Canada and the Panel - did not at any point proceed under Article 4, we consider it inappropriate at this stage - given also our earlier findings of violation of the Agreement on Agriculture - to further pursue the US claim under Article 3.

7.141 On the grounds set out above[519], and in view of the particular circumstances of this case, we thus conclude that we should apply the principle of judicial economy and, therefore, do not examine Article 3 of the SCM Agreement.

C. The Tariff-Rate Quota for Fluid Milk

1. Facts and Claims of the Parties

7.142 In Part I of Canada's Schedule to GATT 1994, Canada established a tariff-rate quota for fluid milk (HS 0401.10.10 and 0401.20.10) of 64,500 tonnes. In-quota imports are subject, initially, to a maximum duty of 17.5 per cent (a rate to be decreased to 7.5 per cent in 2001). Fluid milk imports outside of the 64,500 tonnes tariff-rate quota bear an initial rate of duty equal to 283.8 per cent, declining to 241.3 per cent in 2001. In its Schedule, Canada specified under "Other terms and conditions" that "[t]his quantity [64,500 tonnes] represents the estimated annual cross-border purchases imported by Canadian consumers".

7.143 Referring to its Schedule, Canada currently restricts access to the tariff-rate quota to cross border imports by Canadians of consumer packaged milk for personal use, valued at less than C$20 per entry. Such imports are made under the authority of the General Import Permit No.1 issued under the Export and Import Permits Act. For such imports, no individual permits are required and no duty is being imposed, not even the in-quota duty. Moreover, the quantity of these imports is not monitored so that it is not known whether the tariff-rate quota is actually filled or not, or exceeded. Commercial shipments of milk are not allowed under the tariff-rate quota.

7.144 The United States claims that by confining the scope of fluid milk entries that are eligible under the tariff-rate quota to cross border imports by Canadians of consumer packaged milk for personal use valued at less than C$20 per entry, Canada grants imports of fluid milk treatment less favourable than that provided for in Can-

[519] See paras. 7.138-7.140.

ada's Schedule and, thus, acts inconsistently with its obligations under Article II:1(b) of GATT 1994. The United States further claims that because Canada administers the tariff-rate quota through a general permit restricting any single import entry to a value of C$20 and subjects such entries to a personal use restriction, Canada's licensing procedures introduce additional trade impediments that are inconsistent with its obligations under Article 3 of the Agreement on Import Licensing Procedures ("the Licensing Agreement").

7.145 Canada responds that the limited access to the tariff-rate quota is provided for in its Schedule, read in light of its negotiating history, and that, accordingly, Article II:1(b) of GATT 1994 is complied with. Canada argues that since no restrictions are placed on imports that are additional to the terms and conditions incorporated in Canada's Schedule, Canada's import regime is in complete compliance with the Licensing Agreement.

2. Article II:1(b) of GATT 1994

7.146 Article II:1(b) of GATT 1994 provides:

> "The products described in Part I of the Schedule relating to any contracting party, which are the products of territories of other contracting parties, shall, on their importation into the territory to which the Schedule relates, and *subject to the terms, conditions or qualifications set forth in that Schedule, be exempt from ordinary customs duties in excess of those set forth and provided therein*".[520]

This provision needs to be read in the context of Article II:1(a) of GATT 1994 which states:

> "Each contracting party shall accord to the commerce of the other contracting parties *treatment no less favourable than that provided for in the appropriate Part of the appropriate Schedule* annexed to this Agreement".[521]

7.147 The 64,500 tonnes tariff-rate quota established in Part I of Canada's Schedule can thus only be subject to the 17.5 per cent (in 2001, 7.5 per cent) duty rate set out in Canada's Schedule. Any other "terms, conditions or qualifications" with respect to the access to this tariff-rate quota need to be set forth in Canada's Schedule. In this dispute, two "conditions" effectively imposed by Canada are at issue:

(a) the fact that only consumer packaged milk for personal use can fall within the tariff-rate quota; and

(b) the fact that only entries valued at less than C$20 qualify for the tariff-rate quota.

7.148 The only "terms, conditions or qualifications" set forth in Canada's Schedule are contained in the following phrase, mentioned under "Other terms and conditions", next to the quota quantity of 64,500 tonnes:

> "This quantity represents the estimated annual cross-border purchases imported by Canadian consumers".

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[520] Underlining added.
[521] Underlining added.

If we were to find that this phrase does *not* include the two conditions currently imposed by Canada, Canada would be in violation of Article II:1(b). Our finding on the US claim of violation of Article II:1(b) thus depends on the interpretation we give to this phrase.

7.149 On the interpretation of a particular term in a Member's Schedule, the Appellate Body in its report on European *Communities - Customs Classification of Certain Computer Equipment*, stated as follows:

> "84.... Tariff concessions provided for in a Member's Schedule - the interpretation of which is at issue here - are reciprocal and result from a mutually-advantageous negotiation between importing and exporting Members. A Schedule is made an integral part of the GATT 1994 by Article II:7 of the GATT 1994. Therefore, the concessions provided for in that Schedule are part of the terms of the treaty. *As such, the only rules which may be applied in interpreting the meaning of a concession are the general rules of treaty interpretation set out in the Vienna Convention.*
>
> 85. Pursuant to Article 31(1) of the *Vienna Convention*, the meaning of a term of a treaty is to be determined in accordance with the ordinary meaning to be given to this term in its context and in the light of the object and purpose of the treaty [the Appellate Body then quotes Articles 31(2) to (4)].
>
> 86. The application of these rules in Article 31 of the *Vienna Convention* will usually allow a treaty interpreter to establish the meaning of a term. However, if after applying Article 31 the meaning of the term remains ambiguous or obscure, or leads to a result which is manifestly absurd or unreasonable, Article 32 allows a treaty interpreter to have recourse to:
>
> > ... supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion.
>
> With regard to "the circumstances of [the] conclusion" of a treaty, this permits, in appropriate cases, the examination of the historical background against which the treaty was negotiated".[522]

7.150 Accordingly, we need to examine first the ordinary meaning to be given to the relevant terms in Canada's Schedule in their context and in the light of the object and purpose of GATT 1994.

7.151 The phrase "[t]his quantity represents the estimated annual cross-border purchases imported by Canadian consumers" is mentioned under the heading "Other terms and conditions", next to the quota quantity. Even though one can thus presume that this phrase includes certain "terms and conditions" related to the tariff-rate quota, we find it difficult to read specific access restrictions into this phrase. The words "[t]his *quantity represents* the *estimated* annual ..."[523] are, in our view, intro-

[522] Adopted on 5 June 1998, WT/DS62/AB/R, paras. 84-86, underlining added.
[523] Emphasis added.

ducing "terms" related to the *quantity* of the quota - i.e., describing the way the size of the quota was determined - rather than setting out "conditions" as to the *kind* of imports qualified to enter Canada under this quota. In particular, the ordinary meaning of the word "represent" in this context does not, in our view, call to mind the setting out of specific restrictions or conditions.[524]

7.152 Even if the phrase could be said to include restrictions on access to the tariff-rate quota, we do not see how the two conditions *at issue in this dispute* could be read into this phrase. First, the restriction that only entries valued at less than C$20 qualify for the tariff-rate quota can nowhere be found in Canada's Schedule. Nowhere is any reference made to a maximum value per entry. Second, the requirement that only consumer packaged milk for personal use can fall within the tariff-rate quota, could only be referred to in the words "cross-border purchases imported by Canadian consumers". One could interpret these terms as restricting access to Canadians only (as opposed to, e.g., US citizens or residents) who make cross-border purchases. However, in our view, the ordinary meaning of the words "cross-border purchases" by "consumers" in this context does not warrant the conclusion that only *consumer packaged* milk *for personal use* can enter under the tariff-rate quota. An imported good, by definition, crosses a border. Also, the dictionary meaning of "consumer" is not restricted to a person buying *for personal use in small retail packages*. All dictionary definitions of "consumer" referred to by the parties include wider definitions without these restrictions.[525]

7.153 We find support for our view that the two access restrictions at issue here are not set forth in Canada's Schedule when comparing the phrase in dispute to other "terms and conditions" specified in Canada's Schedule, in particular those in the field of milk and dairy products which are part of the immediate context of the phrase we need to interpret. With respect to the tariff-rate quota for cream, under "Other terms and conditions", the far more precise and mandatory phrase "sterilized cream, minimum 24 per cent butterfat, in cans of a volume not exceeding 200 ml" is added. For the tariff-rate quotas established for yoghurt and ice cream, the following is added: "access for yoghurt [ice cream] in retail sized containers only". No such restrictive language can be found in the phrase at issue here.

7.154 In this respect, we also refer to the object and purpose of Article II of GATT 1994, namely "to preserve the value of tariff concessions negotiated by a Member with its trading partners, and bound in that Member's Schedule. Once a tariff concession is agreed and bound in a Member's Schedule, a reduction in its value by the imposition of

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[524] The *New Shorter Oxford English Dictionary*, for example, defines "represent", as used in this context, as: "1. Bring into the presence of someone or something ... 2. Bring clearly and distinctly to mind, esp. by description or imagination ... 5. ... b. Of a quantity: indicate or imply (another quantity) ..." (Ed. Brown, L., Clarendon Press, Oxford, Volume 2, p. 2552).

[525] The *New Shorter Oxford English Dictionary*, for example, defines "consumer" as "1. A person who or thing which squanders, destroys, or uses up. 2. A user of an article or commodity, a buyer of goods or services. Opp. *producer*" (Ed. Brown, L., Clarendon Press, Oxford, Volume 1, p. 490). The *Black's Law Dictionary*, referred to by Canada, defines "consumer" as: "Individuals who purchase, use, maintain, and dispose of products and services ... Consumers are to be distinguished from manufacturers (who produce goods) and wholesalers and retailers (who sell goods). A buyer (other than for the purpose of resale) of any consumer product" (West Publishing Co., Minneapolis Minn., 1990).

duties in excess of the bound tariff rate would upset the balance of concessions among Members"[526]; as well as to the object and purpose of the WTO Agreement, generally, and of GATT 1994, namely "the security and predictability of the reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade".[527] We cannot read the access restrictions imposed by Canada in its current Schedule. The principles of security and predictability, as well as those of treaty interpretation, do not "condone the imputation into a treaty of words that are not there or the importation into a treaty of concepts that are not intended".[528]

7.155 On these grounds, we consider that the meaning of the terms at issue can be established by examining their ordinary meaning in their context and in the light of the object and purpose of GATT 1994. In accordance with the rules of treaty interpretation referred to above[529], we see no need to also examine the historical background against which these terms were negotiated. We do note, however, that the drafting history of the relevant part of Canada's Schedule is inconclusive, possibly supporting both the view of Canada and that of the United States.[530]

7.156 We, therefore, find that Canada, by restricting the access to the tariff-rate quota for fluid milk to (i) consumer packaged milk for personal use and (ii) entries valued at less than C$20, acts inconsistently with its obligations under Article II:1(b) of GATT 1994.

3. The Licensing Agreement

7.157 Since we have found above that the two access restrictions imposed by Canada with respect to its tariff-rate quota for fluid milk are contrary to Canada's obligations under Article II:1(b) of GATT 1994, we see no need to examine whether in so doing Canada also violates Article 3 of the Licensing Agreement.

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[526] Appellate Body report on *Argentina - Measures Affecting Imports of Footwear, Textiles, Apparel, and Other Items*, adopted on 27 March 1998, WT/DS56/AB/R, para. 47.

[527] Appellate Body report on *European Communities - Customs Classification of Certain Computer Equipment*, op. cit., para. 82.

[528] Appellate Body report on *India - Patent Protection for Pharmaceutical and Agricultural Chemicals*, adopted on 19 December 1997, WT/DS50/AB/R, para. 45, DSR 1998:I, 9.

[529] See para. 7.149.

[530] No agreement between Canada and the United States as to whether or not the phrase in dispute includes the two access restrictions imposed by Canada, can be derived from the drafting history. Canada argues that during the Uruguay Round negotiations it clearly indicated to the United States that "it intended to continue its access for US milk imported by Canadian consumers while non-consumer utilisation would continue to be blocked until equivalency was established" (Canada's oral statement at our second substantive meeting, para. 129). The United States, on the other hand, submits that the phrase at issue was added to clarify that the tariff-rate quota was a continuation of "current access" opportunities already available before the Uruguay Round negotiations; not a phrase limiting access to the quota as such. In so doing, the United States argues, Canada avoided granting the "minimum access opportunities" for products for which there are no significant imports (ranging from 3 to 5 per cent of domestic consumption) refered to in the Agreement on Modalities for the Establishment of Specific Binding Commitments under the Reform Programme (MTN.TNC/W/FA, p. L.19, 20 December 1991).

VIII. CONCLUSIONS

8.1 In the light of the above findings we conclude that Canada:

(a) through Special Milk Classes 5(d) and (e) - and this for all of the dairy products in dispute (butter, cheese and "other milk products") and for both marketing years at issue (1995/1996 and 1996/1997) - has acted inconsistently with its obligations under Article 3.3 and Article 8 of the Agreement on Agriculture by providing export subsidies as listed in Article 9.1(a) and Article 9.1(c) of that Agreement in excess of the quantity commitment levels specified in Canada's Schedule; and

(b) by restricting the access to the tariff-rate quota for fluid milk to (i) consumer packaged milk for personal use and (ii) entries valued at less than C$20, acts inconsistently with its obligations under Article II:1(b) of GATT 1994.

8.2 Since Article 3.8 of the DSU provides that "[i]n cases where there is an infringement of the obligations assumed under a covered agreement [including the Agreement on Agriculture and GATT 1994], the action is considered *prima facie* to constitute a case of nullification or impairment", we conclude that - to the extent Canada has acted inconsistently with its obligations under the Agreement on Agriculture and GATT 1994 - it has nullified or impaired benefits accruing to New Zealand and the United States under these Agreements.

8.3 We *recommend* that the Dispute Settlement Body requests Canada: (i) to bring its dairy products marketing regime into conformity with its obligations in respect of export subsidies under the Agreement on Agriculture[531]; and (ii) to bring its tariff-rate quota for fluid milk into conformity with GATT 1994.

[531] In this respect, we recall our findings under Article 10.1 and Article 8 of the Agreement on Agriculture (paras. 7.117-7.134).

TURKEY - RESTRICTIONS ON IMPORTS OF TEXTILE AND CLOTHING PRODUCTS

Report of the Appellate Body
WT/DS34/AB/R

Adopted by the Dispute Settlement Body
on 19 November 1999

Turkey, *Appellant*
India, *Appellee*
Hong Kong, China; Japan; and the Philippines, *Third Participants*

Present:
Beeby, Presiding Member
Bacchus, Member
El-Naggar, Member

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I. INTRODUCTION

1. Turkey appeals from certain issues of law and legal interpretations in the Panel Report, *Turkey - Restrictions on Imports of Textile and Clothing Products* (the "Panel Report").[1] The Panel was established to consider a complaint by India regarding quantitative restrictions introduced by Turkey on imports of Indian textile and clothing products.

2. On 6 March 1995, the Turkey-EC Association Council adopted Decision 1/95[2], which sets out the rules for implementing the final phase of the customs union

[1] WT/DS34/R, 31 May 1999.
[2] Reproduced in WT/REG22/1.

between Turkey and the European Communities. Article 12(2) of this Decision states:

> In conformity with the requirements of Article XXIV of the GATT Turkey will apply as from the entry into force of this Decision, substantially the same commercial policy as the Community in the textile sector including the agreements or arrangements on trade in textile and clothing.

In order to apply what it considered to be "substantially the same commercial policy" as the European Communities on trade in textiles and clothing, Turkey introduced, as of 1 January 1996, quantitative restrictions on imports from India on 19 categories of textile and clothing products.[3]

3. The Panel considered claims by India that the quantitative restrictions introduced by Turkey were inconsistent with Articles XI and XIII of the GATT 1994, and Article 2.4 of the Agreement on Textiles and Clothing (the "*ATC*"). In the Panel Report, circulated on 31 May 1999, the Panel reached the conclusion that the quantitative restrictions were inconsistent with the provisions of Articles XI and XIII of the GATT 1994 and consequently with those of Article 2.4 of the *ATC*, and rejected Turkey's defence that the introduction of any such otherwise GATT/WTO incompatible import restrictions is permitted by Article XXIV of the GATT 1994.[4]

4. On 26 July 1999, Turkey notified the Dispute Settlement Body (the "DSB") of its intention to appeal certain issues of law covered in the Panel Report and legal interpretations developed by the Panel, pursuant to Article 16.4 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "DSU"), and filed a Notice of Appeal pursuant to Rule 20 of the *Working Procedures for Appellate Review* (the "*Working Procedures*"). On 5 August 1999, Turkey filed its appellant's submission.[5] On 20 August 1999, India filed an appellee's submission.[6] On the same day, Hong Kong, China; Japan; and the Philippines filed third participant's submissions.[7]

5. The oral hearing in the appeal was held on 14 September 1999. The participants and third participants presented oral arguments and responded to questions put to them by the Members of the Division hearing the appeal.

II. ARGUMENTS OF THE PARTICIPANTS

A. Claims of Error by Turkey - Appellant

6. Turkey appeals the Panel's finding that Article XXIV of the GATT 1994 does not allow it to introduce, upon the formation of its customs union with the European Communities, quantitative restrictions on textile and clothing products which are inconsistent with Articles XI and XIII of the GATT 1994 and Article 2.4 of the *ATC*.

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[3] For a further discussion of the underlying facts and a more detailed description of the products involved in this case, see the Panel Report, paras. 2.2-2.46 and 4.1-4.3, and the Annex to the Report.

[4] Panel Report, para. 10.1.

[5] Pursuant to Rule 21(1) of the *Working Procedures*.

[6] Pursuant to Rule 22(1) of the *Working Procedures*.

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

7. Turkey argues that the Panel erred in presuming the existence of a conflict between, on the one hand, Articles XI and XIII of the GATT 1994 and Article 2.4 of the *ATC*, and, on the other, Article XXIV of the GATT 1994. The Panel's reasoning was based on the incorrect presumption that the quantitative restrictions introduced by Turkey in the framework of its customs union with the European Communities were incompatible with Turkey's WTO obligations.

8. According to Turkey, Article XXIV permits the common regulation of commerce of a customs union in a particular sector to be determined by one of the constituent members' lawful quantitative restrictions in that sector, provided that unified regulations are not on the whole more restrictive than the previous regulations of the constituent members.

9. Turkey further contends that Article XXIV is different from exceptions such as Articles XX and XXI of the GATT 1994. The right under Article XXIV to establish a customs union is an autonomous right; it is not an "exception" from other GATT obligations.

10. Turkey argues that the Panel ignored the proper relationship between Article XXIV and the general obligations under the GATT 1994. The Panel did not properly interpret the ordinary meaning of the text of Article XXIV, and, in particular, the chapeau of paragraph 5 of that Article. The ordinary meaning of the chapeau of paragraph 5 demonstrates that Article XXIV confers on WTO Members a right to enter into a customs union, and to derogate, under certain conditions, from their GATT obligations, including, but not limited to, their obligations under Article I.

11. In Turkey's view, other provisions in Article XXIV confirm that forming a customs union or free-trade area is a right of WTO Members. The provisions of Articles XXIV:6, XXIV:7, XXIV:8 and XXIV:9 establish requirements for implementation of a customs union, but do not prohibit its ultimate formation, thereby supporting the proposition that Members have a right to form a customs union under Article XXIV.

12. Turkey argues that there is no textual support for the Panel's conclusion that Article XXIV permits derogations from Article I, but not from other GATT provisions. The chapeau of Article XXIV:5 states that "the provisions of this Agreement" shall not prevent the formation of a customs union, thereby covering all provisions of the GATT 1994, not just Article I.

13. Turkey claims that the Panel's conclusion that Article XXIV:5(a) "does not authorize Members forming a customs union to deviate from the prohibitions contained in Articles XI and XIII of GATT or Article 2.4 of the ATC"[8] was based on a number of legal errors. First, Turkey argues that the Panel misinterpreted the ordinary meaning of Article XXIV:5(a). Specifically, Turkey argues that the Panel ignored the chapeau to Article XXIV:5. The chapeau clearly states that no GATT 1994 provision shall "prevent" the formation of a customs union as long as certain conditions set out in sub-paragraph 5(a) are satisfied. The Panel ignored the chapeau, and, as a result, came to the erroneous conclusion that Article XXIV:5(a) does not "authorize or prohibit" the use of quantitative restrictions upon the formation of a customs union.

[8] Panel Report, para. 9.134.

14. Second, Turkey argues that the Panel's reading of Article XXIV:5(a) must fail because it renders the provision a "nullity". The "economic test" established by sub-paragraph 5(a) applies to the duties and regulations of commerce of the customs union as a whole, not, as stated by the Panel, to the duties and regulations of the particular customs union members. Under the Panel's interpretation, the introduction of an otherwise inconsistent measure could disqualify the customs union even though trade flows were, on the whole, facilitated.

15. Third, Turkey argues that the Panel's analysis of "the immediate context" of Article XXIV:5(a) does not support its interpretation of that provision. The Panel failed to include the chapeau of Article XXIV:5(a) in its analysis of the context. Furthermore, the Panel misinterpreted the context of Article XXIV:5(a), in particular, Articles XXIV:5(b), XXIV:4, XXIV:6, and the location of Article XXIV in Part III of the GATT 1994.

16. Turkey also claims that the Panel failed to interpret properly the ordinary meaning of Article XXIV:8(a). The Panel erred by failing to examine the entire context of Article XXIV:8(a), and, therefore, overlooked the interdependent nature of sub-paragraphs 8(a)(i) and 8(a)(ii), and their relationship in the broader context of Article XXIV.

17. Turkey submits that if it is not allowed to impose quantitative restrictions on the textile and clothing products at issue in this case, the European Communities will exclude 40 per cent of Turkey's exports from the customs union between Turkey and the European Communities, thereby leading to an inconsistency with Article XXIV:8(a)(i). Turkey will thus be exposed to a challenge that the proposed customs union does not cover "substantially all trade" and, therefore, is not consistent with Article XXIV.

18. Turkey notes that the Panel stated that Turkey had several alternatives to the imposition of quantitative restrictions: increased tariffs, rules of origin, early phase-out, and tariffication. Each of these suggestions is flawed, and, moreover, Turkey fails to see how the Panel could conclude that Turkey had a duty to opt for one of these alternatives as long as the measures challenged by India did not result in the common regulation of commerce of the Turkey/EC customs union being on the whole more restrictive than the regulations of Turkey and the European Communities before the formation of the customs union.

19. Turkey also argues that the wider context of Articles XXIV:5 and XXIV:8 and the object and purpose of the *WTO Agreement* do not support the Panel's interpretation. Article XXIV:4, the Preamble of the *Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994* (the "*Understanding on Article XXIV*") and the Singapore Ministerial Declaration do not support a conclusion that the introduction of quantitative restrictions as part of the formation of a customs union is prohibited by Article XXIV.

20. Finally, Turkey argues that the Panel drew the wrong conclusion from past GATT/WTO practice. The Panel concluded from its review of GATT/WTO practice that there is no agreement or acceptance that Article XXIV *authorized or required* the introduction of otherwise GATT/WTO inconsistent measures upon the formation of a customs union. The Panel erred, however, by not reviewing whether GATT/WTO practice *prohibited* the introduction of such measures. Turkey recalls, for example, that during the accession of Sweden to the European Communities, Sweden adopted quantitative restrictions similar to those challenged in this case. In

that case, no GATT Contracting Party challenged those measures under Articles XXII or XXIII of the GATT.

B. Arguments of India - Appellee

21. India argues that the Panel's ruling that Article XXIV does not authorize the introduction of quantitative restrictions in this case is compelled by the recognized principles of interpretation set out in Articles 31 and 32 of the *Vienna Convention on the Law of Treaties*. The terms of Article XXIV:5 exempt from the other obligations of the GATT 1994 only those measures that are "inherent" in the formation of a customs union. For example, in order to form a customs union, preferential treatment inconsistent with Article I of the GATT 1994 must be granted. By contrast, customs unions can be formed without the introduction of new quantitative restrictions on imports that are inconsistent with Article XI of the GATT 1994.

22. India argues that the context of Article XXIV:5 confirms this interpretation. Article XXIV:4 explains why customs unions are permitted and which purposes they are to serve. Based on the context provided by Article XXIV:4, Article XXIV:5 cannot be interpreted to provide a justification for measures raising barriers to the trade of other WTO Members. Furthermore, the existence in Article XXIV:6 of a mechanism for compensation in the case of increases in tariff duties, without a corresponding provision for compensation for the introduction of new quantitative restrictions, makes clear that Article XXIV was not meant to authorize the imposition of quantitative restrictions.

23. Examining the object and purpose of the *WTO Agreement*, India notes Turkey's argument that the requirements of Article XXIV:5 and Article XXIV:8 apply to the import regimes of the WTO Members forming the customs union taken as a whole, not to individual measures. As there is, however, no mechanism for providing compensation for the introduction of new quantitative restrictions, acceptance of Turkey's argument would induce Members forming a customs union to replace the protection afforded by their tariffs with new quantitative restrictions. This result contradicts the object and purpose of the drafters, who established a strong prohibition on the use of quantitative restrictions.

24. With respect to Turkey's general claims of legal error, India argues that the Panel did not presume a conflict between the provisions of Article XXIV and the provisions of Articles XI and XIII of the GATT 1994 and Article 2.4 of the *ATC*. The Panel made no such presumption, and simply addressed the question whether there was a need to examine the consistency of the customs union with Article XXIV. Furthermore, in contrast to what Turkey argues, the Panel never stated that Article XXIV was an exception to GATT obligations. The Panel simply noted that Turkey made an "affirmative defence" based on Article XXIV.

25. Next, India responds to Turkey's statement that Article XXIV:5 permits the formation of a customs union as long as the economic assessment in sub-paragraph 5(a) is fulfilled. Article XXIV defines the purposes for which a WTO Member can deviate from other GATT provisions, but does not define the provisions themselves. Only those provisions of the GATT 1994 that "prevent" the formation of a customs union may provide the basis for a defense under Article XXIV. Under the terms of Article XXIV:5, the formation of a customs union is not "prevented" by the obligations set out in Article XI of the GATT 1994 and Article 2.4 of the *ATC*. The forma-

tion of a customs union is only "prevented" by those provisions of the GATT 1994 that prohibit discrimination, such as Article I of the GATT 1994 and other most-favoured-nation provisions, because discrimination is inherent in regional integration.

26. India also claims that, contrary to Turkey's argument, the Panel did not rule that Article XXIV justifies only deviations from Article I, and that Article XXIV consequently applied only to tariffs. In fact, the Panel made clear that Article XXIV could permit Members to refrain from applying quantitative restrictions, as well as tariffs, to their partner in the customs union.

27. Finally, according to India, Turkey is unable to explain why the mere fact that a type of measure is regulated in Part III of the GATT 1994 demonstrates that the other Parts of the GATT 1994 no longer apply. Turkey's arguments fail to take into account the reason why the drafters divided the GATT into three parts.

28. With respect to Turkey's specific claims of legal error, India responds to Turkey's objection that the Panel failed to consider the chapeau of Article XXIV:5 in its examination of Article XXIV:5(a) by arguing that the Panel in fact conducted a thorough textual and contextual analysis. In response to Turkey's claim that the Panel's interpretation renders Article XXIV:5(a) a nullity, India argues that Article XXIV:5(a) establishes a requirement that Members forming a customs union must meet in addition to their other market access obligations. This additional requirement has not been reduced to inutility by the Panel's interpretation. Members forming a customs union may not have bound all their tariffs or may apply their tariffs at levels below the bound rate, or they may have the right to impose quantitative restrictions consistently with one of the exceptions to Article XI of the GATT 1994. In these circumstances, the Members could exercise their right to increase barriers to trade, but only under the conditions set out in Article XXIV:5(a).

29. India also submits that, in contrast to Turkey's claims, the immediate context of Article XXIV:5(a) supports the Panel's interpretation that that provision does not authorize the introduction of quantitative restrictions. In particular, the text of Article XXIV:5(b), Article XXIV:4, and Article XXIV:6, as well as the placement of Article XXIV in Part III of the GATT 1994, all support the Panel's interpretation. India also argues that, contrary to Turkey's claims, the wider context of Articles XXIV:5 and XXIV:8 and the object and purpose of the *WTO Agreement* support the Panel's interpretation of these provisions.

30. Furthermore, India contends that Turkey's claim that the Panel did not properly interpret the ordinary meaning of Article XXIV:8(a) is incorrect. The Panel found that Article XXIV:8(a)(ii) does not provide authorization for Members forming a customs union to violate the prescriptions of Articles XI and XIII of the GATT 1994 or Article 2.4 of the *ATC*. Turkey objects to this interpretation on the ground that it curtails the right of Members with different trade regimes to form a customs union. Turkey fails to take into account that the right to form a customs union is not absolute. Moreover, the Panel's interpretation does not prevent Turkey from forming a customs union with the European Communities, even though it might affect the nature and timing of the formation.

31. Finally, according to India, the Panel drew the correct conclusions from GATT/WTO practice on this issue. The situation here is different from the case involving Sweden's adoption of quantitative restrictions on the occasion of its accession to the European Union, as Turkey did not accede to the European Union. The

measures at issue here are simply quantitative restrictions adopted by Turkey in the context of an agreement establishing a customs union with the European Communities.

32. In addition to responding to Turkey's general and specific claims of legal error, India makes a number of general observations. First, the argument that Article XXIV of the GATT 1994 can provide a justification for quantitative restrictions has never been accepted under the GATT 1947. Second, the agreement establishing a customs union between Turkey and the European Communities was drafted on the assumption that Article XXIV does not justify the introduction of new quantitative restrictions on imports of textile and clothing products. This agreement explicitly recognized the possibility that Turkey would not be able to impose quantitative restrictions and that, therefore, a system of certificates of origin would continue to be applied on these products. Third, the agreement between Turkey and the European Communities provides for the formation of a customs union only at a future date, and therefore constitutes, at most, an interim agreement for the formation of a customs union. To realize the objectives of this interim agreement, Turkey did not have to impose the same restrictions on imports of textiles and clothing as imposed by the European Communities.

III. ARGUMENTS OF THIRD PARTICIPANTS

A. Hong Kong, China

33. Hong Kong, China argues that Article XXIV is best characterized as a specific provision of the GATT 1994 under which WTO Members are permitted, subject to compliance with certain conditions, to form customs unions or free trade areas that may depart from certain other provisions of the *WTO Agreement*.

34. In interpreting Article XXIV:5, Hong Kong, China notes that it is important to examine the context provided by Article XXIV:4. This paragraph states that the purpose of a customs union or free-trade area is "not to raise barriers to the trade of other contracting parties with such territories." Similarly, the *Understanding on Article XXIV* states that parties to regional trade agreements "should to the greatest possible extent avoid creating adverse effects on the trade of other Members."[9] It would be contrary to the stated purpose of regional agreements set out in Article XXIV:4 to interpret the chapeau to Article XXIV:5 to permit the raising of barriers to trade in violation of Articles XI and XIII of the GATT 1994.

35. Hong Kong, China also states that, under Article XXIV:8(a), a customs union need not result in a total alignment of the external trade regimes of the constituent territories. Furthermore, Turkey's claims about past GATT/WTO practice on this issue are inapposite. In particular, the circumstances in which Sweden introduced discriminatory quantitative restrictions on imports of textile and clothing products were completely different from those in the present case.

[9] Understanding on Article XXIV, Preamble.

B. Japan

36. Japan states that a basic tenet of the *WTO Agreement* is the primacy of the multilateral trading system based on the core principle of the elimination of discriminatory treatment in international trade relations. Members must observe this principle whenever they exercise their rights and obligations under the *WTO Agreement*, including when they enter into regional trade agreements under Article XXIV of the GATT 1994. Regional trade agreements are only allowed if they are complementary to the multilateral trading system and if they comply with the rules set out in Article XXIV of the GATT 1994.

37. Japan does not believe that Article XXIV functions as a "waiver" which allows derogation from the basic tenets of the multilateral trading system. Furthermore, it should not be interpreted as a waiver of the obligation to eliminate quantitative restrictions, which is a central pillar of the WTO system. Hence, Japan disagrees that Article XXIV gives WTO Members the right to introduce quantitative restrictions in contravention of the *WTO Agreement* on the occasion of the formation of a customs union.

C. The Philippines

38. The Philippines first notes that Turkey's invocation of Article XXIV is an affirmative defence to its acknowledged violation of Articles XI and XIII of the GATT 1994 and Article 2.4 of the *ATC*.

39. The Philippines then argues that Turkey's quantitative restrictions are not justified by Article XXIV. First, the quantitative restrictions are not justified because they are on the whole more restrictive than the general incidence of regulations of commerce applicable in the constituent territories prior to the formation of the customs union, in contravention of Article XXIV:5(a). Second, the quantitative restrictions violate Article XXIV:4 because Turkey (and the European Communities) did not avoid creating adverse effects on the trade of other Members to the greatest possible extent. Third, the chapeau of Article XXIV:5 applies solely to the provisions of the GATT 1994 that, if enforced, would prohibit the formation of a customs union. It does not exempt Members from complying with other obligations under the *WTO Agreement*. Fourth, the grounds upon which measures are permitted under Articles XI, XII, XIII, XIV, XV and XX are, by their nature, specific to the Member concerned and, accordingly, cannot be grandfathered.

40. The Philippines also argues that, in any case, Turkey and the European Communities have not formed a customs union. The arrangement between Turkey and the European Communities does not qualify as a customs union under Article XXIV:8 because, *inter alia*, all restrictive regulations of commerce have not been eliminated with respect to substantially all trade between Turkey and the European Communities. In addition, Turkey and the European Communities do not apply substantially the same duties and regulations of commerce to the trade with Members not included in the customs union.

IV. ISSUE RAISED IN THIS APPEAL

41. This appeal relates to certain quantitative restrictions imposed by Turkey on 19 categories of textile and clothing products imported from India. Turkey adopted

these quantitative restrictions upon the formation of a customs union with the European Communities. The Panel found these quantitative restrictions to be inconsistent with Articles XI and XIII of the GATT 1994 and Article 2.4 of the *ATC*.[10] The issue raised by Turkey in this appeal is whether these quantitative restrictions are nevertheless justified by Article XXIV of the GATT 1994.

V. ARTICLE XXIV OF THE GATT 1994

42. In examining Turkey's defence that Article XXIV of the GATT 1994 allowed Turkey to adopt the quantitative restrictions at issue in this appeal, the Panel looked, first, at Article XXIV:5(a) and, then, at Article XXIV:8(a) of the GATT 1994. The Panel examined the ordinary meaning of the terms of these provisions, in their context and in the light of the object and purpose of the *WTO Agreement*. The Panel reached the following conclusions:

> With regard to the specific relationship between, in the case before us, Article XXIV and Articles XI and XIII (and Article 2.4 of the ATC), we consider that the wording of Article XXIV does not authorize a departure from the obligations contained in Articles XI and XIII of GATT and Article 2.4 of the ATC.
>
> ...
>
> [Paragraphs 5 and 8 of Article XXIV] do not ... address any specific measures that may or may not be adopted on the formation of a customs union and importantly they do not authorize violations of Articles XI and XIII, and Article 2.4 of the ATC. ... We draw the conclusion that even on the occasion of the formation of a customs union, Members cannot impose otherwise incompatible quantitative restrictions.[11]

Consequently, the Panel rejected Turkey's defence that Article XXIV justifies the introduction of the quantitative restrictions at issue. Turkey appeals the Panel's interpretation of Article XXIV.

43. We note that, in its findings, the Panel referred to the chapeau of paragraph 5 of Article XXIV only in a passing and perfunctory way. The chapeau of paragraph 5 is not central to the Panel's analysis, which focuses instead primarily on paragraph 5(a) and paragraph 8(a). However, we believe that the chapeau of paragraph 5 of Article XXIV is the key provision for resolving the issue before us in this appeal. In relevant part, it reads:

> Accordingly, the provisions of this Agreement *shall not prevent*, as between the territories of contracting parties, *the formation of a customs union* ...; *Provided* that: ... (emphasis added)

44. To determine the meaning and significance of the chapeau of paragraph 5, we must look at the text of the chapeau, and its context, which, for our purposes here, we consider to be paragraph 4 of Article XXIV.

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[10] Panel Report, para. 9.86.
[11] *Ibid.*, paras. 9.188 and 9.189.

45. First, in examining the text of the chapeau to establish its ordinary meaning, we note that the chapeau states that the provisions of the GATT 1994 "*shall not prevent*" the formation of a customs union. We read this to mean that the provisions of the GATT 1994 *shall not make impossible* the formation of a customs union.[12] Thus, the chapeau makes it clear that Article XXIV may, under certain conditions, justify the adoption of a measure which is inconsistent with certain other GATT provisions, and may be invoked as a possible "defence" to a finding of inconsistency.[13]

46. Second, in examining the text of the chapeau, we observe also that it states that the provisions of the GATT 1994 shall not prevent "*the formation of a customs union*". This wording indicates that Article XXIV can justify the adoption of a measure which is inconsistent with certain other GATT provisions only if the measure is introduced upon the formation of a customs union, and only to the extent that the formation of the customs union would be prevented if the introduction of the measure were not allowed.

47. It follows necessarily that the text of the chapeau of paragraph 5 of Article XXIV cannot be interpreted without reference to the definition of a "customs union". This definition is found in paragraph 8(a) of Article XXIV, which states, in relevant part:

> A customs union shall be understood to mean the substitution of a single customs territory for two or more customs territories, so that
>
> (i) duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated with respect to *substantially all the trade* between the constituent territories of the union or at least with respect to substantially all the trade in products originating in such territories, and,

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[12] "Prevent" is defined as "make impracticable or impossible by anticipatory action; stop from happening." *The New Shorter Oxford English Dictionary* (Clarendon Press, 1993), Vol. II, at 2348.

[13] We note that legal scholars have long considered Article XXIV to be an "exception" or a possible "defence" to claims of violation of GATT provisions. An early treatise on GATT law stated: "[Article XXIV] establishes an *exception to GATT obligations* for regional arrangements that meet a series of detailed and complex criteria." (emphasis added) J. Jackson, *World Trade and the Law of GATT* (The Bobbs-Merrill Company, 1969), p. 576. See also J. Allen, *The European Common Market and the GATT* (The University Press of Washington, D.C., 1960), p. 2; K. Dam, "Regional Economic Arrangements and the GATT: The Legacy of Misconception", *University of Chicago Law Review*, 1963, p. 616; and J. Huber, "The Practice of GATT in Examining Regional Arrangements under Article XXIV", *Journal of Common Market Studies*, 1981, p. 281. We note also the following statement in the unadopted panel report in *EEC - Member States' Import Regimes for Bananas*, DS32/R, 3 June 1993, para. 358: "The Panel noted that Article XXIV:5 to 8 permitted the contracting parties to *deviate from their obligations under other provisions of the General Agreement* for the purpose of forming a customs union ...". (emphasis added)

The chapeau of paragraph 5 refers only to the provisions of the GATT 1994. It does not refer to the provisions of the *ATC*. However, Article 2.4 of the *ATC* provides that "[n]o new restrictions ... shall be introduced *except under* the provisions of this Agreement or *relevant GATT 1994 provisions*." (emphasis added) In this way, Article XXIV of the GATT 1994 is incorporated in the *ATC* and may be invoked as a defence to a claim of inconsistency with Article 2.4 of the *ATC*, provided that the conditions set forth in Article XXIV for the availability of this defence are met.

> (ii) … *substantially the same* duties and other regulations of commerce are applied by each of the members of the union to the trade of territories not included in the union. (emphasis added)

48. Sub-paragraph 8(a)(i) of Article XXIV establishes the standard for the *internal trade* between constituent members in order to satisfy the definition of a "customs union". It requires the constituent members of a customs union to eliminate "duties and other restrictive regulations of commerce" with respect to "substantially all the trade" between them. Neither the GATT CONTRACTING PARTIES nor the WTO Members have ever reached an agreement on the interpretation of the term "substantially" in this provision.[14] It is clear, though, that "substantially all the trade" is not the same as *all* the trade, and also that "substantially all the trade" is something considerably more than merely *some* of the trade. We note also that the terms of sub-paragraph 8(a)(i) provide that members of a customs union may maintain, where necessary, in their internal trade, certain restrictive regulations of commerce that are otherwise permitted under Articles XI through XV and under Article XX of the GATT 1994. Thus, we agree with the Panel that the terms of sub-paragraph 8(a)(i) offer "some flexibility" to the constituent members of a customs union when liberalizing their internal trade in accordance with this sub-paragraph.[15] Yet we caution that the degree of "flexibility" that sub-paragraph 8(a)(i) allows is limited by the requirement that "duties and other restrictive regulations of commerce" be "eliminated with respect to substantially all" internal trade.

49. Sub-paragraph 8(a)(ii) establishes the standard for the trade of constituent members *with third countries* in order to satisfy the definition of a "customs union". It requires the constituent members of a customs union to apply "substantially the same" duties and other regulations of commerce to external trade with third countries. The constituent members of a customs union are thus required to apply a common external trade regime, relating to both duties and other regulations of commerce. However, sub-paragraph 8(a)(ii) does *not* require each constituent member of a customs union to apply *the same* duties and other regulations of commerce as other constituent members with respect to trade with third countries; instead, it requires that *substantially the same* duties and other regulations of commerce shall be applied. We agree with the Panel that:

> [t]he ordinary meaning of the term "substantially" in the context of sub-paragraph 8(a) appears to provide for both qualitative and quantitative components. The expression "substantially the same duties and other regulations of commerce are applied by each of the Members of the [customs] union" would appear to encompass both quantitative and qualitative elements, the quantitative aspect more emphasized in relation to duties.[16]

50. We also believe that the Panel was correct in its statement that the terms of sub-paragraph 8(a)(ii), and, in particular, the phrase "substantially the same" offer a

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[14] Panel Report, para. 9.148.
[15] *Ibid.*, para. 9.146.
[16] Panel Report, para. 9.148.

certain degree of "flexibility" to the constituent members of a customs union in "the creation of a common commercial policy."[17] Here too we would caution that this "flexibility" is limited. It must not be forgotten that the word "substantially" qualifies the words "the same". Therefore, in our view, something closely approximating "sameness" is required by Article XXIV:8(a)(ii). We do not agree with the Panel that:

> … as a general rule, a situation where constituent members have "comparable" trade regulations having similar effects with respect to the trade with third countries, would generally meet the qualitative dimension of the requirements of sub-paragraph 8(a)(ii).[18]

Sub-paragraph 8(a)(ii) requires the constituent members of a customs union to adopt "substantially the same" trade regulations. In our view, "comparable trade regulations having similar effects" do not meet this standard. A higher degree of "sameness" is required by the terms of sub-paragraph 8(a)(ii).

51. Third, in examining the text of the chapeau of Article XXIV:5, we note that the chapeau states that the provisions of the GATT 1994 shall not prevent the formation of a customs union "*Provided that*". The phrase "*provided that*" is an essential element of the text of the chapeau. In this respect, for purposes of a "customs union", the relevant proviso is set out immediately following the chapeau, in Article XXIV:5(a). It reads in relevant part:

> with respect to a customs union …, the duties and other regulations of commerce imposed at the institution of any such union … in respect of trade with contracting parties not parties to such union … shall not on the whole be higher or more restrictive than the general incidence of the duties and regulations of commerce applicable in the constituent territories prior to the formation of such union …;

52. Given this proviso, Article XXIV can, in our view, only be invoked as a defence to a finding that a measure is inconsistent with certain GATT provisions to the extent that the measure is introduced upon the formation of a customs union which meets the requirement in sub-paragraph 5(a) of Article XXIV relating to the "duties and other regulations of commerce" applied by the constituent members of the customs union to trade with third countries.

53. With respect to "duties", Article XXIV:5(a) requires that the duties applied by the constituent members of the customs union *after* the formation of the customs union "shall *not* on the whole be *higher* … than the *general incidence*" of the duties that were applied by each of the constituent members before the formation of the customs union. Paragraph 2 of the *Understanding on Article XXIV* requires that the evaluation under Article XXIV:5(a) of the *general incidence of the duties* applied before and after the formation of a customs union "shall … be based upon an overall assessment of weighted average tariff rates and of customs duties collected."[19] Before the agreement on this Understanding, there were different views among the

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[17] Panel Report, para. 9.148.

[18] *Ibid.*, para. 9.151.

[19] Paragraph 2 of the *Understanding on Article XXIV* further states that "this assessment shall be based on import statistics for a previous representative period to be supplied by the customs union, on a tariff-line basis and in values and quantities, broken down by WTO country of origin."

GATT Contracting Parties as to whether one should consider, when applying the test of Article XXIV:5(a), the *bound* rates of duty or the *applied* rates of duty. This issue has been resolved by paragraph 2 of the *Understanding on Article XXIV*, which clearly states that the *applied* rate of duty must be used.

54. With respect to "other regulations of commerce", Article XXIV:5(a) requires that those applied by the constituent members *after* the formation of the customs union "shall *not* on the whole be ... *more restrictive* than the *general incidence*" of the regulations of commerce that were applied by each of the constituent members *before* the formation of the customs union. Paragraph 2 of the *Understanding on Article XXIV* explicitly recognizes that the quantification and aggregation of regulations of commerce other than duties may be difficult, and, therefore, states that "for the purpose of the overall assessment of the incidence of other regulations of commerce for which quantification and aggregation are difficult, the examination of individual measures, regulations, products covered and trade flows affected may be required."[20]

55. We agree with the Panel that the terms of Article XXIV:5(a), as elaborated and clarified by paragraph 2 of the *Understanding on Article XXIV*, provide:

> ... that the effects of the resulting trade measures and policies of the new regional agreement shall not be more trade restrictive, overall, than were the constituent countries' previous trade policies.[21]

and we also agree that this is:

> an "economic" test for assessing whether a specific customs union is compatible with Article XXIV.[22]

56. The text of the chapeau of paragraph 5 must also be interpreted in its context. In our view, paragraph 4 of Article XXIV constitutes an important element of the context of the chapeau of paragraph 5. The chapeau of paragraph 5 of Article XXIV begins with the word "accordingly", which can only be read to refer to paragraph 4 of Article XXIV, which immediately precedes the chapeau. Paragraph 4 states:

> The contracting parties recognize the desirability of increasing freedom of trade by the development, through voluntary agreements, of closer integration between the economies of the countries parties to such agreements. They also recognize that the purpose of a customs union or of a free-trade area should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories.

57. According to paragraph 4, the purpose of a customs union is "to facilitate trade" between the constituent members and "not to raise barriers to the trade" with third countries. This objective demands that a balance be struck by the constituent members of a customs union. A customs union should facilitate trade within the

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[20] In paragraph 43 of its appellant's submission, Turkey argues that this provision must be interpreted as allowing the constituent members of a customs union to introduce GATT/WTO inconsistent quantitative restrictions upon the formation of the customs union. We see no basis for such an interpretation.

[21] Panel Report, para. 9.121.

[22] Panel Report, para. 9.120.

customs union, but it should *not* do so in a way that raises barriers to trade with third countries. We note that the *Understanding on Article XXIV* explicitly reaffirms this purpose of a customs union, and states that in the formation or enlargement of a customs union, the constituent members should "to the greatest possible extent avoid creating adverse affects on the trade of other Members".[23] Paragraph 4 contains purposive, and not operative, language. It does not set forth a separate obligation itself but, rather, sets forth the overriding and pervasive purpose for Article XXIV which is manifested in operative language in the specific obligations that are found elsewhere in Article XXIV. Thus, the purpose set forth in paragraph 4 informs the other relevant paragraphs of Article XXIV, including the chapeau of paragraph 5. For this reason, the chapeau of paragraph 5, and the conditions set forth therein for establishing the availability of a defence under Article XXIV, must be interpreted in the light of the purpose of customs unions set forth in paragraph 4. The chapeau cannot be interpreted correctly without constant reference to this purpose.

58. Accordingly, on the basis of this analysis of the text and the context of the chapeau of paragraph 5 of Article XXIV, we are of the view that Article XXIV may justify a measure which is inconsistent with certain other GATT provisions. However, in a case involving the formation of a customs union, this "defence" is available only when two conditions are fulfilled. First, the party claiming the benefit of this defence must demonstrate that the measure at issue is introduced upon the formation of a customs union that fully meets the requirements of sub-paragraphs 8(a) and 5(a) of Article XXIV. And, second, that party must demonstrate that the formation of that customs union would be prevented if it were not allowed to introduce the measure at issue. Again, *both* these conditions must be met to have the benefit of the defence under Article XXIV.

59. We would expect a panel, when examining such a measure, to require a party to establish that both of these conditions have been fulfilled. It may not always be possible to determine whether the second of the two conditions has been fulfilled without initially determining whether the first condition has been fulfilled. In other words, it may not always be possible to determine whether not applying a measure would prevent the formation of a customs union without first determining whether there *is* a customs union. In this case, the Panel simply assumed, for the sake of argument, that the first of these two conditions was met and focused its attention on the second condition.

60. More specifically, with respect to the first condition, the Panel, in this case, did not address the question of whether the regional trade arrangement between Turkey and the European Communities is, in fact, a "customs union" which meets the requirements of paragraphs 8(a) and 5(a) of Article XXIV. The Panel maintained that "it is arguable" that panels do not have jurisdiction to assess the overall compatibility of a customs union with the requirements of Article XXIV.[24] We are not called upon in this appeal to address this issue, but we note in this respect our ruling in *India - Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products* on the jurisdiction of panels to review the justification of balance-of-payments re-

[23] *Understanding on Article XXIV*, Preamble.
[24] Panel Report, para. 9.53.

strictions under Article XVIII:B of the GATT 1994.[25] The Panel also considered that, on the basis of the principle of judicial economy, it was not necessary to assess the compatibility of the regional trade arrangement between Turkey and the European Communities with Article XXIV in order to address the claims of India.[26] Based on this reasoning, the Panel assumed *arguendo* that the arrangement between Turkey and the European Communities is compatible with the requirements of Article XXIV:8(a) and 5(a) and limited its examination to the question of whether Turkey was permitted to introduce the quantitative restrictions at issue.[27] The assumption by the Panel that the agreement between Turkey and the European Communities is a "customs union" within the meaning of Article XXIV was not appealed. Therefore, the issue of whether this arrangement meets the requirements of paragraphs 8(a) and 5(a) of Article XXIV is not before us.

61. With respect to the second condition that must be met to have the benefit of the defence under Article XXIV, Turkey asserts that had it not introduced the quantitative restrictions on textile and clothing products from India that are at issue, the European Communities would have "exclud[ed] these products from free trade within the Turkey/EC customs union".[28] According to Turkey, the European Communities would have done so in order to prevent trade diversion. Turkey's exports of these products accounted for 40 per cent of Turkey's total exports to the European Communities.[29] Turkey expresses strong doubts about whether the requirement of Article XXIV:8(a)(i) that duties and other restrictive regulations of commerce be eliminated with respect to "substantially all trade" between Turkey and the European Communities could be met if 40 per cent of Turkey's total exports to the European Communities were excluded.[30] In this way, Turkey argues that, unless it is allowed to introduce quantitative restrictions on textile and clothing products from India, it would be prevented from meeting the requirements of Article XXIV:8(a)(i) and, thus, would be prevented from forming a customs union with the European Communities.

62. We agree with the Panel that had Turkey not adopted the same quantitative restrictions that are applied by the European Communities, this would not have prevented Turkey and the European Communities from meeting the requirements of sub-paragraph 8(a)(i) of Article XXIV, and consequently from forming a customs union. We recall our conclusion that the terms of sub-paragraph 8(a)(i) offer some - though limited - flexibility to the constituent members of a customs union when liberalizing their internal trade.[31] As the Panel observed, there are other alternatives available to Turkey and the European Communities to prevent any possible diversion of trade, while at the same time meeting the requirements of sub-paragraph 8(a)(i).[32] For example, Turkey could adopt rules of origin for textile and clothing products that would allow the European Communities to distinguish between those textile and

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25 Adopted 22 September 1999, WT/DS90/AB/R, paras. 80 - 109.
26 Panel Report, para. 9.54.
27 *Ibid*., para. 9.55.
28 Turkey's appellant's submission, para. 56.
29 Panel Report, para. 9.153.
30 Turkey's appellant's submission, para. 56
31 *Supra*, para. 48
32 Panel Report, para. 9.152.

clothing products originating in Turkey, which would enjoy free access to the European Communities under the terms of the customs union, *and* those textile and clothing products originating in third countries, including India. In fact, we note that Turkey and the European Communities themselves appear to have recognized that rules of origin could be applied to deal with any possible trade diversion. Article 12(3) of Decision 1/95 of the EC-Turkey Association Council, which sets out the rules for implementing the final phase of the customs union between Turkey and the European Communities, specifically provides for the possibility of applying a system of certificates of origin.[33] A system of certificates of origin would have been a reasonable alternative until the quantitative restrictions applied by the European Communities are required to be terminated under the provisions of the *ATC*. Yet no use was made of this possibility to avoid trade diversion. Turkey preferred instead to introduce the quantitative restrictions at issue.

63. For this reason, we conclude that Turkey was not, in fact, required to apply the quantitative restrictions at issue in this appeal in order to form a customs union with the European Communities. Therefore, Turkey has not fulfilled the second of the two necessary conditions that must be fulfilled to be entitled to the benefit of the defence under Article XXIV. Turkey has not demonstrated that the formation of a customs union between Turkey and the European Communities would be prevented if it were not allowed to adopt these quantitative restrictions. Thus, the defence afforded by Article XXIV under certain conditions is not available to Turkey in this case, and Article XXIV does not justify the adoption by Turkey of these quantitative restrictions.

VI. FINDINGS AND CONCLUSIONS

64. For the reasons set out in this report, the Appellate Body concludes that the Panel erred in its legal reasoning by focusing on sub-paragraphs 8(a) and 5(a) and by failing to recognize the crucial role of the chapeau of paragraph 5 in the interpretation of Article XXIV of the GATT 1994, but upholds the Panel's conclusion that Article XXIV does not allow Turkey to adopt, upon the formation of a customs union with the European Communities, quantitative restrictions on imports of 19 categories of textile and clothing products which were found to be inconsistent with Articles XI and XIII of the GATT 1994 and Article 2.4 of the *ATC*.

65. We wish to point out that we make no finding on the issue of whether quantitative restrictions found to be inconsistent with Article XI and Article XIII of the GATT 1994 will *ever* be justified by Article XXIV. We find only that the quantitative restrictions at issue in the appeal in this case were not so justified. Likewise, we make no finding either on many other issues that may arise under Article XXIV. The resolution of those other issues must await another day. We do not believe it neces-

[33] Article 12(3) reads as follows:

> Until Turkey has concluded these arrangements, the present *system of certificates of origin for the exports of textile and clothing* from Turkey into the Community will remain in force and such products not originating from Turkey will remain subject to the application of the Communities Commercial Policy in relation to the third countries in question. (emphasis added)

sary to find more than we have found here to fulfill our responsibilities under the DSU in deciding this case.

66. The Appellate Body recommends that the DSB request that Turkey bring its measures which the Panel found to be inconsistent with Articles XI and XIII of the GATT 1994 and Article 2.4 of the *ATC* into conformity with its obligations under these agreements.

TURKEY - RESTRICTIONS ON IMPORTS OF TEXTILE AND CLOTHING PRODUCTS

Report of the Panel
WT/DS34/R

Adopted by the Dispute Settlement Body
on 19 November 1999
as modified by the Appellate Body Report

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I. INTRODUCTION

1.1 On 21 March 1996, India requested consultations with Turkey pursuant to Article 4.4 of the Understanding on Rules and Procedures Governing the Settlement of Disputes ("DSU") and Article XXIII:1 of the General Agreement on Tariffs and Trade 1994 ("GATT") regarding the unilateral imposition of quantitative restrictions ("QRs") by Turkey on imports of a broad range of textile and clothing products from India as from 1 January 1996 (WT/DS34/1).

1.2 India and Turkey did not enter into consultations, due to disagreement on the appropriateness of participation of the European Communities in such consultations,

and consequently the dispute could not be resolved at that stage. The Dispute Settlement Body ("DSB") was informed accordingly on 24 April 1996.[1]

1.3 In a communication dated 2 February 1998, India requested the DSB to establish a panel to examine the matter in the light of GATT and the Agreement on Textiles and Clothing ("ATC"), in accordance with Article 6.2 of the DSU (WT/DS34/2). In its communication, India claimed that the restrictions imposed by Turkey were inconsistent with Turkey's obligations under Articles XI and XIII of GATT and were not justified by Article XXIV of GATT, which did not authorize the imposition of discriminatory QRs, and that the restrictions were inconsistent with Turkey's obligations under Article 2 of the ATC. India also claimed that the restrictions appeared to nullify or impair benefits accruing to it directly or indirectly under GATT and the ATC.

1.4 On 13 March 1998, the DSB established a panel pursuant to the request of India, with the following standard terms of reference (Article 7.1 of the DSU):[2]

> "To examine, in the light of the relevant provisions of the covered agreements cited by India in document WT/DS34/2, the matter referred to the DSB by India in that document and to make such findings as will assist the DSB in making recommendations or in giving the rulings provided for in those agreements."

1.5 On 11 June 1998, the parties to the dispute agreed on the following composition of the Panel (WT/DS34/3):

Chairman:	Ambassador Wade Armstrong
Members:	Dr. Luzius Wasescha
	Prof. Robert Hudec

1.6 Following the resignation of Prof. Robert Hudec, the parties to the dispute agreed to appoint a new member to the Panel, on 21 July 1998. Accordingly, the composition of the Panel was as follows (WT/DS34/4):

Chairman:	Ambassador Wade Armstrong
Members:	Dr. Luzius Wasescha
	Mr. Johannes Human

1.7 Hong Kong, China; Japan; the Philippines; Thailand; and the United States reserved their third-party rights in accordance with Article 10 of the DSU.

1.8 On 14 August 1998, Turkey requested preliminary rulings by the Panel on a number of issues. On 28 August 1998, the Panel invited India, as well as the third parties, to present their views on the points raised by Turkey. India submitted written comments on the issues; Japan, the Philippines and the United States, as third parties, also submitted written communications. The Panel met on 19 September 1998 with Turkey and India on this matter, and issued its ruling on 25 September 1998.

1.9 The Panel received the first written submissions from the parties on 21 August 1998 (India) and on 18 September 1998 (Turkey). Written submissions were

[1] WT/DSB/M/15, pp. 3-5.
[2] WT/DSB/M/43, p. 6.

also received from Hong Kong, China; Japan; the Philippines; and Thailand, as third parties.

1.10 The first substantive meeting of the Panel with the parties took place on 5-6 October 1998 and the Panel met with third parties on 6 October 1998.

1.11 On 28 October 1998, the Panel addressed a letter to the European Communities, seeking certain relevant factual and legal information under Article 13.2 of the DSU. The European Communities answered in writing the specific questions raised by the Panel on 13 November 1998.

1.12 On 19 November 1998, the Panel received the second written submissions from the parties, with whom it met again on 25 November 1998.

1.13 n a communication dated 20 January 1999, the Chairman of the Panel informed the DSB that the Panel would not be able to issue its report within six months. The reasons for that delay are stated in document WT/DS34/5.

1.14 he Panel issued its interim report to the parties on 3 March 1999. On 12 March 1999, both parties submitted written requests for the Panel to review precise aspects of the interim report; no further meeting with the Panel was requested.

1.15 The Panel submitted its final report to the parties on 26 March 1999.

II. FACTUAL ASPECTS

2.1 This section addresses the factual aspects of the dispute in a sequential order, in which the QRs at issue are described in paragraphs 2.39 to 2.41 below. In view of the nature of the dispute, this section outlines first the factual context in which the dispute is addressed.

A. Regional Trade Agreements in the GATT/WTO Framework

2.2 The relationship between the most-favoured-nation ("MFN") principle and Article XXIV of the GATT, which deals with free-trade areas and customs unions, has not always been harmonious. In 1947, their coexistence in the framework of international trade relations had been viewed as ultimately positive, reflecting the perception that genuine customs unions and free-trade areas were congruent with the MFN principle and directed towards the same objective, i.e. multilaterally-agreed trade liberalization.[3]

2.3 As a matter of fact, trade liberalization under the GATT paralleled a process of increasing economic integration among contracting parties: from 1948 to end-1994, 107 regional trade agreements ("RTAs") were notified to the GATT under Article XXIV.[4]

2.4 Before 1957, the GATT contracting parties dealt with only three such agreements, covering a small fraction of their aggregate trade (see Figure II.1), on which

[3] Customs unions and free-trade areas were viewed as trade-creating instruments (susceptible to expand trade both among the parties and between these and third parties), but there were also concerns about their possible trade-distorting effects.

[4] Of these, only 36 remain today in force, reflecting in most cases the evolution over time of the RTAs themselves, as they were superseded by more modern agreements between the same signatories (usually going deeper in integration), or by their consolidation into wider groupings.

compatibility with Article XXIV was temporarily waived and which were maintained under surveillance.[5] Article XXIV provisions confronted their first real applicability test with the notification of the Treaty of Rome in 1957, which concerned the integration of major players in the international scene. From then on, the examination of RTAs notified to the GATT did not lead to clear-cut assessments of full consistency with the rules, except in one instance.[6] Frictions between GATT contracting parties arising in the context of the formation of customs unions or free-trade areas were dealt with pragmatically.[7]

2.5 The perception that RTAs could contribute to the expansion of world trade was reiterated during the Uruguay Round, when negotiators re-visited certain aspects of Article XXIV, in an endeavour to clarify some of its provisions.[8]

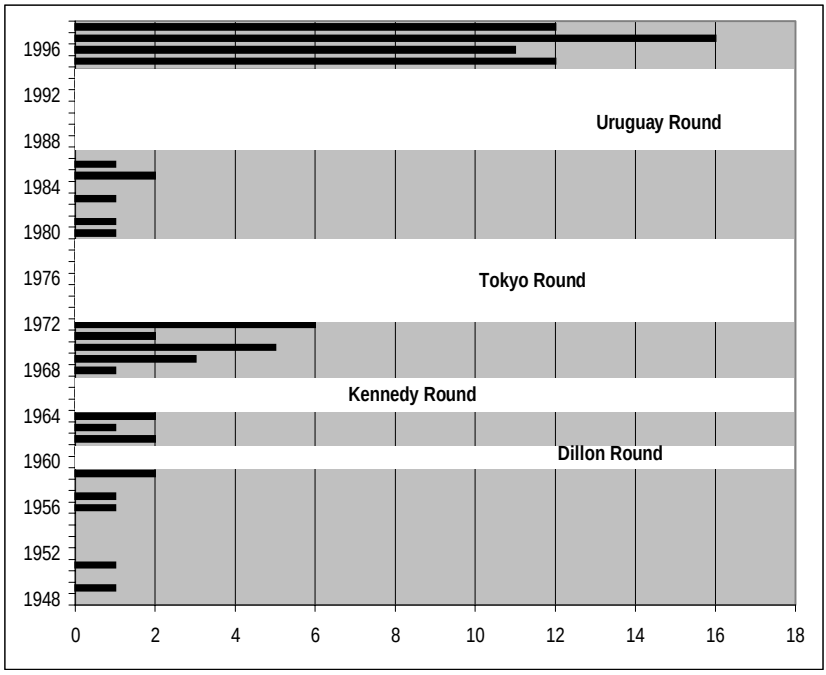
[5] See in this respect: *Report on the Customs Union between South Africa and Southern Rhodesia* (BISD II/176) and corresponding *Decisions* (BISD II/29, and 3S/47); *Decision on the Free-Trade Area Treaty between Nicaragua and El Salvador* (BISD II/30); and *Decision on Participation of Nicaragua in Central American Free-Trade Area* (BISD 5S/29).

[6] This was the case of the Customs Union between the Czech Republic and the Slovak Republic (see *Working Party Report*, GATT document L/7501, dated 4 October 1994).

[7] See, for example, BISD 7S, p. 69 *et seq.*.

[8] The result of such negotiations is embodied in the Understanding on the Interpretation of Article XXIV of GATT 1994.

Figure II.1 - Number of RTAs notified to the GATT/WTO under Article XXIV



2.6 During the course of the Uruguay Round, there was an increase in the number of new RTAs notified to the GATT. The conclusion of the Round and the establishment of the WTO did not put to rest the appeal of regional integration. Since 1 January 1995, a further 60 new RTAs have been notified under Article XXIV of GATT, most of which are presently in force.[9]

2.7 The WTO General Council established, on 6 February 1996, the Committee on Regional Trade Agreements ("CRTA"),[10] with the mandate of, inter alia, examining all RTAs notified to the Council for Trade in Goods ("CTG") under Article XXIV.[11] The CRTA is likewise entrusted with the examination of those RTAs notified under the 1979 Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries and under Article V of the General Agreement on Trade in Services ("GATS"),[12] and referred to it by the Committee on Trade and Development ("CTD") and the Council for Trade in Services ("CTS"), respectively. The mandate of the CRTA also includes the consideration of

[9] The negotiation of RTAs among countries geographically distant has also become an increasingly frequent feature in the 1990s.

[10] WT/L/127.

[11] The CRTA is in charge of the examinations which were previously performed by separate working groups, one per agreement.

[12] These provisions also govern regional integration within the WTO.

"the systemic implications of [RTAs] and regional initiatives for the multilateral trading system and the relationship between them".[13]

2.8 Later in 1996, the WTO Membership expressed its views on RTAs and the role of the CRTA in paragraph 7 of the Singapore Ministerial Declaration, as follows:

> "We note that trade relations of WTO Members are being increasingly influenced by regional trade agreements, which have expanded vastly in number, scope and coverage. Such initiatives can promote further liberalization and may assist least-developed, developing and transition economies in integrating into the international trading system. In this context, we note the importance of existing regional arrangements involving developing and least-developed countries. The expansion and extent of regional trade agreements make it important to analyze whether the system of WTO rights and obligations as it relates to regional trade agreements needs to be further clarified. We reaffirm the primacy of the multilateral trading system, which includes a framework for the development of regional trade agreements, and we renew our commitment to ensure that regional trade agreements are complementary to it and consistent with its rules. In this regard, we welcome the establishment and endorse the work of the new Committee on Regional Trade Agreements. We shall continue to work through progressive liberalization in the WTO as we are committed in the WTO Agreement and Decisions adopted at Marrakesh, and in so doing facilitate mutually supportive processes of global and regional trade liberalization."[14]

2.9 The CRTA 1998 Report to the General Council is self-explanatory on the results so far achieved in its work.[15] Paragraph 6 of the Report, with respect to the examination of the agreements, reads:

> "In 1998, the Committee endeavoured to accelerate the examination of agreements which had already commenced, as well as to handle new agreements referred to it. The Committee has currently under its purview a total of 62 RTAs. To date, the examination of 54 RTAs have been referred to the Committee by the CTG, seven by the CTS and one by the CTD. Draft reports on the examination of 28 agreements are currently under consideration; for 13 other agreements, reports are being drafted or factual examinations are well engaged, while the first round of examination for the remaining 21 RTAs is scheduled for either the Committee's twentieth session or early in 1999 … Thus far, no report has been adopted."

As concluding remarks, paragraph 15 of the CRTA 1998 Report states as follows:

> "… Despite its heavy workload and delays in the submission of certain relevant material, the Committee also made progress in examining

[13] WT/L/127, para.1(d).
[14] WT/MIN(96)/DEC, para. 7.
[15] WT/REG/7.

RTAs. The need to move forward in the process of examination pursuant to WTO rules was recognized; however, progress in this regard was slowed, *inter alia*, by a lack of consensus on the interpretation of certain elements of those rules relating to RTAs. On systemic issues, the Committee held discussions on some important topics and identified different approaches to these subjects; the need to move forward in the discussion of systemic issues was also recognized."

B. Turkey's Trade Relations with the European Communities

1. Association between Turkey and the European Communities, and the GATT/WTO process[16]

2.10 On 12 September 1963, Turkey and the Council and member States of the then European Economic Community ("EEC") signed the *Ankara Agreement*,[17] which entered into force on 1 December 1964. The Ankara Agreement formed the basis of the Association (in the sense of Article 228 of the Treaty of Rome) between Turkey and the European Communities envisaging that its objectives would be reached through a customs union which would be established in three progressive stages: preparatory, transitional and final. Article 28 of the Ankara Agreement also left open "the possibility of the accession" of Turkey to the EEC. The Ankara Agreement itself contained the modalities of the preparatory stage of the Association.

2.11 The terms and conditions for the implementation of the transitional stage were defined in the 1970 *Additional Protocol* to the Ankara Agreement and in the 1971 *Interim Agreement*.[18] The provisions of the Interim Agreement entered into force on 1 September 1971 and the Additional Protocol entered into force on 1 January 1973. These texts provided for an extended transitional period running over 22 years and foresaw the establishment of a customs union by the end of 1995. The Additional Protocol provided for an asymmetrical liberalization of intra-trade, because of the disparity in levels of development between the parties: the European Communities were to abolish all duties and QRs on imports of industrial products from Turkey as from September 1971, while Turkey was to do so over the transitional period, according to a timetable.[19] The Protocol also contained provisions designed to ensure the alignment of Turkey on EC policies in many areas (commercial policy, standards, competition, state aids, trade in services, etc.).

2.12 *Supplementary Protocols* to the Ankara Agreement (and Interim Agreement) were also concluded in 1973 between Turkey and the European Communities, containing adaptation and transition measures following the accession to the European Communities of Denmark, Ireland and the United Kingdom.[20]

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[16] The official titles of the agreements have changed over time The European Communities is a WTO Member.

[17] GATT document L/2155/Add.1.

[18] GATT document L/3554.

[19] Other agreements concluded at the time by the EC with Mediterranean countries contained similar provisions.

[20] GATT document L/3980.

2.13 Starting in 1973, Turkey embarked in the gradual alignment of its customs duties to the EC Common Customs Tariff ("CCT"), as scheduled. The implementation of Turkey's obligations arising out of its Association with the European Communities was interrupted during a number of years, due *inter alia* to the crisis in which the Turkish economy was engulfed following the oil shocks of 1973 and 1979. In 1987, when Turkey requested accession to the European Communities, completion of the customs union was seen as part of a package of measures designed to help Turkey prepare for membership. In 1988, Turkey resumed the reduction of its customs duties and alignment on the CCT.

2.14 The Ankara Agreement and the subsequent instruments concluded in the context of the Association between Turkey and the European Communities during the 1970s were notified to the GATT Contracting Parties under Article XXIV:7 of GATT 1947. The GATT entrusted three separate working parties with the task of examining the different agreements in light of those provisions. Reports of these working parties were adopted by the GATT Council:

(i) Report of the Working Party on the Ankara Agreement, adopted on 25 March 1965 (BISD 13S/59-64);

(ii) Report of the Working Party on the Additional Protocol, adopted on 25 October 1972 (BISD 19S/102-109); and

(iii) Report of the Working Party on the Supplementary Protocols, adopted on 21 October 1974 (BISD 21S/108-112).

2.15 As agreed at a meeting of the Turkey-EC Association Council ("Association Council") held in November 1992,[21] negotiations were initiated between the two parties on the modalities for the completion of the customs union, i.e. for the final phase of the Association. These negotiations were conducted from 1993 to 1995.

2.16 On 6 March 1995, the Association Council took *Decision 1/95*, to enter into force on 1 January 1996.[22] Decision 1/95 set out the modalities for the final phase of the Association between Turkey and the European Communities. In addition to the elimination of customs duties and alignment on the CCT, it contained provisions for the harmonization of Turkey's policies and practices in all areas covered by the Association where this was deemed necessary "for the proper functioning of the Customs Union". In accordance with Article 65 of Decision 1/95 the parties were to consider, before entry into force, whether those harmonization provisions (in particular those contained in Article 12) had been fulfilled. Once this requirement was considered satisfied, at a meeting of the Association Council on 30 October 1995, Decision 1/95 was submitted to the European Parliament for its approval and subsequently formally adopted by the Association Council on 22 December 1995. On 22 December 1995, the Association Council also adopted Decision 2/95, in pursuance of Article 15 of Decision 1/95. Decision 2/95 defined the coverage of products for temporary exception from Turkey's application of the CCT in respect of third countries, and fixed the timetable for their alignment to the CCT (from 1 January 1996 to 1 January 2001).

[21] The Association Council was created by the Ankara Agreement, as the only decision-making body of the Turkey-EC Association.

[22] Decision 1/95 is reproduced in WT/REG22/1.

2.17 The entry into force of "the final phase of the Customs Union" between Turkey and the European Communities was notified to the WTO on 22 December 1995, under Article XXIV of GATT.[23] The texts of Decision 1/95 and Decision 2/95 were distributed to Members on 13 February 1996.[24] On 29 January 1996, the CTG adopted standard terms of reference for the examination of the "Customs Union between Turkey and the European Community"[25] ("Turkey-EC customs union"), and referred such examination to the CRTA.[26]

2.18 Turkey and the European Coal and Steel Community ("ECSC") signed an Agreement on 25 July 1996, which entered into force on 1 August 1996.[27] In their joint communication to the WTO, the parties stated that the Agreement was "intended as the complement to the Customs Union in respect of products covered by the European Coal and Steel Community and as a transitional arrangement in respect of such products until … the year 2002".[28]

2.19 On 30 October 1996, Turkey and the European Communities submitted preliminary information to the WTO on "the final phase of the Customs Union", in accordance with the Standard Format for Information on Regional Trade Agreements.[29] In a joint communication dated 24 November 1997,[30] Turkey and the European Communities provided, "[t]o assist Members in the examination of the Customs Union, … details of the quantitative limits applied by Turkey in respect of imports of certain textile and clothing products from certain WTO Members", including the levels of such quantitative limits for 1997.[31] The CRTA met twice to examine, in the light of the relevant provisions of GATT, the Turkey-EC customs union: on 23 October 1996 and on 1 October 1997.[32] Additional written questions from Members were also replied to by the parties.[33] To date, the CRTA has not yet finalized its examination.

2.20 Turkey and the European Communities transmitted copies of their communications to the CRTA, in relation to the quantitative limits applied by Turkey, and to the Textiles Monitoring Body ("TMB"), for information pursuant to Article 3.3 of the ATC.[34] The TMB took note of the information supplied at its meetings held on 11-12 December 1997. and 26-27 May 1998.[35] To date Turkey has notified to the TMB its

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23 WT/REG22/N/1.

24 WT/REG22/1 and WT/REG22/2, respectively.

25 The terms of reference for the examination are contained in WT/REG22/4. In this Panel report we shall refer to the Turkey-EC customs union without any assessment of the WTO nature of this Article XXIV type of arrangement.

26 G/C/M/8.

27 WT/REG22/1/Add.1.

28 WT/REG22/N/1/Add.1.

29 WT/REG22/5.

30 WT/REG22/7.

31 A similar communication was circulated to Members on 28 July 1998, containing the levels of the quantitative limits in 1998 (Document WT/REG22/8).

32 See WT/REG22/M/1 and WT/REG22/M/2 (Notes on the meetings).

33 WT/REG22/6 and WT/REG22/6/Add.1.

34 G/TMB/N/308 and G/TMB/N/338.

35 See G/TMB/R/38 and G/TMB/R/43, respectively.

lists for the first and second stage of integration and advance integration for a product which will be subject to the third stage of integration.[36]

2. Synopsis of Recent Developments in Turkey-EC trade[37]

2.21 The European Communities[38] has traditionally constituted the major single market for Turkish goods and Turkey's major supplier, accounting for around 50 per cent of both Turkey's exports and imports. Exports to the European Communities in 1996 and 1997 expanded at a slower rate than those destined to the rest of the world. Imports from the European Communities increased 37 per cent in 1996 but rose by only 7 per cent in the next year; by contrast, Turkey's imports from the rest of the world grew 9 per cent in 1996 and by 16 per cent in 1997. (See Figure II.2.)

2.22 In 1997, Turkey's total exports, by broad product categories,[39] were comprised of agricultural products (17 per cent), textiles (10 percent), clothing (27 per cent) and other industrial products (45 per cent). At a more detailed level, main export groups included: edible fruits and nuts (5 per cent), iron and steel (8 per cent) and electrical machinery and equipment (6 per cent). As much as 95 per cent of Turkish total imports in 1997 were made up of industrial products, including 7 per cent accounted for by imports of textiles and clothing. Major sub-groups among the imported industrial products included: fuels, machinery and chemicals.

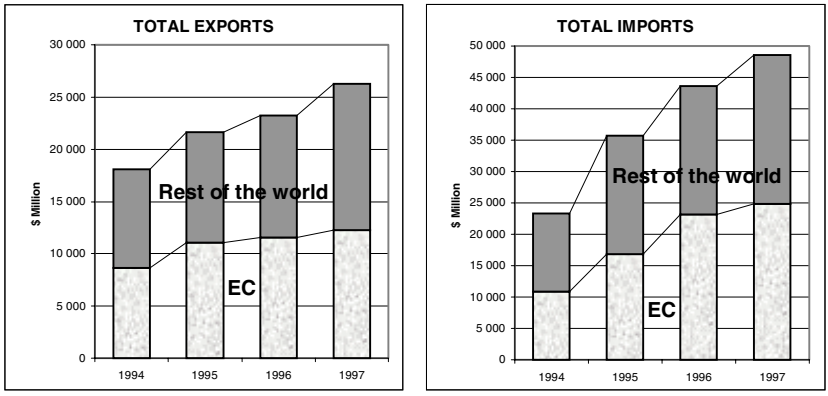
[36] From the point of view of the TMB, Turkey's status is mixed. While it applies restrictions on imports from certain developing countries, in line with its obligations towards the EC, its own exports to the United States and Canada remain under restraint.

[37] Based on trade statistics provided by the Government of Turkey.

[38] Throughout this section, trade figures relate to the EC-15.

[39] The broad product categories are here defined as follows: agricultural products (Turkish tariff chapters 1 to 23); textiles (50 to 60); clothing (61 to 63); other industrial products (24 to 49 and 64 to 97).

Figure II.2 - Turkey's total exports and imports from the European Communities and the rest of the world, 1994-1997



2.23 By broad product categories, the evolution of Turkey's exports to the European Communities during the period 1994-1997 showed some distinct features, when compared to the corresponding developments in Turkey's exports to non-EC countries. For agricultural products, exports to non-EC countries tended to increase (albeit moderately) over practically the whole period, while exports to the European Communities showed increases only in 1995 and 1997. For textiles and clothing, the growth of exports to the European Communities was steady during the period; exports of these products to non-EC countries rose in 1995 and, after virtually stagnating in 1996, increased again in 1997. Exports of other industrial products to the European Communities, after a sharp increase in 1995, slowed down considerably, while those to non-EC countries were steadily up throughout the period, to a level in 1997 46 per cent higher than in 1994. (See Table II.1.)

Table II.1: Turkey's exports to the European Communities and to other countries, by broad product categories, 1994-1997

	Exports to the EC				Exports to other countries			
	1994	**1995**	**1996**	**1997**	**1994**	**1995**	**1996**	**1997**
	($ million)				($ million)			
Agricultural products	1,572	1,841	1,729	1,901	2,060	2,132	2,284	2,643
Textiles and clothing	4,150	5,353	5,665	5,933	2,285	2,967	3,031	3,886
Other industrial products	2,913	3,885	4,154	4,413	5,126	5,460	6,360	7,468
Total exports	**8,634**	**11,078**	**11,549**	**12,248**	**9,471**	**10,558**	**11,676**	**13,997**
	(Percentages)				(Percentages)			
Share of "textiles and clothing" in total exports	*48.1*	*48.3*	*49.1*	*48.4*	*24.1*	*28.1*	*26.0*	*27.7*

Source: Government of Turkey.

2.24 By broad product categories, imports into Turkey of agricultural products from the European Communities declined in both 1996 and 1997, while those from other countries continued to grow, albeit at a slower pace. Imports of textiles and clothing from the European Communities more than trebled between 1994 and 1997; those from other countries recovered from the decline in 1996, to reach in 1997 a level 75 per cent higher than in 1994. (See Table II.2.)

Table II.2: Turkey's imports from the European Communities and from other countries, by broad product categories, 1994-1997

	Imports from the EC				Imports from other countries			
	1994	**1995**	**1996**	**1997**	**1994**	**1995**	**1996**	**1997**
	($ million)				($ million)			
Agricultural products	457	1,031	959	755	810	1,591	1,903	1,809
Textiles and clothing	501	828	1,392	1,617	1,136	1,853	1,590	1,994
Other industrial products	10,172	15,216	21,002	22,713	10,409	15,403	16,995	19,912
Total imports	**10,915**	**16,861**	**23,138**	**24,870**	**12,355**	**18,847**	**20,489**	**23,715**
	(Percentages)				(Percentages)			
Share of "textiles and clothing" in total imports	*4.6*	*4.9*	*6.0*	*6.5*	*9.2*	*9.8*	*7.8*	*8.4*

Source: Government of Turkey.

C. Quantitative Limits in Respect of Turkey's Imports of Certain Textile and Clothing Products

1. Historical Background

2.25 The gradual removal of QRs in major developed countries during the 1950s, in the wake of general liberalization efforts pursued in the GATT, brought about substantial increases in textiles and clothing imports into major developed countries originating in low-cost countries. To alleviate the difficulties caused to their producers, some importing countries convinced exporters of cotton textiles to conclude voluntary export restraint agreements. In an attempt to find a multilateral solution to the problem, in 1960 the GATT CONTRACTING PARTIES recognized the phenomenon of market disruption, thus setting the ground for selective safeguard action in the area of textile and clothing products (as a departure from the requirements of Article XIX of GATT 1947).

2.26 Thereafter, discriminatory restraints took the form of the 1961 Short-Term Arrangement Regarding International Trade in Cotton Textiles, followed in 1962 by the Long-Term Cotton Textiles Arrangement (1962-1973). The Arrangement Regarding International Trade in Textiles or Multifibre Arrangement ("MFA") entered into force in 1974, extending the coverage of the restrictions on textiles and clothing

from cotton products, to include wool and man-made fibre products (and, from 1986, certain vegetable fibre products).[40]

2.27 During its 21 years of existence, from 1974 to 1994, the MFA underwent numerous operational changes and adaptations. The restraints under the MFA developed into a complex network of restrictions, bilaterally negotiated (or imposed in the case of unilateral actions) at short intervals, often every year or so. In the last year of its existence, the MFA had 44 participants, six of which (Canada, Norway, the United States and the European Communities, *plus* Austria and Finland,) applied restraints. Such restraints were used almost exclusively to protect their markets against imports of textiles and clothing from developing countries and, to a lesser extent, from former state-trading countries, also MFA members.

2.28 After more than three decades of special and increasingly complicated regimes governing international trade in textile and clothing products, seven years of negotiations during the Uruguay Round resulted in the ATC. Through the transitional process embodied in the ATC, by 1 January 2005 the extensive and complex system of bilateral restraints will come to an end and importing countries will no longer be able to discriminate between exporters in applying safeguard measures.

2.29 Turkey became a member of the MFA, as an exporting country, in 1981. Since 1979, Turkish textile and clothing products were subjected to restraints in the EC market under the provisions of Article 60 of the Additional Protocol to the Ankara Agreement.[41]

2.30 On 31 December 1994, one day before the ATC came into force, Turkey did not maintain QRs on imports of textile and clothing products. Its exports of certain textile and clothing products were at that time under restraint in the European Communities and other countries' markets under the MFA.

2. Recent Background

2.31 In accordance with Article 13 of Decision 1/95, as of 1 January 1996, the customs duties applied by Turkey to the industrial goods imported from third countries were harmonized with the CCT and the previous Mass Housing Fund levy of some 20 per cent, collected from industrial goods, was abolished. With respect to imports of textile and clothing products, the MFN tariffs applied by Turkey were thereby reduced from roughly 10 per cent for textiles and 14 per cent for clothing in 1994 (*plus* the Mass Housing Fund levy) to 9 per cent in 1996.[42]

2.32 Decision 1/95 included specific provisions with respect to trade in textiles and clothing, in particular in Article 12, supplemented by related statements by both parties. Such provisions called for Turkey's adoption of the relevant EC regulations concerning imports of textiles and clothing, in particular Council Regulation 3030/93, which provided for the bilateral agreements with supplier countries to be

[40] Operationally, the MFA (like the cotton arrangements) provided rules for the imposition of restraints, either through bilateral agreements or, in cases of market disruption or threat thereof, through unilateral action. Importing countries were also required, with certain exceptions, to allow for an annual growth rate in the restraints.

[41] Notified to the Textiles Surveillance Body under Article 7 of the MFA.

[42] The average level of protection of those imports in Turkey was 37 per cent in 1993.

implemented by a set of EC quantitative limits on certain imports and for a system of import surveillance.

2.33 Two Decrees issued by Turkey's Council of Ministers laid down the basis for the alignment of Turkish commercial policy in textiles and clothing to that of the European Communities: Decree No. 95/6815 on *Surveillance and Safeguard Measures for Imports of Certain Textiles Products*, with respect to products from countries with which Turkey concluded bilateral agreements, and Decree No. 95/6816, concerning the *Surveillance and Safeguard Measures for Imports of Textile Products Originating in Certain Countries not Covered by Bilateral Agreements, Protocols and other Arrangements*, both of which were dated 30 April 1995 and published in the Turkish *Official Gazette* on 1 June 1995. Both Decrees were published with the respective Regulations for their application, under the authority of the Under-Secretariat for Foreign Trade, the Turkish responsible body for determination and calculation of the quota levels on imports of textile and clothing products.

2.34 Early in 1995, in its endeavour to complete Decision 1/95 requirements for the "completion of the Customs Union", Turkey sent proposals to the relevant countries (i.e. those whose imports of textiles and clothing were under restraint in the EC market), including India, to reach agreements for the management and distribution of quotas under a double checking system. A standard formula was proposed for calculating the levels of QRs on textile and clothing products to be introduced by Turkey vis-à-vis all third countries concerned.

2.35 On 31 July 1995, Turkey forwarded to the Indian authorities a draft Memorandum of Understanding on trade in the categories of textile and clothing products on which Turkey intended to introduce QRs. India was invited to enter into negotiations with Turkey, with the participation of the European Communities, to conclude, prior to the completion of the Customs Union, an arrangement covering trade in those products which would be similar to the one already existing between India and the European Communities. India maintained that the intended restrictions were in contravention of Turkey's multilateral obligations and declined to enter into discussions on the conditions proposed by Turkey.

2.36 Agreements providing for restraints similar to those of the European Communities were negotiated by Turkey with 24 countries (WTO Members and non-Members). As provided for in Article 12 of Decision 1/95, the EC Commission co-operated with the Turkish authorities in the preparation of negotiating positions and generally participated in the negotiations themselves. As from 1 January 1996, unilateral restrictions or surveillance regimes were applied to imports originating in another 28 countries (WTO Members and non-Members), including India, with which Turkey could not reach agreement. These restrictions only affected products whose export to the European Communities was also under restraint.

2.37 The quantitative limits established by Turkey for 1996 were allocated on a quarterly basis, through Communiqués published in the *Official Gazette* on 19 December 1995, 13 March, 13 June and 25 September 1996. Quantitative limits for 1997 were allocated on a half-year basis, through Communiqués published in the *Official Gazette* on 7 December 1996 and 12 June 1997. Quantitative limits for the year 1998 were allocated through a Communiqué published in the *Official Gazette* on 18 December 1997.

3. *Quantitative Limits Imposed on Certain Turkey's Imports of Textile and Clothing Products from India*

2.38 Turkey applies QRs, as of 1 January 1996, on imports from India of 19 categories of textile and clothing products. (See the Annex to this report, Appendix 1, for a list of the categories and description of products.)

2.39 In the case of India, the formula used by Turkey to fix the level of the QRs corresponded to either (i) the arithmetical average of imports into Turkey from India for the category of products during the period 1992-1994; or (ii) an amount based on total EC imports for the category of products in question multiplied by the percentage of the basket exit threshold laid down in the bilateral agreement between the European Communities and India in force in 1994, multiplied by the percentage share of Turkish GDP in EC-15 total GDP (i.e. 2.5 per cent), whichever was the higher. To this amount the corresponding growth rates in force in quota years 1994 and 1995 had been added to arrive at a level for 1996. The specific criteria retained for the calculation of the quantitative limits on imports of textile and clothing products into Turkey from India were as follows:

(i) average of Turkish imports in 1992-1994, for calculations on product categories 1, 2, 2a, 3a, and 23; and

(ii) option based on GDP, for calculations on product categories 6, 9, 20, 24 and 29 (because there were no imports into Turkey during 1992-1994); and on product categories 3, 4, 5, 7, 8, 15, 26, 27 and 39 (because its outcome was higher than the alternative calculation based on imports).

2.40 Actual quantitative limits established for 1996-1998 on textile and clothing products imported from India can be found in the Annex to this report, Appendix 2.

4. *Statistical Analysis of Turkey's Imports of Textile and Clothing Products under Restraint*

(a) Imports of 61 Textile and Clothing Product Categories under Restraint

2.41 Table II.3 below is based on (i) information provided to the CRTA on the QRs applied by Turkey on imports of certain textile and clothing products from 25 WTO Members (WT/REG22/7) and (ii) import statistics made available by Turkey to the Panel. The data shown below therefore correspond to imports into Turkey of textile and clothing products in the 61 categories identified in the Annex to the document cited under (i) above as being restricted by Turkey for at least one WTO Member in 1997.[43] The statistics in Table II.3 distinguish imports into Turkey from the EC-15 and those originating in other countries (including India).

[43] These product categories are the following: 1-10, 12-24, 26-29, 31-33, 35-37, 39, 46, 50, 61, 67, 68, 70, 72-74, 76-78, 83, 86, 90, 91, 97, 100, 110, 111, 117 and 118.

Table II.3: Turkey's imports of 61 textile and clothing product categories under restraint, from the EC-15 and other countries, 1994-1997

Origin	Import values				Shares			
	1994	1995	1996	1997	1994	1995	1996	1997
	($ million)				(Percentages)			
EC-15	181	326	646	747	25	25	45	47
Other countries	556	960	802	853	75	75	55	53
Imports from all origins	**736**	**1,286**	**1,448**	**1,600**	**100**	**100**	**100**	**100**

Source: WT/REG22/7 and Government of Turkey.

2.42 For the 61 categories of textiles and clothing under restraint, Turkey's imports from all non-EC countries (including India) accounted for 4.5 and 5 per cent of its total imports from those countries in 1994 and 1995, respectively, (i.e. prior to the introduction of the restraints) and for less than 4 per cent of the corresponding totals in 1996 and 1997. The share of imports of those same product categories in Turkey's total imports from the EC-15 increased from 1.7 per cent in 1994 to 3 per cent in 1997.[44]

(b) Imports of the 19 Textile and Clothing Product Categories under Restraint for India

2.43 Statistics provided by India show that the value of its exports to Turkey of the 19 product categories under restriction dropped in 1996 and continued to decline in the following year, albeit less markedly; in 1995, exports under those categories had virtually trebled over their level in 1994. Such fluctuations were mainly due to variations in exports of restricted textile products to Turkey. A different behaviour is observed in India's exports to Turkey of other - unrestricted - products during the period 1994-1997: their share in India's total exports of textiles and clothing to Turkey has increased throughout the period, from 32 per cent in 1994 to 87 per cent in 1997. (See Table II.4, and more detailed statistics in the Annex to this report, Appendix 3a.)

[44] Shares calculated on the basis of data in Tables II.2 and II.3.

Table II.4: India's exports of textiles and clothing to Turkey, 1994-1997

	Export values				Annual change		
	1994	**1995**	**1996**	**1997**	**95/94**	**96/95**	**97/96**
	($ thousand)				(Percentages)		
Textiles	13,960	41,840	21,700	19,570	200	-48	-10
Restricted products							
Clothing	252	396	104	297	57	-74	186
Restricted products							
Textiles and clothing	**20,842**	**94,636**	**69,022**	**147,271**	**354**	**-27**	**113**
All products							
Restricted products	14,212	42,236	21,804	19,867	197	-48	-9
Other products	6,630	52,400	47,218	127,404	690	-10	170

Source: Government of India.

2.44 Data derived from trade statistics supplied by Turkey on its imports from India of the restricted 19 product categories in 1994 to 1997 differ in magnitude or movement from those provided by India.[45] Nevertheless, they point at similar overall trends, both with respect to imports of product categories under restraint and with respect to imports of other textile and clothing products. (See Table II.5, and more detailed statistics in the Annex to this report, Appendix 3b.)

[45] For the restricted product categories, differences are mainly concentrated in textiles. Since differences in trade dollar values are also found in volume terms, and most often pointing in the same direction, the impact of divergent unit values can hardly be the sole explanatory factor. Such differences may derive, not only from the usual time lags of international trade statistics, but also from computation methods. In particular, differences in the data relative to the restrictive product categories could thus be linked to the existence of various stages in the process of export/import licensing, which may serve as a source of the statistics. It is however to be noted that India's export data on unrestricted product categories are also largely at variance with the corresponding import data provided by Turkey.

Table II.5: Turkey's imports of textiles and clothing from India, 1994-1997

	Import values				Annual change		
	1994	**1995**	**1996**	**1997**	**95/94**	**96/95**	**97/96**
	($ thousand)				(Percentages)		
Textiles Restricted products	12,949	45,530	31,651	30,528	252	-30	-4
Clothing Restricted products	133	153	352	131	15	130	-63
Textiles and clothing All products	**32,457**	**104,678**	**93,992**	**137,343**	**223**	**-10**	**46**
Restricted products	13,082	45,683	32,003	30,659	249	-30	-4
Other products	19,375	58,995	61,989	106,684	204	5	72

Source: Government of Turkey.

2.45 In Table II.6, based on Turkish statistics, Turkey's imports of the 19 product categories under restraint for India and of other textile and clothing products are broken down by selected origins, for the 1994-1997 period. Imports from all origins into Turkey of the 19 product categories under restraint for India accounted in both 1994 and 1995 for 24 per cent of Turkey's total imports of textiles and clothing, this share declining to 19 per cent in 1997.

2.46 Turkey's imports of the 19 categories of textiles and clothing under restraint for India from all non-EC countries (including India) accounted for less than 3 per cent of Turkey's imports of all products (including textiles and clothing) from those countries in both 1994 and 1995, and for less than 2 per cent of the corresponding totals in 1996 and 1997. The share of imports of the same 19 product categories in Turkey's imports of all products (including textiles and clothing) from the EC-15 doubled from 0.5 per cent in 1994 to 1.1 per cent in 1997.[46]

Table II.6: Turkey's imports of the 19 textile and clothing product categories under restraint for India, by selected origins, 1994-1997

Origin	Import values				Shares			
	1994	**1995**	**1996**	**1997**	**1994**	**1995**	**1996**	**1997**
	($ million)				(Percentages)			
EC-15	56	101	237	280	14	16	37	41
Other countries	336	548	400	406	86	84	63	59
of which: India	*13*	*46*	*32*	*31*	*3*	*7*	*5*	*5*
Imports from all origins	**392**	**649**	**637**	**686**	**100**	**100**	**100**	**100**

Source: Government of Turkey.

[46] Shares calculated on the basis of data in Tables II.2 and II.6.

III. PRELIMINARY POINTS[47]

A. Issues

3.1 Following the establishment and composition of the Panel, **Turkey** submitted on 14 August 1998 that some points needed to be addressed by the Panel ahead of any examination of the substance of the complaint brought by India. Turkey claimed that:

(i) the request for the establishment of the panel was insufficiently precise in terms of the measures at issue and the product coverage of such measures; by omitting to make clear reference to the measures complained of and their precise product coverage, India had frustrated Turkey's rights of defense;

(ii) the failure by India to direct the complaint to the European Communities as well as Turkey, because the measures at issue stemmed from the Turkey-EC customs union, meant that the complaint should necessarily fail; and

(iii) rules concerning the consultation stage of the dispute settlement procedure with respect to trade in textile and clothing products had not been followed by India.

3.2 In the view of Turkey, the Panel should make a preliminary ruling on these points, rejecting India's complaint.

3.3 **India** requested the Panel to rule that Turkey's request for preliminary rulings had factually and legally no basis, on the grounds that:

(i) the identification of the measures at issue (the restrictions Turkey imposed on textile and clothing products from India as from 1 January 1996, the date when Turkey began to align its restrictions to those of the European Communities) was sufficiently specific to enable Turkey to prepare its defense and the Panel to resolve the dispute;

(ii) it was not possible to bring a complaint against the European Communities with respect to the measures at issue, since these had not been taken by the European Communities nor were they legally attributable to the European Communities because the territorial scope of its obligations under the WTO Agreement did not extend to the customs territory of Turkey. Also, in the absence of a provision for a co-respondent status in the DSU, the European Communities' participation in the proceedings would not, by itself, oblige it to abide by the Panel's ruling and agree to a modification of the common EC-Turkey regime governing restrictions on imports of textile and clothing products from third countries; and

(iii) the special dispute settlement procedures of the ATC did not apply to all restrictions imposed on textile and clothing products but only to those for which the provisions of the ATC were invoked. Since Turkey had notified the TMB that its restrictions were not imposed under

[47] See also para. 1.8 above.

the provisions of the ATC but in accordance with Article XXIV of the GATT, the normal dispute settlement procedures applied to the restrictions at issue. The TMB, established for the sole purpose of supervising the implementation of the ATC, was obviously not the proper forum for the resolution of a dispute on the relationship between Article XXIV of GATT and the general prohibitions of new textile and clothing restrictions set out in Article XI of GATT and Article 2.4 of the ATC.

3.4 India also noted that procedural arguments made by Turkey could not be divorced from the facts and substantive arguments Turkey would present to the Panel. For instance, to rule on Turkey's request the Panel would need to know whether Turkey presented any product-specific arguments, whether the measures at issue were taken by the European Communities or Turkey and which provisions of the GATT and/or the ATC Turkey invoked to justify its restrictions. India therefore stated its preference for the Panel to address the procedural points raised by Turkey after its substantive arguments were presented and an opportunity given to India to rebut those arguments.

3.5 **Japan**, the **Philippines** and the **United States**, as third parties, also submitted their views in this respect Both Japan and the United States considered that, in the absence of any standard working procedures for preliminary rulings, the procedural and organizational issues raised by Turkey should be disposed of by the Panel *in limine litis*, so that India would have an opportunity to address defects, if any, before the conclusion of the work of the Panel. The Philippines argued that the Panel should not consider Turkey's request for preliminary rulings because (i) the request was an *ex parte* communication in the sense of Article 18.1 of the DSU, not being required nor contemplated in the Panel's working procedures; (ii) the Panel's findings on the issues of law and fact involved in the request could deprive India and the third parties of their rights under procedural due process; and (iii) the issues raised in the request were inextricably linked with the substance of India's complaint and could not be resolved separately.

B. Precision of the Request for the Establishment of the Panel

1. Arguments by the Parties

3.6 **Turkey** submitted that it was incumbent upon the Panel to examine the request for its establishment to ensure its compliance with both the letter and the spirit of Article 6.2 of the DSU. It was important that a panel request be sufficiently precise because (i) it often formed the basis of the terms of reference of the panel pursuant to Article 7 of the DSU, and (ii) it informed the defending party and the third parties of the scope and the legal basis of the complaint.[48] Since the jurisdiction of a

[48] See Appellate Body Report on *EC - Regime for the Importation, Sale and Distribution of Bananas*, adopted on 25 September 1997, WT/DS27/AB/R ("*EC - Bananas III*"), para. 142. See also Panel Report on *EC - Regime for the Importation, Sale and Distribution of Bananas*, adopted on 25 September 1997, WT/DS27/R/MEX ("*EC - Bananas III*"), para. 7.37.

panel was established on its terms of reference, by which it was bound,[49] no uncertainty with regard to their scope was permissible, since any such uncertainty would be tantamount to a basic uncertainty concerning the scope of the jurisdiction of that panel.

3.7 Turkey also considered that, as noted by the Appellate Body in the *EC - Regime for the Importation, Sale and Distribution of Bananas* case,[50] such a fundamental issue concerning the scope of the panel jurisdiction could be decided early in the panel procedure without unfairness to any party or third party, but Turkey did not believe that for this purpose detailed panel working procedures needed to be first established, since panels had regularly addressed preliminary issues of this kind *in limine litis*.[51]

3.8 Turkey recalled that Article 6.2 of the DSU required a request for the establishment of a panel to identify "the specific measures at issue". In its request submitted in the present case, India merely referred to "the unilateral imposition of QRs by Turkey on imports of a broad range of textile and clothing products from India as from 1 January 1996",[52] which Turkey considered a clearly insufficient description of the "specific measures at issue". In particular, the measures complained of were not specified by reference to the place of publication, by a clear indication of the date of adoption or promulgation, the issuing authority and the type of measure, nor by a reference to their precise product coverage. In Turkey's view, such a lack of precision was contrary to the letter and the spirit of Article 6.2 of the DSU. The basic right of defense, or due process implicit in the DSU would be impaired if the identification of the specific measures complained of were not clear, so that the party with the *better guess* would prevail. It was fundamental for a fair process that the party that had allegedly committed a breach of its obligations be fully aware of the case held against it. Turkey considered that, this could only be achieved, in the circumstances of the present case, by a clear reference to the measures complained of and their exact product coverage.

3.9 **India** pointed out that Turkey could not claim that it was not adequately informed about the scope of the dispute at the beginning of the panel proceedings. The domestic legal basis and product coverage of Turkey's measures could not have escaped the notice of its own authorities since Turkey had itself notified all details to the WTO. Furthermore, India raised the matter of the restrictions imposed by Turkey on a number of separate occasions.[53] On none of these occasions did Turkey indicate

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[49] See Appellate Body Report on *India - Patent Protection for Pharmaceutical and Agricultural Chemical Products*, adopted on 16 January 1998, WT/DS50/AB/R ("*India - Patent*"), para. 92, DSR 1998:I, 9.

[50] See Appellate Body Report on *EC - Bananas III*, para. 144 (footnote 1).

[51] For a recent example of preliminary rulings issued at the beginning of the first meeting with the parties by the Panel, see Panel Report on *Indonesia - Certain Measures Affecting the Automobile Industry*, adopted on 2 July 1998, WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R ("*Indonesia - Autos*"), Section XIV.A, paras. 14.1-9.

[52] WT/DS34/2, para. 1.

[53] DSB meeting of 27 March 1996 (WT/DSB/M/13, dated 13 May 1996); DSB meeting of 24 April 1996 (WT/DSB/M/15, dated 15 May 1996); DSB meetings of 13 February 1998 and 13 March 1998 (WT/DSB/M/42, dated 16 March 1998, and WT/DSB/M/43, dated 8 April 1998); CRTA

that the description of the measure left any uncertainty regarding the scope of the dispute. On the contrary, Turkey made it clear that it was fully aware of the product coverage when it stated before the DSB that "… with regard to Turkey's textile quotas … none of the textiles and clothing categories which were subject to QRs had been fully utilized by any exporting country. In the case of India, textile and clothing quotas had been underutilized in both 1996 and 1997".[54] All Members, including Turkey, were thus fully informed of the facts on which Turkey now claimed ignorance.

3.10 India noted further that one of the purposes of the requirement of prior consultations (Articles XXII and XXIII of GATT and Article 4 of the DSU) was to ensure that Members conducted a detailed exchange of facts and views before resorting to the panel procedure. During consultations the respondent had the opportunity to seek clarifications regarding the scope of the complaint. India recalled in this context that Turkey had refused to consult with India altogether without the presence of the European Communities, although, in India's view, it would have been free to raise in the consultations the issue of European Communities' participation in the proceedings. To buttress its present claims, Turkey had invoked the principle of due process, recognized by the Appellate Body as inherent in the DSU.[55] However, India failed to see how could it be consistent with the principle of due process if a Member were permitted to first refuse to hold consultations and then claim ignorance on matters that could have been clarified in those consultations. India therefore considered Turkey's claim that it was insufficiently informed by India about the scope of the dispute as a case of *venire contra factum proprium* which should, for that reason alone, be rejected by the Panel.

3.11 India also submitted that its request for the establishment of a panel stated that the measures at issue were the "QRs [imposed unilaterally] by Turkey on imports of a broad range of textile and clothing products from India as from 1 January 1996",[56] thus clearly identifying the specific measures at issue. It noted that Turkey was aware of the details of the quantitative limits imposed by it, since these were notified jointly by the European Communities and Turkey to the CRTA and a copy of this notification was also sent to the Chairman of the TMB. There could be no uncertainty for the Turkish authorities regarding such details as the product coverage of these restrictions, the place of publication, the date of adoption or promulgation, the issuing authority or the type of measure. The identification of the specific measures at issue in India's request for a panel, therefore, did not require Turkey to engage in conjectures as to the scope of the dispute.

3.12 India submitted further that its complaint was directed against Turkey's restrictive regime for textile and clothing products from India agreed with the European Communities. The dispute between Turkey and India concerned one narrow legal issue, namely, whether Article XXIV of GATT, the only provision invoked by

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meeting of 16-18 and 20 February 1998 (WT/REG/M/16, dated 18 March 1998, paras. 140 and 141).

[54] WT/DSB/M/43, dated 8 April 1998, Item 2, para. 3.

[55] See Appellate Body Report on *India - Patent*, para. 94.

[56] WT/DS34/2, para.1.

Turkey to justify its restrictions, permitted Turkey to impose new restrictions on imports of textile and clothing products from India that were inconsistent with the provisions of Article XI:1 of GATT and Article 2.4 of the ATC. The manner in which India had identified the measures at issue fully enabled Turkey to prepare its defense on this dispute and the Panel to rule on it. India considered that the identification of the measures at issue was, therefore, sufficiently precise for the purposes of Article 6.2 of the DSU.

3.13 **Turkey** recalled the findings of the panel on *EEC - QRs against Imports of Certain Products from Hong Kong*, which included the following:

> "The Panel considered that just as the terms of reference must be agreed between the parties prior to the commencement of the Panel's examination, *similarly the product coverage must be clearly understood* and agreed between the parties to the dispute. The Panel considered that to allow the inclusion of an additional product item about which one party had not been formally advised prior to the commencement of the proceedings would be to introduce an element of inequity" (emphasis added).[57]

3.14 Turkey noted that, since under the DSU the parties to the dispute needed no longer to agree on the establishment of a panel, it was all the more important that the parties and the third parties be in the clear about the precise scope of the dispute, as the Appellate Body found in the *EC - Bananas III* case.[58] It also noted that, in the *EC - Customs Classification of Certain Computer Equipment* case, the Appellate Body, taking into account such clear logical and legal necessities, stated that "it may also be necessary to identify the products subject to the measures in dispute",[59] in this case rejecting the claim by the European Communities that the United States had violated Article 6.2 of the DSU on the basis that "the complaining parties may have identified [the products at issue] by broader grouping, but not spelled out in sufficient detail".[60]

3.15 Turning to the present case, Turkey recalled that, in its request for the establishment of a panel, India had not even indicated a broader grouping of products, but limited itself to a generic reference to "a broad range of textile and clothing products". In Turkey's view, if such generic reference would be deemed to be sufficient to comply with Article 6.2 of the DSU, the word "specifically" in that provision would be inevitably reduced to redundancy or inutility, thus breaching a fundamental principle of interpretation of international public law.[61]

3.16 **India** responded that Article 6.2 of the DSU did not prescribe the manner in which the specific measures at issue were to be identified. Turkey's interpretation was supported neither by GATT/WTO practice nor by Appellate Body rulings. In most requests for the establishment of a panel made under the GATT and the WTO

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[57] Panel Report on *EEC - QRs against Imports of Certain Products from Hong Kong*, adopted on 12 July 1983, BISD 30S/129 ("*EEC - Imports from Hong Kong*"), para. 30.

[58] See Appellate Body Report on *EC - Bananas III*, para. 142, footnote 1.

[59] Appellate Body Report on *EC - Customs Classification of Certain Computer Equipment*, adopted on 22 June 1998, WT/DS62, 67, 68/AB/R ("*EC - Computer Equipment*"), para. 67.

[60] *Ibid.*, para. 70.

[61] See Appellate Body Report on *United States - Reformulated and Conventional Gasoline*, adopted on 20 May 1996, WT/DS2/AB/R ("*US - Gasoline*"), p. 23, footnote 45.

Agreement, the measures at issue were not identified by date and place of publication nor was the product coverage indicated with precision. The WTO *EC - Bananas III* case, cited by Turkey in support of its position, was no exception. Close to 100 different regulations made up the EC regime for the importation, sale and distribution of bananas, which applied to over a dozen different products. Both the panel and the Appellate Body examined the totality of this regime, irrespective of whether the regulations at issue were identified in the terms of reference in detail, and neither the panel nor the Appellate Body considered the generic description of the products to which this regime applied to be inconsistent with Article 6.2 of the DSU.[62]

3.17 In India's view, Article 6.2 of the DSU essentially required that the complainant identify clearly the matter in dispute. Details were in most cases irrelevant to its resolution.[63] If Turkey's interpretation were accepted, Members would only be able to bring complaints about elements of a trade regime whose domestic legal basis and product coverage could be identified with precision at a particular point in time, leaving the authorities of the respondent complete freedom to change a detail of the regime and claim that the new regime was no longer the measure ruled upon by the DSB. Requests for the establishment of a panel on defined aspects of a trade regime had frequently been made in the past and the panels and parties had not found an indication of the domestic legal basis and product coverage as necessary to resolve the disputes. India considered that the possibility to bring complaints on the basis of such requests should remain in the future if the DSU was to serve its purpose.

3.18 India noted further that the GATT and WTO precedents cited by Turkey did not support its position. For instance, Turkey had quoted the GATT Panel Report on *EEC - Imports from Hong Kong*.[64] During the course of proceedings of this panel, Hong Kong had requested a ruling on a product not mentioned at all in its panel request. There was no parallel there with India's complaint because India did not request in its first submission a ruling on products that it had not mentioned in its panel request. The panel on the *EC - Computer Equipment* case had pointed out that the *EEC - Imports from Hong Kong* s case had to be distinguished from the case in which the complaining party merely elucidated the product coverage already specified in the request for the establishment of a panel.[65] India, just like the United States in the *EC - Computer Equipment* case, merely provided in its first submission details on the present product coverage of measures already identified in the panel request. Finally, Turkey referred to the Appellate Body Report on the *EC - Computer Equipment* case, in which the Appellate Body recognized that the complaining party might identify the products subject to the measures at issue "by broader grouping", rejecting the European Communities' claim that each individual product had to be identified

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62 See Panel and Appellate Body Reports on *EC - Bananas III (Complaint by the United States)*.

63 For instance, if a Member complained about the import licensing procedures of another Member, it would normally not be necessary to identify the place and date of publication of the regulation promulgating the procedures and its current product coverage. What was relevant for the resolution of such a dispute was the import licensing procedure as such, not its current domestic legal basis and the particular products to which it applied at a particular point in time.

64 See BISD 30S/129.

65 See Panel Report on *EC - Computer Equipment,* para. 8.9.

with precision.[66] However, this Appellate Body ruling supported India's position that the identification of the measures at issue as the restrictions Turkey imposed as from 1 January 1996 on imports of textiles and clothing from India was sufficiently precise.

3.19 **Turkey** recalled Article 22.4 of the DSU, which referred to the "level of nullification and impairment", questioning how such level could be established if the precise product coverage of the dispute was unknown.

3.20 **India** made reference to Article 22.6 of the DSU, according to which the level of suspension of concessions, in the case of a failure to comply with recommendations or rulings adopted by the DSB under the procedures of Article 22 of the DSU, should be equivalent to the level of the nullification or impairment. India considered that Turkey's argument that such equivalence could only be determined if the product coverage was precisely determined during the panel proceedings had no merit. The level of suspension to which the complainant was entitled to under Article 22.4 of the DSU obviously depended on the level of nullification or impairment at the time when the failure to comply with the DSU recommendations occurred. India's rights under Article 22 of the DSU would in the present case thus depend on the nullification or impairment caused by the Turkish measures when the reasonable period for compliance with the DSB recommendations or rulings would have elapsed. Thus, if Turkey were to remove several items from the coverage of its restrictive regime for Indian textile and clothing products, India's right to suspend concessions or other obligations would be curtailed correspondingly. In India's view, the product coverage at the present time was thus not relevant for the purposes of Article 22 of the DSU. Moreover, any dispute regarding the level of suspension was to be resolved under the separate procedures set out in Article 22.6 of the DSU. There was, therefore, no need to make in the panel proceedings the factual findings that might have to be made in a subsequent Article 22.6 proceeding.

3.21 **Turkey** also pointed out that a faulty request for the establishment of a panel could not be "cured" by a complaining party's argumentation in its written submissions to the panel, in accordance with the findings of the Appellate Body in *EC - Bananas III*.[67] The deficiency of India's request for the establishment of a panel was therefore a fatal procedural obstacle to carrying this case any further. Any other decision would amount to a violation of Turkey's essential procedural right as a respondent to be aware of the case held against it which was part of the demands of due process to be preserved by the Panel.[68]

3.22 **India** noted that no issue of a "cure", as implied in Turkey's reference to the Appellate Body ruling in *EC - Bananas III*, could arise when, as was the case of India's request for a panel and its first submission, the measures at issue in the request for a panel were the same measures that were referred to in the first submission of the complainant.

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[66] See Appellate Body Report on *EC - Computer Equipment*, para. 67.

[67] See Appellate Body Report on *EC - Bananas III*, para. 143.

[68] See Appellate Body Report on *India - Patent*, para. 94, where it is stated that "the demands of due process … are implicit in the DSU".

3.23 India concluded that the identification of the measures at issue was sufficiently specific to enable Turkey to prepare its defense and the Panel to resolve the dispute, and it, therefore, met the requirements of Article 6.2 of the DSU.

2. *Arguments by Third Parties*

3.24 **Japan** referred to the *Japan - Measures Affecting Consumer Photographic Film and Paper* case as an additional important precedent for the interpretation of Article 6.2 of the DSU. For the identification of the specific measures at issue in that case, the panel found that a measure not explicitly described in a request for the establishment of a panel, to be regarded as being included in the measures at issue, had to be subsidiary or so closely related to the latter that the responding party could reasonably be found to have received adequate notice.[69]

3.25 The **Philippines** submitted that there was no specific standard on the degree of specificity required in the phrase "identify the specific measures at issue" other than the phrase "sufficient to present the problem clearly", in Article 6.2 of the DSU. In the Philippines view, Turkey, by its own acts, had made it sufficiently clear that it understood the problem clearly, or ought to understand it, as a reasonable party acting in good faith in the context of non-contentious proceedings (as pointed out in Article 3.10 of the DSU). The Philippines also rejected Turkey's argument related to the level of nullification and impairment as having no relevance whatsoever to the identification of the specific measures at issue. The Philippines concluded that India was in compliance with Article 6.2 of the DSU.

C. *Non-Participation of the European Communities in the Dispute*

1. *Arguments by the Parties*

3.26 **Turkey** noted that the creation and existence of a customs union was not only a fact which was taken into account by the drafters of the GATT, but was expressly referred to in Article XXIV:4 of GATT as "desirable" because of the economic integration between the countries parties to the customs union. India was well aware that the measures subject of its complaint had not been taken *unilaterally* by Turkey, but resulted from the completion of the customs union agreed between Turkey and the then EEC in the Ankara Agreement, as specified in more detail in Association Council's Decision No. 1/95 "on implementing the final phase of the Customs Union". Turkey referred to paragraphs 1 and 2 of Article 12 of Decision No. 1/95 as evidence of its lack of autonomy in adopting its external commercial policy concerning imports of textile and clothing products from countries outside the customs union. Turkey recalled that the conclusion of the Turkey-EC customs union, and more particularly the above-mentioned provisions were duly notified to the GATT and to the WTO.

3.27 **India** noted that the restrictions imposed by Turkey were acknowledged by both Turkey and the European Communities as having been imposed by Turkey. Thus, Article 12 of Decision 1/95 provided that "*Turkey shall*, in relation to countries

[69] See Panel Report on *Japan - Measures Affecting Consumer Photographic Film and Paper*, adopted on 22 April 1998, WT/DS44/R.

which are not members of the Community, *apply* provisions and implementing *measures which are substantially* similar *to those of the Community*'s commercial policy set out in the following Regulations" (emphasis added).[70] Furthermore, the joint Turkey-European Communities communication to the CRTA on 8 November 1996 (containing preliminary information on Decision 1/95) reads as follows: "In this framework, *Turkey has introduced quantitative restrictions* and surveillance measures parallel with the practices of the EC and will similarly *align itself* with EC liberalization" (emphasis added).[71] In the Turkey-European Communities communication to the CRTA on the details of the QRs imposed, there was again joint and clear acknowledgement that:

> "In order to assist Members in the examination of the customs union, Turkey and the European Communities are pleased to confirm, in the Annex hereto, details of the quantitative limits applied by Turkey in respect of imports of certain textile and clothing products from certain WTO Members, and in conformity with the provisions of Article XXIV of GATT 1994" (emphasis added).[72]

In India's opinion, there was therefore no doubt that the measures at issue were restrictions imposed by Turkey and not by the European Communities.

3.28 **Turkey** recalled that, according to the Appellate Body in *Japan - Taxes on Alcoholic Beverages*, Panel and Appellate Body Reports "*are not binding, except* with respect to resolving the particular dispute *between the parties to that dispute*"(emphasis added).[73] This corresponded to internationally recognized standards: Article 59 of the Statute of the International Court of Justice ("ICJ") contained similar language, as indicated in footnote 30 of the above-mentioned Appellate Body report. Turkey added that Article 63 of the ICJ Statute allowed for all the parties to an international convention to become an intervenient with regard to the interpretation of that convention, it being understood that such an intervenient would then be bound by the judgement of the ICJ.[74] Turkey noted that such a provision was absent from the DSU, Article 10 giving third parties only limited rights of participation.

3.29 **India** noted that, although the DSU did not provide for the status of co-respondent, the European Communities would have had the right to participate in the present proceedings as a third party (Article 10). As such, it would have had the right to request the Panel to accord it the enhanced third-party status which certain GATT and WTO panels have accorded to third parties with a direct contractual interest in

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[70] See WT/REG22/1.

[71] WT/REG22/5, Section II.8 (Trade Provisions, Sector-specific provisions), sub-section on Textiles and Clothing.

[72] WT/REG22/7, p. 1.

[73] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages*, adopted on 1 November 1996, WT/DS8/AB/R ("*Japan - Alcoholic Beverages*"), p. 14, DSR 1996:I, 97.

[74] Article 63 of the Statute of the International Court of Justice reads as follows: "1. Whenever the construction of a convention to which states other than those concerned in the case are parties is in question, the Registrar shall notify all such states forthwith. 2. Every state so notified has the right to intervene in the proceedings; but if it uses this right, the construction given by the judgement will be equally binding upon it."

the outcome of a proceeding.[75] This would have permitted it to be present at all meetings of the Panel with the parties and to submit its views in all stages in the proceedings. The European Communities deliberately chose not to participate in the proceedings in accordance with the provisions of the DSU. It would amount to an amendment of the DSU by the Panel if the European Communities were accorded rights of participation not foreseen in the DSU and never before granted to a GATT contracting party or WTO Member interested in supporting the respondent.

3.30 **Turkey** further submitted that it could not be obliged by a DSB ruling to breach an international agreement that was duly notified and had a recognized status in the WTO by virtue of Article XXIV of GATT. A generally accepted rule of public international law was contained in Article 26 of the Vienna Convention of the Law of Treaties ("VCLT"): *pacta sunt servanda*. This made it legally impossible for Turkey to act inconsistently with its obligations under the Turkey-EC customs union without the consent of the other party to that agreement. Any other solution would amount to obliging Turkey to breach its international obligations *vis-à-vis* the European Communities and would thereby be contrary to general principles of public international law which, in accordance with Article 3.2 of the DSU, was a source of law within the WTO dispute settlement system.

3.31 **India** considered that, although it might be true that Turkey faced conflicting obligations in the WTO and in its bilateral agreement with the European Communities, this issue was not germane to the task of the Panel, whose mandate according to Article 7.1 of the DSU was to examine exclusively Turkey's obligations under the WTO agreements cited by the parties to the dispute, not any other treaties accepted by Turkey. This was not the first case in GATT/WTO history in which a panel had examined GATT-inconsistent measures taken by the defendant as a result of a bilateral agreement with another State. So far, all panels faced with that situation had simply ignored it and left it to the defendant to decide how to resolve its conflict of international obligations.[76] Turkey's potential conflict of international obligations was, therefore, irrelevant in the current proceedings.

3.32 India noted that it was undisputed in international law that a treaty between two States does not create either obligations or rights for a third State without its consent.[77] The agreement reached between Turkey and the European Communities, therefore, could not modify the rights which India asserted before this Panel. Contrary to Turkey's defense based on the recognized status of a customs union under Article XXIV of the GATT, India argued that nothing in Article XXIV could possibly be interpreted as authorizing WTO Members forming a customs union to restrict

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[75] See Panel Report on *EC - Bananas III (Complaint by the United States)*, para. 7.5; and the references to GATT precedents in footnote 330 of that report.

[76] Examples of such cases are: *Norway - Restrictions on Imports of Certain Textiles Products*, BISD 27S/119 (restrictions discriminating against Hong Kong imposed under bilateral agreements with six developing countries); *Japan - Trade in Semi-Conductors*, BISD 35S/116 (export restrictions on semi-conductors imposed under an agreement with the United States); *EC - Bananas III (Complaint by the United States)*, para. 3.30 (country-specific allocations of tariff quota shares under the "Framework Agreement on Bananas" concluded between the EC and certain Latin American countries).

[77] Article 34 of the VCLT: "*pacta tertiis nec nocent nec prosunt*" ("A treaty does not create either obligations or rights for a third State without its consent").

imports from third WTO Members. Article XXIV provisions could not be understood as an expression of the consent of third WTO Members to bear the consequences of whatever restrictions might be imposed on their trade under an agreement between WTO Members forming a customs union.

3.33 **Turkey** also maintained that India's claim could not succeed as long as India was unwilling to direct its complaint against both the European Communities and Turkey. If the European Communities was not fully involved in the present dispute, it would not be bound by its outcome and would therefore be under no obligation to agree to apply the agreement in a way that would satisfy India's pretensions. Turkey considered that India's claim should be rejected on the basis that, in order to pursue its claims properly, India should have cited both parties to the Turkey-EC customs union as respondents. In Turkey's view, the present case was comparable to a situation where the complainant directed its complaint against country A for a measure taken by country B; in such situation, the complaint would have to be turned down for lack of standing due to the obvious absence of international liability. The same rule should therefore apply in the present case, since there was no basis, in fact or in law, for the assumption that Turkey was alone internationally answerable and individually responsible for acts collectively taken by the parties to the Turkey-EC customs union through its institutions.

3.34 In that context, Turkey viewed India's ultimate aim as that of being able to increase its trade in textile and clothing products with the Turkey-EC customs union, and not with Turkey alone. However, the "level of nullification or impairment" (Article 22.4 of the DSU) of QRs applied by the Turkey-EC customs union with regard to such trade with a final destination in Turkey would in fact be nil, while such trade impairment was potentially measurable with regard to the trade in these products with a final destination in European Communities. India's choice of the respondent therefore amounted to a circumvention of the essential rights of defense of the European Communities as the party in the Turkey-EC customs union which would have to bear the trade consequences of any change in the existing import regime for textile and clothing products in Turkey as a constituent territory of the Turkey-EC customs union.

3.35 **India** noted that Turkey was not an EC Member State. Hence, the territorial scope of the European Communities' obligations under the WTO Agreement did not comprise the Turkish customs territory and the Turkish government was not an authority for whose acts the European Communities had assumed any responsibility under the WTO Agreement. The import restrictions adopted by Turkey within its customs territory were measures neither adopted by, nor legally attributable to the European Communities.[78] In the absence of any EC restrictions that India could pos-

[78] In India's view, the only measure the EC took with respect to the measures at issue was to seek a common EC-Turkey regime for third-country imports of textiles and clothing and to reach an agreement with Turkey on such a regime. However, these actions of the EC, by themselves, were not measures covered by WTO law. The only provision in the WTO agreements which specifically prohibited Members to seek the imposition of a measure by another Member or to conclude an agreement with another Member on such imposition was Article 11 of the Safeguards Agreement, a provision which obviously did not apply in the present case.

sibly challenge under the WTO agreements, India could not reasonably be expected to initiate proceedings against the European Communities under the DSU.

3.36 Finally, in India's view, according to Article 19.1 of the DSU, the DSB could request the European Communities to modify their agreement with Turkey only if EC participation in that agreement, by itself, constituted a measure inconsistent with a WTO agreement covered by the DSU. This was, however, not the case. Moreover, a Member participating as a third party in the normal panel procedures is not bound by the outcome of the proceedings merely by virtue of its participation. As confirmed by the Appellate Body, the results of a panel proceeding bound only the complainant and the defendant in the proceedings.[79] There was no obligation for third parties participating in panel proceedings corresponding to that contained in the arbitration procedures of Article 25 of the DSU.[80]

3.37 India could therefore not see how a mere change in the status of the European Communities in the proceedings of the Panel could entail a change in India's rights towards the European Communities under the WTO agreements and oblige the European Communities to agree to a modification of the common EC-Turkey regime for imports of textile and clothing products from India. Under general international law, such an obligation could result only from an agreement between India and the European Communities according to which these would commit themselves to abide by the Panel ruling if it were permitted to participate in the Panel proceedings. India noted that the European Communities had not offered to assume that obligation.

2. Arguments by Third Parties

3.38 **Japan** submitted that the Panel had been established in accordance with the provisions of the DSU, since India questioned Turkey's obligations under the WTO Agreements (not Turkey's obligations *vis-à-vis* the European Communities under the Ankara Agreement). Japan further noted that there was no obligation under the DSU for India to complain against the European Communities in this particular case and that any general issue of mandatory co-respondents should be addressed in another context.

3.39 The **Philippines** submitted that the European Communities were not an indispensable party to the dispute and that the resolution of India's claims against Turkey was not precluded without the participation of the European Communities. The Philippines observed, in particular, the following:

(i) Turkey's invocation of the *pacta sunt servanda* principle contained in Article 26 of the VCLT was not relevant in this context, since the terms and conditions of any agreement between Turkey and the European Communities, as between themselves, was not the subject of the dispute. Rather, a necessary consequence of Articles 26 and 34 of the VCLT was that, in the WTO, as between Turkey and India, Turkey could not invoke whatever conflicting obligations it might have under a Turkey-EC agreement.

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[79] See Appellate Body Report on *Japan - Alcoholic Beverages*, Section E.

[80] Where all parties to the proceeding, including any third Member that agreed to participate, "shall agree to abide by the arbitration award".

(ii) Even assuming that Turkey had acted in performance of an obligation imposed by a Turkey-EC agreement, the operative act from which India's cause of action arose (the promulgation of a law applicable in Turkish territory) was the exclusive and sovereign act of Turkey.

(iii) The Panel, or the Appellate Body, had no choice but to apply the WTO Agreement, since the Turkey-EC agreements were not "covered agreements". Moreover, in accordance with paragraph 4 of Article 30 of the VCLT,[81] the WTO Agreement was exclusively applicable as between Turkey and India in the context of this dispute.

(iv) It was irrelevant and immaterial that the European Communities be bound by the results of this dispute, since India did not seek any remedy from the European Communities.

3.40 The **United States** also argued in support of India's views, noting the following:

(i) The text of Article 10 of the DSU drew a balance between the rights of the parties to a dispute and the rights of other Members, a point made clear in the *EC - Bananas III* case, when the panel granted part but not all of a request for additional participatory rights for third parties.[82] In the present dispute, the European Communities had however not chosen to avail themselves of the rights afforded to it by the provisions of Articles 10.1-10.3 of the DSU.

(ii) Turkey's claim that it was not individually responsible under the WTO Agreement for the measures at issue because of Turkey's entry into the Ankara Agreement could not be accepted. The existence of the Ankara Agreement could not by itself limit the rights of India under the WTO Agreement with respect to those measures. This principle of customary international law, *pacta tertiis nec nocent nec prosunt*, was expressed in Article 34 of the VCLT: "A treaty does not create either obligations or rights for a third State without its consent."

(iii) Turkey's citation of the principle of *pacta sunt servanda* was inapposite, as the text of Article 26 of the VCLT made it clear that "Every treaty in force is binding *upon the parties to it* and must be performed by them in good faith" (emphasis added). This Article did not have an effect on Turkey's obligations to India, or India's rights *vis-à-vis* Turkey, as India was not a party to the Ankara Agreement.

(iv) The measures in question were not acts adopted by institutions of the Ankara Agreement but were of Turkey's responsibility, as clearly stated by the European Communities at the DSB meeting on 13 February 1998: the "basic policy on Turkey's future textiles regime [in-

[81] "When the parties to the later treaty do not include all the parties to the earlier one: ... (b) as between a State party to both treaties and a State party to only one of the treaties, the treaty to which both States are parties governs their mutual rights and obligations".

[82] See Panel Report on *EC - Bananas III*, paras. 7.8-7.9.

cluding the measures in question] had been agreed by the Communities and Turkish Ministers…".[83]

(v) In the *EC - Bananas III* case, the Appellate Body had already endorsed the examination under the DSU of measures adopted by one Member even when those measures were related to that Member's other international agreements and that the other parties to such agreements were not parties in the WTO dispute settlement proceeding.

D. Consultation Stage of the Dispute Settlement Procedure with Respect to Trade in Textile and Clothing Products

1. Arguments by the Parties

3.41 **Turkey** submitted that India had violated cogent rules of procedure which were applicable in the present case and which took precedence over the ordinary rules under the DSU. In Turkey's view, the Panel had thus not been regularly established with respect to matters which were covered by the ATC and should decide, therefore, *in limine litis* that all the alleged violations of the ATC were not correctly before it and that it could not rule upon them.

3.42 Turkey claimed that, though alleging inconsistency of the Turkish measures with Article 2 of the ATC, India had disregarded the requirements of the special and additional procedural rules under Article 8, paragraphs 5 and 10, of the ATC (in the context of Article 1.2 and Appendix 2 of the DSU). In particular, India had not requested the TMB to review promptly the particular matter that it considered detrimental to its interests under the ATC. By so doing, it did not allow the TMB to make the appropriate recommendations. However, pursuant to Article 8.10 of the ATC, a matter might be brought before the DSB under Article XXIII:2 of GATT and the relevant provisions of the DSU only *after* the TMB had made recommendations and these could not be implemented. Thus, according to Article 1.2 of the DSU, the ordinary DSU rules did not apply in this case with respect to the alleged violation of the ATC: in particular it was not possible to request the DSB to establish a panel on this aspect of India's complaint in the absence of a TMB recommendation.

3.43 Turkey recalled that as from 1 January 1995, two dispute settlement procedures concerning textile and clothing products had undergone the complete panel and Appellate Body procedure.[84] In both cases, the TMB was requested to make recommendations before the request for the establishment of the panel was filed to the DSB.[85] In the Panel Report on *United States - Restrictions Affecting Imports of Woven Wool Shirts and Blouses*, in which India was the complaining party, the following could be read:

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[83] WT/DSB/M/42, item 3, p. 6.

[84] *United States - Restrictions on Imports of Cotton and Man-Made Fibre Underwear* (complaint WT/DS24) and *United States - Restrictions Affecting Imports of Woven Wool Shirts and Blouses* (complaint WT/DS33).

[85] See Panel Report on *United States - Restrictions on Imports of Cotton and Man-Made Fibre Underwear*, adopted on 25 February 1997, WT/DS24/R ("*US - Underwear*"), paras. 2.8-2.18.

> "India noted that the matter had remained unresolved in spite of bilateral consultations between India and the United States held under Article 6.7 of the ATC…; the examination of the matter by the Textile Monitoring Body (TMB) under Article 6.10 of the ATC…; the communication sent to the TMB under Article 8.10 of the ATC, within one month of the TMB recommendations; and the review of the matter by the TMB under Article 8.10 of the ATC… Consequently, India considered that it had met all requirements in Article 8.10 of the ATC for the direct recourse to Article XXIII.2 of GATT 1994."[86]

3.44 In Turkey's view, India did not meet in the present case, unlike in the above-mentioned precedent, all requirements in Article 8.10 of the ATC, since it did not allow the TMB to make recommendations, it denied Turkey the opportunity to make its views known to the TMB before such recommendations were made and it disregarded the special and additional procedural rules under Appendix 2 of the DSU.

3.45 **India** submitted that Turkey's argumentation was based on the notion that the special dispute settlement procedures of the ATC applied to all restrictions on textile and clothing products whatever their legal basis. This, however, was clearly not the case. Pursuant to Article 2.4 of the ATC, new restrictions on textile and clothing products might be justified by invoking either a provision of the ATC or a provision of the GATT. If a Member invoked a provision of the ATC, the matter might be examined by the TMB, since Article 8.1 of the ATC gave to the TMB the mandate "to examine all measures taken *under this Agreement* and their conformity therewith" (emphasis added). If a Member invoked a GATT provision, such as Articles XII, XVIII or XIX, as the legal basis for its restrictions on textile and clothing products, the TMB would have to leave the matter to the WTO body competent to examine measures taken under the GATT provision, for instance the Committee on Balance-of-Payments Restrictions or the Committee on Safeguards. This followed not only from the definition of the TMB's mandate in Article 8:1 of the ATC but also from Article 3:3, which stipulated that "… Members shall provide to the TMB, *for its information*, notifications …" (emphasis added).

3.46 India noted that Article 2.4 of the ATC prohibited in principle all new restrictions on textile and clothing products except those justified by ATC or GATT provisions. If a restriction on such products was introduced under the provisions of the ATC, the TMB was competent and the special dispute settlement provisions of the ATC applied. This was not relevant to the present dispute, since Turkey had neither notified, pursuant to Article 2.1 of the ATC, QRs maintained under the MFA, not had it based its restrictions on the specific transitional safeguard mechanism of Article 6 of the ATC.

3.47 India argued further that, if a new restriction on textile and clothing products was introduced under the provisions of the GATT, the TMB was merely informed of the matter and the normal dispute settlement procedures applied. Article XXIV of GATT was so far the only provision Turkey had invoked to justify its introduction of new QRs on imports from India of certain textile and clothing products as from 1

[86] Panel Report on *United States - Restrictions Affecting Imports of Woven Wool Shirts and Blouses*, adopted on 20 March 1997, WT/DS33/R ("*US - Shirts and Blouses*"), para. 1.2.

January 1996.[87] In accordance with Article 3.3 of the ATC, Turkey provided to the TMB, for its information, on two occasions the notifications which were submitted to the CRTA for the measures at issue.[88] Consistently with its limited mandate, the TMB had merely taken note of the information provided.[89]

3.48 India noted that it was contradictory for Turkey to invoke a GATT provision as the legal basis for its new restrictions while claiming before this Panel that procedures of the ATC should be used by India to address the question of whether that GATT provision in fact provided the required legal basis. The TMB, established for the sole purpose of supervising the implementation of the ATC, was obviously not the proper forum for the resolution of a dispute on the relationship between Article XXIV of GATT and the general prohibitions of new textile and clothing restrictions set out in Article XI of GATT and Article 2.4 of the ATC.

3.49 India, therefore, concluded that it was entitled to pursue its claim that Turkey's restrictions violated Article 2.4 of the ATC under the normal dispute settlement procedures of the DSU.

2. Arguments by Third Parties

3.50 The **Philippines** submitted that India's claims under the ATC were within the Panel's jurisdiction, on the following grounds:

(i) It was not mandatory on Members, in the context of Article 8.5 of the ATC, to refer a matter to the TMB, but only mandatory on the TMB to act on a matter brought before it.

(ii) Article 8.10 of the ATC applied to a situation where a matter had been referred to the TMB; it did not establish exclusive jurisdiction in favor of the TMB to the exclusion of the DSB.

(iii) With reference to Turkey's invocation of Article 1.2 of the DSU, there was no difference between the special or additional rules and procedures set forth in the ATC and those under the DSU. Even if such difference existed, Article 1.2 of the DSU provided for a solution aiming at keeping the integrity of the claim intact: "the rules and procedures set out in [the DSU] should be used to the extent necessary to avoid the conflict".

IV. ADDITIONAL INFORMATION

4.1 Pursuant to Article 13.2 of the DSU, the Panel sought from the European Communities certain relevant factual and legal information regarding the matters at issue. The Chairman of the Panel therefore addressed the following letter, dated 28 October 1998, to the Permanent Representative of the European Communities in Geneva:

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87 See WT/REG22/1, WT/REG22/5, WT/REG22/7 and WT/REG22/8.
88 See G/TMB/N/308 and G/TMB/N/326.
89 See para. 2.20 above.

"I am writing with regard to the Panel on *Turkey - Restrictions on Imports of Textiles and Clothing Products*, Request by India (document WT/DS34). In this context, the Panel has had a first meeting with the parties and has asked them a series of questions in order to help clarify the facts of this dispute and the parties' related legal arguments. As you may be aware, parties in that dispute have invoked and raised arguments that relate to the Agreement between Turkey and the European Communities which these Members have notified to the WTO (document WT/REG22/1).

In order to ensure that the Panel has the fullest possible understanding of this case, and pursuant to Article 13.2 of the DSU, the Panel would like to ask the European Communities for factual or legal information relevant to this case that they would wish to provide (for your information the full list of questions posed to Turkey is attached). In particular, the Panel would invite the European Communities to submit written responses to the following questions:

1. Can you provide the Panel with information with regard to negotiations which resulted in what was notified to the WTO under WT/REG22/1? Article 12 of Decision 1/95 provides that "From the date of entry into force of this Decision, Turkey shall, in relation to countries which are not members of the Community, apply provisions and implementing measures which are *substantially similar to those of the Community's commercial policy* set out in the following Regulations: (…)" Can the EC provide us with a description of all the alternatives that the EC and Turkey considered in trying to identify textile and clothing policies that would have been "substantially similar" to those of the EC. Was there any effort to look at alternative means of securing the same effect other than adopting exactly the same policy as that of the EC? Did parties consider using rules of origin to ensure that *only* Turkish exports of textile and clothing products to the EC would benefit from the preferential market access treatment to the EC market as envisaged in the customs union? Was any consideration given to the use of a provisions similar to that of Article 115 of the EC Treaty which has effectively been used amongst EC member states for many years before the completion of the EC single market?

2. How do you explain that the initial agreement between Turkey and the EC was signed in 1963 and that the transition period until now has lasted some 35 years? How would you qualify the nature of the Agreement notified as WT/REG22/1? Is it an interim agreement that should lead to a customs union by 2005 or would you qualify this agreement implementing a completed customs union?

3. Do all textile and clothing products circulate freely between EC territory and Turkey's territory? If so, since when? What about other industrial and agricultural goods? What legal means are used to ensure an effective EC border control of these goods under restrictions *vis-à-vis* Turkey?

4. How does the EC administer and control the respect of the overall EC/India and Turkey/India textile and clothing quotas at EC-Turkey's borders?

5. The agreement between the EC and Turkey provides that the parties maintain antidumping, countervailing and safeguard regimes applicable to imports of textile and clothing products from each other? Have parties used such measures against imports from each other?"

4.2 The EC Representative in Geneva replied substantively as follows:

"In reply to your letter of 28 October 1998, I would like to answer the questions that the Panel has asked of the European Communities pursuant to Article 13.2 of the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU).

Before doing so, I would like to clarify that it is not our intention to participate in any other way in this procedure, since India has chosen to direct its complain exclusively against Turkey in spite of the fact that it was clearly indicated to India that the measures at issue were taken in the framework of the formation of the EC/Turkey customs union. The European Communities has taken good note of this deliberate choice of India and our contribution to the debate before this Panel should therefore not be treated as that of a party or a third party to its proceedings.

We are of course pleased to answer the specific questions raised by the Panel under Article 13.2 DSU, but we do not believe it would be appropriate for us, under this provision, to enter into a broader discussion of the factual or legal elements that may be relevant for the resolution of this dispute since this could be confused with the pleading of a case before the Panel. We will therefore stick to the specific questions asked by the Panel and provide the requested factual information to the Panel as objectively as we can."

4.3 The Annex to the EC letter contained replies to the specific questions asked by the Panel, as follows:

Reply to question 1

"The objective from the outset of the negotiations was to include textile and clothing products within the customs union. Turkish exports to the European Union of textiles and clothing amounted to approximately 40 per cent of all Turkish industrial exports to the European Union and it was therefore considered essential that these products formed part of the customs union and hence be in free circulation within the customs union.

The use of rules of origin benefiting only Turkish exports would have been an exception to the principle of free circulation within the customs union and would have required the maintenance of customs and border checks within the customs union designed to ensure that Turkey would not become a transit point of goods in circumvention of the

Community's quota system arising from Turkey's adoption of the Community's rates of tariffs, etc.

Article 115 of the EC Treaty lost a considerable degree of relevance following the completion of the EC single market. As such, no serious consideration was given to the use of provisions akin to those of Article 115 of the EC Treaty but it appears very doubtful whether such measures would have been workable or proportionate within the customs union."

Reply to question 2

"The core of the Ankara Agreement signed in 1963 is the establishment of a Customs Union in three stages. The Additional Protocol signed in 1970 and which entered into force in 1973 defined the modalities for implementing the transitional stage which was supposed to end after 22 years (in 1995). In accordance with the planned calendar, the final stage of the Customs Union entered into force on 31 December 1995 (with the adoption of Decision 1/95 of the EC-Turkey Association Council). Decision 1/95 defines the rules which ensure the proper functioning of the Customs Union. Despite the fact that Turkey benefits from certain adaptation periods (until 2001), in some areas such as preferential commercial policy, protection of the intellectual property rights etc, we consider that the customs union has already reached its final phase with regard to the requirement of Article XXIV:8(a) of the GATT 1994. Precise data concerning the trade coverage and other details concerning the functioning of the customs union were submitted to the WTO Committee for Regional Trade Agreements and were also discussed in the recent Trade Policy Review of Turkey. It is worth noting that many provisions in the Customs Union Decision go beyond the definition of a Customs Union under Article XXIV of the GATT 1994."

Reply to question 3

"Industrial products including textiles products have been in free circulation between the EU and Turkey since the entry into force of the customs union on 31 December 1995. Shipment of textiles and clothing requires an ATR document indicating that the goods are in free circulation. No indication of origin is required for goods in free circulation. There is thus no specific EC border control in respect of goods for which Turkey has quantitative restrictions, the Turkish authorities having effected such control on entry of the goods into free circulation in Turkey.

Agricultural products will be included in the customs union following an adaptation period and for the time being enjoy preferential treatment subject to proof of origin including EUR-1 certificates and invoice declarations to enable the identification of the products."

Reply to question 4

"Turkey has adopted all the European Communities' relevant regulations concerning imports of textiles (e.g. Regulation EEC/3030/93, Regulation EEC/517/94 and Regulation EEC/3951/92). Thus the basic administrative principles are the same in both parts of the customs union. The Turkish authorities have observer status in the "management" committee chaired by the Commission set up under the relevant regulations. In addition, the Turkish authorities maintain an interdepartmental committee in order to take any necessary measures to ensure consistency between the EU and Turkey. So far as the management by the Community's integrated system of licensing is concerned, the Turkish authorities have full access to the European Community's computerized licensing system (Système Integré de Gestion de Licences or SIGL) and there is a regular exchange of information at administrative level. Thus, there is no administration or control of the overall EC/India and Turkey/India textile and clothing quotas at the EC/Turkey's borders. Once goods enter the customs union pursuant to the parties' respective systems, they are in free circulation and no further controls are necessary."

Reply to question 5

"The Customs Union Decision maintains the possibility for each party to apply trade defense instruments, including anti-dumping measures to the products originating from the other party. The Community imposed definitive anti-dumping measures on imports of polyester fibres from Turkey in June 1996. Provisional anti-dumping duties were imposed on imports of unbleached cotton fabrics from Turkey in April 1998. However, these expired in October without the imposition of definitive measures."

V. CLAIMS OF THE PARTIES

5.1 **India** requested the Panel to rule that the import restrictions which Turkey had imposed since 1 January 1996 in the context of its trade agreement with the European Communities on textiles and clothing products from India:

(i) were inconsistent with Articles XI and XIII of GATT and Article 2.4 of the ATC and were not justified by Article XXIV of GATT, and;

(ii) impaired benefits accruing to India under Articles XI and XIII of GATT and Article 2.4 of ATC.

5.2 India requested the Panel to recommend that Turkey bring its restrictions into conformity with its obligations under GATT and the ATC, basing its rulings and recommendations on the following findings:

(i) Article XXIV:5 of GATT did not permit Members forming a customs union to impose QRs on imports from third Members;

(ii) to the extent that there was a conflict between the provisions of Article 2.4 of the ATC (which permitted the European Communities but

not Turkey to impose restrictions on imports of textiles and clothing products from India) and the provisions of Article XXIV:8 of GATT (which required Members forming a customs union to apply substantially the same restrictions on imports from third Members), the provisions of Article 2.4 of the ATC prevailed; and

(iii) Turkey had not rebutted the presumption that its restrictions on imports of textiles and clothing impaired benefits accruing to India under Articles XI and XIII of GATT and Article 2.4 of the ATC.

5.3 Subsidiarily, if the Panel were to accept the argument by Turkey that Article XXIV of GATT provided a waiver from the obligations under Articles XI and XIII of GATT and Article 2.4 of the ATC for measures necessary for the purposes of a customs union meeting the standards of Article XXIV, India requested the Panel to base its rulings on the following findings:

(i) for the purposes of the EC-Turkey trade agreement, an immediate harmonization of import restrictions on textiles and clothing products was unnecessary, because (a) the European Communities and Turkey were applying different import duties and regulations in respect of many sectors, policy instruments and trading partners and (b) in all areas in which their import duties or regulations differ, the European Communities and Turkey were able to implement border controls ensuring that only products originating in the territories of the European Communities and Turkey benefit from the preferential treatment under the EC-Turkey trade agreement; and

(ii) the type of agreement concluded between the European Communities and Turkey, that is an agreement providing for the establishment of a customs union at a future date, was not governed by the provisions of Article XXIV of GATT on completed customs unions and Turkey could therefore not invoke those provisions as justification for the restrictions.

5.4 **Turkey** requested the Panel to find that:

(i) India had not sufficiently exhausted the avenues of Article XXII of GATT, Article 4 of the DSU and Article XXIV of GATT in order to bring about an amicable settlement and adjustment;

(ii) India had not complied with the procedural requirements of the ATC;

(iii) the Panel could not substitute itself for the CRTA which had not yet completed its examination of the Turkey-EC customs union;

(iv) since Turkey argued that the measures forming the object of the complaint were a requirement of the Turkey-EC customs union, the Panel could not rule on their legality in the absence of agreed conclusions on the consistency of the Turkey-EC customs union with the obligations of Turkey and the European Communities under GATT;

(v) Turkey had not acted inconsistently with its rights and obligations under GATT and the ATC; and

(vi) as required under Article 3.6 of the DSU, the parties to the dispute should seek a negotiated solution to the matter, taking into account

India's commercial interests and Turkey's obligations arising from the Turkey-EC customs union.

VI. MAIN ARGUMENTS BY THE PARTIES

A. Introductory Points

1. Consultations

6.1 **Turkey** submitted that India had failed to comply with the principle of procedural economy and the spirit of the WTO dispute settlement mechanism which required that the panel procedure was to be considered as *ultima ratio* means to solve conflicts between Members, when unable to find a negotiated solution.[90] India had refused to enter into bilateral negotiations offered by Turkey, including the European Communities, and had also refused to deal with the issues in consultations under Article XXII of GATT.

6.2 Turkey said that it had accepted the request by India for consultations under Article XXIII of GATT on the measures it applied, on condition that representatives of the European Communities participate. Their participation was deemed essential, given that the application of the restrictions which constituted the object of India's complaint derived from the alignment of Turkey's commercial policy on that of the European Communities. Consultations scheduled to be held in Geneva on 18-19 April 1996 did not occur owing to India's refusal to accept the participation of EC officials. Turkey continued to offer to find a negotiated solution to India's complaint, and the subject was raised in discussions held in both capitals at different times and at a meeting between both countries' Trade Ministers in Geneva in May 1998. However, and despite the fact that the measures in question had never formed the subject of a consultation between Turkey and India under Articles XXII and XXIII of GATT, India requested the DSB to establish a panel regarding the imposition by Turkey of QRs on imports of certain textiles and clothing products.

6.3 **India** submitted that Turkey had violated Articles 3 and 4 of the DSU, since it had not entered within the 30-day period into the bilateral consultations requested by India, with a view to reaching a mutually satisfactory solution. India submitted that Turkey had in particular contravened the provisions of Article 3.10 of the DSU. India considered that its recourse to the provisions of GATT and the DSU as regards consultations was frustrated in a most unprecedented manner, and the dispute remained unresolved.[91]

6.4 India explained that its request for consultations, pursuant to Article 4 of the DSU and Article XXIII:1 of GATT,[92] had been accepted by Turkey on 1 April 1996. While confirming its agreement to enter into consultations "on textiles and clothing restrictions applied by Turkey" at a mutually acceptable time and venue, Turkey considered that "the European Communities as our partner in the customs union should also be represented in the consultations". On 4 April 1996, India proposed the venue

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[90] See Articles 3.10 and 4, as well as Articles 5.4 and 3.7 of the DSU.
[91] The DSB was informed of this situation on 24 April 1996 (WT/DSB/M/15, para. 3).
[92] See WT/DS34/1.

(Geneva) and dates (18-19 April 1996) for such consultations while clearly stating that it could not accept that the European Communities should participate in the consultations since, under the GATT and WTO practices, consultations under Article XXIII:1 of GATT were bilateral in nature; India asked for confirmation by Turkey of the date and venue of the bilateral consultations. On 16 April 1996, Turkey scheduled a meeting with its Indian counterparts for 18 April 1996 (3.30 to 6 p.m.), while stating its "understanding that representatives of the European Communities would also be participating". India stated that, despite that very short notice, it ensured the presence of its delegation at the consultations, but the delegation of Turkey did not attend the scheduled meeting nor did it provide an explanation for its absence. India submitted that it sent another communication to Turkey on 18 April 1996, proposing to enter into bilateral consultations on 19 April 1996. When India endeavoured to confirm with Turkey the date and venue of these consultations, it was informed that the latter was not in a position to enter into these consultations without the participation of the European Communities, and that this would be conveyed to India in writing by close-of-business on 19 April 1996. India submitted that the communication from Turkey, dated 19 April 1996, was received on 22 April 1996.

6.5 **Turkey** responded that it had refused consultations on the ground that such consultations did not involve the European Communities. It had good and proper reasons not to engage in formal consultations in which the European Communities would not be involved, namely that the measures complained of were a direct consequence of the Turkey-EC customs union and could not be modified without the consent of the European Communities. This did not mean that Turkey was not prepared to examine with India how to adjust the measures challenged and to bring about an amicable settlement. Turkey recalled the various steps it took and the latest attempts made as recently as 28 September 1998.

6.6 Turkey submitted that the issue it raised in its request for a preliminary ruling, with respect to EC participation in the dispute had also a substantive aspect.[93] It considered that in this case findings and recommendations, if any, of the Panel directed against the measures challenged by India and the resulting recommendations and rulings of the DSB, if any, could hardly be addressed to Turkey alone, as Turkey was only one of the parties to the Turkey-EC customs union.

6.7 **India** believed that Turkey's claim that, given its obligations towards the European Communities under the EC-Turkey trade agreement, it could not remove the restrictions on imports of textiles and clothing products from India without the consent of the European Communities, had no basis in international law. According to the relevant part of Article 41.1 of VCLT, "[t]wo or more parties to a multilateral treaty may conclude an agreement to modify the treaty as between themselves alone *if ... the modifications in question ... do[es] not affect the enjoyment by the other parties of their rights under the treaty ...*" (emphasis added).

6.8 India stated that the European Communities and Turkey were both party to a multilateral treaty, the WTO Agreement. In their trade agreement they had committed

[93] In this context, Turkey welcomed the invitation addressed by the Panel to the European Communities to provide written information related to the customs union and hoped that the Panel would not refrain from asking the European Communities to present evidence orally, should that prove necessary.

themselves to harmonize their textiles and clothing policies towards third countries without regard to Turkey's obligations under the WTO Agreement. They had thus concluded between them a treaty which modified the WTO Agreement as between them in a manner that affected the enjoyment of India's and other WTO Members' rights under the WTO Agreement. According to Article 41 of the VCLT, Turkey was therefore not bound by the EC-Turkey trade agreement to the extent that it entailed a violation of Turkey's obligations under the WTO Agreement towards third WTO Members.

6.9 India feared that, if the DSB were to rule in India's favour, Turkey would use its obligations under the EC-Turkey trade agreement as a pretext for not implementing the ruling. The European Communities' decision not to participate in the Panel's proceedings as third party suggested that it might lend its hand in such an approach. This would set an extremely harmful precedent for the multilateral trading system because it would imply that the obligations under a bilateral trade agreement could provide a justification for a failure to implement the obligations under the WTO Agreement. India therefore requested that the Panel make use of its power under the second sentence of Article 19.1 of the DSU and suggest that Turkey, when bringing itself into conformity with its obligations under the GATT and the ATC, took into account the principles set out in Article 41 of the VCLT.

6.10 India also noted later that, following its arguments on Article 41.1 of the VCLT, Turkey had conceded that two or more parties to a multilateral treaty that concluded an agreement amongst themselves could not make modifications to the multilateral treaty that affected the rights of other parties under the multilateral treaty. To Turkey's argument that remedy for the situation did not lie with Turkey alone, India reiterated that since in this case, the measure in question was taken by Turkey alone, India could bring a dispute against Turkey only.

2. Offers to Settle

6.11 **Turkey** claimed that India, through its refusal to negotiate in a bilateral constellation, including the European Communities, had to assume responsibility for neglecting the avenue of a mutually satisfactory compensatory arrangement. In order to ensure that trade diversion into EC territory did not occur after the completion of the Turkey-EC customs union, Turkey had to impose, in accordance with its obligations under Decision 1/95,[94] restrictions on imports from India of those products already subject to quantitative limits when exported to the European Communities.

6.12 Turkey argued that a parallel could be drawn between the renegotiation of bound duties through the procedures established in Article XXIV:6 of GATT and the negotiation of compensatory adjustments or other equivalent means of compensation for the QRs required by the Turkey-EC customs union, which should be considered as "other regulations of commerce" in the meaning of Article XXIV:5(a) and XXIV:8(a) of GATT. Therefore, all the countries whose exports of textiles and clothing products were subject to EC restrictions were offered the possibility to negotiate with Turkey arrangements consistent with those that they had concluded with the European Communities. Such arrangements, in the negotiation of which the

[94] In particular, Article 12 of Decision 1/95, para. 2 (see WT/REG22/1).

European Communities took an active part, were reached with 24 countries in the period which preceded and immediately followed the completion of the Turkey-EC customs union.[95] Turkey also noted that there were 28 other countries, including India, with which it was not possible to reach agreement and to which it accordingly applied unilateral restrictions or surveillance regimes. These restrictions only affected products whose export to the European Communities was also under restraint.

6.13 Turkey explained that a draft Memorandum of Understanding covering trade in certain textiles and clothing products had been sent to the Indian Embassy in Ankara on 31 July 1995 and that India had been invited to negotiate with Turkey, prior to the completion of the Turkey-EC customs union, an arrangement similar to the already existing India-EC arrangement covering trade in those products. The request was repeated in December 1995. Turkey claimed that it could not modify the restrictions unilaterally and accordingly insisted on the participation of EC officials in the bilateral negotiations. India refused negotiations with Turkey on the grounds that EC representatives would be present.

6.14 **India** recalled that it had all along stated clearly that the unilateral imposition of QRs by Turkey on imports of textile and clothing products from India was inconsistent with Turkey's obligations under GATT and the ATC, and were not authorized by Article XXIV of GATT. India also recalled that Turkey did not enter into consultations requested by India under the DSU. In bilateral discussions outside the framework of the DSU, India had requested the removal of the quotas at issue but Turkey merely offered to marginally increase their size. Neither the European Communities nor Turkey submitted offers of compensation to India.

6.15 **Turkey** also noted that it had made a fresh attempt to reach a negotiated solution with India to the problem which formed the object of India's complaint. In response to a suggestion made by its President to the President of India during the latter's state visit to Turkey on 17-20 September 1998, negotiations were held with the Indian counterparts in New Delhi on 28 September 1998. In the course of those negotiations, Turkey offered to increase by an average of 200 per cent - but in some categories by much more than that - the quotas made available for Indian exports of textiles and clothing to Turkey. It claimed that India refused to examine this offer and claimed instead that it was only prepared to discuss the complete elimination of quotas. Nevertheless, through a Note addressed on 12 October 1998 by the Turkish Embassy in New Delhi to the Indian Ministry of External Affairs, Turkey reiterated its call for a bilateral solution to be explored and invited India to attend further negotiations in Ankara, in the course of October 1998. According to Turkey, no response to this Note had yet been received from India.

6.16 In this respect, **India** pointed out that it was for India to assess the best means by which it could protect its interests, noting that the dispute was then clearly in the final stages of argumentation before the Panel.

[95] Since then, integration lists identical to those of the EC had been put into effect by Turkey, in compliance with the relevant ATC provisions.

B. Legal Arguments

1. Burden of Proof

6.17 **India** submitted that it was for Turkey to invoke an exception from the prohibition of discriminatory QRs set out in Article XI:1 of GATT and Article 2.4 of the ATC.

6.18 India argued that the current state of WTO case law in the area of burden of proof was summarized in the recent panel on *Argentina - Certain Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items* as follows:

> "Concerning the issue of what one may call the "burden of proof", the Appellate Body has confirmed the GATT practice whereby
>
> (a) it is for the complaining party to establish the violation it alleges;
>
> (b) it is for the party invoking an exception or an affirmative defense to prove that the conditions contained therein are met; and
>
> (c) it is for the party asserting a fact to prove it."[96]

6.19 In India's view, the wording of Article 2.4 of the ATC, whereby it prohibited the introduction of new restrictions after 31 December 1994 "*except* under the provisions of this Agreement or relevant GATT 1994 provisions" (emphasis added) made it clear that the specific transitional safeguard mechanism in the ATC or any GATT provision that might justify the introduction of new discriminatory restrictions constituted an exception in terms of Article 2.4 of the ATC. It was thus for Turkey to invoke an exception to Article 2.4 of the ATC and to prove that the conditions contained under the relevant provisions were met.

6.20 Reacting to Turkey's statement that Articles XI and XIII of GATT and Article 2 of the ATC were not relevant, India referred to the ruling of the panel on the *Australia - Measures Affecting the Importation of Salmon* case.[97] In India's view, Turkey had not presented any arguments or facts to refute India's claim of inconsistency; therefore, it was correct to state that the violation of Articles XI and XIII of GATT and Article 2.4 of the ATC had not been disputed by Turkey. India believed that the legal *relevance* of these provisions was another matter.

2. Articles XI:1 and XIII of GATT

6.21 **India** submitted that Article XI:1 of GATT constituted a general prohibition on the imposition of QRs on imports. The QRs imposed by Turkey on imports of textiles and clothing were clearly inconsistent with this general prohibition and were not saved by any of the exceptions to this provision contained in GATT.

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[96] Panel Report on *Argentina - Certain Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items*, adopted on 22 April 1998, WT/DS56/R ("*Argentina - Textiles and Apparel*"), paras. 6.34-6.40.

[97] As cited approvingly in the Appellate Body Report on *Australia - Measures Affecting the Importation of Salmon*, adopted on 6 November 1998, WT/DS18/AB/R ("*Australia - Salmon*"), paras. 1-3.

6.22 India submitted further that, to the extent that Turkey's QRs were discriminatory in nature, they were also inconsistent with the prohibition on discriminatory QRs in Article XIII:1 of GATT.

6.23 **Turkey** reiterated that its restrictions on imports of textiles and clothing from a number of third countries were consistent with Article 2 of the ATC on the basis of the provisions of Article 2:4. Once a measure was justified under Article 2.4 of the ATC, the debate about its consistency with the obligations arising from Articles XI and XIII of GATT became redundant, since the ATC provided an exception to the rules contained in those Articles.[98]

3. Article 2 of the ATC

6.24 **India** submitted that Article 2 of the ATC permitted WTO Members to continue to apply, during the transition period provided for, restrictions on textile and clothing products that were in force on the day before the entry into force of the Agreement (i.e. 31 December 1994) under the MFA. According to Article 2.1 of the ATC, such restrictions were to be notified in detail to the WTO by the Members maintaining them within 60 days following the entry into force of the WTO Agreement. As stated in Article 2.4 of the ATC, the restrictions so notified were "deemed to constitute the totality of such restrictions applied by the respective Members on the day before the entry into force" of the ATC. Turkey had not maintained restrictions on imports of textile and clothing products from India on 31 December 1994. The restrictions on textiles and clothing products from India were imposed by Turkey on 1 January 1996 and were consequently not in force on the day before the entry into force of the WTO Agreement.

6.25 India also noted that Article 2.4 of the ATC also provided that "[n]o new restrictions in terms of products or Members shall be introduced except under the provisions of this Agreement or relevant GATT 1994 provisions". India argued that the only provision of the ATC under which a Member could be allowed to introduce new QRs on imports of textiles and clothing products was under the transitional safeguard mechanism set out in Article 6 of the ATC. However, Turkey did not invoke the specific transitional safeguard mechanism set out in Article 6 of the ATC as a justification for its new restrictions. India argued that the GATT did not contain any provision permitting the imposition of discriminatory import restrictions for the purpose of protecting a Member's domestic industry. Turkey's restrictions were therefore inconsistent with Article 2.4 of the ATC, and also contravened Article XI:1 of GATT, which specifically prohibited QRs.

6.26 **Turkey** submitted that its restrictions on imports of textiles and clothing from a number of third countries were consistent with Article 2 of the ATC on the basis of the provisions of Article 2.4. Turkey claimed that the measures were justified under Article XXIV of GATT, which was to be considered as a "relevant GATT provision" in the sense of Article 2.4 of the ATC, and therefore covered by this provision. Tur-

[98] See paras. 6.26 and 6.27 below.

key later confirmed that Article XXIV was the legal basis for its restrictions at issue.[99]

6.27 In Turkey's opinion, India assumed that there was a conflict between Article XXIV of GATT and the ATC and that, in that case, ATC obligations prevailed. Turkey refuted such an assumption on the grounds that footnote 3 to Article 2.4 of the ATC did not exclude Article XXIV, which meant, in the present case, that Turkey could introduce new restrictions under Article XXIV.

6.28 **India** did not agree with Turkey's interpretation, recalling the drafting history of the ATC. It argued that footnote 3 to Article 2.4 merely restricted the applicability of safeguard provisions under Article XIX of GATT to products already integrated; for non-integrated products, the provisions of Article 6 of the ATC would apply.

6.29 **Turkey** responded in this respect that the drafting history was only relevant when doubts subsisted as to the precise meaning of legal provisions. Turkey considered that, in this particular case, no such doubts could be justified since footnote 3 was quite explicit.

4. Article XXIV of GATT

(a) Relationship between Article XXIV and other GATT Provisions

6.30 **India** submitted that what was at issue in the present dispute was not whether the Turkey-EC customs union met the requirements of Article XXIV:5(a) but whether this provision provided an authorization to impose, on the occasion of the formation of a customs union, new barriers to the trade of third Members inconsistently with Article XI:1 of GATT and Article 2.4 of the ATC on the grounds that other barriers to imports had been voluntarily reduced. India's claim was that WTO Members forming a customs union, irrespective of whether their union met the requirements set out in Article XXIV or not, had to abide by the disciplines of Article XI:1 of GATT and Article 2.4 of the ATC with respect to the trade of third Members. The question of whether the Turkey-EC customs union was consistent with the requirements of Article XXIV therefore did not arise in this dispute. India was seeking a ruling on an obvious legal point on which there had so far been agreement among WTO Members, including the European Communities, Turkey's partner in the envisaged customs union.

6.31 **Turkey** submitted that the measures challenged by India could not possibly be assessed on their consistency with the relevant WTO rules separately and in isolation from the Turkey-EC customs union of which they were an integral part. Turkey disagreed with India's position that the GATT did not permit the application of restrictions determined by the Turkey-EC customs union on imports from other Members into the Turkey-EC customs union via Turkey, despite the fact that this customs

[99] On 24 November 1998, the Panel asked the following question to Turkey: "Can the Panel assume that Turkey's defence to India's claims of violations of Articles XI and XIII of GATT and Article 2.4 of ATC is based exclusively on Article XXIV of GATT?" Turkey responded: "Yes. Turkey believes that Article XXIV provides the legal basis for the measures which India complains about."

union and in particular its common regulation of commerce would be consistent with GATT.

6.32 Turkey presented the arguments below in support of its view that the consistency of the measures challenged by India with the WTO rules was to be determined by reference to Article XXIV:5 to XXIV:8 of GATT and not to other GATT provisions.

6.33 Turkey started its presentation by analyzing the ordinary meaning of Article XXIV:4 and XXIV:5. Recalling the terms of these provisions, Turkey considered that their plain meaning was clearly that the provisions of GATT did not prevent the imposition of a regulation of commerce at the institution of a customs union, as long as on the whole this was not more restrictive than the general incidence of the duties and regulations of commerce applicable in the constituent territories prior to the formation of the customs union. If, as argued by India, Article XXIV:5(a) did not allow Members forming a customs union to introduce a common regulation of commerce determined by restrictive measures lawfully applied by a Member party to that customs union, the plain wording of Article XXIV:5(a) would be deprived of any meaning. As had been made clear by the Appellate Body[100], an interpretation might not result in reducing whole clauses or paragraphs to redundancy or inutility.

6.34 Turning to the context of Articles XXIV:5 to XXIV:8, Turkey noted that Article XXIV basically dealt with:

(i) the territorial scope of the GATT as regards customs territories (paragraphs 1 and 2);

(ii) preferences granted between adjacent countries in certain circumstances (paragraph 3);

(iii) rules applying to the formation of economic integration agreements, i.e. customs unions and free-trade areas (paragraphs 4 to 10);

(iv) the special relationship between India and Pakistan; and

(v) the application of the GATT to sub-central entities (paragraph 12).

6.35 Turkey viewed all these provisions as having in common that they were all concerned with the scope of application of the GATT, both generally and in particular circumstances. Article XXIV should therefore not be regarded as a "justification", a "defense", an "exception" or a "waiver". Rather, Article XXIV determined the outer limits of the scope of GATT and was not an incursion into the normal application of the rights and obligations contained in its substantial provisions, as the above-referred words appeared to suggest. For instance, sub-central entities were subject to a "best endeavours" clause under Article XXIV:12, while economic integration agreements under Article XXIV:4 and following had to comply with specific requirements in order to qualify as such, but these requirements were different from the obligations which applied to separate customs territories not related among themselves by an economic integration agreement.

6.36 Turkey argued that, on the basis of these considerations, Article XXIV:4-10 could be viewed as *lex specialis* for the rights and obligations of WTO Members at the time of formation of an economic integration agreement. Such a characterization

[100] See Appellate Body Report on *US - Gasoline*, p. 22, DSR 1996:I, 21, IV.

did obviously not alter in any way the concrete obligations to be fulfilled by WTO Members wishing to enter into an economic integration agreement in conformity with these provisions.

6.37 Turkey added that its conclusion that Article XXIV:5-8 did not constitute an exception found also support in a systemic analysis. It was significant that Article XXIV:5-8 did not appear in Part II of GATT, which contained substantive provisions and derogations from and exceptions to these substantive obligations (e.g., Articles XX and XXI). Article XXIV belonged to Part III of GATT, which contained a number of general and institutional provisions (such as those on "Joint Action by the Contracting parties", "Acceptance, Entry into Force and Registration", "Amendments" and "Withdrawal").

6.38 In Turkey's view, free-trade areas, and even more so customs unions, implied that GATT contracting parties, now WTO Members, embarked on a closer economic integration and entered *inter se* into commitments that were going beyond those of the GATT. This resulted in trade between the constituent parties as a rule free from all customs duties and other classical obstacles to trade. In free trade areas this regime applies to goods originating in the constituent parties. In customs unions this regime applied also to goods originating in other countries, provided that such goods had been subjected, when imported in any of the constituent parties of such customs union, to common customs duty rates and a common regulation of commerce. When forming free trade areas, and even more so customs unions, countries created a new situation in their relationships with other GATT contracting parties. The situation arising in the case of customs unions bore some analogy to two or more GATT contracting parties entering into a confederation.

6.39 Turkey noted that the GATT could have left such a situation to negotiations, if and when contracting parties decided to form a free-trade area or a customs union, but instead it had foreseen provisions, i.e. Article XXIV:4-8, designed to deal with the new situation, defining what GATT meant by customs unions and free-trade areas and setting forth the conditions under which this new situation in the relationship between the constituent parties and the other GATT contracting parties was deemed to be in conformity with the GATT. These provisions were thus quite properly inserted in Part III on general and institutional provisions.

6.40 In view of these arguments Turkey concluded that, contrary to what India asserted, the consistency with WTO rules of the measures challenged by India was to be determined by reference to Article XXIV:5-8 of the GATT and not to other GATT provisions. This in turn depended on the consistency with the WTO rules of the Turkey-EC customs union of which the measures challenged formed integral part. In Turkey's view, there was no room for conflict between these measures and other GATT provisions.

6.41 **India** had understood Turkey as arguing in essence that the terms "the provisions of [the GATT] shall not prevent" in Article XXIV:5 implied that Article XXIV was an exception from other GATT provisions and hence also from Article XI, and as considering that the present dispute concerned the question of whether Article XXIV contained a sufficient justification for the measures at issue. Later, Turkey had also claimed, in responding to questions, that Article XXIV was the legal basis for its actions but denied its use of this provision as a defense or justification, considering that Article XXIV defined "the outer limits of the applicability of the GATT" and that this provision "disapplied" Article XI.

6.42 India considered that all rules of the GATT defined the limits of applicability of the GATT and it was not clear to India what this legal characterization of Article XXIV implied for the resolution of the present dispute. India also did not know what Turkey attempted to convey with the novel term "disapply" and in what respects a provision establishing an exception differed from a provision that "disapplied" another. The relevance of the fact that Article XXIV had been included in Part III of the GATT 1947, to which Turkey apparently attached importance, escaped India. In its view, this fact might simply be related to the existence of the grandfather clause in the Protocol of Provisional Application and accession protocols. Non-tariff measures covered by Part II, but required under existing legislation, were exempted by that clause, while Article XXIV applying in practice to *future* arrangements did not need to be qualified by such clause.

6.43 In India's opinion, the simple fact was that new restrictions on imports of textiles and clothing from a single Member were explicitly prohibited by Articles XI and XIII of GATT and Article 2.4 of the ATC and that it was up to Turkey to assert that another provision in a WTO agreement permitted those restrictions.[101] That assertion would normally be described as a defense and the provision invoked as such a justification.

6.44 India disputed Turkey's claim that Members forming a customs union might impose new restrictions on imports from third WTO Members (even discriminatory restrictions on the trade of one WTO Member) by meeting only the two requirements set out in paragraphs 5(a) and 8(a)(ii) of Article XXIV. If this was the case, such Members would thus be freed from the burden of satisfying the many substantive and procedural requirements other Members imposing quantitative restrictions had to meet. Thus, it would not be necessary for them to invoke and observe the provisions of the Safeguards Agreement or the ATC when they wished to accord temporary import protection to their textiles or clothing industry; they could do this simply under the framework of Article XXIV.

6.45 India noted that the requirements for quantitative restrictions permitted under the exceptions from Article XI of the GATT applied to each and every individual restriction that a Member imposed. By contrast, the requirements set out in paragraphs 5 and 8 of Article XXIV applied to the import regimes of the Members forming the customs union taken as a whole. They neither authorized nor prohibited any specific set of import restrictions. Therefore, if Turkey were correct, an individual restrictive import measure imposed in the context of the formation of a customs union could never be the subject of a panel ruling because it could, as such, not be found to be inconsistent with Article XXIV:5 and 8.

6.46 India pointed out, however, that Members forming a customs union that wished to raise the level of a tariff above the rate bound under Article II had to negotiate with its trading partners in accordance with Article XXVIII of the GATT and offer compensatory market-opening commitments. India argued that by definition a customs union or free-trade area could not be formed without the elimination or reduction of tariffs on a preferential basis, but could be formed without the imposition

[101] This followed from the consistent jurisprudence of the Appellate Body on the distribution of the burden of proof (Report on *Australia - Salmon*, section VI, paras. 1-2).

of new QRs against third parties. There was thus no corresponding obligation to compensate Members adversely affected by non-tariff restrictions, including those covering bound items, that Members forming a customs union could impose. Moreover, acceptance of Turkey's argument would therefore induce WTO Members forming a customs union to replace the protection afforded by their tariffs by quantitative restrictions. This would upset the balance of concessions resulting from past trade negotiations and undermine the principle that protection should be afforded by ordinary customs duties only.

6.47 India was of the view that, if Turkey's argument were accepted, Members forming a customs union could legally circumvent the procedural and substantive requirements in respect of quotas, which the negotiators of the WTO agreements agreed to permit in exceptional circumstances, and would have every incentive to do so. In respect of such Members, the WTO agreements could no longer operate as a legal framework providing effective assurance of market access and the WTO dispute settlement procedures would be rendered ineffective. This would create a serious imbalance between the obligations of Members forming a customs union and other Members, and would upset the balance of concessions negotiated between them. The drafters of the GATT and the Uruguay Round agreements could not possibly have intended this result.

6.48 India recalled the statement by the Appellate Body that, since all interpretation must be based on the text of the treaty, the process of interpretation had not to lead to "the imputation into a treaty of words that are not there or the importation into the treaty of concepts that were not intended".[102] India considered that an acceptance of Turkey's position would clearly be contrary to this fundamental principle of interpretation.

6.49 Moreover, India argued that Turkey's view that Article XXIV:4-10 was *lex specialis* in relation to Articles XI and XIII of GATT and to Article 2.4 of the ATC logically implied that there was a conflict between these two sets of provisions.[103] India considered that, if such a view were to be accepted, the inevitable conclusion, in the light of the General Interpretative Note on Annex 1A to the WTO Agreement, would be that Turkey had to resolve the conflict by observing Article 2.4 of the ATC.[104]

(b) Article XXIV:5(a)

6.50 **India** recalled that, in the communication dated 9 January 1996 handed to the Indian authorities at Ankara, Turkey attempted to justify its new restrictions with reference to Article XXIV:5(a) of GATT. India submitted that obligations under Article XI:1 of GATT and Article 2.4 of the ATC were not modified by Article XXIV:5(a) of GATT.

6.51 India argued that any interpretation of Article XXIV:5(a) that would entail an authorization to impose, on the occasion of the formation of a customs union, new

[102] Appellate Body Report on *India - Patent*, para. 45.

[103] The *lex specialis derogat legi generali* principle was inseparably linked to the question of conflict (see Panel Report on *Indonesia - Autos*, footnote 649).

[104] See also paras. 6.95 to 6.100 below.

barriers to the trade of third Members inconsistently with Article XI:1 of GATT and Article 2.4 of the ATC on the grounds that other barriers to imports had been voluntarily reduced was excluded by the general principle set out in Article XXIV:4, which provided a recognition of the purpose of a customs union as "not to raise barriers to the trade" of other Members with such territories.

6.52 India noted that, according to Article XXIV:6 of GATT, Members parties to a customs union wishing to raise tariffs beyond the rate bound under Article II of GATT had to renegotiate them under the procedure for the modification of tariff concessions in Article XXVIII of GATT. India considered that, if tariff concessions under Article II could not be ignored by Members forming a customs union, an interpretation of Article XXIV permitting such Members to ignore their obligations under Article XI:1 of GATT and Article 2.4 of the ATC was not justified.

6.53 India also recalled that the issue of the introduction of new QRs by a party to a regional trade agreement had been discussed in detail in the GATT Working Party on the Accession of Greece to the European Communities.[105] Several delegations stated their concern with the introduction of new discriminatory QRs by Greece on imports from state-trading countries of products, which they claimed were contrary to Articles XI and XIII of the GATT and contravened their Protocols of Accession. The Working Party Report recorded the response of the European Communities as follows:

> "With reference to Article XXIV:5 and against the background of the very considerable liberalization of restrictions which would occur in Greece, it was hard to claim that barriers were being created; even if it might be true for one or two products, the overall situation was clearly the opposite. On the question of the alleged inconsistency of this with Article XIII, the EC did not consider this point relevant to the Article XXIV:5 exercise; the matter could be further discussed in the context of the relevant Accession Protocols for the countries concerned."[106]

6.54 The issue of new QRs was again discussed in detail in the GATT Working Party on the Accession of Spain and Portugal to the European Communities.[107] Several delegations expressed concern regarding Spain's imposition of new QRs on imports from third countries. The European Communities defended the new restrictions with the argument that, on the whole, the number of Spanish restrictions had declined. Those delegations responded that newly established GATT-inconsistent measures could not be traded off against the alleged reduction of other barriers. The Working Party Report recorded the ensuing discussion as follows:

> "Some members of the Working Party stated that since acceding to the Communities, Spain had introduced discriminatory QRs which contravened Articles XI, XIII and XXIV:4 as well as their countries' Protocols of Accession to the GATT under which contracting parties undertook not to increase the element of discrimination which they maintained on these countries' imports. Before acceding to the Com-

[105] See BISD 30S/168, paras. 25-33.
[106] *Ibid.*, para. 32.
[107] See BISD 35S/293, paras. 19-21.

> munities, Spain had repeatedly notified the GATT that it maintained no discriminatory QRs on their countries' imports and they had no reason to doubt the validity of these notifications. Since Article XXIV did not provide a waiver from obligations contained in Articles XI and XIII and did not allow or require a country acceding to a customs union to adopt the more restrictive trade regime of the customs union, they called on the Communities and Spain to eliminate all GATT-inconsistent measures, which in the case of one of these countries affected one quarter of its total exports to Spain. The same members of the Working Party considered that measures that were inconsistent with the GATT could not be traded off against the alleged reduction of other barriers and could not be included in the assessment of incidence of changes in "other regulations of commerce" required by Article XXIV:5(a) under which only GATT-consistent measures should be taken into account. They did not consider the Treaty of Accession was in conformity with the GATT and reserved their rights under the General Agreement."[108]

6.55 India noted that, on the question of other regulations of commerce, and in particular QRs, the European Communities agreed that Article XXIV did not provide a waiver from other provisions of the GATT. By the same token, however, the role of the Working Party in this context was to examine the situation in the light of Article XXIV rather than with respect to any other provision such as Articles XI or XIII. Contracting parties were free to reserve their GATT rights and to have recourse to other provisions on these questions.[109]

6.56 **Turkey** submitted that Article XXIV:5 of GATT authorized the formation of a customs union, as defined by Article XXIV:8(a), provided that the conditions of Article XXIV:5(a) were met. If it had been the intention of the Members to ban the imposition of new QRs whenever a customs union was being instituted, Article XXIV:5 would have been a redundant provision.

6.57 Turkey considered that provisions of Article XXIV:5(a) should be read as permitting, at the time of the completion of a customs union, the introduction of restrictive regulations of commerce to the trade of third countries, provided that the overall incidence of duties and other regulations of commerce was not higher or more restrictive after the completion of the customs union than before. Further clarification was brought to the expression "on the whole" used in Article XXIV:5, in paragraph 2 of the Understanding on the Interpretation of Article XXIV of GATT 1994 ("Understanding on Article XXIV"). The view that a total prohibition on new restrictions was not intended, found its confirmation in the last sentence of that paragraph, which stated, *inter alia*, that "for the purposes of the overall assessment of the incidence of other regulations of commerce for which quantification and aggregation are difficult, the examination of individual measures, regulations, products covered and *trade flows affected* may be required" (emphasis added). In Turkey's view, such a

[108] See BISD 35S/293, paras. 19-20.
[109] *Ibid.*, para. 45.

provision would not be meaningful if it had been the intention to totally prohibit the imposition of new restrictions by one party to the customs union.[110]

6.58 Turkey noted that this point had been made very effectively by the European Communities at a meeting of the Working Party on the Accession of Spain and Portugal, as follows:

> "The task was general, namely to reach a view on whether the general incidence of customs duties and regulations after enlargement was on the whole more or less restrictive than before. Even if a negative incidence were shown to be the case for certain items, such as when duties were increased or replaced by variable levies, one had to consider whether these effects were not balanced by the effects of other changes in the tariff sector taken as a whole. An overall appreciation of effects of changes in tariffs and regulations of commerce had to be made. In assessing general incidence, one had to avoid too static an analysis and to take into account the trade-creating effects of the establishment or enlargement of a customs union."[111]

In its conclusions, the Working Party had noted that:

> "Because of the divergent views expressed, [it] was unable to reach agreed conclusions as to the consistency of the Treaty with the General Agreement. It decided to forward to the Council, this report which summarizes the views expressed by its members during the discussion. It noted the fact that many members of the Working Party had reserved their rights under the General Agreement and that these rights would not be prejudiced by submission of the report."[112]

6.59 Nevertheless, problems which might have arisen in connection with the accession of Spain and Portugal to the European Communities were settled under the procedures of Article XXIV:6 and no contracting party chose to invoke Articles XXII and XXIII in relation to the question of whether the obligations arising out of Articles XXIV:4 and XXIV:5(a) had been met.

6.60 Turkey noted further that, if it had been the intention of WTO Members to prohibit the imposition of new restrictions at the time of the formation or enlargement of customs unions, they would no doubt have seized the opportunity provided by the Uruguay Round to do so.

6.61 Turkey also recalled that, despite regular examinations of the Association Agreements between Turkey and the European Communities, both prior to and subsequent to the completion of the Turkey-EC customs union, no recommendations had ever been addressed to the parties to the agreement under Article XXIV:7(b). In the absence of such recommendations, it could not be argued that the Association Agreement and the Turkey-EC customs union to which it had led were inconsistent with obligations arising out of Article XXIV.

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[110] In its Report on *US - Gasoline*, the Appellate Body had made clear that an interpretation might not result in reducing whole clauses or paragraphs to redundancy or inutility (p. 22).

[111] Appellate Body Report on *US - Gasoline*, para. 6.

[112] *Ibid.*, para. 49.

6.62 In Turkey's view, therefore, Article XI:1 had to be read in conjunction with Article XXIV, concluding that measures whose application constituted a requirement of the Turkey-EC customs union were deemed to be justified under Article XXIV.[113]

6.63 In support of its argument, Turkey also recalled changes in its import regime *vis-à-vis* third countries triggered by the completion of the Turkey-EC customs union, which led to an incidence of tariff levels much lower than that of Turkey's previous tariff and to a process of alignment of its external trade policy with that of the European Communities resulting in the Turkish market becoming as open as the EC market to products of third countries. Turkey also referred to developments in its imports of textiles and clothing products in this respect, stressing that the lower level of tariff protection had led to a more open access to the Turkish market in these products despite the introduction of a system based on QRs, and recalled that the restrictions in question were of a temporary nature and would be phased out as foreseen in the ATC.

6.64 Turkey concluded that, overall, the Turkey-EC customs union had resulted in the lowering of the general incidence of duties and other regulations of commerce and, consequently, the requirements of Article XXIV:5(a) had been met.

6.65 Turkey explained that there were basically only three options open to the parties to a customs union when setting up a single set of external trade rules, in accordance with Article XXIV:8(a)(ii) requirements, both for reasons of logic and for practical purposes. Supposing that WTO Member A and WTO Member B formed a customs union, the options for establishing single external trade rules could be:

(i) to extend the external trade rules of Member A to the entire customs union;

(ii) to extend the external trade rules of Member B to the entire customs union; or

(iii) to develop an external trade regime for the entire customs union somewhere in the middle between options (i) and (ii).

6.66 For this reason, Article XXIV:6 provided for the procedure to give compensatory adjustment in case of increased bound customs duties, which clearly indicated that the otherwise stringent rules of Article II were in this case applied in a more flexible way in order not to stand in the way of the creation of a customs union. However, the special rules contained in Article XXIV:5-8 did not only provide increased flexibility in the application of Article II. For example, although not specifically spelled out anywhere in these provisions, Turkey stated that it would simply make no sense if they did not authorize a derogation from Article I as well, and this had never been contested.

[113] In this context, Turkey recalled that the accession of Sweden to the European Union on 1 January 1995 had led it to adopt the EC's common commercial policy in textiles and clothing, which had resulted in the replacement of a tariff-based system by QRs similar to those applied by Turkey since the completion of the Turkey-EC customs union, without the relevant procedures of the MFA being observed. No country had however invoked Article XXII or Article XXIII rights in connection with the adoption of those measures by Sweden despite the fact that Sweden was not applying quantitative restrictions to imports of textiles and clothing before. Moreover, the formula used in the calculation of the quota levels to be applied by Turkey after completion of the Turkey-EC customs union was the same as the one used in the accession of Austria, Finland and Sweden.

6.67 Turkey argued that the derogation authorized by Article XXIV:5 was not limited to a particular GATT rule, but encompassed all those rules from which a derogation was necessary to permit the formation of customs unions. In support of this argument, Turkey noted that the opening clause of Article XXIV:5 was drafted in language that was similar to the language used in the opening clause of Article XX, which demonstrated that the derogation referred to all the provisions of the GATT, and not just from those contained in Article II, more specifically mentioned in Article XXIV:6.[114] In this context, Turkey recalled that it had offered to enter into negotiations to address India's concerns with regard to the change in its external trade regime, but India had not wished to participate in such negotiations.

6.68 **India** endeavoured, following the provisions of Article 3.2 of the DSU and the consistent jurisprudence of the Appellate Body, to interpret Article XXIV:5 of the GATT, which Turkey invoked as a defense, in accordance with the principles of interpretation set out in Articles 31 and 32 of the VCLT. These principles required an interpretation in accordance with the ordinary meaning to be given to the terms of Article XXIV:5 in their context and in the light of the object and purpose of the GATT.

6.69 India could not see how the terms of Article XXIV:5 could provide for a justification of the measures taken by Turkey. This provision authorized merely the formation of a customs union or free trade area, nothing else. Its terms consequently exempted from the other obligations under the GATT only measures inherent in the formation of a customs union. For instance, a customs union or a free trade area could only be formed by the granting of preferential treatment inconsistent with Article I and Article XXIV therefore clearly provided a justification for it. However, customs unions and free trade areas could be formed without the introduction of new QRs on imports from third Members inconsistent with Article XI of GATT. There was, in particular, nothing that required Members forming a customs union to impose new restrictions on imports from one particular third Member inconsistently with Article XIII of GATT and Article 2.4 of the ATC. Article XXIV:4, according to which the purpose of customs unions and free trade areas should not be to raise barriers to the trade of third Members, was drafted on that assumption. The terms of Article XXIV therefore could not be interpreted to provide a legal basis for discriminatory restrictions against a third Member inconsistent with Articles XI and XIII of GATT and Article 2.4 of the ATC.

6.70 In this regard, India referred to the GATT panel on the *EEC-Member States' Import Regimes for Bananas*, which summarized the legal implications of the text of Article XXIV as follows:

> "The Panel noted the argument of the EEC that the restrictions and prohibitions on imports of bananas, even if inconsistent with Article XI:1, were nonetheless consistent with the General Agreement because they were covered under the provisions of Article XXIV. *The*

[114] Of course, as required by Article XXIV:5(a), the overall impact of the creation of the customs union should not be such as to be on the whole more trade-restrictive than the general incidence of the duties and regulations of commerce applicable to the constituent territories prior to the formation of the customs union. As demonstrated before, however, this was not the case in the Turkey-EC customs union.

> *Panel noted that Article XXIV:5 to 8 permitted the contracting parties to deviate from their obligations under other provisions of the General Agreement for the purpose of forming a customs union or free trade-area, or adopting an interim agreement leading to the formation of a customs union or free trade area, but not for any other purpose. Article XXIV:5 to 8 therefore did not provide contracting parties for a justification for restrictive import measures as such; it merely provided them - within the limits set out in this provision - with a justification for not applying to imports originating in such a union or area the restrictive measures that they were permitted to impose under other provisions of the General Agreement*. The Panel therefore considered that the import restrictions on bananas could not be justified by Article XXIV."[115]

6.71 Though the report of this panel was not adopted, the Appellate Body recognized that the reasoning in a not-adopted panel report could provide useful guidance.[116] In India's view, the succinct and clear exposition of the legal situation flowing from the terms of Article XXIV in the above quotation was such an example.

6.72 With reference to the next element to be considered under the principles of interpretation of the VCLT, i.e. the context in which the terms set out in Article XXIV:5 appeared, India noted that, since the preceding paragraph, Article XXIV:4, stated why customs unions and free trade areas were permitted and which purposes they were to serve, Article XXIV:5 had to be interpreted consistently with the principles set out therein. This meant that, in the absence of any clear indication to the contrary, Article XXIV:5 could not be interpreted as providing a justification for measures raising barriers to the trade of third Members.

6.73 India noted further that Article XXIV:6 was also part of the context of Article XXIV:5. Both according to the terms of this provision and the consistent practice under it, it applied only to custom duties bound under Article II, and the related paragraphs 5 and 6 of the Understanding on Article XXIV, also referred only to customs duties. There was no corresponding mechanism for renegotiation and compensation following an increase in QRs. India considered this a logical consequence of the principle that tariffs were negotiable (and renegotiable under Article XXVIII) while QRs might only be imposed in narrow circumstances defined in the WTO agreements. Given that rules governing quotas were fundamentally different from the rules governing tariffs, there was no basis to apply Article XXIV:6 by analogy to quotas, as Turkey had claimed. Moreover, paragraph 4 of the Understanding on Article XXIV made it explicit that paragraph 6 of Article XXIV established the procedures to be followed when a Member forming a custom union proposed to increase a bound rate of duty. Had the Uruguay Round negotiators meant to extend Article XXIV:6 to quotas, they would have formulated this provision accordingly.

6.74 India noted that two important conclusions for the interpretation of Article XXIV:5 could be drawn from Article XXIV:6. Firstly, if Members forming a cus-

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[115] Panel Report (not adopted) on *EEC - Member States' Import Regimes for Bananas*, DS32/R ("*EEC - Bananas I*"), para. 358 (emphasis added).

[116] Appellate Body Report on *Japan - Alcoholic Beverages*, section E.

toms union could not ignore their obligations under Article II and any duty increased by such Members was to be brought into conformity through a renegotiation under Article XXVIII, it could reasonably be concluded that they could also not ignore such obligations in respect of quotas. Secondly, Members adversely affected by a duty increase had to be compensated under the procedures of Article XXVIII; since Article XXIV did not provide for any form of compensation for Members adversely affected by the imposition of a new quota, it could logically be concluded that Article XXIV was not meant to authorize the imposition of quotas.

6.75 Turning to analyze, in accordance with Article 31:3(b) of the VCLT, subsequent practice in the application of Article XXIV:5, India could not find any which would lend support to Turkey's interpretation of this provision.

6.76 India recalled that the claim that Article XXIV:5 of GATT authorized QRs inconsistent with Article XI was made by the six members of the EEC in 1957 when the CONTRACTING PARTIES to GATT 1947 examined the Treaty of Rome. The Report of the Sub-Group considering the EEC's restrictions recorded the following:

> "Most members of the sub-group could not accept the interpretation of the Six of paragraph 5(a) ... The notion that paragraph 5(a) would require that temporary QRs should be treated in the same way as normal protective measures such as tariffs in determining the trade relations between countries in a customs union and third countries would be contrary to the basic provision of the Agreement which precludes the use of QRs as an acceptable protective instrument."[117]

6.77 India noted that this had been the position of third countries in all cases in which the claim that Article XXIV:5 justified restrictions had been made.[118] More recently the European Communities had accepted this position since it stated during the GATT examination of Portugal and Spain's Accession to the European Communities as follows:

> "On the question of the other regulations of commerce, and in particular QRs, the Communities agreed that Article XXIV did not provide a waiver from other provisions of the GATT."[119]

6.78 India also considered that it was on the basis of such interpretation of Article XXIV that the EC-Turkey Association Council Decision 1/95 had been drafted. Referring to paragraphs 2 and 3 of Article 12 of the Decision, it noted that the provisions described the adoption of the same policy in the textile sector as an "objective" and recognized that "cooperation" between the European Communities and Turkey was required to achieve this objective. Moreover, the provisions made it clear that the drafters envisaged the possibility that Turkey would not succeed in negotiating restraint agreements identical to those of the European Communities because they explicitly agreed that in this case the European Communities would continue to apply the system of certificates of origin to prevent the circumvention of its policies

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[117] *Reports on the European Economic Community*, adopted on 29 November 1957, BISD 6S/70, para. 5.

[118] See detailed references to past discussions in the GATT on the use of QRs by Members forming a customs union in the third-party submission of Thailand (para. 7.84 below).

[119] *Report of the Working Party on the Accession of Portugal and Spain to the EC*, adopted on 19-20 October 1988 (BISD 35S/293).

through shipments into the European Communities *via* Turkey. The parties, when drafting these provisions, thus recognized that Turkey could not, simply by invoking Article XXIV, unilaterally impose the import restrictions which the European Communities was entitled to impose under the transitional provisions of the ATC.

6.79 India recognized that the pronouncements listed above might not be sufficiently "concordant, common and consistent" to constitute subsequent practice within the meaning of Article 31:3(b) of the VCLT;[120] however, they demonstrated that the claim that Article XXIV:5 provided a waiver from the general prohibition of QRs had never been accepted and that the European Communities and Turkey had themselves not proceeded on the assumption that it did provide such a waiver. Turkey negotiated restraint agreements similar to those of the European Communities with 24 countries; it imposed unilateral restrictions or surveillance regimes to imports from 28 countries with which it was not possible to reach agreements, among them India. India noted that the interpretation of Article XXIV which the European Communities and Turkey had adopted in response to their failure to conclude restraint agreements with all exporting countries was in complete contradiction with the legal assumption on which their original decision to negotiate such agreements was based.

6.80 **Turkey** disagreed with India's argument according to which, if the Turkey-EC customs union could put in place a common regulation of commerce determined by restrictive measures applied by the European Communities, the obligations under Article XI:1 of GATT and Article 2.4 ATC would be ignored. Turkey pointed out that, while the GATT expressly stated that its provisions "shall not prevent the formation of a customs union" (the *chapeau* of Article XXIV:5), it took account of the pre-existing obligations of members of a customs union *vis-à-vis* other GATT contracting parties by the requirements in Article XXIV:5(a) relating to the customs tariff and the common regulation of commerce of the customs union.

6.81 Turkey also disagreed with India's argument that, unlike in the case of the raising of customs duties rates for certain items that might result from the establishment of a common customs tariff, there was no procedure on compensatory adjustment for QRs and that as a result Article XI obligations could be ignored. According to Turkey, it could not be inferred from the fact that Article XXIV:6 only referred to increases of customs duty rates that the intention behind Article XXIV:5(a) was to prohibit restrictive measures of a common regulation of commerce of a customs union, determined by one of the parties to such customs union. Such interpretation would be difficult to reconcile with Article XXIV:5(a) providing a test for the GATT consistency of a customs union with the GATT establishing, *inter alia*, that a regulation of commerce of a customs union could not *on the whole* be more restrictive than the regulation of commerce applicable in the constituent territories prior to the formation of the customs union.

6.82 Turkey noted that Article XXIV:6 did not exclude compensatory adjustments, where the common regulation of commerce of a customs union applied a restrictive measure taking account of the application of such a measure by a party to a customs union prior to the formation of that customs union. In agreeing to the Understanding

[120] See the Appellate Body Report on *Japan - Alcoholic Beverages*, Section E, on this issue.

on Article XXIV, WTO Members made this clear. In paragraph 2 of that Understanding they agreed on further rules on the evaluation under Article XXIV:5(a) of the general incidence of duties *and* other regulations of commerce applicable before and after the formation of a customs union, when recognizing "that for the purpose of the overall assessment of the incidence of other regulations of commerce for which quantification and aggregation are difficult, the examination of individual measures, regulations, products covered and trade flows affected may be required".

6.83 Turkey submitted that it would make little sense to provide for an evaluation of the overall incidence of other regulations of commerce if, as India asserted, the regulation of commerce of the Turkey-EC customs union could not be determined by pre-existing restrictive measures applied by the European Communities. It would equally make little sense to provide for an examination of individual measures, with a view of the evaluation of their incidence if, as India asserted, GATT did not permit the regulation of commerce of the Turkey-EC customs union to be determined by pre-existing restrictive measures applied by the European Communities. Why evaluate the incidence of a measure which would be prohibited? It would also make little sense to provide for an evaluation of the incidence of individual measures of a regulation of commerce of a customs union, if this would not to give rise, where appropriate, to a duty to offer a compensatory adjustment. In this context, Turkey drew attention to the steps taken by Turkey in this sense. In respect of textiles and clothing products, Turkey had negotiated adjustments with 24 countries. Turkey had also, repeatedly but in vain, offered to India to negotiate adjustments.

(c) Article XXIV:8(a)

(i) Relationship between Article XXIV:8(a)(ii) and Other Article XXIV Provisions

6.84 **India** submitted that the obligations under Article XI:1 of GATT and Article 2.4 of the ATC were not modified by Article XXIV:8(a)(ii) of GATT, which required Members forming a customs union to apply substantially the same regulations of commerce to the trade with other Members of the WTO.

6.85 India recalled that, in the communication dated 9 January 1996, Turkey attempted to justify its new restrictions with reference to Article XXIV:8(a)(ii) of GATT as follows:

> "The GATT jurisprudence since 1957 has considerably widened the scope of "regulations of commerce". Indeed, in the 1986 Working Party examining the accession of Spain and Portugal to the Community, it was no longer disputed that QRs formed part of "other regulations of commerce". The conformity assessment of the EU-Turkey Customs Union in the framework of Article XXIV should therefore not be abused in an attempt to shape new substantive WTO law. *Since a customs union must cover "substantially all trade" and may not exclude particular economic sectors, the EC's customs union with Turkey must also cover the textiles sector*, which, it must be recalled, represents over 40% of Turkey's trade with the Community." (Emphasis added.)

6.86 In India's view, however, that sub-paragraph merely defined one of the requirements to be fulfilled by an RTA to qualify as a customs union within the mean-

ing of Article XXIV. The provision could not possibly be interpreted to imply that Members, in fulfilling that requirement, were *entitled* to ignore their WTO obligations when applying restrictions to imports from third Members. Article XXIV:4 made it clear that the purpose of a customs union was not to raise barriers to the trade of third countries, and Article XXIV:6 stipulated that tariff bindings could not simply be ignored by Members forming a customs union which, if necessary, had to renegotiate them in accordance with the procedures set out in Article XXVIII. If the obligations under Article II could not be ignored by Members forming a customs union, how could one reasonably conclude that the obligations under Article XI:1 of GATT and Article 2.4 of the ATC could be ignored?

6.87 India recalled that this position was also taken by the representative of Thailand at the meeting of the CRTA in October 1996:

> "... Article XXIV:6 ... required the parties to RTAs to enter into compensation negotiations under Article XXVIII. A unilateral withdrawal of concessions under Article II of GATT 1994 would thus constitute a breach of the multilateral rules. Similarly, the imposition of QRs by new members of a customs union violated the provisions of GATT 1994, as this could not be justified under Article XXIV."[121]

6.88 India also warned against importing into Article XXIV:8(a)(ii) in terms of creating rights to impose QRs where there were not specifically provided. Moreover, while Turkey claimed to be obliged by Article XXIV:8 to adopt common quotas with the European Communities for textiles and clothing, it was also claiming the right to follow divergent trade policy practices and to adopt different instruments in other areas. India noted in this respect differences *inter alia* in external trade policies on agriculture, steel and other sensitive industrial products, as well as in relation to anti-dumping, countervailing and safeguards measures. There was additionally no requirement that Members fulfil the requirements of Article XXIV:8(a) immediately.

6.89 **Turkey** submitted that Article XXIV:8(a)(ii) required it to apply to third countries import restrictions similar to those applied to the same countries by the European Communities, since the term "regulations of commerce" had traditionally been interpreted as incorporating QRs.[122] This was precisely the reason for Article 12 of Decision 1/95 unequivocally envisaging the wholesale adoption by Turkey of the EC Common Commercial Policy Instruments, as well as the EC Customs Code, in the area of textiles and clothing products, prior to the completion of the Turkey-EC customs union. Article 12(1) specified the external trade measures to be adopted by Turkey towards third countries, which constituted the critical mass of commercial policy regulations applied by the European Communities. Appropriate measures were envisaged to prevent trade diversion to Turkey over the EC customs territory.[123] The provisions of Decision 1/95 which had permitted the European Communities to con-

[121] WT/REG22/M/1, para. 17. India, Japan, Hong Kong, and the United States expressed their agreement with Thailand.

[122] See BISD 35S/293, para. 45.

[123] A transitional period was only provided for in Article 16 of Decision 1/95 (see WT/REG22/1) for alignment by Turkey on the EC preferential trade policy as no risk of trade diversion through the Turkish customs territory was likely as long as Turkey maintained towards the countries concerned a more restrictive import regime than that of the European Communities.

tinue applying - even after the completion of the Turkey-EC customs union - certificates of origin to imports of textiles and clothing from Turkey, had lapsed because Turkey had been able to meet all the requirements for the free circulation of these products set out in the Decision itself (including the adoption of substantially the same commercial policy as the European Communities for those products).

6.90 Turkey referred again to the example of a customs union between WTO Members A and B, where A applied (fully WTO-compatible) QRs on certain imports but low tariffs, while B had no QRs but (fully WTO-compatible) high tariffs on such imports. In such a case, the mentioned option (i) would entail that the A-B customs union would have to adapt its external trade regime to that of B, which meant raising tariffs to the high B level, an undoubtedly permissible move under Article XXIV:6. Option (ii) would result in the A-B customs union aligning its external trade regime with A, which would entail the introduction of QRs corresponding to those of A. Option (iii) would attempt to find some middle ground between the other two options.

6.91 In Turkey's view, the position of India would entail, in the context of the present case, that options (ii) and (iii) be legally unavailable. This would come down to an overly restrictive interpretation of Articles XXIV:5 and XXIV:8(a)(ii), because under this reading, the inescapable need to raise the tariffs to a high level could easily enter into conflict with the requirement of Article XXIV:5(a) according to which the external trade regime of the customs union should not on the whole be more restrictive than the general incidence of the external trade regime of each of the constituent territories prior to the formation of the customs union. This would make option (i) likewise legally unavailable.

6.92 Turkey was of the view that any interpretation of Article XXIV which could lead to the conclusion that in certain circumstances, WTO Members with diverging external trade regimes were legally inhibited from forming a customs union would also be in contradiction with the objective clearly stated in Article XXIV:4. In order to fully preserve the right of WTO Members to form customs unions, it was necessary to keep open in all cases options (i), (ii) and (iii) as referred to above, since only by maintaining this flexibility would it be possible to allow WTO Members to form a customs union where they have diverging (but entirely legal) external trade regimes prior to the formation of such a customs union. As already mentioned, this reading of Article XXIV:8(a)(ii) was also commanded by the requirements laid down in Article XXIV:5(a).

6.93 Turkey considered therefore that, under India's reading, Articles XXIV:5-8 could stand in the way of the formation of a customs union between WTO Members with diverging external trade regimes. Such a reading of the portions of Article XXIV flew in the face of the purpose of this provision which was, on the contrary, to facilitate the formation of customs unions.

6.94 Turkey submitted further that, contrary to India's reading, Article XXIV:8(a)(ii) did not merely define a customs union. If such interpretation were followed, the set of GATT provisions on customs unions would be incoherent and logically inconsistent. If, in order to qualify as a customs union, the Turkey-EC customs union had to cover substantially all trade - as required by Article XXIV:8(a)(i) - it had obviously to cover trade in textiles and clothing products, which represented 40 per cent of Turkey's sales in the European Communities. If such trade had to be covered, the Turkey-EC customs union had to have a common regulation of com-

merce with other countries in accordance with Article XXIV:8(a)(ii). Such common regulation of commerce, as determined by restrictive measures which the European Communities applied in conformity with WTO rules, applied to goods imported in the Turkey-EC customs union *via* Turkey. Article XXIV:5(a) could not be interpreted as prohibiting this: if it were, the absence of a common regulation of commerce for textiles and clothing products would result in the exclusion of these products from the coverage of the Turkey-EC customs union, which then would not meet the requirement of Article XXIV:8(a)(i).

(ii) Relationship between Article XXIV:8(a)(ii) of GATT and Article 2.4 of the ATC

6.95 **India** believed that, implicit in Turkey's argument that Article XXIV:8(a)(ii) required it to apply to its customs territory the same import restrictions that the European Communities were authorized to apply under the transitional arrangements of the ATC, there was the claim that a conflict existed between the provisions of Article 2 of the ATC and those of Article XXIV:8(a)(ii) of GATT. India also believed that, implicit in this argumentation was the further claim of Turkey that it was entitled to resolve this conflict in favour of its obligations under Article XXIV:8(a)(ii).

6.96 For these reasons, India considered that Turkey's argumentation had to be examined in the light of the General Interpretative Note to Annex 1A of the WTO Agreement, which read:

> "In the event of a conflict between a provision of the General Agreement on Tariffs and Trade 1994 and a provision of another agreement in Annex 1A of the Agreement Establishing the WTO ..., the provision of the other agreement shall prevail to the extent of the conflict."

6.97 In the *EC-Bananas III* case, the panel interpreted this note as covering two types of conflicts: Firstly, conflicts between obligations contained in GATT and obligations contained in agreements listed in Annex 1A to the WTO Agreement, where those obligations were *mutually exclusive* in the sense that a Member could not comply with both obligations at the same time. Secondly, the situation where *a rule in one agreement prohibited what a rule in another agreement explicitly permitted*, illustrated by the panel with the following example:

> "… Article XI:1 of the GATT 1994 prohibits the imposition of quantitative restrictions ... Article 2 of the … ATC … authorizes the imposition of quantitative restrictions in the textiles and clothing sector, subject to conditions specified in Article 2.1-21 of the ATC. In other words, Article XI:1 of GATT 1994 prohibits what Article 2 of the ATC permits in equally explicit terms. It is true that Members could theoretically comply with Article XI:1 of GATT, as well as with Article 2 of the ATC, simply by refraining from invoking the right to impose quantitative restrictions ... However, such an interpretation would render whole Articles or sections of Agreements covered by the WTO meaningless and run counter to the object and purpose of many agreements listed in Annex 1A which were negotiated with the intent

> to create rights and obligations which in parts differ substantially from those of the GATT 1994."[124]

6.98 India noted that, in the present proceedings, no conflict of the first type arose because the European Communities and Turkey could meet their obligations under Article XXIV and Article 2.4 of the ATC simply by not imposing any restrictions on imports of textiles and clothing. However, the second type of conflict between Article XXIV:8(a) of GATT and Article 2.4 of the ATC did arise because, while the former required the European Communities and Turkey to apply substantially the same regulations of commerce, the latter explicitly required them to apply different regulations of commerce. The provisions of Article 2.4 of the ATC therefore clearly prevailed to the extent of this conflict.

6.99 India therefore submitted that the European Communities and Turkey could meet their obligations under the WTO agreements if they were to form a customs union under which the import policies of the European Communities and Turkey on textiles and clothing differed to the extent that their obligations differed under Article 2.4 of the ATC. Turkey's defense based on the notion of a conflict of obligations was therefore without any legal basis. In this context, India noted further that the ATC was a newly negotiated agreement designed to exempt partially the textiles and clothing sector from the earlier GATT disciplines during a transitional period; it therefore constituted a later and more specific statement of Members' rights and obligations in the field of textiles and clothing.

6.100 **Turkey** submitted that, with regard to the ATC, no conflict existed. In addition, Turkey considered that it was in the first place for the TMB to determine the relationship between the ATC and GATT, as this relationship depended on an interpretation of the ATC. Turkey therefore continued to believe that this issue could not be considered by the Panel without prior examination by the TMB which had been given the task to examine measures taken under the ATC and their conformity therewith.

6.101 Turkey submitted further that, in any case, since the ATC specifically referred back to the "relevant GATT 1994 provisions" in Article 2.4, Turkey could not see any basis for construing a conflict between ATC and GATT. This was also evidenced by footnote 3 to Article 2.4 of the ATC, which solely excluded Article XIX of GATT from the reference contained in the main body of this provision.[125] Finally, the ATC established a transitional regime, the ultimate aim of which was full integration of the textiles and clothing sector in the GATT. It would therefore be surprising if Article XXIV of GATT would be considered inapplicable in the context of the ATC, since the purpose of the ATC was to phase out gradually any special rules applying to textiles and clothing products and to phase in all the GATT rules, which obviously included Article XXIV.

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[124] Panel Report on *EC - Bananas III (Complaint by the United States)*, para. 7.159 and footnote 403.

[125] See also, in this respect, paras. 6.27 to 6.29 above.

(iii) Differences between the Formation of a Customs Union and the Enlargement of an Already Existing One

6.102 **India** noted that Turkey had not become a Member State of the European Communities, and the territory to which the European Communities applied the WTO Agreement had therefore not been extended to comprise that of Turkey. The new restrictions were consequently not EC measures extended to the territory of Turkey, but restrictions imposed by Turkey. In this context, India recalled that, in the communication dated 9 January 1996, Turkey further attempted to justify its new restrictions as follows:

> "To the extent that the EC's current regime for textiles is in accordance with WTO rules including the ATC, nothing prevents the Community from applying its existing regime to the enlarged territory of the EU-Turkey customs union, as has been done by the EC on the occasion of previous enlargements."

6.103 India was of the opinion that this statement was both factually and legally incorrect. While the European Communities were responsible for the implementation of the WTO Agreement within its own separate customs territory (which essentially comprised the European territories of its Member States),[126] it had assumed no obligations under the WTO Agreement in respect of the territory of those countries with which it had concluded a customs union agreement. The case before the Panel was thus not the case of an extension of the territory to which the European Communities applied the WTO Agreement (which occurred for instance when Austria, Finland and Sweden acceded to the European Communities and when Germany was unified). This case concerned the adoption by Turkey of the EC restrictive textiles and clothing import regime within the framework of an RTA. There was therefore no need for the Panel to make any findings on the complex legal issues arising from an extension of the territorial application of the WTO Agreement by the European Communities to the territory of States that acceded to the European Communities but remained Members of the WTO.

6.104 **Turkey** submitted that, from the point of view of rights and obligations arising out of membership of the WTO, there was no distinction between accession to the European Communities and participation in a customs union with it, as long as a single customs territory had been created with the inclusion of both parties. For that reason, the procedures followed, whether in relation to Article XXIV:5(a) or Article XXIV:6, were identical in both cases. In Turkey's opinion, the precedents set by EC accessions were valid for the examination of its own customs union with the European Communities. While the decision-making processes varied depending on whether a country had acceded to the European Communities or joined in a customs union with it, what mattered was the fact that the obligations which arose out of both cases were indistinguishable in essence, as in the case of the Turkey-EC customs union which had a single customs territory as provided for in Article 3(3) of Decision 1/95. Precisely because a common commercial policy was applied over this single customs territory, Turkey and the European Communities had insisted on the latter's

[126] See Article XXIV:1 and the Explanatory Notes at the end of the WTO Agreement.

participation in the examination of India's complaint by the Panel, since the elements of that common commercial policy could not be modified without the consent of the European Communities.

6.105 Turkey therefore did not agree with the argument made by India concerning the alleged difference in WTO terms between an extension of the EC customs union through accession of new member States and the substitution of a single Turkey-EC customs territory for the pre-existing individual customs territories of Turkey and the European Communities respectively. In fact, in both cases, the territory covered by the customs union was extended by comparison to the situation prevailing beforehand. The main difference was in the administration of the customs union, which was the responsibility of the European Communities alone in the case of an accession, but the joint responsibility of Turkey and the European Communities in the case of the Turkey-EC customs union. This was however entirely irrelevant for the application of Article XXIV:5 to 8 of GATT.

(iv) Scope of Harmonization of the External Trade Regime in the Turkey-EC Regional Trade Agreement

6.106 **India** noted that Turkey and the European Communities had chosen to eliminate the barriers on trade between them in respect of most industrial products, and Turkey had harmonized certain aspects of its external trade policies with those of the European Communities. However, outside the sector of textiles and clothing, the European Communities and Turkey would continue to apply different trade policy measures to third countries. The RTA between the European Communities and Turkey, at its present stage of implementation, could best be characterized as a free-trade area whose parties had chosen to harmonize certain aspects of their external trade policies. The argument that Article XXIV required Turkey to raise the level of its restrictions in the field of textiles and clothing to that of EC restrictions was therefore particularly unconvincing in this context. As the representative of the United States pointed out in the CRTA:

> "The reasoning by the EC that Article XXIV required new member countries to adopt certain restrictive and discriminatory arrangements so as to ensure the smooth functioning of the Turkey-EC customs union was dubious, as it was not applied across the board. The selectivity of this reasoning confirmed that it was being used as a disguised restriction to the trade of third countries. In textiles, Turkey was required to adopt quotas, but in other areas was exempted. Regional trade agreements should have the objective of strengthening, rather than weakening the multilateral trading system."[127]

6.107 **Turkey** submitted that over 98 per cent of trade between Turkey and the European Communities was covered by the Turkey-EC customs union and the criteria contained in the twin sub-paragraphs of Article XXIV:8(a), were more than fulfilled in the completion of the customs union. With reference to the requirements in Article XXIV:8(a)(i), Turkey noted the following:

[127] WT/REG22/M/1, para. 13.

(i) Duties and QRs had been eliminated on intra-trade in industrial products. Textiles and clothing products, which accounted for around 40 per cent of Turkey's exports to the European Communities, were in free circulation in the Turkey-EC customs union. As far as steel products were concerned, they would be incorporated into the customs union before the ECSC was phased out in 2001 and benefit from free circulation.

(ii) The only sector not fully covered by the Turkey-EC customs union in 2002 would be agriculture, although intra-trade in agricultural products would have been significantly liberalized. 90 per cent of intra-trade in agricultural products had been liberalized as a result of a separate Decision of the Association Council, Decision 1/98, which entered into force on 1 January 1998.

6.108 With respect to the harmonization exercise carried out by Turkey in the area of commercial policy, Turkey referred to the provisions contained in Section III of Decision 1/95 and, stressing its comprehensive nature, noted as follows:

(i) Turkey had adopted the CCT for all industrial products, except those of EURATOM and ECSC.[128]

(ii) Turkey had adopted in the textiles and clothing sector a trade regime identical to that of the European Communities, in conformity with Article 12(2) of Decision 1/95.

(iii) Turkey, as the European Communities, applied restrictions on a limited range of products imported from some state-trading countries not Members of the WTO.

(iv) In order to achieve free circulation of agricultural products between the two parties, Turkey has to adopt necessary elements of the Common Agricultural Policy. The "European Strategy" for Turkey, endorsed by the European Council at its meeting held in Cardiff on 15-16 June 1998, had proposed modalities for reaching that objective and discussions on these proposals were expected to be initiated shortly

(v) In competition and state-aids, the harmonization process had already been initiated and, once completed, resort to anti-dumping and countervailing duties would cease and identical policies would be applied to third countries.[129] (Meanwhile, the Parties to the Turkey-EC customs union were required to coordinate their actions towards third countries.)[130] Such gradual integration of anti-dumping actions was envisaged in Article 4.3 of the WTO Agreement on Implementation of Article VI of the GATT 1994.

6.109 Consequently, Turkey was of the view that the Turkey-EC customs union could not be described, as India did, as a "free trade area whose members have cho-

[128] Exceptionally, for a transitional period ending on 1 January 2001, imports from third countries of products covering 1.4 per cent of eight-digit tariff lines would be subjected to higher duties than the CCT, in accordance with Article 19 of the Additional Protocol.
[129] See Article 44(1) of Decision 1/95 (WT/REG22/1).
[130] See Article 45(2) of Decision 1/95 (WT/REG22/1).

sen to harmonize certain aspects of their external trade policies", nor could it be argued that "Turkey has chosen to harmonize its commercial policies with those of the EC on a selective basis".

(v) Other Options Available

6.110 **Turkey** submitted that there were no alternative solutions to the imposition of quantitative limits. No alternative could be devised which would not impair the principle of free circulation of these products between Turkey and the European Communities as long as their importation into the European Communities was subject to restrictions. Since 1 January 1996, no specific border controls (other than regular border checks to verify that goods are under free circulation or under preferential regime) existed between Turkey and the European Communities for products covered by the customs union, including those which were subject to QRs when imported from third countries; products were accompanied by a circulation document which indicates that they are in free circulation. All textile and clothing products therefore circulated freely between the European Communities and Turkey's territories since that date.

6.111 Turkey indicated that maintaining the regulations of commerce applied prior to the formation of the Turkey-EC customs union would be equivalent to excluding the goods, imported into Turkey under Turkey's pre-customs union regulation of commerce, from the coverage of the customs union. Reintroducing the pre-customs union regime would also substantially reduce the degree of market access available for third countries in Turkey, and would require the European Communities (as the other party in the Turkey-EC customs union) to raise bound tariffs substantially, which was almost certainly not feasible.

6.112 Turkey recalled that the deviations from the Turkey-EC customs union were in any case of a temporary nature and insignificant in terms of the volume of trade affected. For that reason, the provisions of Decision 1/95 relating to compensatory measures during the period until Turkey had fully aligned itself to the CCT and EC preferential trade policy, had never been invoked.

6.113 **India** submitted that, in all areas in which their import duties or regulations differed, the European Communities and Turkey were able to implement border controls ensuring that only products originating in their respective territories would benefit from the preferential treatment under the trade agreement.

6.114 India noted that, because of the many differences in the duties and restrictions the European Communities and Turkey applied to imports from third countries, they had to ensure that exporters of other countries did not take advantage of such differences by transshipping their exports *via* the partner with the lowest barriers to imports. Given the absence of a complete harmonization of external policies, Decision 1/95 explicitly safeguarded the parties' right to impose the necessary controls in these areas. In this respect, India referred to the customs controls in the case of differences in arrangements on textiles and clothing, as contained in paragraphs 2 and 3 of Article 12 of the Decision; the supplementary levies in the case of differences in import duties, provided for in its Article 16.3(a); and the trade controls needed because of differences in the use of countervailing and anti-dumping measures and safeguard actions, according to Article 46 of the Decision. In India's view, all these provisions demonstrated that Decision 1/95 provided, in each case in which EC and Turkey's import policies differed, for the border controls necessary to ensure that exporters in

third countries did not take advantage of those differences. In each of these cases, the principle of free circulation did not apply.

6.115 India drew attention in particular to the fact that Article 12.3 of Decision 1/95 specifically provided for the application of restrictions and certificates of origin to textiles and clothing products from third countries with whom Turkey had not concluded restraint arrangements equivalent to those of the European Communities, thereby explicitly contemplating differences between their individual arrangements with third countries and giving the European Communities the right to apply the controls necessary to ensure that such differences did not entail transshipments *via* Turkey.

6.116 India concluded that, though Turkey had claimed that there were no alternatives to its restrictions on imports of textiles and clothing products from India, Decision 1/95 itself provided for such an alternative. With respect to the European Communities' response to a question by the Panel that it appeared "doubtful" that the use of rules of origin benefiting only Turkish exports of textiles and clothing products "would have been workable or proportionate within the customs union",[131] India remarked that such measures were considered to be workable and proportionate in the many other areas in which EC and Turkey's policies diverged.

6.117 India further submitted that for the purposes of the EC-Turkey trade agreement, any immediate harmonization of import restrictions on textiles and clothing products was unnecessary. The European Communities and Turkey were applying different import duties and regulations in respect of many sectors, policy instruments and trading partners. They pursued entirely different external policies in respect of a very broad range of products, trading partners and trade policy instruments.[132] The agreement which the European Communities and Turkey claimed to be a customs union was concluded in the form of Decision 1/95 of the EC-Turkey Association Council. According to the text of Decision 1/95 and the recent Secretariat Report on Turkey issued in the context of the Trade Policy Review Mechanism ("TPR Secretariat Report"), the European Communities and Turkey maintained divergent policies in the following areas:

(i) In their automobile import policies in relation to Japan, in accordance with Article 12.4 of the Decision, which stated that the provisions of the Decision should not constitute a hindrance to the implementation by the European Communities and Japan of the Arrangement relating to trade in motor vehicles, mentioned in the Annex to the WTO Agreement on Safeguards.

(ii) In customs duties for non-agricultural products, in accordance with Article 15.1 of the Decision, which allowed Turkey to retain until 1 January 2001 customs duties higher than the CCT in respect of third countries for products agreed by the Association Council.[133]

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[131] See para. 4.3 above, Reply to question 1.

[132] See WT/REG22/M/1 and also *Trade Policy Review: Turkey*, *Report by the Secretariat,* dated 14 September 1998, WT/TPR/S/44 ("*TPR Secretariat Report on Turkey*"), pp. xii-xiv.

[133] According to the *TPR Secretariat Report on Turkey* (p. 22), Turkey would maintain rates of protection above those specified in the EC's common external tariff (CET) for "sensitive" products equivalent to 290 items at the HS-twelve-digit level for up to five years. These items included *motor*

(iii) With respect to preferential trade regimes, given that, according to Article 16.1 of the Decision, Turkey was to align itself progressively with the EC preferential customs regime until 1 January 2001. However, to the extent that the EC preferential regime was based on agreements, this was subject to successful negotiations with the third countries concerned.[134]

(iv) In agricultural products, an additional period (of undefined length) is required to put in place the conditions necessary to achieve free movement of these products, according to Article 24 of the Decision.

(v) With respect to trade defense instruments (i.e. countervailing and anti-dumping measures as well as safeguard actions), according to Articles 44-47 of the Decision, the European Communities and Turkey were able to take such measures against each other and, independently from one another, against third countries.[135]

(vi) In government procurement, Article 48 of the Decision merely foresaw negotiations on a harmonization of policies in this area. At present, the European Communities were party to the WTO Agreement on Government Procurement, but not Turkey.

(vii) On trade-related investment measures, foreign companies setting up a joint venture in the automobile sector typically agreed to incorporate a certain share of local content in their production under informal arrangements with the Turkish government.[136] These arrangements, which had not been notified to the WTO, led to competitive conditions for imported automobile parts and components in the Turkish market different from those prevailing in the EC market.

6.118 India argued from the above that the European Communities and Turkey did not have the same external trade policies in the field of agriculture, 290 "sensitive" industrial products, shoes and other leather goods. The automobiles and automobiles parts and components sectors in Turkey and the European Communities were subject to different arrangements affecting imports. The European Communities and Turkey did not apply the same legislation or the same external policies with respect to anti-dumping, countervailing and safeguard measures. The import tariffs for automobiles and the export restraints agreed with Japan differed. Turkey restricted the purchase of imported automobile parts and components through informal arrangements but not

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vehicles with an engine capacity smaller than 2,000cc, bicycles, *leather cases and bags*, *footwear* and their parts, *furniture*, chinaware and ceramic ware, iron and steel wires and ropes not electrically insulated, and paper or paperboard sacks and bags for cement or fertilizers.

[134] According to the *TPR Secretariat Report on Turkey* (paras. 33 and 36), Turkey had not yet adopted the GSP of the EC and was still discussing free-trade agreements with Tunisia, Egypt, Morocco and Palestine

[135] In the CRTA, the EC representative confirmed that Decision 1/95 had no provisions on the common application of anti-dumping and countervailing measures (see WT/REG22/M/1, para. 45) and further explained that the European Communities and Turkey would harmonize common safeguards rules only after a transitional period (*Ibid*., para. 40).

[136] *TPR Secretariat Report on Turkey* (para. 87).

the European Communities. The European Communities and Turkey had not liberalized their mutual trade in agricultural products except for the industrial component of processed agricultural products. [137] Therefore, for the purposes of the trade agreement they concluded, Turkey and the European Communities did not have to impose the same restrictions on imports of textiles and clothing. Given the long transitional periods agreed for so many sectors, policy instruments and trading partners, they could also have exempted the textiles and clothing sector from the coverage of the agreement until the end of 2004 when the transitional period under the ATC lapsed. Turkey's decision to immediately adopt the EC policies in the field of textiles and clothing restrictions but not in the agricultural, automobile, shoes and leather goods sectors could be easily explained by a desire of Turkey to tailor the scope of the customs union to its domestic political constraints rather than its obligations under the GATT and the ATC.

(d) Turkey-EC Regional Trade Agreements in the Framework of Article XXIV

(i) Compatibility with Article XXIV Provisions

6.119 **Turkey** submitted that the legitimacy of RTAs, whether customs unions or free- trade areas, as an exception to the MFN rule, had been recognized since work started on the Charter of the International Trade Organisation in the 1940s. The Havana Charter recognized the desirability of "preferential agreements for economic development and reconstruction".[138] The present text of Article XXIV of GATT was adopted at the Havana Conference in 1948. In Turkey's opinion, it was generally acknowledged that such arrangements could lead to a better allocation of world resources as long as their "trade diverting" effects were less significant than their trade creating effects."

6.120 Turkey submitted further that full transparency had always been maintained in the GATT, and subsequently the WTO, by Turkey and the European Communities with respect to the Association between them and its evolution over the years. In asserting that its Association with the European Communities had never been challenged in the GATT or the WTO, Turkey summarized the main observations contained in the Working Party Reports on (i) the Ankara Agreement, (ii) the 1970 Additional Protocol and (iii) the 1973 Supplementary Protocols, as follows:[139]

(i) "The signatories of the [Ankara] Agreement recalled that ... the final objective of the Agreement, notably by the institution of a customs union, [was] the accession of Turkey to the Community when the operation of the Agreement [made] it possible ..." The Working Party was informed of the fact that the external tariff of the customs union

[137] This, despite the fact that the agricultural sector of Turkey accounts for 14 per cent of GDP and about half of the labour force, and would therefore most likely be an important element in EC-Turkey trade relations were zero tariffs applied to such products as well. (See *TPR Secretariat Report on Turkey*, p. xi.)

[138] See United Nations Conference on Trade and Employment, *Final Act and Related Documents*, ICITO, April 1948, Chapter 15.

[139] See para. 2.14 for references to these Reports.

would be that of the EEC, that trade regulations applied by Turkey towards third countries would be approximated with those of the EEC and that as between the parties, the customs union regime would involve the elimination of all customs duties and charges with equivalent effect and all QRs. The main criticism raised by Contracting Parties related to what was considered to be the "undetermined duration" of the transition to the customs union. One of the members of the Working Party, considered that the tariff quotas to be put into effect by the EEC for the benefit of exports of certain Turkish products constituted a unilateral preferential arrangement which had the effect of "widening the area of discrimination against third countries and eroding their rights under the General Agreement". The parties responded that "it was a case of an economic integration Agreement between parties at very different stages of development and that such arrangements are rightly characterized by a certain imbalance in the obligations undertaken during their formative period". In reply to further questions regarding the possible trade effect of the Agreement on third parties, Turkey and the EEC stated that they were prepared "to consult with contracting parties on matters affecting the operation of the General Agreement as required by Article XXII". One member of the Working Party said that "if the CONTRACTING PARTIES were to decide that the Agreement was not in conformity with the relevant provisions of Article XXIV, then the provisions of paragraph 7(b) should apply". However, no contracting party resorted to the provisions of Article XXII and no recommendation was addressed to the parties to the Agreement under Article XXIV:7(b).

(ii) When Turkey and the EEC notified to the GATT the 1970 Additional Protocol and Interim Agreement, they stated that the "Additional Protocol defined the rhythm and modalities of the realization of the customs union". The parties, in their statements to the Working Party, reiterated the fact that the long-term objective of the Agreement was "Turkey's accession to the EEC" and that the details for the implementation of the transitional stage prior to the completion of the customs union were set out in the Additional Protocol. While some members of the Working Party found the provisions of the Protocol "reasonable and justified when considering the different levels of development of the EEC and Turkey", others were of the view that the extended period for completing the customs union could not be considered "reasonable" in the sense of Article XXIV:5(c). In accordance with Article XXII:1 of GATT 1947, Turkey and the EEC undertook to "give sympathetic consideration to representations made by contracting parties". However, no such representations were ever made.

(iii) At the further examination of the Association, on the basis of the 1973 Supplementary Protocols and Interim Agreement, some members of the Working Party agreed with the parties that the Supplementary Protocol "conformed fully to Article XXIV of the General Agreement". Other members of the Working Party considered the transi-

tional period envisaged as too long and criticized the maintenance of discrimination in the dismantling of duties and QRs by Turkey in favour of the European Communities. Nevertheless, no contracting party invoked the right to consult under Article XXII in relation to any provision of the Agreement.

6.121 Turkey recalled that, in subsequent years, the two parties had reported regularly on the implementation of the Association Agreements and on the progress made in reaching their objectives. Full transparency had therefore been maintained on this subject and contracting parties had had the opportunity of expressing their views on it when the reports were examined by the GATT Council. No country invoked any rights under GATT 1947 throughout this period.

6.122 Turkey also recalled that, on 22 December 1995, Turkey and the European Communities notified to the WTO the text of Decision 1/95 which had been formally adopted on that same day and which set out the modalities for the completion of the Turkey-EC customs union provided for in the Association Agreements. Turkey and the ECSC notified in July 1996 the free-trade agreement on ECSC products, which entered into force on 1 August 1996.

6.123 Turkey noted that, in the WTO context, two meetings of the CRTA had so far been devoted to examining Decision 1/95, which set out the modalities for the completion of the Turkey-EC customs union provided for in the Association Agreements. At the first meeting, the Chairman stated that "the parties had provided the Secretariat with information and data to enable it to compute the general incidence of duties as required under Article XXIV:5(a), and for purposes of facilitating negotiations under Article XXIV:6 of GATT 1994". Some members of the CRTA had agreed with the parties in that the creation of a customs union between them was consistent with the provisions of Article XXIV:4, 5 and 8, and that the Turkey-EC customs union would benefit third parties, as the general incidence of duties and other regulations of commerce had been lowered. Other members considered that the agreement failed to meet the obligations of Article XXIV, essentially because it did not at the moment provide for free movement of agricultural products, and because of the QRs on imports of textiles and clothing products introduced by Turkey to align its external trade policy on that of the European Communities. Turkey and the European Communities had responded by explaining that liberalization of trade in agricultural products was a requirement of the Association Agreement (a separate Association Council Decision providing in due course for the elimination of most restrictions on such trade between the two parties entered into force on 1 January 1998).

6.124 Turkey considered that, though the CRTA had not yet concluded its examination of the Turkey-EC customs union, there was no indication, two and a half years after the completion of the customs union, that it would recommend to the parties, under Article XXIV:7(b), that modifications be made to the Agreement. Turkey added that no country had asked for compensatory adjustment with respect to any tariff bindings that might have been affected by the Turkey-EC customs union. It also noted that the completion of the customs union as originally scheduled convincingly replied to the principal criticism raised in the Working Parties entrusted with the task of examining the Association in the past, namely that the transitional period was too long to be considered "reasonable". By fulfilling its commitments as originally intended, Turkey had demonstrated that it had made good use of such transitional period.

6.125 Noting that India recognized that the present dispute did not cover the question of whether or not Turkey met the requirements of Article XXIV:5(a), Turkey concluded that, for the purposes of the present dispute, India did not contest that the provisions of this Article were applicable to the Turkey-EC customs union and that it assumed, for the purposes of this dispute, that the Turkey-EC customs union fulfilled the requirements of those provisions. In Turkey's opinion, it could hardly be otherwise, since the question of the compatibility of the Turkey-EC customs union as such with the requirements of Article XXIV:5(a) was not within the terms of reference of this Panel. Rather, this question was presently examined by the CRTA under Article XXIV:7(b). Turkey noted that the present dispute was therefore limited to the question as to whether Article XXIV contained a sufficient justification for the measures at issue.[140]

6.126 **India** agreed with Turkey that panels should not make determinations which were to be made according to explicit provisions of the GATT and other WTO Agreements by bodies composed of representatives of Members. India also did not believe that the present case required the Panel to assess the consistency of the EC-Turkey trade agreement with the requirements of Article XXIV.[141]

(ii) Type of Agreement under Article XXIV

6.127 **India** submitted that, if the Panel were to consider the relationship between the EC-Turkey trade agreement and the provisions of Article XXIV relevant for its conclusions, it should, in the view of India, adopt the approach followed by the GATT panel on *EEC-Bananas I*, which reacted as follows to the EEC's claim that the preferences it granted to developing countries in the framework of the Lomé Convention were covered by Article XXIV:

> "The Panel first examined the argument of the EEC that Article XXIV:7 sets out special procedures for the examination of free trade areas by the CONTRACTING PARTIES, and that the overall consistency of such free trade area with Article XXIV could therefore not be investigated by a panel established under Article XXIII. ... The Panel observed that, whatever the precise relationship between the procedures under Article XXIII and XXIV, the provisions of Article XXIV:7 empower the CONTRACTING PARTIES to make recommendations *only* on agreements establishing a customs union or free trade area, or interim agreements leading to such a union or area. These provisions thus do no apply to *any* agreement notified to the CONTRACTING PARTIES but only the four specified types of agreements. The Panel therefore concluded that, notwithstanding the issue of whether the procedures of Article XXIV:7 supersede those of Article XXIII:2, it would first have to examine whether the Lomé

[140] See also, in this respect, para. 6.133 below.

[141] India reserved the right to challenge in a future proceeding the preferences that the EC and Turkey accord each other if WTO jurisprudence were to emerge according to which panels are entitled to rule also on those matters that were to be resolved according to the provisions of the GATT and other WTO legal instruments by bodies composed of Members, such as the provisions of Articles XII:4, XVIII:12, XIX:3 XXVIII:1 and XXIV:7 of GATT.

> Convention is an agreement of the type to which the procedures of Article XXIV:7 apply. The Panel could not accept that tariff preferences inconsistent with Article I:1 would, by notification of the preferential arrangement and invocation of Article XXIV against the objections of other contracting parties, escape any examination by a panel established under Article XXIII. If this view were endorsed, a mere communication of a contracting party invoking Article XXIV could deprive all other contracting parties of their procedural rights under Article XXIII:2, and therefore also of the effective protection of their substantive rights, in particular those under Article I. The Panel concluded therefore that a panel, faced with an invocation of Article XXIV first had to examine whether or not this provision applied to the agreement in question. ... The Panel then proceeded to examine whether the Lomé Convention was one of the types of agreement mentioned in Article XXIV."[142]

6.128 In India's view, the reasoning underlying this example of judicial restraint could be transposed to the present case. The Panel need not decide whether the determinations to be made under Article XXIV:7 could be made by a panel nor whether the EC-Turkey agreement was consistent with Article XXIV. It was sufficient for the Panel to decide into which of the four categories of agreements the type of agreement notified by the European Communities and Turkey fell. India argued that the type of agreement concluded between the European Communities and Turkey (i.e. an agreement under which the same import duties and regulations were to be applied to imports from third countries only at a future date) was not governed by those provisions of Article XXIV that related to completed customs unions, but fell into the category of interim agreements leading to the formation of a customs union. Since Turkey had invoked the provisions of Article XXIV on completed customs union as a legal cover for measures taken under an agreement that provided for the establishment of such an union at a future date and to which those provisions could not apply, the Panel should reject Turkey's invocation of the provisions on completed customs unions as a potential legal basis for the restrictions at issue.

6.129 India considered that there was yet another reason why the Panel need not determine whether the EC-Turkey agreement met the requirements of Article XXIV. When the agreement was examined by the CRTA, the European Communities and Turkey did not clarify the precise nature of the agreement and made contradictory and vague statements on this issue in response to pointed questions raised by other Members. Although the European Communities and Turkey claimed that the agreement established a customs union fully consistent with the requirements of Article XXIV,[143] they also said that the harmonization of certain policies would take place at the end of transitional periods,[144] thereby admitting that the agreement was in effect an interim agreement leading to the formation of a customs union.

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[142] *EEC - Bananas I*, paras. 158-159 (emphasis in the original).
[143] See WT/REG22/M/1, para. 4.
[144] See WT/REG22/M/1, paras. 5, 8, 10, 12, 28, 29 and 30.

6.130 India further noted that Turkey had claimed in the CRTA that it might, consistently with Article XXIV, apply import policies *different* from those of the European Communities in the areas of agriculture, steel and other "sensitive" industrial products, preferential trade agreements, the GSP, anti-dumping duties, countervailing measures, and safeguards. Before the Panel, Turkey claimed that, to conform to Article XXIV, it had to apply the *same* policies as the European Communities in the field of textiles and clothing. However, these two legal claims could not be simultaneously accepted by the Panel. The first proposition was correct if the EC-Turkey agreement was an *interim agreement* leading to the formation of a customs union because, in that case, Turkey's import policies could deviate from those of the European Communities during a transitional period in certain sectors, including textiles and clothing. The second proposition was correct if that agreement was a fully fledged customs union because, in that case, Turkey would be required to adopt the same policies in all areas, including textiles and clothing. India agreed that the Panel should not determine whether the EC-Turkey agreement met the requirements set out in Article XXIV for customs unions or those for interim agreements leading to the formation of a customs union. However, India disagreed that the Panel had to accept the proposition implied in Turkey's argumentation that one agreement notified under Article XXIV could be at the same time a customs union agreement *and* an interim agreement leading to the formation of a customs union.

6.131 India noted, furthermore, that, to question 2 of the Panel, on whether in its view the agreement with Turkey was an interim agreement that should lead to a customs union by 2005 or an agreement implementing a completed customs union, the European Communities avoided a reply by incorrectly referring to the date of 2001, by mentioning Article XXIV:8(a), and by defining the requirements of this subparagraph in terms of a "final phase".[145] The reference to 2001 was incorrect because the agreement did not establish *any* final date for common policies in the fields of agriculture, "commercial defense" instruments and preferential trade policies. Moreover, the European Communities appeared to take the view that the requirements of Article XXIV:8(a) were met by entering into the "final phase with regard to the requirements of Article XXIV:8(a)" and thus imparted upon this provision the notion of transition that was contained in the concept of interim agreement. It might therefore be concluded that the European Communities in response to a clear question by the Panel refused to confirm that the EC-Turkey agreement established a customs union within the meaning of Article XXIV:8(a).

6.132 In view of the above, India concluded that the type of agreement existing between the European Communities and Turkey was not governed by the provisions of Article XXIV on customs unions.

6.133 **Turkey** submitted that it had defended the view that it was not the Panel's task to substitute itself for the CRTA and that the Panel could not rule on the legality of the measures forming the object of the complaint in the absence of agreed conclusions on the consistency of the Turkey-EC Agreements with Article XXIV. Turkey wished to clarify that, while pursuant to the institutional arrangements of the WTO the assessment of the Turkey-EC customs union was a matter for the CTRA and ul-

[145] See para. 4.3 above.

timately for the CTG, this should not prevent the Panel from verifying whether the Turkey-EC customs union might *prima facie* be regarded as a customs union within the meaning of Article XXIV:8(a).

6.134 In this connection, Turkey drew attention to the TPR Secretariat Report on Turkey, which in the Introduction to the Summary Observations highlighted, as a general point, the wide range of reforms implemented by Turkey within the framework of the customs union between Turkey and the European Communities "taking it significantly beyond its Uruguay Round commitments as well as generating improved and more secure trading opportunities for third countries",[146] noting in particular that "the [Customs Union Decision] goes well beyond the basic requirements of a customs union".[147]

6.135 Turkey disagreed with India's allegations that the customs union between Turkey and the European Communities was in fact an interim agreement and that therefore under this agreement Turkey was not required to apply the same external trade policy, including in the area of textiles and clothing, as the European Communities. Turkey also noted that, while India, in its first submission, had described the Turkey-EC customs union as such, it had later decided to downgrade the status of the customs union to that of a *mere trade agreement*.

6.136 Turkey elaborated that the customs union was a definitive agreement providing for the phasing in of harmonized policies in certain specific areas which did not affect the character of the customs union because of their limited trade impact. The 290 "sensitive" products for which a transitional period ending on 1 January 2001 had been allowed for Turkey to adjust to the CCT only accounted for 1.5-2 per cent of Turkey's total imports. Much of the gradual alignment on the CCT which started with the completion of the customs union had already been made in the 2.5 years elapsed since then and the margin of difference between the CCT and the tariff applied for those products in Turkey was being progressively reduced so that the alignment would be completed on 1 January 2001, bearing in mind that for the remaining 17,000 tariff lines covered by the customs union the alignment had already been completed on 1 January 1996. Coal and steel products would be incorporated in the Turkey-EC customs union when included in the EC customs union itself, in 2002; meanwhile , they were covered by a free-trade agreement similar to the ECSC Agreement itself. Alignment on the EC preferential trade regimes was taking place. As far as agriculture was concerned, the objective of free movement was contained in the Association Agreement and was being reached by stages. Association Council Decision 1/98, which provided for mutual trade preferences in these products and entered into force on 1 February 1998, consolidated the elimination of customs tariffs on 70 per cent of trade in these products between Turkey and the European Communities.

6.137 Turkey therefore concluded that India's arguments on the alleged incomplete nature of the Turkey-EC customs union were groundless.

6.138 **India** remarked that the quote of the TPR Secretariat Report made by Turkey was partial and therefore misleading. There was no reference to Article XXIV re-

[146] *TPR Secretariat Report on Turkey*, p. x.
[147] *TPR Secretariat Report on Turkey*, p. xi.

quirements in the Secretariat's observations. In India's view, since a customs union could be established without a harmonization of a number of domestic policies, the Secretariat had correctly observed that certain of the measures taken went beyond the requirements of a customs union.

5. Nullification or Impairment

(a) Trade Aspects

6.139 **Turkey** submitted that the Turkey-EC customs union had benefited third countries and could not be described as having raised barriers to their trade with Turkey. The CCT, adopted under the Turkey-EC customs union, had an incidence of tariff levels much lower than that of Turkey's previous tariff. The average Turkish tariff had been 18 per cent while the level of the CCT was 5.6 per cent and, with the implementation of the Uruguay Round results, this rate would fall further to 3.5 per cent.

6.140 Turkey added that, in undertaking the process of alignment of its external trade policy with that of the European Communities, it had embarked in the negotiation of free trade agreements with the countries which had concluded similar arrangements with the European Communities. Those agreements already in force had been notified to the WTO; further such agreements would be notified prior to their entry into force. Turkey was also preparing the adoption of a GSP scheme similar to that of the European Communities and of preferential arrangements applicable to ACP countries under the Lomé Convention. In accordance with Article 16 of Decision 1/95, alignment by Turkey with the EC common commercial policy would be completed in 2001.

6.141 Turkey considered that, as a result, the Turkish market had became as open as the EC market to third-country products and that those products would enjoy even larger benefits in the Turkish market following the completion of the Turkey-EC customs union. It also affirmed that, overall, the Turkey-EC customs union had resulted in the lowering of the general incidence of duties and other regulations of commerce. The requirements of Article XXIV:5(a) of GATT had therefore been met.

6.142 Turkey submitted further that, although the replacement of an essentially tariff-based system by one based on quantitative controls might appear to be more trade restrictive, the exact opposite occurred with its new import regime for textiles and clothing products, reflecting the fact that a prohibitively high tariff-based system had been replaced by a more transparent and predictable regime. Turkey noted that, in the preparatory process to the customs union, Turkey's import duties on textiles and clothing products from third countries had been reduced from 37 per cent in 1993, to 27 per cent in 1994 and 21 per cent in 1995, this benefiting those countries even before the customs union itself was completed. Moreover, in the following two years, due to the further reduction in tariffs offered by the customs union, imports of textiles and clothing products increased considerably, reaching $3.6 billion in 1997, which represented an increase of over 100 per cent compared to 1994. Turkey also noted that, following the completion of the Turkey-EC customs union, its imports

from third countries had increased faster than those from the European Communities.[148]

6.143 Turkey stressed that the above import results should be seen against the fact that Turkey was a major exporter of textiles and clothing, with a highly competitive industry. The substantial expansion of imports, particularly of those from third countries, in 1996 and 1997 was an indication of the degree of liberalization attained as a result of the completion of the Turkey-EC customs union.

6.144 In this context, Turkey considered India as an important competitor for Turkish producers in certain categories of textiles and clothing, not only in third countries' markets but also in the Turkish market itself. The imposition of QRs on imports of certain categories of textile and clothing products originating in India had not reduced the inflow of products from that country. Imports of textile and clothing products from India into Turkey had increased from $32.5 to $137 million in the period 1994-1997.[149] Despite such a massive increase, Turkey had chosen not to invoke the means available to it under the WTO, to slow down this process.

6.145 Turkey added that India benefited more in terms of market share than any other country from the opening of the Turkish textile and clothing market resulting from the completion of the Turkey-EC customs union. Its share in Turkey's total imports of these products had risen from 1.99 per cent in 1994 to 3.82 per cent in 1997.

6.146 Turkey pointed out that, for most of the 19 categories of textile and clothing imports to which QRs were applied India had never been an important and regular supplier to the Turkish market,[150] and its share in the Turkish market in those products remained below 3 per cent for the period 1994-1997.[151] Before the entry into force of the Turkey-EC customs union, its imports from India of the products under the relevant tariff headings corresponding to those 19 categories were subject to an average custom duty rate of 34.31 per cent. After the entry into force of Turkey-EC customs union, these products were subject to an average custom duty rate of 11.74 per cent (1996). This rate had been lowered further to 11.6 per cent in 1997, and would continue to be lowered further as a result of the implementation by Turkey of the concessions made by the European Communities during the Uruguay Round. Turkey pointed out that the improvement in market access was reflected in the 134 per cent increase in imports from India of products in the 19 categories between 1994 ($13.08 million) and 1997 ($30.66 million).[152]

6.147 Commenting upon trade figures, Turkey noted that in 1995, i.e. the last year before completion of the customs union, duty reductions were phased in three separate instalments and India's exports immediately began to benefit from these reductions. In Turkey's view, 1995 was therefore clearly an atypical year for trade projections.

6.148 **India** remarked that the correct figure for India's exports to Turkey of the 19 restricted product categories in 1997 was $19.87 million, not $30.66 million as re-

[148] See Table II.2 above.
[149] See Table II.5 above.
[150] The only exceptions were product categories 1, 23, and 29.
[151] See the supporting tables reproduced in the Annex to this report, Appendix 4a and Appendix 4b.
[152] See Table II.5 above.

ported by Turkey.[153] India also noted that, apart from absolute values, the important point was the trend in exports, which demonstrated that Turkey's QRs had affected India's interests. From the trade data provided (Table II.4), two irrefutable facts could be drawn in this respect: a serious and significant decline in India's exports of restricted products to Turkey had occurred after the introduction of the restrictions; and for the non-restricted categories, there was an increase in India's exports to Turkey.

6.149 In India's view, the level of exports of textiles and clothing products from India to Turkey was influenced not only by Turkey's trade regime but also by the evolution of the market, as well as by the import regimes of other countries. It would not be possible to segregate the impact of the quotas from the impact of such other factors. It would also not be possible to segregate the impact of Turkey's reduction of tariffs from the impact of the new restrictions.

(b) Arguments

6.150 **India** noted that the presumption that measures inconsistent with the GATT impaired the benefits accruing to a Member under the GATT could not be rebutted with a demonstration that the restrictions had no trade effect.[154] It was not possible to balance the adverse impact of the (discriminatory) quotas against any favourable impact of the (MFN) tariff reductions for the purpose of determining the consistency of the quotas with Articles XI and XIII of GATT and Article 2.4 of the ATC.[155]

6.151 India submitted further that the import restrictions which Turkey had imposed since 1 January 1996 in the context of its trade agreement with the European Communities on textiles and clothing products from India impaired benefits accruing to India under Articles XI and XIII of GATT and Article 2.4 of ATC.

6.152 India noted later that, though Turkey claimed (in answering a question from India) that the restrictions at issue had "no economic substance" and that India was therefore not subject to nullification or impairment, it had not elaborated this point in its defense. India considered as violating the principle of due process recognized by the Appellate Body to be inherent in the DSU if the defendant were permitted to present a defense in its first submission but leave the presentation of all the facts and arguments substantiating that defense to its rebuttal submission, thereby either depriving the complainant of the opportunity to respond to that defense in its rebuttal submission or delaying the panel procedures if such an opportunity was granted.

6.153 India therefore did not know how Turkey would later substantiate its claim. It had assumed, for the purposes of the argument, that Turkey would attempt to demon-

[153] See paras. 2.43 to 2.46 above for details on differences between trade data provided by India and Turkey.

[154] See also the arguments reported in paras. 6.159 and 6.160 below.

[155] See the rulings of the panel on *United States - Section 337 of the Tariff Act of 1930* (BISD 36S/386-387), which clearly rejected such a "balancing test" for the purposes of Article III. The reasoning of this panel applied equally to the balancing the benefits of voluntary tariff reductions against the adverse impact of quotas imposed inconsistently with Articles XI and XIII of GATT and Article 2.4 of the ATC.

strate on the basis of trade statistics that no impairment had occurred. India was of the view that such an attempt could not succeed.[156]

6.154 India noted that, in 1960, the CONTRACTING PARTIES to GATT 1947 decided that a GATT-inconsistent measure was presumed to cause nullification or impairment and that it was up to the party complained against to demonstrate that this was not the case.[157] This principle was taken over in the dispute settlement procedures adopted at the end of the Tokyo Round,[158] and was now reflected in Article 3.8 of the DSU. In this context, Turkey might claim that the "adverse impact" to which this provision referred was the trade impact caused by its failure to carry out its obligations under Articles XI and XIII of GATT and Article 2.4 of the ATC and that, therefore, a demonstration that the exports of India did not decline was sufficient to rebut the presumption. However, Article 3.8 of the DSU needed to be interpreted in the light of GATT 1947 jurisprudence reflected in this provision. According to this jurisprudence, the "adverse impact" of the violation of a provision prescribing conditions of competition could not be determined on the basis of the actual impact of the violation on trade flows.

6.155 India recalled that in the *Japan-Measures on Imports of Leather* panel proceedings, Japan argued that, since the quotas had not been fully utilized, they had not restrained trade and had consequently not caused a nullification or impairment of benefits accruing under Article XI of GATT. The panel rejected the argument on the grounds that the existence of a QR "should be presumed to cause nullification or impairment not only because of any effect it had on the volume of trade but also for other reasons, e.g., it would lead to increased transaction costs and would create uncertainties which could affect investment plans".[159] This ruling indicated that a demonstration that no adverse trade impact had as yet occurred was insufficient to rebut the presumption. The rationale of prohibiting QRs required a demonstration that there was no potential future impact.

6.156 This reasoning was carried further in the *United States-Taxes on Petroleum and Certain Imported Substances* case. The United States argued that the tax differential between domestic and imported petroleum products was not causing nullification or impairment because it was so small that it could not possibly cause trade effects. However, the panel ruled that Article III did not protect expectations on trade volumes but expectations on competitive conditions accorded to imported products, and that a measure establishing conditions of competition less favourable for im-

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[156] For a complete review of the jurisprudence on non-violation cases, see the following publications cited by the Appellate Body in its report on *India - Patent* (footnote 26): Ernst-Ulrich Petersmann, "Violation-Complaints and Non-Violation Complaints in Public International Trade Law", in *German Yearbook of International Law*, Volume 34, 1991, pp. 175 - 229; and Frieder Roessler, "The Concept of Nullification and Impairment in the Legal System of the World Trade Organization", in Ernst-Ulrich Petersmann (ed.), *International Trade Law and the GATT/WTO Dispute Settlement System*, Studies in Transnational Economic Law, Volume 11, Kluwer Law and Taxation Publishers (Deventer and Boston: 1997), pp. 123-142.

[157] See BISD 11S/99-100.

[158] See para. 5 of the Annex to the Understanding on Dispute Settlement adopted on 28 November 1979.

[159] Panel Report on *Japan - Measures on Imports of Leather*, BISD 31S/94 ("*Japan - Leather*"), para. 55.

ported products than for domestic products was therefore *ipso facto* a nullification of the benefits accruing under that provision, whether or not trade volumes were adversely affected. The panel explained its ruling as follows:

> "An acceptance of the argument that measures which have only an insignificant effect on the volume of exports do not nullify or impair benefits accruing under Article III:2, first sentence, implies that the basic rationale of this provision - the benefit it generates for the contracting parties - is to protect expectations on export volumes. That, however, is not the case. Article III:2, first sentence, obliges contracting parties to establish certain competitive conditions for imported products in relation to domestic products ... It is conceivable that a tax consistent with the national treatment principle (for instance a high but nondiscriminatory excise tax) has a more severe impact on the exports of other contracting parties than a tax that violates that principle (for instance a very low but discriminatory tax). The case before the Panel illustrates this point: the United States could bring the tax on petroleum in conformity with Article III:2, first sentence, by raising the tax on domestic products, by lowering the tax on imported products or by fixing a new common tax rate for both imported and domestic products. Each of these solutions would have different trade results, and it is therefore logically not possible to determine the difference in trade impact ... resulting from the nonobservance of this provision. For these reasons, Article III:2, first sentence, cannot be interpreted to protect expectations on export volumes; it protects expectations on the competitive relationship between imported and domestic products. A change in the competitive relationship contrary to that provision must consequently be regarded *ipso facto* as a nullification or impairment of benefits accruing under the General Agreement."[160]

6.157 In its report on *EC-Bananas III*, the Appellate Body ruled that the reasoning in the GATT panel report cited above applied also in that case,[161] which concerned, inter alia, the EC obligations under Articles XI and XIII of GATT. It thereby rejected the argument of the European Communities that the benefits accruing to the United States under these provisions had not been impaired because the United States had not exported a single banana to the European Communities, nor was it in a position to do so. The Appellate Body thereby rejected as untenable the idea that a measure might be inconsistent with a GATT provision prescribing certain conditions of competition but nevertheless not impair benefits accruing under it for lack of any trade effect. India observed that the provisions at issue in the present dispute - Articles XI and XIII of GATT and Article 2.4 of the ATC - were all provisions prescribing conditions of competition. Any attempt by Turkey to rebut the presumption of Article 3.8 of the DSU with trade statistics could not therefore but fail.

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[160] Panel Report on *United States - Taxes on Petroleum and Certain Imported Substance*, BISD 34S ("*US - Superfund*"), p. 159.

[161] Appellate Body Report on *EC - Bananas III*.

6.158 India also referred to the case involving an Italian scheme under which credit facilities were accorded to farmers in a manner discriminating against imported agricultural machinery, where the panel reacted to Italy's claim that the measure had no adverse trade effects by stating: "If the considered view of the Italian Government was that these credit facilities had not influenced the terms of competition on the Italian market, there would not seem to be a serious problem in amending ... the law so as to avoid any discrimination".[162] With this case in mind, India asked why the Turkish authorities did not eliminate the restrictions at issue in this dispute if their considered view was that they had no economic substance.

6.159 Although India considered trade statistics completely irrelevant for the resolution of the present dispute, it nevertheless highlighted a few features in the evolution of India exports to Turkey. During the year before the imposition of Turkey's restrictions, exports of the clothing items that were now restricted had grown by 57 per cent compared to the previous year. During the year immediately following the imposition of the measures, they declined by 74 per cent. In respect of textiles, the situation was even more extreme. Here, the growth rate in the year prior to the introduction of the measures was 200 per cent and the decline in the subsequent year 48 per cent.[163] Against this background, India questioned the validity of Turkey's allegation that its complaint was without economic substance.

6.160 Finally, India recalled that it was not seeking in these proceedings findings specific to particular restricted items, nor had Turkey presented any defense specific to any particular restricted items. The dispute could therefore be settled by a ruling on all restrictions imposed by Turkey on textile and clothing products imported from India as from 1 January 1996 (that is, to the knowledge of India, the items included in the 19 product categories).

6.161 **Turkey** noted that it followed from the text of Article 3.8 of the DSU that (i) a proceeding brought by a complaining party against a violation of a WTO rule was and remained based on the purpose to protect benefits against nullification or impairment; and (ii) a violation of a WTO rule was not in and by itself a nullification or impairment of benefits of a Member complaining about such violation, but constituted only a presumption of nullification or impairment.

6.162 Turkey also noted that a WTO rule could be seen as an obligation for one Member and a right for another one. The concept of nullification and impairment made clear that for a complaint to succeed there needed to be more than a breach of a complainant Member's right. That such a concept appeared in GATT 1947 and was maintained in the DSU was hardly surprising. Many domestic jurisdictions required an "interest to sue", i.e. that a complainant should show more than that his right was breached. Similarly in international law a complainant had to show a legal interest.[164]

6.163 Turkey considered that the requirement that a benefit be nullified or impaired made it clear that the alleged breach of a Member's right had to have an economic impact on the complaining Member. This had been confirmed in several panel re-

[162] Panel Report on *Italy - Discrimination Against Imported Agricultural Machinery*, BISD 7S/67.

[163] See also paras. 6.148 and 6.149 above, Table II.4 and the Annex to this report, Appendix 3a.

[164] See ICJ, *South West Africa Cases* (Second Phase), ICJ Report 1966, p. 47; ICJ, *Barcelona Traction Light and Power Co. Ltd*, ICJ Report 1970, p 32.

ports, in particular *US-Superfund*, and in the Appellate Body Report on *EC-Bananas III*.

6.164 In Turkey's view, the quantities that could be exported by India to Turkey under the restrictions of the Turkey-EC customs union exceeded on the average by 134 per cent India's exports to Turkey in 1994, the last full year before the tariff reductions provided by the Turkey-EC customs union were phased in over 3 separate instalments in 1995. Moreover, India's exports to Turkey in the years 1996-1998 of the products covered by the measures challenged remained significantly below the possibilities opened under these measures.[165] It seemed obvious to Turkey that the way in which the panel in the *US-Superfund* case and the Appellate Body in the *EC-Bananas III* case defined nullification or impairment, and the reasons for which they considered that the presumption had not been rebutted could be of no assistance to India in the present case:

(i) In the *US-Superfund* case the panel considered that Article III:2 GATT "protects expectations on the competitive relationship between imported and domestic products. A change in the competitive relationship contrary to that provision must consequently be regarded *ipso facto* as a nullification or impairment of benefits accruing under the General Agreement".[166] In that case, the competitive relationship between the imported and the domestic gasoline, whose change to the detriment of the imported gasoline was considered as a nullification or impairment of benefits accruing to the complaining GATT Contracting Parties, resulted from the imposition of a rate of tax applied to imported gasoline that was 3.5 cents/barrel higher than the rate applied to domestic gasoline which competed on the United States market. As this higher tax rate was passed through to consumers, its trade impact was obvious.

(ii) The present case did not concern Indian products subjected on the Turkish market to a discriminatory taxation rendering them more expensive on that market than similar Turkish products. The measures challenged had no impact on the competitive relationship between Indian and Turkish textiles and clothing products on the Turkish market. In fact, the competitive relationship improved in view of the substantial reduction of tariff protection resulting from the customs union.

In *EC-Bananas III*, the Appellate Body referred to a "potential export interest by the United States" that "cannot be excluded". On this point the Appellate Body report was far from clear and did not explain why this potential export interest amounted to "an expectation of a com-

[165] In 1996, for 12 out of the 19 categories the amounts licensed remained below 50 per cent of the quotas , and for 8 out of these 19 categories even below 10 per cent. In 1997 for 6 out of the 19 categories the amounts licensed remained below 50 per cent of the quotas. In 1998 for 9 out of 19 categories the amounts licensed remained below 50 per cent of the quotas.

[166] Panel Report on *US - Superfund*, para. 5.1.9.

petitive relationship" that needed to be protected against the EC measures.[167]

The present case did not relate to a situation in which India was a potential exporting country faced with measures that effectively prevented exports to Turkey. The measures challenged were manifestly not preventing India from exporting to Turkey. As already indicated, the quantities that might be imported from India into Turkey far exceeded India's exports in 1994, the last complete year before the entry into force of the Turkey-EC customs union. Moreover India's current exports to Turkey were significantly below the effectively more favorable possibilities opened by the measures challenged. As indicated earlier, the quantities India stated it would export to Turkey were quite unrealistic.

6.165 Turkey also drew attention to some particular developments of the WTO law relating to the concept of nullification and impairment that were relevant to this case. Though in 1987 the panel in the *US-Superfund* case noted that "there was no case in the history of the GATT in which a contracting party had successfully rebutted the presumption" and concluded that "the presumption had in practice operated as an irrefutable presumption",[168] later developments made it clear that Members did not share or endorse that view. On the contrary, when they agreed on the DSU, they expressly confirmed in Article 3.8 that a violation was only a *prima facie* case of nullification and impairment. They even added a qualification: "This means that there is *normally* a presumption" (emphasis added). This was all the more significant as in the WTO Agreement on Subsidies and Countervailing Measures a claim of nullification or impairment of benefits no longer needed to be made in dispute settlement procedures concerning prohibited subsidies, as appeared from Article 4.1 of the Agreement. Similarly, the concept of a violation as a rebuttable presumption of nullification or impairment was absent from the GATS, as a Member which considered "that any other Member fails to carry out its obligation or specific commitments under this Agreement may have recourse to the DSU" (GATS Article 23:1). In light of these developments, Turkey was of the view that *US-Superfund* could no longer be considered as good law and that a recommendation or a ruling of the DSB that would treat the presumption of nullification and impairment as irrefutable would add to the rights of a complaining party and diminish those of a respondent party.

6.166 Turkey concluded that its alleged violation, if any, of the relevant WTO rules, should be treated fully as a rebuttable presumption of a nullification or impairment of India's benefits and that it had demonstrated that *prima facie* the alleged violation, if any, of the relevant WTO rules had not resulted in a nullification or impairment of India's benefits.

6.167 Turkey also put forward an additional argument against a finding of nullification and impairment in the present case. By introducing the presumption that a violation of a WTO rule by a Member constituted nullification and impairment of benefits accruing to the complaining Member, Article 3.8 of the DSU made also clear that

[167] Appellate Body Report on *EC - Bananas III*, para. 252.
[168] Panel Report on *US - Superfund*, paras. 5.1.6 and 5.1.7.

there was necessarily a causal link between the violation of a WTO rule and the nullification or impairment. Assuming *arguendo* that India's exports would have been higher but for the measures challenged and from this that Turkey had not rebutted the presumption of Article 3.8 of the DSU, according to Turkey, it was highly relevant that India repeatedly rejected Turkey's offer to negotiate and preferred to do otherwise than the 24 countries that accepted to negotiate with Turkey and obtained satisfactory adjustments. This meant in effect that, even if India's benefits were nullified or impaired, the chain of causation between the measures challenged and the nullification and impairment would be broken by India's rejection of the opportunity to negotiate adjustments.

6.168 Turkey submitted that there was a general principle of law, that could be expressed in a variety of doctrines and could take a variety of forms, according to which one could not seek redress for harm that one had brought onto oneself by not taking measures that would have prevented or at least mitigated the harm caused by another party. This general principle was *inter alia* reflected in the International Law Commission's Draft Articles on State Responsibility, whose Article 6bis (paragraph 2) provided that "[i]n the determination of reparation, account shall be taken of the negligence or the wilful act or omission … of the injured State".[169]

6.169 Turkey also argued that a WTO case consisted of the violation element and the resulting nullification and impairment element; if the complainant failed in either one of the elements, a panel ought to reject the complaint without addressing the other element. According to Turkey, in the present case, it had rebutted the presumption that the alleged violation resulted in nullification or impairment of India's benefits. Therefore, India's complaint could be rejected without addressing the issue of the alleged violation of the relevant WTO rules.

6.170 To this last argument, **India** responded that the question of nullification or impairment was legally and logically subsidiary to the question of violation.[170] The Panel had first to examine whether an infringement occurred. India considered that this followed also from Article 11 of the DSU, which did not entitle panels to deny the complainant the right to a ruling on the conformity of the measures at issue on the grounds that they had no adverse effects. To the knowledge of India, there was no case in the history of the GATT and the WTO in which a panel examined the question of whether the presumption of impairment had been rebutted before the question of whether the presumption applied.

6.171 India also questioned the validity of Turkey's argument that India was partly responsible for the damage it incurred, because it had refused to accept Turkey's offer to negotiate a settlement based on an increase in the quotas. In India's view, the principle of international law cited by Turkey could not apply when a WTO Member refused to accept a partial implementation of the obligation incurred by another Member.

6.172 India also noted that discriminatory import restrictions were inconsistent with Articles XI and XIII, irrespective of whether the relevant quotas were exhausted.[171]

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[169] *Yearbook of the International Law Commission* (1993), Vol. II, Part II, Chapter IV.

[170] The presumption in Article 3.8 of the DSU only applying "in cases in which there is an infringement of the obligations assumed under a covered agreement".

[171] BISD 31S/113.

6.173 India argued that Turkey had essentially claimed that the customs union was on balance beneficial to India because any adverse effect of the quantitative restrictions adopted in the framework of the EC-Turkey trade agreement was offset by the effect of the tariff reductions. India, according to Turkey, was therefore incorrect when it argued that the evidence demonstrated "that the customs union has impaired benefits to which it claims entitlement."

6.174 India remarked that at issue in this complaint was *not* whether the EC-Turkey trade agreement was consistent with Article XXIV and consequently also not whether benefits accruing to India were impaired as a result of the customs union that the European Communities and Turkey alleged to have formed under that agreement. At issue were the restrictions which Turkey had imposed since 1 January 1996 on imports of textiles and clothing products from India and consequently whether *these restrictions* impaired benefits accruing to India under the GATT and the ATC. The overall impact of the customs union on India's exports was therefore irrelevant to the measure at issue.

6.175 India added that implied in Turkey's argumentation was the assertion that discriminatory import restrictions inconsistent with Articles XI and XIII of GATT and Article 2.4 of the ATC did not impair benefits accruing under these provisions if the Member imposing the restrictions voluntarily reduced its import tariffs and thereby accorded offsetting trade benefits to other Members. However, in India's view, ordinary customs tariffs applied on an MFN basis have an impact on the conditions of competition that was completely different from that of prohibited discriminatory QRs. Tariff reductions tended to improve India's opportunities to engage in price competition but Articles XI and XIII of GATT and Article 2.4 of the ATC guaranteed India the right to engage in price competition without being hampered by discriminatory quantitative limitations. It was this benefit accruing to India which was being impaired by the measures at issue. India pointed out that, in its Third Party Submission, the United States had noted that Turkey said that the reduction in average tariffs resulting from the customs union agreement meant that the agreement "cannot be described as having raised barriers" to trade with Turkey. In the first place, the evaluation under Article XXIV of the level of trade barriers went beyond an evaluation of tariffs. Moreover, implicit in Turkey's argument was the assertion that India should accept the discriminatory QRs unilaterally imposed by Turkey because of the tariff reductions Turkey voluntarily granted to all WTO Members under the agreement, since the net effect of the two measures taken together was an increase in India's exports. This argument was fundamentally flawed for two reasons.

6.176 Firstly, as made clear by the reasoning of the *US-Superfund* panel[172], endorsed by the Appellate Body in the EC-*Bananas III* case,[173] the benefit accruing to India under Articles XI and XIII of GATT and Article 2.4 of the ATC was not the protection of its expectations on the volume of textiles and clothing products to Turkey. These provisions protected India's expectations regarding the competitive conditions for its exports of textiles and clothing products to Turkey. The competitive conditions prescribed by the provisions of the GATT governing multilateral tariff

[172] Panel Report on *US - Superfund*, p.158.
[173] Appellate Body Report on *EC - Bananas III*, paras. 249-253.

reductions were completely different from those prescribed by the provisions governing QRs. The former were designed to ensure that all Members could equally engage in price competition, the latter were intended to ensure that price competition was not subject to quantitative limits, to the extent that such limits were permitted, that they did not differ between Members. Turkey's calculations demonstrating that "a net profit" resulted from the grant of tariff reductions and the imposition of discriminatory quotas were irrelevant.

6.177 Secondly, implicit in Turkey's claim was the assertion that India had the obligation to accept the denial of benefits to which it was entitled under the rules governing discriminatory restrictions because of the reductions of duties consequent upon the formation of a customs union. There was no WTO provision nor any principle of law that supported this proposition. Paragraph 6 of the Understanding on Article XXIV confirmed that the advantages accruing to third Members as a result of the formation of a customs union did not entail any obligations on their part. If this was the principle that governed Article XXIV:6 negotiations, a different principle could not govern the assessment of the adverse impact of an illegal measure in the context of Article 3.8 of the DSU.

6.178 India also noted that Turkey had recognized that past panels and the Appellate Body in the *EC-Bananas III* case had consistently ruled that the provisions of the GATT on non-tariff measures protected expectations on conditions of competition and not on trade volumes and that, consequently, the presumption that a measure inconsistent with such a provision impaired benefits accruing under the GATT could not be rebutted with a demonstration that the complainant's exports did not decline.

6.179 In response to Turkey's claim that these precedents were no longer "good law" because they had been superseded by legal developments that dictated another approach and that rejection of these precedents was implicit in the inclusion of Article 3.8 into the DSU, India noted that the wording of Article 3.8 of the DSU was in substance identical to the wording of the third and fifth sentences in paragraph 5 of the Annex to the 1979 Dispute Settlement Understanding. If the drafters of Article 3.8 of the DSU had meant to negate the continued validity of the principles on nullification and impairment developed under GATT jurisprudence, they would surely not have adopted language identical to the terms of the provision under which that jurisprudence was developed.

6.180 India noted that the Appellate Body had confirmed in the *EC - Bananas III* case the continued validity of the jurisprudence developed under the GATT 1947, in particular the principles developed in the *US - Superfund* case.[174] In response to Turkey's allegation that the present case was distinct from the *EC - Bananas III* case, India pointed out that India was actually an exporting country faced with measures by Turkey that effectively prevented exports to Turkey.

6.181 India also stated that Turkey had apparently further misunderstood India's argument. India had not questioned the existence of Article 3.8 of the DSU. The 1979 Decision also had the same provision. There were two aspects: Firstly, India disagreed with Turkey when Turkey argued that the Panel had to first discuss whether nullification and impairment had occurred and that the question of violation

[174] Appellate Body Report on EC - Bananas III, paras. 249-253.

could be taken up later. In India's view, the first issue was whether a violation had occurred. In this context, India noted that implicit in the remarks by Turkey was an admission that there was a case of violation. India certainly had demonstrated it. Secondly, India had pointed out on the basis of the available jurisprudence, that the provisions of the GATT on non-tariff measures protected expectations on conditions of competition and not on trade volumes and that, consequently, the presumption that a measure inconsistent with such a provision impaired benefits accruing under the GATT could not be rebutted with a demonstration that the complainant's exports did not decline. Trade volumes were not relevant. Even assuming that trade volumes were relevant, India had already supplied data to the Panel which clearly demonstrated that the discriminatory QRs imposed by Turkey had adversely affected India's textile and clothing exports to Turkey.

VII. SUMMARY OF ARGUMENTS PRESENTED BY THIRD PARTIES

A. Hong Kong, China

1. General

7.1 Hong Kong, China submitted that Turkey had unilaterally imposed discriminatory QRs on imports of textiles and clothing from Hong Kong, China and some other WTO Members as from 1 January 1996. Turkey's measures covered a broad range of textile and clothing products from selected Members including Hong Kong, China. According to Turkey, these measures were taken in order "to achieve the Customs Union between the EC and Turkey" and "to fulfill the requirements of Article XXIV".[175]

7.2 Hong Kong, China did not question the right of Members to form a customs union in accordance with WTO rules and had no intention to focus on whether Turkey had fulfilled the requirements of Article XXIV of GATT. Its concern was that Turkey's measures constituted an infringement of the WTO Agreement. Specifically, Hong Kong, China submitted that the measures were inconsistent with Article 2.4 of the ATC and hence with Article XI *ipso facto* and Article XIII of GATT. The GATT did not provide *carte blanche* for a customs union to introduce discriminatory QRs.

7.3 Hong Kong, China considered that, in line with the views of the Appellate Body in *US - Shirts and Blouses*,[176] a party claiming a violation of a provision of the WTO Agreement by another Member needed to assert and prove its claim. Having done so, it was up to the defending party to bring forward evidence and arguments to disprove the claim. Furthermore, the burden of establishing a defense including that derived from exceptions from obligations under certain provisions of GATT should rest with the defending party. Turkey claimed that the measures were required as part of a process of alignment of its external trade policy with that of the European Communities so as to ensure the free circulation of products, including textile and clothing products, covered by the Turkey-EC customs union, relying on Article XXIV to justify the measures. The burden of proof rested therefore with Turkey to substantiate

[175] WT/REG22/6.
[176] Appellate Body Report on *US - Shirts and Blouses*, p. 16, DSR 1997:I, 323.

its claim that a customs union formed under Article XXIV did provide a derogation from other GATT provisions.

2. Article 2 of the ATC and Articles XI and XIII of GATT

7.4 Hong Kong, China submitted that Turkey's measures were in violation of Article 2.4 of the ATC. Hong Kong, China viewed Article 2 of the ATC and Article XI of GATT as both dealing with QRs, the former specifically about QRs in the textiles and clothing sector, and the latter about QRs in the goods field. Since the former was *lex specialis* to the latter, any time Article 2.4 of the ATC was violated, Article XI of GATT was violated *ipso facto* (but not vice versa).

7.5 The objective of the ATC was to reintegrate trade in the textiles and clothing sector into the full disciplines of the GATT over a period of ten years starting from 1995. Article 2.4 of the ATC provided that the restrictions which were notified by a Member under Article 2.1 when the WTO came into force constituted "the totality of such restrictions" and that no new restrictions in terms of products or Members were to "be introduced except under the provisions of this Agreement or relevant GATT provisions".

7.6 As at or before 31 December 1994, Turkey maintained no QRs on imports of textile and clothing products from Hong Kong, China. It only started to do so on 1 January 1996. Obviously, Turkey's measures were *new* restrictions which had never been notified as having been in force on the day before entry into force of the ATC. Nor had Turkey justified them under other provisions of the ATC. Turkey had therefore violated Article 2.4 of the ATC unless it could justify the measures under other provisions of GATT.

7.7 The burden of proof was with Turkey to identify "the relevant GATT 1994 provisions" and to clearly demonstrate the relevance of such provisions in the context of the ATC in general, and to the extent that such provisions should provide an exception to Article 2.4 of the ATC in particular. However, Turkey had not provided any legal arguments that could substantiate its claim in this respect. Hong Kong, China therefore submitted that Turkey had failed to discharge the burden of proof. Moreover, in its view, Article XXIV:5 of GATT did not provide any exemption for Turkey's measures.

7.8 Hong Kong, China submitted further that Turkey's measures were inconsistent with Article XIII of GATT. Non-discrimination was a fundamental principle of the WTO. Since the measures applied only to selected Members and textile and clothing products from many other Members were not subject to the same measures, Turkey was obviously in breach of the principles of non-discrimination under Article XIII of GATT.

3. Article XXIV of GATT

7.9 In the view of Hong Kong, China, Article XXIV only set out the obligations to be fulfilled when customs territories of the constituent parties formed a customs union. It did not enable or provide justifications for any Member to establish or extend discriminatory QRs against selected third parties. Article 31 of the VCLT required that "a treaty shall be interpreted … in the light of its object and purpose". The specific object and purpose of GATT was set out in its preamble as "entering into reciprocal and mutually advantageous arrangements directed to the substantial re-

duction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international commerce".

7.10 If the imposition of discriminatory QRs using Article XXIV as a waiver was permitted, it would render meaningless the purpose of a customs union, as reaffirmed in the preamble of the Understanding on Article XXIV, that economic integration agreements "should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other Members with such territories; and that in their formation or enlargement the parties to them should to the greatest possible extent avoid creating adverse effects on the trade of other Members". It would be difficult to think of a more adverse effect than the imposition of discriminatory QRs against selected third parties.

7.11 Hong Kong, China did not agree with Turkey's view that the intention of the authors of Article XXIV:5 had been to permit the introduction of new restrictive regulations of commerce which might be made necessary by the formation of a customs union, as long as their effect on the whole was not more restrictive than that of the previously applicable regime. Hong Kong, China did not consider that Article XXIV:5 went so far as to provide a waiver from other provisions of the GATT.[177] It also questioned whether an overall reduction of barriers could legally justify GATT-inconsistent measures.

7.12 Were Article XXIV:5 to be interpreted as providing *carte blanche* for customs unions to impose discriminatory QRs against selected third parties, subject only to the proviso that the balance of all third parties' trade interests taken as a whole be respected, the outcome could be highly discriminatory, contrary to the interests of natural justice, and not consistent with the object and purpose of GATT as stated above. Such an interpretation would thus not be in accordance with the VCLT. Hong Kong, China considered, therefore, that the opposite was the case, i.e. that Article XXIV:5 did not sanction the imposition of discriminatory QRs.

7.13 In the view of Hong Kong, China, Article XXIV:8 was a definition clause. In itself it created neither rights nor obligations. Article XXIV:8(a)(i), on the internal trade regime of a customs union, entailed the elimination of duties and other restrictive regulations of commerce with respect to (i) substantially all the trade between the constituent territories, or (ii) substantially all the trade in products originating in such territories. Article XXIV:8(a)(ii), on the external trade regime of a customs union, entailed the application by members of a customs union of substantially the same duties and other regulations of commerce to the trade of third parties.

7.14 While the meaning of the two key terms "substantially all the trade" in Article XXIV:8(a)(i) and "substantially the same" in Article XXIV:8(a)(ii) might not be completely clear and precise, they all undoubtedly pointed to the unambiguous effect that the required free circulation of goods within a customs union and the alignment of the external trade regimes of constituent territories *need not be absolute*.

7.15 As regards the internal trade regime of a customs union, it was quite clear from Article XXIV:8(a)(i) that a customs union could be based on (i) the principle of free circulation of goods or (ii) a set of origin rules, provided its benefits applied to

[177] This was the view of the European Communities stated in the Working Party on the Accession of Portugal and Spain to the EC (see BISD 35S/318, para. 45).

substantially all the trade in products originating in the constituent territories. In other words, some deviations from the free circulation of goods within a customs union were not ruled out totally.

7.16 Likewise, some differentials between the external trade regimes of constituent territories were clearly provided for in sub-paragraph (a)(ii) as borne out by the use of the word "substantially". Hong Kong, China considered that the purpose of such flexibility was to address, among others, situations where it was not justified, by virtue of other provisions of Article XXIV, for a constituent territory to impose new discriminatory QRs against selected third parties for the purpose of alignment. In the view of Hong Kong, China, Article XXIV of GATT did not necessarily require a constituent territory to align every aspect of its external trade regime with that of the other constituent territory, especially if the regime of the latter was more restrictive and discriminatory.

4. Alternative Solutions and Conclusions

7.17 As far as Hong Kong, China understood, a border still existed between the European Communities and Turkey. There were existing arrangements which satisfied the procedural/ documentary requirements for goods entering the EC Member States *via* Turkey. Against this background, derogation from the free circulation of goods was possible and was, in fact, foreseen by Decision No.1/95 of the EC-Turkey Association Council implementing the final phase of the Turkey-EC customs union, e.g.:

(i) Equivalent but independent anti-dumping legislation was maintained *vis-à-vis* third countries. The customs authorities of each party ensured that their own anti-dumping measures were not circumvented by checking the origin of the products imported into their territory from the other party.

(ii) The EC customs authorities checked, at the border between the European Communities and Turkey, the origin of vehicles imported into the European Communities *via* Turkey. EC imports of Japanese vehicles *via* Turkey were treated as direct EC imports for the purpose of the ceilings laid down in the 1991 EC-Japan Agreement relating to trade in motor vehicles, mentioned in the Annex to the WTO Agreement on Safeguards.

7.18 Since derogation from free circulation of goods was to a certain extent permitted within a customs union, Hong Kong, China doubted whether Turkey's measures were a necessary precondition for the implementation of the Turkey-EC customs union. Hong Kong, China's view was that a temporary certificate of origin system on textile and clothing products not originating in Turkey, until quotas were phased out altogether by the end of 2004, was a viable alternative to QRs. This meant a different import regime for regulating the circulation from Turkey to the European Communities of products not originating in Turkey. However, it could hardly be construed as excluding a major sector of trade from the customs union, nor would it require the suspension of the free circulation of textile and clothing products originating in Turkey, which need not be affected.

7.19 Hong Kong, China concluded from its analysis that Turkey's measures were inconsistent with Article 2.4 of the ATC (Article XI of GATT was violated *ipso*

facto) and Article XIII of GATT, and that they were not justified by Article XXIV of GATT. Hong Kong, China requested the Panel to pronounce on the inconsistency of Turkey's measures with Article 2.4 of the ATC and Articles XI and XIII of GATT, and to recommend that Turkey brings its measures into conformity with its obligations under the WTO.

B Japan

1. General

7.20 Japan submitted that, being a country which was not a party to any RTA and was greatly benefiting from the multilateral trading system, it had a great interest in ensuring that RTAs were consistent with the WTO Agreement and that such agreements did not lead to forming trade blocs. Japan's trade interests would be severely affected, if any measure similar to Turkey's import quota on textiles and clothing should be introduced as a consequence of the establishment of similar customs unions. As this panel is to address the systemic issue of consistency of the automatic application of restrictive measures at the institution of a customs union with WTO principles, Japan has a substantial interest in this case.

7.21 Japan considered that RTAs derogated inherently from the MFN principle and could bring discriminatory treatment to third countries. RTAs, therefore, might run the risk of weakening the open multilateral trading system. In this context, in accordance with Article XXIV of GATT, it was necessary to avoid their negative effects upon the trade of third countries, a point Members reaffirmed in the preamble of the Understanding on Article XXIV.[178] In the Singapore Ministerial Declaration, Ministers also reaffirmed the primacy of the multilateral trading system and renewed their commitment to ensure RTAs' complementarity with it and consistency with its rules.

7.22 In Japan's view, RTAs were governed by Article XXIV of GATT, but the parties to RTAs, as WTO Members, should also abide by the MFN principle and other provisions of the WTO Agreement. Close scrutiny of RTAs was called for and the provisions of Article XXIV of GATT were to be interpreted strictly in the light of the purposes of the multilateral trading system, to ensure and strengthen it. Article XXIV had to be interpreted in good faith, in the context of and in the light of the object and purpose of the WTO Agreement as a whole,[179] and with due consideration given to its overall spirit and basic principles.

2. Arguments

7.23 Japan submitted that the introduction of new QRs by Turkey was inconsistent with Turkey's obligation under Article XI of GATT and Article 2.4 of the ATC, unless Turkey demonstrated that it fulfilled the conditions for invoking Article XXIV of GATT. In the *US - Underwear* case, the need for strict interpretation of the provi-

[178] Members reaffirmed "that the purpose of such agreements should be to facilitate trade ... and not to raise barriers ... and that ... the parties to them should to the greatest possible extent avoid creating adverse effects on the trade of other Members".

[179] Panel Report on *United States - Import Prohibition of Certain Shrimp and Shrimp Products*, adopted on 6 November 1998, WT/DS58/R ("*US - Shrimp*"), para. 7.35.

sions for exception clauses was demonstrated by the panel concluding that the parties invoking the exception bore the burden of proof that the conditions for invoking the exception had been fulfilled.[180]

7.24 Japan believed that the claims by Turkey that Article XXIV:5 or XXIV:8 of GATT were applicable to the current case and that it was entitled to the exception to the general rule stipulated in Article XI of GATT and Article 2.4 of the ATC, could not be justified.

7.25 In Japan's view, the requirement contained in Article XXIV:8(a)(ii) of GATT, that a member of a customs union apply "substantially" the same duties and other regulations of commerce *vis-à-vis* third parties, did not mean that "exactly" the same regulations of commerce were necessarily to be applied.[181] The issue then lied in whether there were any specific types of regulations of commerce whose very nature did not merit uniform application by the members of the customs union. What needed examination was whether a measure had minimized the adverse effect on third countries, and in light of the relevant WTO provisions and their intent.

7.26 Japan submitted that consideration of both Article XXIV:8 and other relevant WTO provisions led to the conclusion that Article XXIV:8(a)(ii) should not be interpreted so as to give the parties the right to introduce new restrictive measures, including QRs and anti-dumping and safeguard measures which had not been allowed prior to their signing the RTA. Article XXIV:8(a)(ii) did not call for the parties to take any measures inconsistent with other provisions of the WTO Agreement in order to apply "substantially the same duties and other regulations of commerce" and could thus not be invoked as a "relevant GATT 1994 provision" under which "new restrictions" could be exceptionally introduced, as provided in Article 2.4 of the ATC. Japan therefore believed that the introduction of new QRs by Turkey, which was inconsistent with Turkey's obligation under Article XI of GATT and Article 2.4 of the ATC, could not be justified by Article XXIV:8(a)(ii) of GATT.

7.27 Japan noted further that it was important to interpret provisions in Article XXIV:5 of GATT in the light of the purpose of a customs union or of a free-trade area, as contained in Article XXIV:4. Japan also recalled the provisions in paragraph 2 of the Understanding on Article XXIV with respect to the overall assessment of weighted average tariff rates and of customs duties collected and the recognition contained therein that "for the purpose of the overall assessment of the incidence of other regulations of commerce for which quantification and aggregation are difficult, the examination of individual measures, regulations, products covered and trade flows affected" might be required. In this regard, it noted the difficulty to numerically assess the effect of QRs, let alone make judgments as to whether QRs in conjunction with the duties and other regulations of commerce imposed at the same time was "on the whole higher or more restrictive than the general incidence of the duties and regulations of commerce …", as required in Article XXIV:5(a).

7.28 In Japan's view, the individual regulations of Turkey needed to be examined in order to verify that they did not constitute more restrictive measures *vis-à-vis* third

[180] Panel Report on *US - Underwear*, para. 7.16.

[181] For example, it would not be necessary or adequate that an anti-dumping measure of a member of the customs union be introduced automatically in the other members simply because they formed a customs union.

countries. In this context, the introduction of GATT-inconsistent measures (in this case, those inconsistent with Article XI of GATT and Article 2.4 of the ATC) should be first presumed as "more restrictive" in the sense of Article XXIV:5 of GATT.

C. The Philippines

1. General

7.29 The Philippines noted that the preamble of the Understanding on Article XXIV recognized that customs unions and free-trade areas had "greatly increased in number and importance since the establishment of GATT 1947" and covered "a significant proportion of world trade". The formation of such RTAs could contribute to the attainment of the objectives of the WTO Agreement. However, if interpreted and invoked erroneously, or abused, WTO provisions authorizing the formation of customs unions and free-trade areas could likewise easily lead to the entrenchment of practices which were in subversion of those objectives.

7.30 Panels in disputes involving Article XXIV of GATT 1947 and of GATT 1994, for various reasons, did not rule squarely on issues similar to those raised in this dispute. Contracting Parties to GATT 1947 and WTO Members had expressed various views on some of such issues in the relevant bodies, but those views remained as such. The Philippines considered that, short of an authoritative interpretation by the Members themselves, this was a timely opportunity for a rules-based analysis of the relevant provisions of Article XXIV of GATT.[182]

7.31 The Philippines had opted to participate as a third party primarily on the basis of its legitimate trade interest in exports of textile and clothing products to Turkey. In addition, the Philippines realized that the broader systemic implications of the issues raised were indeed far-reaching and delved into core principles which were the very foundation of the WTO itself.

2. Articles XI and XIII of GATT and Article 2 of the ATC

7.32 The Philippines submitted that the promulgation and imposition of the QRs established by Turkey as of 1 January 1996 on imports into its territory of a broad range of textile and clothing products, applicable only on imports of some Members, including India and the Philippines, were *prima facie* violations of Articles XI:1 and XIII:1 of GATT since:

(i) the restrictions were in the nature of proscribed "prohibitions and restrictions" in the sense of Article XI:1 of GATT;

(ii) Turkey did not cite the existence of any of the situations specified in Article XI:2 of GATT under which the prohibitions and restrictions otherwise proscribed under Article XI:1 may be imposed; neither did it attempt to establish that it had complied with any of the conditions specified thereunder; and

[182] At present, in essence, WTO Members were still going through the process of acclimatising themselves from a *pragmatic, diplomacy-based* multilateral trading system to one avowedly *rules-based*. However, today, in the context of a rules-based system, pragmatism and diplomacy could have a proper role after, and only after, subsisting rules had been clarified.

(iii) Turkey did not attempt to establish that the restrictions were applicable to imports of textile and clothing products from all Members, in accordance with provisions in Article XIII:1 of GATT; on the contrary, as part of its affirmative defense, it confirmed that the restrictions were not applied against the importation of like products from, at the very least, the EC Member States.

7.33 The Philippines also considered that, since Turkey had no restrictions in force as of 1 January 1995 and thus did not so notify under Article 2.1 of the ATC, Turkey's quantitative limitations on imports of textile and clothing products were proscribed "new restrictions", for purposes of Article 2.4 of the ATC. In the context of Article 2.4 of the ATC, Turkey did not attempt to establish that its restrictions were imposed under ATC provisions within the exceptions provided for, but invoked Article XXIV of GATT as a "relevant GATT 1994 provision" justifying its restrictions.

7.34 The Philippines submitted that Article XXIV was not a "relevant GATT 1994 provision" for purposes of Article 2.4 of the ATC. "Relevant" qualified "GATT 1994 provisions". Based on the succeeding discussion, Article XXIV was not a "relevant" GATT provision. Article XXIV neither permitted Turkey to promulgate the measure nor to impose the restrictions. The "relevant" GATT provision was, and remained to be, Article XI, under which Turkey did not attempt to justify the restrictions.

7.35 Therefore, the promulgation of the measures and the imposition of the restrictions were *conclusively* in violation of Article 2.4 of the ATC. The Philippines noted that Turkey's defense was in the nature of an *affirmative defense*: Turkey admitted the violation of Articles XI and XIII of GATT and of Article 2.4 of the ATC, but attempted to exonerate itself on the basis of Article XXIV.

3. Article XXIV of GATT

(a) Customs Unions in Context

7.36 The Philippines viewed a customs union as a paradox in the context of the WTO Agreement. When parties eliminated duties and other restrictive regulations of commerce on trade between their respective territories, "substantial reduction of tariffs and other barriers to trade" was achieved. However, this subverted the underlying contractual intent of "elimination of discriminatory treatment in international trade relations".[183] Non-discrimination was a core principle of the WTO Agreement, implemented in GATT through the twin rules of MFN and national treatment. Nevertheless, Article XXIV allowed the formation of customs unions and, as an exception to MFN, tolerated the resultant discrimination, but subject to compliance with certain conditions. Article XXIV could therefore only be construed strictly and narrowly, and all doubt resolved against the perpetuation of discrimination. A Member invoking Article XXIV had the burden of establishing strict compliance with the terms and conditions stated thereunder.

7.37 The Philippines noted that, in the examination of an arrangement purporting to be a customs union, it was pivotal to establish the specific date when it qualified, if at all, as a customs union. An agreement might have some of the features of a

[183] See third paragraph of the preamble of the WTO Agreement.

customs union as of any given date, but unless it fully qualified as such, the parties could not implement the (permitted) discriminatory aspects of the customs union without according the same treatment to third parties. The most that such an arrangement could be, if at all, was an agreement necessary for the formation of a customs union (a "leading-to agreement"). Without delving into whether or not a similar requirement was imposed on a full-fledged customs union, a leading-to agreement could not be implemented without the approval of third parties and without according them the opportunity to examine the arrangement and to make recommendations to the parties.

7.38 The Philippines recalled the provisions in Article XXIV:5 and XXIV:7 of GATT relating to the distinct requirements with respect to leading-to agreements. Referring to Article XXIV:10, the Philippines noted that the phrase "proposals which do not fully comply with the requirements of paragraphs 5 to 9" applied by definition to leading-to agreements, thereby expressly made subject to the approval of two-thirds of the Members; in the process of such approval, Members were to find that "such proposals lead to the formation of a customs union" in the sense of Article XXIV.

7.39 The Philippines argued that the letter and context of those provisions prohibited parties from implementing a leading-to agreement unless they had (i) notified the third parties; (ii) consulted them in a manner consistent with their substantive right to make recommendations and (iii) modified the leading-to agreement in accordance with such recommendations.[184] Aside from the letter and context of the relevant provisions, the broader context likewise supported the conclusion that parties could not implement a leading-to agreement without giving due regard to the right of third parties to be consulted. The Philippines noted that in a leading-to agreement, the union was not complete, there was no single customs territory, and the trade-off situation for permitting the resultant otherwise prohibited discrimination was not in place. To allow parties to implement discriminatory measures under such circumstances subverted the WTO Agreement. All doubts had to be resolved against the perpetuation of discrimination. Policy reasons would also support such a rule. Otherwise, while the core principle of non-discrimination was allegedly being pursued, a back-door for its subversion would be left wide open. The system, in effect, would be working against itself.

7.40 The Philippines therefore considered that in the present dispute it was vital to determine the exact status of the arrangement between Turkey and the European Communities as of 1 January 1996, when Turkey's measures took effect.[185] For pur-

[184] The word "maintain" in relation to the phrase "as the case may be" in the last sentence of Article XXIV:7(a) should be taken in the context of Article XXIV:7(c). Thus, once a leading-to agreement had passed scrutiny of third parties, the parties might not introduce a substantial change in the plan or schedule without again respecting the right of the former to be consulted.

[185] On 22 December 1995, barely a few days prior to its entry into force, Turkey and the EC informed the Members that "the final phase of the Customs Union between Turkey and the EC will enter into force on 1 January 1996, following the decision of the EC-Turkey Association Council of 22 December 1995" (document WT/REG22/N/1). Thus, it took the parties more than nine months to notify other Members, on a date within the holiday season. The text of the Decision was circulated to the Members on 13 February 1996 (document WT/REG22/1), more than one month after its entry

poses of determining such status, what might have transpired thereafter was not relevant.

(b) Article XXIV:4

7.41 The Philippines noted that Members had established a standard, separate and distinct from the standard imposed under Article XXIV:5, for the implementation of the phrase "not to raise barriers to the trade of other contracting parties" in Article XXIV:4, since the preamble of the Understanding on Article XXIV provided, among others, that in the formation or enlargement of RTAs "the parties to them should to the greatest possible extent avoid creating adverse effects on the trade of other Members".

7.42 The Philippines considered that, as a general rule, parties were free to establish the conditions under which harmonization under Article XXIV:8(a)(ii) was to be achieved. In this instance, Turkey and the European Communities opted to impose the same restrictions subsisting in the European Communities to achieve harmonization, at least in respect of textile and clothing products. In the process of harmonization, Turkey and the European Communities had opted for the most restrictive and discriminatory option when other less restrictive and discriminatory options were equally available. Among other ways to achieve harmonization, the Philippines noted (i) the possibility of the European Communities maintaining or imposing QRs against Turkey, as expressly allowed by Article XXIV:8, without adversely affecting the status of the Turkey-EC relationship as that of a customs union; or (ii) the harmonization of EC policies to those of Turkey, by abolishing its global QRs altogether. Turkey was therefore in violation of Article XXIV:4 of GATT, in relation to the Understanding on Article XXIV.

(c) Article XXIV:5

7.43 The Philippines noted that the word "[a]ccordingly" at the start of Article XXIV:5 related and linked such paragraph to Article XXIV:4. As to the phrase "the provisions of this Agreement shall not prevent" in Article XXIV:5, it could not be interpreted to mean that Members becoming parties to a customs union were absolved from all of their obligations under the WTO Agreement and that the only provision thereunder which governed their conduct as Members was Article XXIV. If interpreted in the proper context, "the provisions of this Agreement" would exclusively refer to those provisions in GATT which otherwise would have prohibited the formation of a customs union. Derogation therefrom was a matter of necessity, but did not imply that derogation might also exist in respect of other provisions, based solely on the convenience of the parties.

7.44 The Philippines also noted that in the standard imposed under Article XXIV:5(a), which seemed less stringent than that under Article XXIV:5(b), the key phrases were "general incidence", "not on the whole higher or more restrictive" and "applicable in the constituent territories".

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into force. Turkey and the EC thus presented other Members with a *fait accompli*, a fact that might not be coincidental in light of the requirement of prior approval of a leading-to agreement.

7.45 In the Philippines view, paragraph 2 of the Understanding on Article XXIV was determinative of the issue underlying Turkey's arguments in support of its alleged compliance with Article XXIV:5 (i.e. that the effects of the QRs imposed were balanced by and more than compensated for by its lower tariffs now applicable to imports as a result of the formation of the customs union), by its separate treatment of (i) duties and other charges, and (ii) other regulations of commerce for which quantification and aggregation were difficult.[186] This view was further supported by the context of other relevant provisions:

(i) According to paragraph 6 of the Understanding on Article XXIV, Turkey had no right to demand or to expect compensatory adjustment from other Members as a result of the "reduction of duties consequent upon the formation of a customs union". There was thus no basis whatsoever for Turkey to demand or to impose compensatory adjustment on other Members by way of the sufferance of the restrictions imposed.

(ii) As provided in Article XXIV:6, compensatory adjustment applied only to increases in rates of duties, and was likewise in the form of the reduction of duties. There was no basis for a compensatory adjustment for QRs and other regulations of commerce for which quantification or aggregation was difficult.

7.46 The Philippines considered that at issue in the present dispute was whether or not the general incidence of the "other regulations of commerce" was "more restrictive", in the sense of Article XXIV:5(a). Properly assessed as an individual measure pursuant to paragraph 2 of the Understanding on Article XXIV, the option chosen by Turkey and the European Communities was the most restrictive and discriminatory of the options available, since it had resulted in the extension to Turkey of the territorial application of QRs previously imposed solely in the territory of the European Communities. The reduction in the general incidence of some or even all duties which might result from the Turkey-EC customs union was irrelevant for purposes of the dispute.

[186] Paragraph 2 of the Understanding on Article XXIV distinguished the assessment of the general incidence of the duties from that of the general incidence of other regulations of commerce. In its first sentence, the first part ("The evaluation....customs union") pertained to the evaluation of the "general incidence of the duties *and* other regulations of commerce" (emphasis added), with reference to the corresponding condition in Article XXIV:5(a); the second part ("shall in respect of duties and charges"), in relation to its first part, qualified the phrase thereafter as relating exclusively to the evaluation of "duties and charges"; the last part, in relation to the first two parts, prescribed the basis for the evaluation of the general incidence of duties. The second, third and fourth sentences ("This assessment ... applied rates of duty") specified detailed rules for the "overall assessment" sought. The last sentence ("It is recognized that for ... may be required") referred solely to "other regulations of commerce for which quantification and aggregation are difficult" as a category distinct from objectively quantifiable "duties and charges", and provided that in respect of such regulations, the "examination of individual measures ... may be required". Ordinarily, the word "may" denoted being permissive, but when qualified by a situation or condition (in this instance, "regulations of commerce ...") and that situation or condition obtained, it could acquire a mandatory tenor; in this instance, particularly more so in light of the other provisions of paragraph 2 of the Understanding on Article XXIV.

7.47 The Philippines, noting that the import statistics presented by Turkey in an attempt to establish that its present regime was less restrictive were irrelevant, argued that nullification or impairment sufficed.[187]

7.48 The Philippines also submitted that, for purposes of determining the adverse (more restrictive) effects of Turkey's restrictions, the relevant market was that of Turkey *and* the European Communities. Turkey's restrictions were imposed purportedly as a necessary element in the formation of a customs union with the European Communities. As a result of the alleged customs union, Turkey's competitive advantage as a major exporter of textile and clothing products[188] had been unduly enhanced *vis-à-vis* other Members: while Turkey's textile and clothing products entered the European Communities duty-free and without the burden of QRs, other Members, including India and the Philippines, now had to compete with Turkey in the EC market bearing the dual burden of both duties and QRs. While the relatively lower EC tariffs for such products (independently of the customs union with Turkey) might have improved the ability of other Members to compete with EC domestic producers, the alleged customs union placed them at a disadvantage *vis-à-vis* Turkey. In the Philippines' view, such potential benefits had therefore been nullified or impaired and EC commitments in its Schedules under Article II were rendered academic *vis-à-vis* other Members, at least in respect of textile and clothing products and in light of Turkey's discriminatory advantage.

7.49 The Philippines concluded that the promulgation of the Turkish measure and imposition of the restrictions were in violation of Article XXIV:5(a) because, as a result thereof, the general incidence of regulations of commerce were on the whole more restrictive.

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[187] "In general international law, material damage is neither a constitutive element of an internationally wrongful act nor a requirement of state responsibility. GATT dispute settlement practice likewise recognizes that the GATT inconsistency of a trade measure, and nullification or impairment in terms of GATT Article XXIII, do not depend on damage" (E.U. Petersmann, *The GATT/WTO Dispute Settlement System: International Law, International Organizations and Dispute Settlement*, 1997, p. 136). While this is in the chapter entitled "Non-Violation and Situation Complaints in GATT/WTO Law", the quotation relative to material damage as a (non-)constitutive element of an internationally wrongful act and a non-requirement of state responsibility is nevertheless appropriate.

Prof. Petersmann further states: "As stated in the GATT panel report adopted by the GATT Council on 17 June 1987 concerning 'US Taxes on Petroleum', 'the impact of a measure inconsistent with the General Agreement is not relevant for a determination of nullification or impairment' because the function of most GATT rules (such as Article I-III and XI) is to establish conditions of competition and to protect trading opportunities, and violations of GATT rules are presumed to adversely affect these conditions of competition." The footnote to the above statement reads as follows: "See the GATT panel report in BISD 34S/135, 156, 158. See also the GATT panel report adopted on 25 January 1990, on EEC Subsidies Paid to Processors of Oilseeds ... (BISD 37/S86, 125) [the] panel report emphasizes 'that the CONTRACTING PARTIES have consistently interpreted the basic provisions of the General Agreement on restrictive trade measures as provisions establishing conditions of competition', and that 'nullification or impairment of benefits' depends therefore on *adverse changes in competitive conditions and not on an actual decline in volumes of trade*" (emphasis added).

[188] In 1997, textile and clothing products constituted 41.4 per cent of Turkey's entire manufacturing exports. See the *TPR Secretariat Report on Turkey*, p. 117.

(d) Article XXIV:8

7.50 The Philippines noted that there were only two essential requirements in Article XXIV:8(a), to characterize an arrangement between two or more customs territories as that of being a customs union. In respect of the requirement in Article XXIV:8(a)(i), derogation from the MFN obligation under Article I was needed to allow parties to eliminate duties and other restrictive regulations of commerce among themselves without according the same treatment to third parties. In respect of the requirement in Article XXIV:8(a)(ii), derogation from the obligations under Article II was necessary to allow parties to harmonize duties and charges, subject to the provisions of Article XXIV:(6) in relation to Article XXVIII and of Article XXIV:(5)(a) in relation to paragraph 2 of the Understanding on Article XXIV.

7.51 The Philippines argued that, however, in respect of the requirement of harmonization of other regulations of commerce, derogation from Articles XI and XIII, among others, was not necessary. Even the parties, as among themselves, could impose measures authorized under the Articles bracketed in Article XXIV:8(a)(i), among which were Articles XI and XIII. If the parties could impose such measures among themselves, their imposition towards third parties in the guise of harmonization was likewise not necessary.

7.52 The Philippines therefore submitted that the phrase "the provisions of this Agreement shall not prevent" in Article XXIV:5 did not exempt parties from complying with all other relevant provisions of the WTO Agreement, including GATT, and more particularly the provisions of the Articles bracketed in Article XXIV:8(a)(i), including Articles XI and XIII.

7.53 The Philippines considered that the formation of a customs union did not *per se* result in the merger of the legal personalities of the parties; it did not create a *successor entity* assuming the rights and obligations of the parties as Members. Members maintained their standing as such and retained their corresponding rights and obligations.

7.54 The Philippines argued that the measures permitted under the bracketed Articles disclosed at least a common feature in that the grounds upon which the imposition of the measures was permitted were specific to the Member concerned. It illustrated its argument recalling the texts of Articles XI, XII and XX.[189] It noted, for instance, that there was no basis, in fact and in law (positive law under the WTO Agreement), for a party to a customs union to claim that, for example, the existence of a critical food shortage or a state of serious decline in monetary reserves in one of the parties likewise constituted its own critical food shortage or monetary reserves crisis. The grounds were specific to the party concerned, and the corresponding right

[189] Article XI referred to "Export prohibitions or restrictions temporarily applied to prevent or relieve critical shortages of foodstuffs or other products *essential to the exporting contracting party*"; Article XII dealt with "Import restrictions instituted, maintained or intensified … *by a contracting party* … to forestall the imminent threat of, or to stop, as serious decline *in its monetary reserves* …"; and Article XX stated: "… nothing in this Agreement shall be construed to prevent the adoption or enforcement *by any contracting party* of measures … relating to the conservation of exhaustible natural resources if such measures are *made effective in conjunction with restrictions on domestic production or consumption* …" (emphasis added).

to impose a measure permitted under the bracketed Articles, including Articles XI and XIII, likewise pertained exclusively to such party.

7.55 The Philippines therefore submitted that neither the grounds upon which the European Communities had relied in justifying its QRs,[190] nor the corresponding right to impose QRs were assignable to Turkey, whether voluntarily or by operation of law. While it might be *convenient* for parties (whether for procedural reasons or, more substantively, for purposes of securing undue advantage in competition) to adopt the same measures permitted under the bracketed Articles (including Articles XI and XIII) towards the trade of third parties, such convenience could not prevail over the specific requirements under those Articles.

7.56 The Philippines considered that, in accordance with the ordinary meaning of Article XXIV:8 (a)(i), *all* duties and other restrictive regulations of commerce (except those authorized under the Articles specified within brackets) should have been eliminated with respect to substantially all trade between Turkey and the European Communities. It noted, however, the following:

(i) Paragraph 2 of Article 44 of Decision 1/95 provided, among others, that "[t]he modalities of implementation of anti-dumping measures set out in Article 47 of the Additional Protocol remain in force". Thus, Turkey might impose anti-dumping measures against the European Communities, and vice versa.[191] Article VI of GATT, governing anti-dumping measures (i.e. restrictive regulations of commerce) was not one of the bracketed Articles.

(ii) Article 34 of Decision 1/95 in relation to Article 38 effectively allowed Turkey and the European Communities to impose countervailing measures against each other. Article VI of GATT, governing countervailing measures (i.e. restrictive regulations of commerce) was not one of the bracketed Articles.[192]

(iii) Articles 32 and 33 of Decision 1/95, in relation to Article 38, effectively allowed Turkey and the European Communities to impose "appropriate measures" *vis-à-vis* each other on the basis of practices which "causes or threatens to cause serious prejudice to the interest of

[190] Since QRs imposed by the EC were not at issue in this dispute, it could only be presumed that they were based on grounds specified under relevant provisions of the WTO Agreement, or at least were in force on the basis of the tolerance of Members. In any event, the grounds and the corresponding right to impose the appropriate measure(s) were specific to each Member. As such, they were beyond the commerce of Members, not assignable, not capable of being appropriated by others. Neither was the tolerance of Members.

[191] This was confirmed in the *TPR Secretariat Report on Turkey* (para. 11, p. xii) and in Annex II of the *Communications from the Parties to the Customs Union*, WT/REG22/5, dated 30 October 1996, containing a list of "Anti-Dumping and Countervailing Measures applied by the European Union on Turkish Products" and "Anti-Dumping Duties applied by Turkey" on products of some EC Member States (see also in p. 4 of that same document, reference by the parties to Article 44 of the Decision).

[192] Article 37 of Decision 1/95 provided that in the absence of rules which are to be adopted by Turkey and the EC for the implementation of Articles 32, 33 and 34 and related parts of Article 35, "the provisions of the GATT Subsidies Code shall be applied as the rules for the implementation of Article 34" (see WT/REG22/1).

the other Party or material injury to its domestic industry".[193] "Appropriate measures" was broad enough as to cover any measure, including other restrictive regulations of commerce (in addition to anti-dumping and countervailing measures). It could thus include "emergency action" under Article XIX of GATT, likewise based on injury to domestic industry. Article XIX, authorizing such action (i.e. a restrictive regulation of commerce) was not one of the bracketed Articles.

(iv) In Article 63 of Decision 1/95, the parties confirmed "that the mechanism and modalities of safeguard measures provided for in Article 60 of the Additional Protocol remain[ed] valid". Turkey and the European Communities thus retained the right to impose such "safeguard measures" against each other on the grounds of serious disturbances occurring in a sector of economic activity; threat to external financial stability; or difficulties which had the effect of altering the economic situation of any of their respective areas. Such grounds were much broader than those upon which measures under the bracketed Articles might be imposed. Moreover, such "safeguard measures" were likewise broad enough to cover every conceivable restrictive regulation of commerce.

(v) According to paragraph 1 of Article 8 of Decision 1/95, Turkey should incorporate into its internal legal order the Community instruments relating to the removal of technical barriers to trade. As of 1 January 1996 therefore, Turkey had not eliminated regulations relative to technical barriers to trade *vis-à-vis* the European Communities. Regulations relative to technical barriers to trade were not among those contemplated in the bracketed Articles, but such regulations could have the effect of being restrictive regulations of commerce.

(vi) According to Article 7 of Decision 1/95, Turkey and the European Communities retained the right to impose QRs (i.e. restrictive regulations of commerce) on each other on the ground of "public security", among others. Article XXI of GATT, governing the so-called "security exemptions" was not one of the bracketed Articles.

7.57 The Philippines submitted that the arrangement between Turkey and the European Communities did not qualify as a customs union under Article XXIV:8(a)(i) because, among others, all *restrictive regulations of commerce* had not been eliminated with respect to substantially all the trade between Turkey and the European Communities. Therefore, the promulgation of the measure by Turkey and the imposition of the restrictions could not be justified because the Turkey-EC arrangement had not resulted in the formation of a customs union.

7.58 The Philippines submitted further that the arrangement between Turkey and the European Communities did not qualify as a customs union under Article XXIV:8(a)(i) because, among others, *duties* had not been eliminated with respect to substantially all the trade between Turkey and the European Communities.

[193] See para. 1 of Article 32 and para. 1 of Article 33 of Decision 1/95 (WT/REG22/1).

7.59 The Philippines considered that, in interpreting the phrase "substantially all" in Article XXIV:8 (a)(i), the "ordinary meaning … in their context and in the light of its object and purpose" was determinative, as the basic rule of treaty interpretation contained in Article 31.1 of the VCLT. It therefore noted that "substantially" was defined as "1. in a substantial manner; solidly; firmly; with strength. 2. to a substantial degree; specifically, (a) truly; really; actually; (b) largely; essentially; in the main".[194] "Substantially" thus meant "essentially" and its context was better understood in light of the object and purpose of:

(i) Article XXIV:8(a), which commenced by stating that a customs union should "be understood to mean the substitution of a single customs territory for two or more customs territories, so that …"; and

(ii) the preamble of the Understanding on Article XXIV, which contained the recognition that "… the contribution to the expansion of world trade that may be made by closer integration between the economies of the parties to such agreements … is increased if the elimination between the constituent territories of duties and other restrictive regulations of commerce extends to all trade, and diminished if any major sector of trade is excluded".

7.60 Thus, in the Philippines view, in applying the "substantially all" requirement, the focus should be more on what was excluded, since what was included should have been included *as a matter of course*. As to the exclusion, the Philippines proposed to at least test it against the criterion that it should not be indicative of the absence of the existence of a genuine substitution of a single customs territory for two or more customs territories. Otherwise, the possible contribution to the expansion of world trade that may be made by the closer integration between the economies of the parties would diminished, contrary to the underlying rationale for allowing, in this instance, exception from compliance with the MFN core principle.[195]

7.61 The Philippines also considered that, in applying the "substantially all" requirement, the meaning of the word "trade" in the phrase "the trade of the constituent

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[194] Websters, *New Twentieth Century Dictionary*, unabridged, 2nd edition.

[195] In this regard, "substantially all" could not necessarily be assessed quantitatively, i.e.:

$$100^{*}\frac{x}{y} = z$$

where x =product lines on which duties and other restrictive regulations were eliminated in intra-trade, y=product lines in potential intra- trade, and z=resulting percentage

If z equalled 100%, it could of course be concluded that the "substantially all" requirement had been more than fully complied with. If z was less than 100%, regardless of how close it might be to 100%, it would nevertheless be proper to apply the criterion on what is excluded.

y was a sensitive factor. In the context of a genuine customs union, y was the totality of products which could *potentially* be traded between the parties, not *actual* products traded. The latter construction would perpetuate discrimination. For example, assuming that Member A produced and traded in products A-1 to A-10, and party B in products B-1 to B-10; assuming further that Member A exported only product A-1 to Member B, and that Member B exported only product B-1 to party A, if both parties were to eliminate duties and other restrictive regulations of commerce in trade between them in respect of products A-1 and B-1, the arrangement could not be characterized as a customs union; instead, it would be a "classic" discriminatory arrangement .

territories ... all the trade in products....in such territories" was also germane. "Trade" was defined as "the act or business of exchanging commodities for other commodities or for money; the business of buying and selling; commerce; barter".[196] The synonyms of "trade" were: "business, traffic, sale, exchange".[197] "Trade" was thus used in the phrase in the broad generic sense, and there was no basis in qualifying it with "actual". This was the ordinary meaning in context, and in light of the object and purpose of Article XXIV (a single customs territory as trade-off for allowing exceptions from compliance with MFN obligations). Trade therefore included all *potential* trade, and was not confined to *actual* trade. Otherwise, the arrangement would not be that of a customs union; rather, it would be a classic discriminatory arrangement.

7.62 The Philippines then recalled that the European Communities was composed of three communities, namely: the ECSC, the EEC and the European Atomic Energy Community (EURATOM), each dealing with certain specific products and matters. The Treaties establishing the ECSC[198] and EURATOM[199] dealt with, among others, duties and other regulations of commerce applicable to the products they respectively covered. Turkey claimed to have entered into a customs union with the European Communities, whose Member States were, at the same time, parties to the ECSC and EURATOM. However, the ECSC and EURATOM respectively covered trade in products which were excluded from the coverage of the Turkey-EC arrangement under Decision 1/95, as the parties themselves disclosed.[200] The Philippines further noted that Decision 1/95 itself excluded agricultural products and the agricultural component of processed agricultural products from its coverage.[201]

7.63 The Philippines considered that it was unquestionable that agriculture was a major sector,[202] that the ECSC also covered a major sector,[203] and that products covered by the EURATOM Treaty also comprised a major sector.

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[196] Websters, *New Twentieth Century Dictionary,* unabridged, 2nd edition.

[197] *Ibid*.

[198] The ECSC Treaty was signed in Paris on 18 April 1951 (Paris Treaty establishing the European Coal and Steel Community). Its Article 4 provided, among others: "The following are recognized as incompatible with the common market for coal and steel and shall accordingly be abolished and prohibited within the Community, as provided in this Treaty: (a) import and export duties, or charges having equivalent effect, and QRs on the movement of products; ...".

[199] Article 93 of the EURATOM Treaty provided, among others, for the abolishment of "all customs duties on imports and exports or charges having equivalent effect, and all QRs on imports and exports" in respect of selected listed products.

[200] See WT/REG/22/5, para. I:3. A Free Trade Agreement between Turkey and the ECSC entered into force on 1 August 1996 (WT/REG22/1/Add.1).

[201] The provisions of Decision 1/95 on the elimination of customs duties and charges and the elimination of QRs or measures having equivalent effect apply only to goods in Chapter I. Agricultural products were dealt with in Chapter II (see WT/REG22/1). In this regard, the *TPR Secretariat Report on Turkey* (para. II(I) 1., p. 16) confirmed that "there is no firm timetable of the integration of agriculture" in the Turkey-EC arrangement.

[202] "The agriculture sector accounts for 14% of GDP and employs about half of the labour force" of Turkey (*TPR Secretariat Report on Turkey*, para. 17, p. xiii).

[203] See Annex I of WT/REG22/1/Add.1, for the list of products covered. See also paras. 42, 44, 45, 76 and 77 of the *TPR Secretariat Report on Turkey*, as illustrative of the product coverage.

7.64 The Philippines therefore submitted that the arrangement between Turkey and the European Communities did not qualify as a customs union under Article XXIV:8(a)(i) because, among others, all duties had not been eliminated with respect to substantially all the trade between Turkey and the European Communities.
7.65 It also submitted that the arrangement between Turkey and the European Communities did not qualify as a customs union under Article XXIV:8(a)(ii) because, among others, Turkey and the European Communities did not apply "substantially the same duties and regulations of commerce" to the trade of third parties in the categories of products covered by the ECSC and the EURATOM Treaties, and in agricultural products.
7.66 The Philippines added that even with respect to products which were supposedly part of the customs union, Turkey and the European Communities did not apply "substantially the same duties and regulations of commerce" to third parties' trade in certain products, i.e. 290 items.[204] In addition, under Article 15 of Decision 1/95, Turkey (in agreement with the European Communities) retained the right to impose higher duties on third parties' trade and in respect of potentially all products covered by the alleged customs union.
7.67 The Philippines submitted that, therefore, the promulgation of Turkey's measures and the imposition of the restrictions could not be justified because the Turkey-EC arrangement *had not* resulted in the formation of a customs union.
7.68 On the question whether the territory of Turkey and the territory of the European Communities constituted a single customs territory, as provided for in Article XXIV:8(a), the Philippines noted that "single customs territory" implied genuine economic integration. It was only under this circumstance when exception from compliance with the MFN obligation was permissible. In the absence of genuine economic integration, an arrangement characterized by the elimination of some but less than all or substantially all duties and regulations of commerce on trade between the parties and/or harmonization in respect to some but less than all or substantially all of their trade regimes *vis-à-vis* third parties was merely a preferential trading arrangement in violation of MFN, regardless of the manifested intention of the parties.[205]

7.69 In regarding the Turkey-EC arrangement in perspective, the Philippines noted that Turkey and the European Communities had maintained the right to impose restrictive regulations of commerce on each other beyond the measures authorized under Article XXIV:8(i), including anti-dumping, countervailing, and safeguard measures, which were similarly based on the concept of injury to domestic industry (or serious injury in the case of safeguard measures). However, not a single measure

[204] This was confirmed by the *TPR Secretariat Report on Turkey*, para. 22.
[205] "The pivotal requirement of Article XXIV is that *the union be complete, freeing substantially all internal trade*. The main reason for that requirement is non-economic. The requirement exists primarily to discourage governments from using 'customs unions' as an excuse to engage in ad hoc discriminations for short-run advantage. It also seeks to create a stable end situation upon which other governments can plan, and can negotiate." (emphasis added), in Robert E. Hudec, *GATT Legal System and World Trade Diplomacy*, (Butterworth Legal Publishers), 2nd edition, p. 221.

permissible under any of the bracketed Articles was based on such concept.[206] It was thus conceptually irreconcilable that a part of a single customs territory could impose restrictive regulations of commerce on other parts on that basis, since a single customs territory could not impose anti-dumping duties, countervailing measures, and safeguard measures on its own self.

7.70 The Philippines noted further that, while the reasons why the products covered by the ECSC and EURATOM Treaties were not covered by the alleged customs union between Turkey and the European Communities were not material in this dispute, perhaps more revealing was the reason cited by Turkey and the European Communities for the non-inclusion of agricultural products in the alleged customs union, that is:

> "The Decision envisages an additional period for the achievement of free movement of agricultural products between the Parties, on account of the different policies and trade regimes pursued by each. The adoption of the Common Agricultural Policy measures of the EC by Turkey was determined as a prerequisite condition for the establishment of free movement of such products…"[207]

7.71 The Philippines was of the view that the formation of a customs union between two sovereign states certainly did have economic consequences, the parties usually expecting that it would likewise be of benefit to their respective economies. However, compliance with Article XXIV was inextricably based on the political will to establish a genuine single customs territory, regardless of the economic consequences. However, in this regard, the Philippines submitted that the attendant circumstances analyzed in the preceding paragraphs and the joint Turkey-EC declaration just quoted above were (perhaps) indicative of the deficiency of genuine political will to establish a likewise genuine single customs territory between Turkey and the European Communities, notwithstanding manifested intentions.

4. Conclusions

7.72 The Philippines submitted that the promulgation of the measure by Turkey and the imposition of the restrictions were in violation of Articles XI and XIII of GATT and of Article 2.4 of the ATC, and were not justified under Article XXIV of GATT.

7.73 The *prima facie* violation of Articles XI and XIII of GATT and of Article 2.4 of the ATC was not disputed by Turkey. The Philippines considered that Turkey's defense was based on the argument that the territories of Turkey and the European Communities formed one single customs union and that the promulgation of the measure by Turkey was but part of the process of harmonization under Article XXIV:8(a)(ii). In the Philippines' view, even assuming that the Turkey-EC arrangement qualified as a customs union under Article XXIV:8, the promulgation of the measure and the imposition of the restrictions were in violation of Article XXIV:4, in

[206] This is but a logical and necessary consequence of the formation of a customs union. In a genuine customs union, there is only one domestic industry - that of the Parties', collectively.
[207] WT/REG/22/5, para. 8.

relation to the Understanding on Article XXIV,[208] since other less restrictive and less discriminatory options were available to Turkey and the European Communities to achieve such harmonization. Furthermore, such promulgation and imposition were likewise in violation of Article XXIV:5, in relation to the Understanding on Article XXIV, as the general incidence of regulations of commerce applicable in the constituent territories were on the whole more restrictive compared to that prevailing prior to the formation of the alleged customs union.

7.74 The Philippines considered that, in any event, Turkey could not invoke (the excuse of) harmonization under Article XXIV:8(a)(ii), because the territory of Turkey and the territory of the European Communities did not constitute a genuine single customs territory, the Turkey-EC arrangement having not established the existence of a customs union between the parties, neither in relation to the required elimination of duties and other restrictive regulations of commerce on intra-trade nor the application of substantially the same duties and other regulations of commerce to the trade of third parties.

D. Thailand

1. Arguments

7.75 Thailand submitted that the imposition of the QRs by Turkey was inconsistent with its obligations under the provisions of Article 2.4 of the ATC and under the provisions of Article I:1, Article XI:1 and Article XIII:1 of GATT. Thailand submitted further that these inconsistencies could not be justified by the provisions of Article XXIV:5(a) and/or Article XXIV:8(a)(ii).

7.76 Thailand noted that the imposition of QRs by Turkey pursuant to Decision 1/95 were new restrictions prohibited by Article 2.4. Turkey's measures did not fall within the exception provisions of the ATC to the prohibition of new restrictions, namely the "transitional safeguard" (Article 6), since Turkey did deliberately not invoke this mechanism for its justification. Turkey, instead, invoked the provisions of Article XXIV:5(a) and Article XXIV:8(a)(ii) of GATT as its defense. The question to be considered in this regard was therefore whether those provisions fell within the meaning of the "relevant GATT 1994 provisions" provided for in Article 2.4.

7.77 Thailand submitted that the terms "relevant GATT 1994 provisions" in Article 2.4 of the ATC related only to the provisions of the GATT that pertained to permissible QRs, such as Article XII and Article XX. By virtue of footnote 3 to Article 2.4 of the ATC, however, the phrase did not include the provisions of Article XIX in respect of the products not yet integrated into GATT. It had nothing to do nor did it cover the provisions of Article XXIV. The imposition of QRs by Turkey, therefore, did not fall within the exception provisions of the relevant GATT provisions.

7.78 Thailand considered that provisions of the ATC and the GATT had to be interpreted "in accordance with customary rules of interpretation of public international

[208] Such harmonization was contrary to the standard "not to raise barriers to the trade of other contracting parties with such territories" in Article XXIV:4. Turkey and the EC did not likewise "to the greatest possible extent avoid creating adverse effects on the trade of other Members" (see preamble of the Understanding on Article XXIV).

law", as instructed by the provisions of Article 3.2 of the DSU, of which the cardinal rule of interpretation was enshrined in Article 31 of the VCLT.

7.79 In this regard, Thailand noted that the context of Article 2.4 was Article 2 itself and the ATC as a whole. Article 2 dealt with the elimination of existing QRs and the prohibition against the introduction of new ones in textile and clothing products as specified in the ATC Annex, which were in the transitional process of being integrated into GATT. As to the ATC, it was the international agreement "to be applied by Members during a transition period for the integration of the textiles and clothing sector into GATT 1994".[209] Article 2 and the ATC itself did not at all deal with nor had anything to do with customs unions or free trade areas as contained in GATT.

7.80 Thailand noted further that the primary object and purpose of the ATC were the integration of textiles and clothing sector into the GATT, the strengthening of GATT rules and disciplines, and trade liberalization, as evident from the preambular first paragraph of the ATC.[210] Consequently, unless otherwise clearly provided for by the ATC or the GATT as permissible, any new QRs on any other basis, including on the basis of the formation of customs unions under Article XXIV of GATT, could not legitimately be made. To allow any other different interpretation would impair or nullify the objects and purposes of the ATC.

7.81 Thailand added that this interpretation was consistent with the purpose of a customs union or of a free trade area as provided for in Article XXIV:4, of , *inter alia*, "not to raise barriers to the trade of other contracting parties with such territories". Even assuming, *arguendo*, that the terms "relevant GATT 1994 provisions" included Article XXIV, this Article did not authorize QRs in violation of Articles I, XI, and XIII of GATT.

7.82 Thailand noted that Turkey's had asserted that its imposition of QRs for the furtherance of its objective of the formulation of the customs union with the European Communities was allowed by Article XXIV:5(a) and Article XXIV:8(a)(ii) of GATT, in particular the terms "other regulations of commerce". This assertion was in part based on the allegation that Turkey's association with the European Communities had never been challenged in the GATT or the WTO, and no recommendation was addressed to the parties to the Agreement under Article XXIV:7(b).

7.83 Thailand considered such arguments as factually incorrect, without a basis under the GATT, and contrary to the GATT jurisprudence. The consistency of the Treaty of Rome and the Ankara Agreement with the provisions of Article XXIV had continually been contested by contracting parties to the GATT and Members of the WTO since the initial examination of the Treaty of Rome in 1957.

7.84 In this respect, Thailand submitted that GATT jurisprudence, as reflected by a number of reports of Working Parties and of panels examining issues pertaining to Article XXIV, clearly substantiated that the provisions of Article XXIV were not the

[209] Article 1.1 of the ATC.

[210] "... negotiations in the area of textiles and clothing shall aim to formulate modalities that would permit the eventual integration of this sector into GATT on the basis of strengthened GATT rules and disciplines, thereby also *contributing to the objective of further liberalization of trade*" (emphasis added).

exception to, nor the justification or waiver for the institution or maintenance of any form of QRs. This point was illustrated by the following examples:

(i) During the examination of the conformity of the Treaty of Rome with the provisions of Article XXIV, in Sub-Group B (QRs) of the relevant Committee, the representatives of the parties asserted that they could, by virtue of the provisions of Article XXIV:5(a) in combination with the provisions of Article XXIV:8(a)(ii), impose QRs for balance of payment reasons against other contracting parties while impose none of such restrictions among themselves. However, most members of the Sub-Group opposed strongly to such assertion and interpretation.[211]

Sub-Group C (Trade in Agricultural Products) came to the conclusion that in the view of the majority of members of the Sub-Group the Treaty of Rome was not consistent with the provisions of Article XXIV and noted that the failing of making recommendations did not mean or could be interpreted to mean that the Treaty of Rome and the measures thereof were consistent with those provisions.[212]

(ii) In discussions within the Working Party on the Accession of Greece to the European Communities, the question of the compatibility of the Treaty of Rome was again raised.[213] In addition, a large number of delegations had raised several questions and strongly objected to the actions of Greece which, as a result of the accession liberalized the existing QRs to EC members only (without extending the benefits of such liberalization to any other contracting parties), while at the same time imposing new QRs to these contracting parties. In the view of these delegations, the said actions of Greece were in contravention with the provisions of Article XI and XIII, and were not in conformity with the provisions of Article XXIV since these provisions were not at all the exception of nor the justification or waiver for the GATT prohibition of QRs.[214]

(iii) During the discussions within the Working Party on the Accession of Portugal and Spain to the European Communities, many delegations expressed the view that Article XXIV was at most an MFN exception and, in particular, not an exception to provisions concerning QRs, namely Articles XI, XII and XIII. They also stated that Article XXIV, being the exception to the cardinal MFN principle, had to be interpreted very restrictively. It was important to note at this juncture that

[211] See *Reports on the European Economic Community*, adopted on 29 November 1957, BISD 6S/76-81, paras. B.4 to B.8.
[212] See BISD 6S/88-89, para. 14 and especially para. 15.
[213] See BISD 30S/174, para. 14.
[214] The questions and objections referred to above were evident in many paragraphs of the Report. See, for instance, BISD 30S/190, paras. 51, 55 and 60.

the European Communities themselves did not deny the validity of those delegations' view.[215]

7.85 From the above examples, Thailand inferred that it was generally accepted, even by the European Communities, that the provisions of Article XXIV were not the exception to nor the justification or waiver for the institution or maintenance of any form of QRs.

7.86 Thailand stressed that, even if Turkey itself had on several occasions, including the present case, claimed that it could impose or maintain QRs on any other contracting parties except the European Communities by virtue of the provisions of Article XXIV, such a claim had never been accepted; on the contrary, it had been strongly objected to by virtually all the contracting parties. Thus, for example, in the context of the examination of the Ankara Agreement, the Report of the Working Party concluded, *inter alia*, that "[s]ome members of the Working Party … criticized the discriminatory removal of QRs and import deposits".[216] Another example could be seen in the Working Party which examined the Additional Protocol to the Ankara Agreement, where Turkey claimed that it had the right to maintain the existing QRs or to impose new ones by virtue of the provisions Article XXIV in combination with the consideration that Turkey was the developing country and thereby should be provided with special leniency.[217]

7.87 Thailand observed in this context that none of Turkey's Agreements with the European Communities had been approved by the examining Working Parties as consistent with the provisions of Article XXIV. The legal status of these Agreements and their conformity with the provisions of Article XXIV remained open in the same manner as the Treaty of Rome and its related Agreements. Therefore, the examination of whether the Agreement for the formation of a Customs Union between Turkey and the European Communities was in accord with the provisions of Article XXIV had not only to be considered in the light of the provisions of Article XI, XIII and XXIV, but also be measured in view of the fact that the legal status of the previous Turkey-EC Agreements and their conformity with the provisions of Article XXIV remained inconclusive.

7.88 Thailand noted that, in the present case, despite the GATT rules and the GATT jurisprudence delineated above, Turkey still claimed that it could impose or maintain quantitative restrictions to the importation of textiles and clothing from any other contracting parties except the European Union by virtue of the provisions of Article XXIV and the GATT jurisprudence, and that the practice of the contracting parties in the GATT had widened the scope of the terms "other regulations of commerce" in Article XXIV.5(a) and Article XXIV.8(a)(ii) to include quantitative restrictions. In Thailand's view, this claim was unfounded, and in fact a distortion of the GATT rules and jurisprudence. The GATT rules and jurisprudence were completely opposite to what Turkey had claimed.

7.89 Thailand also noted that the practice was not uniform in respect of the widening of the scope of the terms "other regulations of commerce" in Article

[215] See BISD 35S/318, *inter alia* paras. 19, 35, 39 and 45.
[216] See BISD 19/108, para. 14.
[217] See BISD 21S/110-112, paras. 12 and 17.

XXIV:5(a) and XXIV:8(a)(ii). The European Communities and its partners once in a while had claimed that the terms covered QRs. However, a larger number of the contracting parties opposed to such a claim. In the view of the latter, the terms signified only to the matters such as customs procedures, grading and marketing requirements, and similar routine controls in international trade. In the Report of the Sub-Group B of the Committee on the EEC, it was clearly stated as follows:

> "Most members of the Sub-Group could not accept of the interpretation of the Six of paragraph 5(a). In their view the use of the term "regulations" in this paragraph and in paragraph 8(a)(ii) does not include QRs imposed for balance-of-payments reasons. An examination of the provisions of the Agreement indicates that the term "regulations" is consistently used to describe such matters as customs procedures, grading and marketing requirements, and similar routine controls in international trade. This interpretation is reinforced by the fact that in paragraph 8(a)(i) the term "regulation" is qualified by the word "restrictive" in the one instance where Article XXIV specifically refers to the balance-of-payments Articles. Moreover, the term "regulation" does not appear in the balance-of-payments Articles of the General Agreement. The General Agreement prohibits the use of QRs for protective purposes and permits their use only in exceptional circumstances and mainly to deal with balance-of-payment difficulties. Accordingly, the notion that paragraph 5(a) would require that temporary QRs should be treated in the same way as normal protective measures such as tariffs in determining the trade relations between countries in a customs union and third countries would be contrary to the basic provisions of the Agreement which preclude the use of QRs as an acceptable protective instrument."[218]

7.90 In this connection, Thailand emphasized that the GATT being an international agreement, it thereby was subject to the rules and principles of public international law, as instructed by the DSU Article 3.2. The VCLT Article 31 provided, *inter alia*, that "[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning of the terms of the treaty in their context and in the light of its object and purpose". In the light of these rules of interpretation, it was clear that the primary objective and purpose of the GATT, and in particular Article XXIV, was trade liberalization not trade restrictions, especially QRs. Therefore, if two or more interpretations of the GATT in general and Article XXIV in particular were possible, the one favouring trade liberalization should prevail.

7.91 Thailand added that in the presence of clear provisions of the GATT to the contrary, and in the absence of uniform interpretation and practice of the terms "other regulations of commerce ", subsequent interpretation and practice of a few countries which would benefit from such interpretation and practice was meaningless and completely lacked any legal validity. In addition, the said practice could in no way be treated as the customary rules under the GATT, since the two fundamental prerequisites for the formation of a customary rule, namely (i) the consistent and uniform

[218] BISD 6S/78-79, para. 5.

practice of states and (ii) the psychological element that the practice is necessitated by the requirement of law ("*opinio juris sive necessitatis*") were lacking. The strong protest to such practice by many contracting parties of the GATT and Members of the WTO was clearly evident. For the same reasons, the lack of or infrequent protest to such interpretation and practice in the dispute settlement body of the GATT by the contracting parties could not be regarded as tacit agreement or acceptance of such interpretation and practice by all the contracting parties.

7.92 In this context, Thailand recalled a number of panel decisions supporting the assertions that Article XXIV provisions were not the exception to nor the justification or waiver for QRs; that the lack of or infrequent protest to the European Communities and associated members' interpretation and practice of the term "other regulations of commerce" did not mean or imply tacit agreement or acceptance of such interpretation and practice; and that QRs were possible only when they fully conformed to the permissible provisions of the GATT, such as Article XI, XII, and XIII.

7.93 Citing the case on *EC - Tariff Treatment on Imports of Citrus Products from Certain Countries in the Mediterranean Region*,[219] Thailand recalled that the European Communities argued that the United States could not contest its preferential trade treatment on citrus products given to certain countries in the Mediterranean Region because the Working Parties which had examined the Treaty of Rome itself and other related agreements never gave any recommendation that these agreements were not in conformity with the provisions of Article XXIV, such non-recommendation constituting a tacit acceptance by the CONTRACTING PARTIES as a whole as well as the individual contracting parties that these agreements were in conformity with the provisions of Article XXIV. Such acceptance, in other words, applied *erga omnes*, and the United States could not circumvent its validity by means of the dispute settlement procedures under the provisions of Article XXIII. In response to this argument, the United States stated in paragraph 3.12 of the Report, *inter alia*, the following:

> "... In no case did a working party unanimously agree that any agreement in question was compatible with the General Agreement. It was clear that the Council had been aware of the strong divergence of views within the working parties, and its adoption of the report should be viewed from this perspective. The failure of the CONTRACTING PARTIES to reject the agreements did not imply acceptance nor did it constitute a legal finding of GATT consistency with Article XXIV. The fact that the CONTRACTING PARTIES were aware that the EEC was going to implement the agreements could not be equated with approval. Similarly, the fact that these agreements had been in place for a number of years did not confer legitimacy. The pragmatic attitude the CONTRACTING PARTIES had adopted in their treatment of free-trade areas and customs unions did not envisage a loss of the right to subsequently challenge the legal validity of such agreements.

[219] Panel Report (not adopted) on *EC - Tariff Treatment on Imports of Citrus Products from Certain Countries in the Mediterranean Region*, GATT document L/5776, of 7 February 1985.

> The implication of the decision of the CONTRACTING PARTIES with respect to the Treaty of Rome was that, while the legal issues could not be fruitfully discussed *at that stage*, such legal issues could be raised at a later point in time. Moreover, as the EEC had pointed out itself, the decisions on customs unions and free-trade areas had been adopted on the explicit understanding that the legal rights of contracting parties under the General Agreement would not be affected. This clearly implied that the CONTRACTING PARTIES meant the right of individual contracting parties to challenge the consistency of the agreement with the requirements of Article XXIV to remain intact."[220]

7.94 The United States further argued, *inter alia*, that:

> "... it was customary in the GATT to refrain from raising legal principles in cases where a contracting party after taking into account overall economic interests and political concerns, was unsure that its trade interests would be adversely affected. Given this customary practice and the history of GATT consideration of these agreements, one could not characterize the failure to make recommendations under paragraph 7(b) as constituting approval by the CONTRACTING PARTIES."[221]

7.95 In so far as the right of a contracting party to challenge the conformity of the Treaty of Rome and its related agreements with the provisions of Article XXIV by the dispute settlement procedures under Article XXIII, the United States added, *inter alia*, as follows:

> "The *United States* replied that the consequence of the EC position was that a failure to assert legal rights immediately constituted a permanent bar to future legal challenge. It would penalize those contracting parties that waited to assert their legal rights until a specific trade problem occurred. If the EEC view was accepted, the result would be an immediate termination of the pragmatic approach which had been characteristic of the GATT. The GATT would not be well-served by the approach suggested by the EEC..."[222]
>
> "The *United States* argued that, whatever the scope of the Article XXIV: 7 procedures for the examination of interim agreements, the existence of these procedures in no way curtailed the general right of contracting parties to challenge the GATT-consistency of any measure under the procedures of Article XXIII. Neither the wording of Article XXIII nor the Understanding on Article XXIV Regarding Notification, Consultation, Dispute Settlement and Surveillance adopted by the CONTRACTING PARTIES in 1979 (BISD 26S/210) limited in any way the right of contracting parties to bring complaints under Ar-

[220] Panel Report (not adopted) on *EC - Tariff Treatment on Imports of Citrus Products from Certain Countries in the Mediterranean Region*, GATT document L/5776, of 7 February 1985, para. 3.12, p. 38.
[221] *Ibid.*, para. 3.94, p. 70.
[222] *Ibid.*, para. 3.22, p. 40.

> ticle XXIII, nor suggested that the applicability of Article XXIV was meant to be excluded."[223]

7.96 With respect to the cited arguments, Thailand noted that although the panel made an implicit conclusion to the effect that the legal status of the agreements in question remained open; however, it did not make a ruling on the arguments because the complainant, the United States, had not requested it to do so, nor was it proper for it to do so by itself, as can be seen, *inter alia*, in the conclusions of the Report:

> "Given the lack of consensus among contracting parties, there had been no decision by the CONTRACTING PARTIES on the conformity with Article XXIV of the agreements under which the EC grants tariff preferences to certain citrus products originating from certain Mediterranean countries, and therefore the legal status of the agreements remained open; ..."

7.97 Thailand recalled in this connection the wording of paragraph 12 of the Understanding on Article XXIV and argued that, although the panel report in the above-referred case was not adopted by the CONTRACTING PARTIES as a whole due to the objection of certain contracting parties as could be expected, the juridical value of the panel's findings as well as the legal validity of the principles and rules of the GATT and international law behind and underpinning those findings on this particular point had not been impaired.

7.98 Thailand also mentioned that many GATT panels in the past, such as those on *Japan - Leather*[224] and in *EEC - Imports from Hong Kong*,[225] had confirmed that the fact that for a long time illegitimate practices of the contracting parties in violation of Article XI:1 of the GATT were not challenged under the GATT dispute settlement procedures, did not make them consistent with the GATT. In the latter case, the panel stated explicitly that:

> "... It recognized that restrictions had been in existence for a long time without Article XXIII ever having been invoked by Hong Kong in regard to the products concerned, but concluded that this did not alter the obligations which contracting parties had accepted under GATT provisions. Furthermore the Panel considered it would be erroneous to interpret the fact that a measure had not been subject to Article XXIII over a number of years, as tantamount to its tacit acceptance by contracting parties..."

7.99 Thailand also referred to the arguments of the parties to the dispute the *EEC - Bananas I*, noting that the findings of the panel in that case was important and pertinent to the present dispute. In that case, the legal regimes of the EEC Member giving preferential trade treatments to the African, Caribbean and Pacific Countries ("ACPs") were challenged by a number of Latin American contracting parties, on the grounds that, by imposing a zero per cent duty and no quota to the importation of

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[223] Panel Report (not adopted) on *EC - Tariff Treatment on Imports of Citrus Products from Certain Countries in the Mediterranean Region*, GATT document L/5776, of 7 February 1985, para. 3.26, p. 41.

[224] See Panel Report on *Japan - Leather*, para. 44.

[225] See Panel Report on *EEC - Imports from Hong Kong*, para. 28.

bananas from the ACPs while imposing a 20 per cent duty and a range of quotas (or in some cases complete prohibition) to the importation of bananas from them, such regimes were in contravention with several provisions of the GATT, including in particular Article I, Article II, Article XI, Article XIII, and Article XXIV.[226]

7.100 Thailand noted that in that case the complainants argued in essence that Article XI was one of the cardinal principles of the GATT. It prohibited all forms of QRs not only because of their damaging effects on the quantities of the importation of certain goods, but also because of their distorting impacts upon the present and future markets of the importing contracting parties. The effects and impacts of such QRs should not be gauged only from their names and appearances, but should also be measured from their practical and damaging effects on the importation of the goods. Therefore, it had always been upheld by many panels in the past that there were presumption against the legality of QRs, and it was the onus of the contracting parties who had undertaken such actions to rebut the presumption, such as by proving that these actions fell within the exceptions of the Article itself. In addition, economic, social, and historical factors were extraneous to the consideration of a panel established in accordance with the provisions of Article XXIII which had to consider only the relevant provisions of the GATT.

7.101 Thailand further noted that in that case the panel found the EEC Member States' QRs contrary to the provisions of Article XI:1 and not justified by the provisions of Article XI:2(c), and, more importantly, confirmed the GATT jurisprudence regarding the relationship between Article XI and Article XXIV, when it stated:

> "The Panel noted the argument of the EEC that the restrictions and prohibitions on imports of bananas, even if inconsistent with Article XI:1, were nonetheless consistent with the General Agreement because they were covered under the provisions of Article XXIV. The Panel noted that Article XXIV:5 to 8 permitted the contracting parties to deviate from their obligations under other provisions of the General Agreement for the purpose of forming a customs union or free-trade area, or adopting an interim agreement leading to the formation of a customs union or free-trade area, but not for any other purpose. *Article XXIV:5 to 8 therefore did not provide contracting parties with a justification for restrictive import measures as such*; it merely provided them - within the limits set out in this provision - with a justification for not applying to imports originating in such a union or area the restrictive import measures that they were permitted to impose under other provisions of the General Agreement. *The Panel therefore considered that the import restrictions on bananas could not be justified by Article XXIV.*"[227]

2. Conclusions

7.102 Accordingly, Thailand submitted that the imposition of the QRs by Turkey was inconsistent with its obligations under the provisions of Article 2.4 of the ATC,

[226] See Panel Report on EEC - Bananas I.
[227] Panel Report on *EEC - Bananas I*, para. 358 (emphasis added).

the provisions of Article I:1, Article XI:1 and Article XIII:1 of GATT, and that these inconsistencies could not be justified by the provisions of Article XXIV:5(a) and/or Article XXIV:8(a)(ii) of GATT.

7.103 Consequently, in the light of the provisions of Article 19 of the DSU, Thailand requested that the Panel recommend that Turkey bring its measures into conformity with the above-mentioned provisions of the ATC and GATT, and that it might also suggest the ways in which Turkey could implement the recommendations.

E. United States

7.104 The United States stated that Turkey had asserted no substantive defense under the ATC or Article XI of GATT for the QRs at issue in this dispute. The only legal basis that Turkey claimed for its unilateral imposition of new QRs was that measures whose application constituted a requirement of the Turkey-EC customs union were deemed to be justified under Article XXIV of GATT. The United States was unable to agree with Turkey on that point.

7.105 Turkey claimed that Article XXIV provided a derogation from all the provisions of the GATT, and that that derogation in turn justified Turkey's new QRs. Turkey said that, as applied to customs unions and free trade areas, Article XXIV permitted deviation from the MFN obligations of Article I:1. The United States agreed with Turkey, up to a point. Article XXIV:8 provided that to constitute a customs union (or a free-trade area) duties and other regulations of commerce had to be eliminated as between the constituent members of that customs union (or free-trade area). The United States agreed that, in light of Article XXIV, the provisions of Article I:1 did not require the constituent members of the customs union (or free-trade area) to offer such elimination of duties and restrictive regulations of commerce to non-originating goods. Turkey went on to suggest, however, that *all* the provisions of GATT were overridden by Article XXIV, and at that point the United States disagreed with Turkey.

7.106 The object and purpose of Article XXIV were authoritatively given in Article XXIV:4. In light of the second sentence of that provision, it was difficult to see how Turkey's action in this case was justifiable. In fact, the GATT generally prohibited QRs entirely, as an especially serious barrier to trade. Therefore, it was hard to see how a customs union could introduce new QRs consistently with Article XXIV:4, unless some other provision of the WTO Agreement independently justified those restrictions.

7.107 The United States recalled that the argument that Turkey was now advancing had been made before, but had not been accepted. In 1957, when the CONTRACTING PARTIES were considering the consistency with the GATT of the Treaty of Rome, the six members of the EEC proposed that Article XXIV:5 authorized those six members to deviate from the provisions of the GATT concerning QRs. The report of the Sub-Group considering the Community's QRs recorded the following:

> "Most members of the sub-group could not accept the interpretation of the Six of paragraph 5(a). ... The General Agreement prohibits the use of QRs for protective purposes and permits their use only in exceptional circumstances and mainly to deal with balance-of-payments difficulties. Accordingly, the notion that paragraph 5(a) would require

> that temporary QRs should be treated in the same way as normal protective measures such as tariffs in determining the trade relations between countries in a customs union and third countries would be contrary to the basic provisions of the Agreement which preclude the use of QRs as an acceptable protective instrument."[228]

7.108 More recently, the European Communities, Turkey's partner in the Ankara Agreement, had taken the opposite position to Turkey on this issue. During the examination of the Accession of Spain and Portugal to the European Communities, several GATT contracting parties claimed that, as a result of the accession, Spain and Portugal had imposed new restrictions that violated Articles XI and XIII. The Working Party report recorded the EC response as follows:

> "On the question of other regulations of commerce, *and in particular QRs,* the Communities agreed that Article XXIV did not provide a waiver from other provisions of the GATT."[229]

7.109 Furthermore, in 1993, the *EEC - Bananas I* panel confirmed the point when it found that "Article XXIV:5 to 8 ... did not provide contracting parties with a justification for restrictive import measures as such ..."[230]

7.110 For all these reasons, Turkey's contention that its customs union with the European Communities allowed it to maintain new QRs on imports from third countries in derogation from the provisions of the Article XI of GATT should be rejected.

7.111 The United States also disagreed with Turkey's interpretation of Article XXIV:8(a)(ii). Article XXIV:8(a) was a definitional paragraph. It described the characteristics of a customs union, one of which was that the constituent Members applied substantially the same regulations of commerce to trade from outside the union. However, Article XXIV:8 did not require or authorize the customs union to adopt any *particular* set of such external regulations. Most importantly, Article XXIV:8(a)(ii) nowhere provided that the external regulations that the customs union chose to apply could be inconsistent with WTO requirements. (Of course, if Turkey wished to act inconsistently with its WTO obligations it was always free to seek a waiver.)

7.112 A customs union could, in principle, meet the requirements of Article XXIV in different ways. In fact, the Panel could decide this dispute on straightforward grounds. As the delegation of the Philippines had pointed out, it was clear that the European Communities and Turkey could just as easily have chosen to remove the QRs that either one of them previously imposed against Indian textile and clothing products. The delegation of Hong Kong, China, had pointed out that the European Communities and Turkey could have chosen to implement a certificate of origin system to ensure that goods entering the European Communities from Turkey were in fact of Turkish origin. Had the European Communities and Turkey taken either of these approaches, they could still have continued to apply the same regulations of

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[228] *Reports on the European Economic Community*, adopted on 29 November 1957, BISD 6S/70, para. B.5.

[229] *Report of the Working Party on the Accession of Portugal and Spain to the EC*, adopted on 19-20 October 1988, BISD 35S/293, para. 45 (emphasis added).

[230] Panel Report on *EEC - Bananas I*, para. 358.

commerce externally. And, they would not have raised the trade barriers that Turkey had with its new QRs.

7.113 Because these alternatives were open to them, Turkey could not claim that the provisions of the WTO Agreement (and in particular, the provisions of the ATC) were preventing the formation of a customs union with the European Communities. For that reason, as well as the others outlined, Turkey was incorrect in claiming that Article XXIV:5 and 8(a) authorized these measures.

7.114 The United States noted that Turkey appeared to pre-suppose that the agreement between Turkey and the European Communities met the requirements of Article XXIV. After all, Turkey's entire defense relied on the assumption that its relationship with the European Communities qualified under Article XXIV as a customs union. It was important to recall, however, that the Ankara Agreement, and the Turkey-EC customs union, had never been found to be consistent with the requirements of Article XXIV. They were still under examination by the CRTA. Turkey itself acknowledged this fact. The Panel should therefore not conclude that the Turkey-EC agreement was a customs union consistent with the requirements of Article XXIV of GATT.

7.115 The United States also noted that Turkey argued that the reduction in average tariffs resulting from the customs union agreement meant that the agreement could not be described as having raised barriers to trade with Turkey. In the first place, the evaluation under Article XXIV of the level of trade barriers went beyond an evaluation of tariffs, and therefore Turkey's statement was not correct. Secondly, this claim was a variation of the "reverse compensation" argument that had been raised but never accepted in the past; the argument was that contracting parties that reduced duties in forming a customs union were entitled to compensation for that reduction. Paragraph 6 of the Understanding on Article XXIV expressly eliminated that argument, however. Turkey's claim in this case that the agreement had not raised barriers to trade was just another version of that old argument and should not be accepted.

7.116 Turning to some procedural matters, the United States expressed its concern over Turkey's requested finding that, *because Turkey has made the argument* that its QRs were a requirement of the customs union, *therefore* the Panel could not rule on the legality of its QRs in the absence of agreed conclusions on the consistency of the Turkey-EC customs union with GATT. Turkey did not appear to have supplied any argument in support of this request.

7.117 In fact, the suggestion that this Panel could not rule on the legality of Turkey's measures was inconsistent with the WTO Agreement in several ways. First of all, nothing in the text of GATT or any other part of the WTO Agreement supported the notion that measures could be excluded from dispute settlement merely because a Member *made an argument* about the justification of a measure. Quite the reverse: Article XXIII did not exclude any measures from its scope. Furthermore, Appendix 2 to the DSU did not list Article XXIV as one of the special or additional rules and procedures to which the DSU was subject. Moreover, Turkey's suggestion contradicted the provisions of paragraph 12 of the Understanding on Article XXIV. Of course, it could not be otherwise. If a Member could prevent a panel from issuing rulings merely by making arguments about its measures, then dispute settlement would grind to a halt. This point was made clear by the panel in the *EEC - Bananas I* case:

> "If preferences granted under *any* agreement for which Article XXIV had been invoked could not be investigated under Article XXIII, any contracting party, merely by invoking Article XXIV, could deprive other contracting parties of their rights under Article XXIII."[231]

7.118 The United Stated noted that Turkey had even gone so far as to suggest that the present case should not proceed in the absence of *agreed* conclusions in the CRTA. Such a procedure would subject WTO dispute settlement to the ability of any Member to block consensus; and the central feature of the WTO dispute settlement system was the inability of any Member to prevent dispute settlement by consensus blocking. In short, this Panel should reject Turkey's suggestion that it lacked the power to decide the question of the consistency of Turkey's measures with the requirements of the WTO Agreement.

7.119 The United States further noted that Turkey's argument that India's supposed failure to engage in meaningful consultations should deprive India of the right to pursue this dispute was unfounded. Article 3.7 of the DSU made clear that the dispute settlement mechanism was available in absence of a mutually agreed solution. And, Article 4.7 of the DSU made it quite clear that the complaining party was entitled to request a panel if the dispute had not been settled within 60 days after the date of receipt of the request for consultations.

7.120 The United States also noted Turkey's statement that there was no difference in WTO terms between an EC enlargement and the formation of a new customs union. It was not clear how this statement advanced Turkey's arguments in this dispute. Perhaps Turkey was attempting to bolster its observation that no Member had initiated a dispute as a result of the extension of the EC textiles and clothing restrictions to Sweden, but the Swedish analogy did not help the Turkish position. As a previous GATT panel made clear, "... it would be erroneous to interpret the fact that a measure had not been subject to Article XXIII over a number of years, as tantamount to its tacit acceptance by contracting parties".[232] Another panel pointed out that "[t]he decision of a contracting party not to invoke a right *vis-à-vis* another contracting party at a particular point in time can therefore, by itself, not reasonably be assumed to be a decision to release that other contracting party from its obligations under the General Agreement".[233] Therefore, the fact that no Member objected to the new Swedish restrictions did not mean that either those restrictions or the ones challenged in this case were consistent with the requirements of the WTO Agreement. In any event, the United States concurred with India's observation that this Panel need not make any findings on the complex issues relating to the extension of the WTO Agreement to the territory of states that acceded to the European Communities.

7.121 The United States also noted that India had submitted that the only provision of the ATC under which a Member could introduce new QRs on imports of textile and clothing products was under the transitional safeguard mechanism set out in Article 6 of the ATC. That statement was not entirely accurate; the United States recalled that other provisions of the ATC, such as Article 5.4, also allowed for the in-

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[231] Panel Report on *EEC - Bananas I*, para. 367.
[232] Panel Report on *EEC-Imports from Hong Kong, para. 28*.
[233] Panel Report on *EEC-Bananas I*, para. 362.

troduction of new restrictions in specified circumstances. But India was correct to draw attention to the Article 6 safeguard mechanism, because - assuming that the customs union as a whole could demonstrate the serious damage or threat thereof required by Article 6 (and footnote 5) of the ATC - it could provide the Turkey-EC customs union with cover, once the European Communities removed its textiles and clothing restrictions to match the earlier Turkish regime.

7.122 The United States also noted that Japan had proposed "the need for strict interpretation of the provisions for exception clauses" and that a previous panel "concluded that the parties invoking the exception must bear the burden of proof that it has fulfilled the conditions for invoking the exception." However, the interpretation of the *US - Underwear* panel (referred to by Japan) had been superseded by the Appellate Body discussion in *US - Shirts and Blouses,* where the question also arose. The Appellate Body disagreed with the notion that Article 6 of the ATC was an exception in the same sense as provisions such as Article XX of GATT and stated that "[t]he ATC is a transitional arrangement that, by its own terms, will terminate when trade in textiles and clothing is fully integrated into the multilateral trading system. Article 6 of the ATC is an integral part of the transitional arrangement manifested in the ATC and should be interpreted accordingly".[234]

7.123 In conclusion, the United States urged the Panel to decide this dispute, notwithstanding Turkey's claim that it could not do so. The United States further urged the Panel not to accept the various justifications that Turkey had advanced for the QRs that India had challenged. In particular, Article XXIV of GATT should not be read to permit Members to introduce QRs that were not consistent with their obligations under the WTO Agreement.

F. Comments by the Parties

7.124 **Turkey** did not intend to take a position on each of the issues raised by the third parties. To the extent that they would have been raised by India, these issues would be addressed in Turkey's own submissions. Turkey stressed, however, that third parties were neither complainants nor respondents and had therefore to intervene in the matter as defined by the terms of reference, limited to the claims of the complaining party. Noting that, in the present case, there had been such a situation, Turkey stated that a third party could not be permitted to raise new issues, as otherwise the whole dispute settlement procedure would be subverted and disputes would become open-ended, which could not be the purpose of the dispute settlement mechanism.

7.125 **India** responded that it conceptually agreed with Turkey that third parties were not expected to add new claims to those made by the complaining party. In its view, however, the third parties had basically rebutted Turkey's claim that the measures at issue were justified under Article XXIV of GATT.

[234] Appellate Body Report on *US - Shirts and Blouses*, p. 16, DSR 1997:I, 337.

VIII. INTERIM REVIEW[235]

8.1 On 12 March 1999, Turkey and India requested the Panel to review, in accordance with Article 15.2 of the DSU, certain aspects of the interim report that had been transmitted to the parties on 3 March 1999. No request for a further meeting with the Panel was received from either party.

8.2 We have reviewed the arguments and suggestions presented by the parties, and finalized our report, taking into account those comments by the parties which we considered justified. In this context we have made small changes, including those to paragraphs 9.148, 9.151 and 9.191. In addition, we have made other minor linguistic and typographical corrections.

8.3 Turkey submits that, contrary to the Panel's view, it never claimed that the measures which form the object of India's complaint had been taken by another entity than itself. Turkey therefore requests the Panel to modify paragraphs 9.33 to 9.43 of the Interim Panel Report. We note that in its very first submission Turkey wrote: "Given this situation, the Panel should reject India's claim on the basis that India's choice of the respondent in this dispute is incorrect. … The situation here is in fact comparable with a situation where the complainant directs its complaint against country A for a measure taken by country B. … In Turkey's view the same rule must apply in the present case … There is no basis in fact or in law, for the assumption … that Turkey is individually responsible for acts that are collectively taken by the members of the Turkey-EC customs union through the institutions created by the custom union agreement."[236] As we mention in paragraph 9.33 we have examined all alternatives possible to cover Turkey's argument that the measure had been taken by an entity other than Turkey. We were of the view that there were only two other alternatives: the measures could have been those of the Turkey-EC customs union or those of the European Communities. We find that the measures at issue were clearly Turkish measures. We then proceed further (paragraph 9.38) to examine whether the measures at issue could be measures of the Turkey-EC customs union or measures of the European Communities and we find that we have no alternative but to conclude that the measures at issue are only Turkish measures (paragraph 9.40). Having noted

[235] Pursuant to Article 15.3 of the DSU, the findings of the panel report shall include a discussion of the arguments made at the interim review stage. Consequently the following section entitled Interim Review is part of the Findings of this Panel report.

[236] See para. 3.33 above which refers to page 14 of Turkey's request for preliminary ruling: " Given this situation, the Panel should reject India's claim on the basis that India's choice of the respondent in this dispute is incorrect. In order to pursue its claims properly, India should have *chosen both parties to the Turkey-EC customs union* as respondents, not just one of them. The situation here is in fact comparable with a situation where the *complainant directs its complaint against country A for a measure taken by country B*. In such a situation, the complaint would have to be turned down for lack of standing due to the obvious absence of international liability. In Turkey's view, the same rule must apply in the present case, since Turkey alone is not internationally answerable for acts adopted by the *institutions created by the agreement creating the Turkey-EC customs union*. There is no basis, in fact or in law, for the assumption - on which however India's complaint appears to be founded - that Turkey is individually responsible for acts that are collectively taken by the members of the Turkey-EC customs union through the institutions created by the customs union agreement." (emphasis added).

that the Turkey-EC customs union is not a Member of the WTO, we also examine the rules of state responsibility in public international law public, and find that in the absence of a specific treaty provision (in the DSU as drafted) individual states remain responsible for any wrongful act committed by their common organ. We see no reason to change these findings. We reach the conclusion that the measures under examination were those of Turkey itself and Turkey alone, and only Turkey could therefore be defendant to this dispute, especially as the Panel was not assessing the WTO compatibility of the Turkey-EC customs union.

8.4 Turkey also reiterates that its position is that such measures are the basic requirements of the customs union into which it has entered with the European Communities, and as long as the European Communities itself maintains similar measures with their imports of the same products from a number of countries. We refer to our considerations and findings in paragraphs 9.140 to 9.182. We find that there are WTO compatible alternatives for Turkey to form a customs union or an interim agreement leading to a customs union with the European Communities or others. We also find that even if the Turkey-EC customs union agreement did require Turkey to adopt all EC trade policies, an issue that we do not have to address, we consider that such a requirement would not be sufficient to exempt Turkey from its obligations under the WTO Agreement.

8.5 India requests the Panel to review its interpretation of Article XXIV:8(a)(ii) because, according to India it is not based on the language of this provision. The Panel finds that the phrase "substantially the same duties and other regulations of commerce" does not impose an absolute standard and that not "all" the constituents' duties and not all the constituent members' regulations of commerce shall be the same. We find that this standard leaves an element of flexibility to the constituent members. India argues that when the Panel finds that "a situation where the constituent members have comparable trade regulations having similar effects with respect to trade with third countries, would generally meet the requirements of Article XXIV:8(a)(ii)" the Panel is effectively turning the requirement to apply "substantially the same regulations" into "the same regulations on substantially all the trade". We are of the view that the wording of Article XXIV:8(a)(ii) makes it clear that the term "substantially the same" qualifies both the "duties" and the "other regulations of commerce". In other words, we consider that the ordinary meaning of the term "substantially the same … regulations of commerce" in the context of sub-paragraph 8(a) appears to provide for both qualitative and quantitative components; we also consider that in many cases, when constituent members adopt comparable trade regulations having a similar effect, they will be in compliance with the provisions of sub-paragraph 8(a)(ii) whereby constituent members are required to adopt "substantially the same … regulations of commerce". We also consider that the greater the degree of policy divergence, the lower the flexibility as to the areas in which this can occur; and vice-versa. We find as well that this degree of flexibility does not provide Turkey with the right to impose otherwise WTO incompatible quantitative restrictions. On the contrary, we find that Turkey's conditional right to form a regional trade agreement compatible with Article XXIV, without violating Articles XI and XIII and Article 2.4 of the ATC, is confirmed by the flexibility offered by the wording of Article XXIV.

8.6 Finally, in response to India's claim, in its request for review of the interim report, that the Panel should not reach any conclusion on the alternatives open to

Turkey when forming a "fully fledged" customs union since Turkey could always have claimed before the CRTA that its customs agreement with the European Communities was not a complete customs union, we would like to reiterate[237] that we are not assessing the nature of the regional trade agreement between the EC and Turkey, nor its stage of integration. In this report, we simply respond to Turkey's defense based on Article XXIV:8(a) and find that even if the Turkey-EC customs union is to be considered a complete customs union as alleged by Turkey, in the present dispute there are alternatives open to Turkey to form a customs union where measures adopted by constituent members would not violate other provisions of the WTO. In the context of an interim agreement leading to a custom union, Turkey would have further flexibility, since compliance with Article XXIV:8(a) is required only at the end of the transitional period leading to the formation of a customs union.

IX. FINDINGS

A. Preliminary Rulings Recalled

9.1 On 14 August 1998 Turkey requested the Panel to make three preliminary rulings *in limine litis*. On 28 August 1998 we invited India and the third parties to comment in writing on Turkey's request. The Panel held a meeting with the parties only on 19 September 1998 to consider the request and on 25 September 1998, the Panel issued its rulings on the issues raised by Turkey. In its first submission, Turkey also requested the Panel to reject India's complaint on the grounds that the consultations preceding the request for establishment of a panel were defective. In this section, as foreshadowed in our rulings of 25 September 1998, we recall and expand on those rulings rejecting Turkey's first three preliminary objections and then analyze Turkey's claim concerning the inadequacy of the consultations.

1. Article 6.2 of the DSU

9.2 Firstly, in its request for preliminary rulings, Turkey claimed that India's request for the establishment of a panel did not respect the specificity requirements of Article 6.2 of the Understanding on the Rules and Procedures Governing the Settlement of Disputes ("DSU") in that it failed to identify specifically the measures at issue and the products subject to those measures and that its basic rights of defense and due process were impaired.[238]

9.3 On 25 September 1998 the Panel issued the following ruling on this point:

> "In assessing Turkey's claim that India's request for the establishment of a panel was not sufficiently precise, we consider that it is important that a panel request, which defines the terms of reference, meets this criterion so as to inform the defending party and potential third parties both of the measures at issue, including the products they cover, and

[237] See our statement to this effect in footnotes 241 and 285 hereafter.

[238] Turkey's arguments are further detailed in paras. 3.6 to 3.8, 3.13 to 3.15, 3.19 and 3.21, India's arguments are in paras. 3.9 to 3.12, 3.16 to 3.18, 3.20, 3.22 and 3.23 and the third parties' arguments are in paras. 3.24 and 3.25 above.

of the legal basis of the complaint. This is necessary to ensure due process and the ability of the defendant to defend itself.

We have examined India's request for establishment of the panel (WT/DS34/2). While not identified by place and date of publication, the measures are specified by type (i.e. quantitative restrictions), by effective date of entry into force (1 January 1996) and by product coverage (textiles and clothing, a well defined class of products in the WTO).[239] In our view the panel request meets the minimum requirements of specificity of Article 6.2 of the DSU as interpreted by the Appellate Body in *Bananas III* and *LAN*.[240] Even if we agree that India's request could have been more detailed, we conclude that Turkey is sufficiently informed of the measures at issue and the products they cover, and that our terms of reference are sufficiently clear. Consequently, we reject Turkey's claim that the Panel should refuse to accept India's request *in limine litis* for its failure to respect the basic requirements of Article 6.2 of the DSU."

2. Necessity of Participation of the European Communities

9.4 Secondly, in its request for preliminary rulings, Turkey claimed that the Panel should dismiss India's claims because they are directed only against Turkey while the measures at issue were taken pursuant to a regional trade agreement between Turkey and the European Communities[241], and according to Turkey, the European Communities should also have been a party to the dispute.[242]

9.5 On 25 September 1998, the Panel issued the following ruling on this point:

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[239] [Footnote original]We note also that during the period of consultations Turkey and the EC jointly sent notifications and other communications to the CRTA (WT/REG22/5, WT/REG22/7) and, pursuant to Article 3.3 of the ATC, to the TMB (G/TMB/N/308), in which Turkey lists the new textile import restrictions it adopted following the conclusion of the agreement between the EC and Turkey. In addition, during the meetings of the CRTA (WT/REG22/M1 and M2), and the TMB (meetings of 11-12 December 1997), which preceded the request for the establishment of a panel, the parties discussed the issues relating to this dispute. This confirms to us that Turkey is sufficiently informed of the measures challenged by India in this dispute and the products covered by the measures at issue. Moreover, we note that no comments were made on this issue at any of the meetings of the DSB where the present dispute was discussed (WT/DSB/M13, 15, 42 and 43) and that no Member questioned the scope of the terms of reference in this regard.

[240] Appellate Body Report on *European Communities - Regime for the Importation, Sale and Distribution of Bananas*, adopted on 25 September 1997, WT/DS27/AB/R ("*EC-Bananas III*") and *European Communities - Customs Classification of Certain Equipment* adopted on 22 June 1998, WT/DS62, 67, 68/AB/R, ("*EC - Computer Equipment*" or "*EC - LAN*").

[241] The official title of that agreement is the Customs Union between Turkey and the Community (see WT/REG22/1). The European Communities is a WTO Member. In this Panel report we shall refer to the Turkey-EC customs union without any assessment of the WTO nature of this Article XXIV type of arrangement.

[242] Turkey's arguments are further detailed in paras. 3.26, 3.28, 3.30, 3.33 and 3.34, India's arguments are in paras. 3.27, 3.29, 3.31, 3.32, and 3.35 to 3.37 and the third parties' arguments are in paras. 3.38 to 3.40 above.

"Turkey states that the measures at issue were introduced in the context of the trade agreement concluded with the EC, which Turkey and the EC notified to the CRTA as a customs union (WT/REG/22/1). The Panel will obviously have to assess whether such import restrictions introduced by Turkey in the context of that trade agreement are compatible with the WTO Agreement and its related instruments.

We note that the EC has decided not to participate as a third party in this dispute. We note that the DSU does not allow for any other form of participation in favour of a Member, not party to the dispute, other than the third-party rights under Article 10 of the DSU, which, we also note, have been extended in previous cases to meet the specific circumstances of the case. In the absence of any relevant provision in the DSU, in light of international practice[243], and noting the position of the EC to this point, we consider that we do not have the authority to direct that a WTO Member be made third-party or that it otherwise participate throughout the panel process.

We can find no provision in the DSU that would prevent India from initiating a panel procedure against measures imposed by Turkey in these circumstances. Moreover, we are not aware of any general rule applicable to cases in which disputed measures arise from a bilateral or multilateral agreement, that would prohibit a Member from initiating a dispute settlement procedure against one party to such agreement. Accordingly, we do not accept Turkey's claim that India's request should be rejected at this stage of the panel process because India's request was not directed against all parties to the trade agreement which, according to Turkey, forms the basis for the introduction of the measures at issue. This is without prejudice to our decision whether the said measures are WTO compatible. We would like also to emphasize that we shall ensure due process throughout these panel proceedings and that in this context we are aware of the means existing under the DSU for panels to obtain technical advice and information from any relevant source."

9.6 In terms of Article XXIII of the 1994 General Agreement on Tariffs and Trade ("GATT") and the DSU any Member may initiate a dispute settlement procedure against any other Member if it considers that its rights have been nullified or impaired by this other Member. We note that there is no special provision in the DSU for dispute settlement proceedings involving customs unions or any other type of regional trade agreements. We note also that the Turkey-EC customs union itself is

[243] [Footnote original]The Panel examined relevant principles of international law, including the practice of the International Court of Justice in the *Military and Paramilitary Activities in and Against Nicaragua* case ([1984], ICJ Reports, pp.430-431) and the *Phosphate Lands in Nauru* case([1992], ICJ Reports, p.259-262) cases (preliminary objections).

not a Member of the WTO and therefore cannot be the subject of any DSU procedure, as it lacks WTO legal personality.[244]

9.7 We also recall that in the *EC - Bananas III*[245] dispute the Panel and the Appellate Body addressed the compatibility of EC measures adopted pursuant to the Lomé Convention with the WTO Agreement, notwithstanding the EC claim that it was required to adopt the measures pursuant to that Convention and notwithstanding the fact that its Lomé partners were not parties to the dispute.

9.8 It is relevant to recall the case law of the International Court of Justice (ICJ). The ICJ has not declined to exercise jurisdiction in cases similar to this one. For example in the ICJ *Military and Paramilitary Activities in and Against Nicaragua* case, the US argued that the application brought by Nicaragua was inadmissible because Nicaragua had not also impleaded third countries whose participation was essential. The ICJ dismissed this argument, saying:

> "There is no doubt that in appropriate circumstances the Court will decline, …, to exercise the jurisdiction conferred upon it where the legal interests of a State not party to the proceedings "would not only be affected by a decision, but would form the very subject-matter of the decision". … Where however claims of a legal nature are made by an Applicant against a Respondent in proceedings before the Court, and made the subject of submissions, the Court has in principle merely to decide upon those submissions, with binding force for the parties only, and no other State… Other States which consider that they may be affected are free to institute separate proceedings, or to employ the procedure of intervention. *There is no trace, either in the Statute or in the practice of international tribunals, of an "indispensable parties" rule* of the kind argued for by the United States, which would only be conceivable in parallel to a power, which the Court does not possess, to direct that a third State be made a party to proceedings."[246]

9.9 The ICJ *Phosphate Lands in Nauru* case concerned a proceeding initiated by Nauru against Australia alone in respect of the administration of a fund in favour of Nauru. The case was based on an international treaty whereby Australia, New Zealand and the United Kingdom were co-administrators of the fund. The ICJ exercised jurisdiction despite the absence of the two other administering authorities since the legal interest of those third countries (which could be affected by the result of the dispute) did not form the subject-matter of the dispute which was the legal relationship between Australia and Nauru. The ICJ stated:

> "In the present case, a finding… regarding the existence or the content of responsibility attributed to Australia by Nauru might well have im-

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[244] We recall that in its Report on *India - Patent Protection for Pharmaceutical and Agricultural Chemical Products* adopted on 16 January 1998, WT/DS50/AB/R ("*India - Patent*"), the Appellate Body stated: "Although panels enjoy some discretion in establishing their own working procedures, this discretion does not extend to modifying the substantive provisions of the DSU. (…) Nothing in the DSU gives a panel the authority either to disregard or to modify other explicit provision of the DSU", para. 92.

[245] Appellate Body Report on *EC - Bananas III*, , paras. 164 -188.

[246] *Military and Paramilitary Activities in and Against Nicaragua* [1984] at 431.

> plications for the legal situation of the two other States concerned, but no finding in respect of that legal situation will be needed as a basis for the Court's decision on Nauru's claims against Australia. Accordingly, the Court cannot decline to exercise its jurisdiction."[247]

In its separate opinion, Judge Shahabuddeen added:

> "To return to the question under examination, as to whether Australia may be sued alone, I consider that an affirmative answer is required for three reasons. First, the obligations of the three Governments under the Trusteeship Agreement were joint and several. Second, assuming that the obligations were joint, this did not by itself prevent Australia from being sued alone. Third, a possible judgment against Australia will not amount to a judicial determination of responsibility of New Zealand and the United Kingdom."[248]

9.10 The practice of the ICJ indicates that if a decision between the parties to the case can be reached without an examination of the position of the third state (i.e. in the WTO context, a Member) the ICJ will exercise its jurisdiction as between the parties. In the present dispute, there are no claims against the European Communities before us that would need to be determined in order for the Panel to assess the compatibility of the Turkish measures with the WTO Agreement.[249]

9.11 It should be noted that there is no WTO concept of "essential parties". Based on our terms of reference and the fact that we have decided (as further discussed hereafter) not to examine the GATT/WTO compatibility of the Turkey-EC customs union, we consider that the European Communities was not an essential party to this dispute; the European Communities, had it so wished, could have availed itself of the provisions of the DSU, which we note have been interpreted with a degree of flexi-

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[247] *Certain Phosphate Lands in Nauru* ("*Nauru*"), [1992] ICJ Reports, 240 (June 26); p. 261-262.

[248] *Nauru* case; Separate Opinion of Judge Shahabuddeen, at 271, italics added. A separate opinion is not a dissenting opinion but reflects the additional discussion of one of the Judge of the ICJ.

[249] We are aware that the ICJ has declined to exercise its jurisdiction when it concluded that the real "subject-matter of the dispute" is the legal position of a third country which is not before it. In the *Monetary Gold Removed from Rome in 1943* case, Italy brought a case against the United Kingdom claiming it had priority over both the British and Albanian claims to the gold in question. However, Albania took no part in the dispute. The ICJ declined to exercise its jurisdiction because it would have been necessary to decide upon the international responsibility of Albania - the very subject-matter of the dispute - without her consent. (See [1954] ICJ Reports, p. 32). In the *Case of East Timor*, Portugal complained against Australia concerning a treaty between Australia and Indonesia for the delimitation of the continental shelf between Australia and Indonesian-occupied East Timor. Indonesia had not been impleaded by Portugal and had not applied for permission to intervene as a third party. The ICJ declined to exercise its jurisdiction because it would have had to rule, as a prerequisite, on the lawfulness of the possession of East Timor by Indonesia, which was not present in the case. (See [1995] ICJ Reports, pp. 90-106)

bility by previous panels[250], in order to represent its interests. We recall in this context that Panel and Appellate Body reports are binding on the parties only.[251]

9.12 Under WTO rules, the European Communities and Turkey are Members with equal and independent rights and obligations. For Turkey, it is not at all inconceivable that it adopted the measures in question in order to have its own policy coincide with that of the European Communities. However, in doing so, it should have been aware, in respect of the measures it has chosen, that its circumstances were different from those of the European Communities in relation to the Agreement on Textiles and Clothing ("ATC") and thus could reasonably have been anticipated to give rise to responses which focussed on that distinction.

9.13 In the context of our concern for due process and pursuant to Article 13 of the DSU, we put a series of questions to the European Communities and invited it to comment on any matter it considered relevant. The European Communities, while responding to the specific questions, did not avail itself of the latter opportunity.[252]

3. The Need to Exhaust TMB Procedures

9.14 Thirdly, in its request for preliminary rulings, Turkey claimed that India was required to exhaust the special dispute settlement procedures under the ATC first before it could refer the matter to the DSB and that consequently, this Panel had not been established properly.[253]

9.15 On 25 September 1998, the Panel issued the following ruling on this point:

> "We note that the special and additional dispute settlement procedures before the Textile Monitoring Body (TMB) apply when measures are imposed pursuant to the ATC and that Article 8.1 of the ATC provides that the TMB is established to examine measures taken under the ATC and their conformity therewith.
>
> We note that Turkey, in its own notifications to the Committee on Regional Trade Agreements (CRTA) and to the TMB (pursuant to Article 3.3 of the ATC), stated that the import restrictions at issue were justified and had been introduced pursuant to its agreement with the EC and in conformity with Article XXIV of GATT 1994. For instance, in its 7 November 1997 notification to the TMB (G/TMB/N/308), Turkey wrote that it was notifying the TMB of the "details of certain quantitative limits introduced by Turkey in respect of imports of certain textile and clothing products into Turkey from certain WTO Members, and necessary to give effect to the Customs

[250] See for instance the Panel Reports on *European Communities - Regime for the Importation, Sale and Distribution of Bananas*, adopted on 25 September 1997, WT/DS27/Rs ("*EC - Bananas III*"), paras. 7.4-7.9 and on *European Communities - Measures Concerning Meat and Meat Products (EC - Hormones)*, adopted on 13 February 1998, WT/DS26, 48/R, paras. 8.12-8.15.

[251] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages*, WT/DS8, 10, 11/AB/R, adopted on 1 November 1996 ("*Japan - Alcoholic Beverages*"), p. 13.

[252] For further information on the details of this procedure and the Panel's invitation to the European Communities, see paras. 4.1 to 4.3 above.

[253] Turkey's arguments are further detailed in paras. 3.41 to 3.44 , India's arguments are in paras. 3.45 to 3.49 and the third parties' arguments are in para. 3.50 above.

> Union in conformity with the provisions of Article XXIV of GATT 1994". We also note that the notification to the TMB, for its information, was made pursuant to Article 3.3 of the ATC, which refers to "any new restrictions (…) taken under any GATT 1994 provision".
>
> In our view India's claim under Article 2.4 of the ATC is a reflection of its claims under GATT 1994. This is to say that India does not claim a violation of the ATC except in so far as the ATC, in Article 2.4, prohibits the imposition of restrictions inconsistent with GATT 1994. Article 2.4 of the ATC provides that all new import restrictions on textile and clothing products are prohibited, except if justified under the ATC or under GATT 1994.
>
> As noted above, Turkey itself has indicated that its new restrictions on textile and clothing products are justified under and have been imposed pursuant to Article XXIV of GATT 1994, and as such can be exempted from the general prohibition against new restrictions mentioned in Article 2.4 of the ATC.
>
> Since the measures at issue are alleged to have been imposed pursuant to GATT 1994 (and India's claim relates to Turkey's alleged justification pursuant to GATT 1994), we reject Turkey's *in limine litis* request that the TMB should have been seized of the matter under Article 8 of the ATC prior to its referral to the DSB. This ruling is without prejudice to our eventual decision on whether the said measures at issue constitute a WTO compatible justification pursuant to Article 2.4 of the ATC and other WTO rules."

9.16 In our view, the determination of this case depends on the Panel's assessment of Turkey's defense that its measures were taken in the context of its customs union with the European Communities, and so for Turkey, were authorized by Article XXIV of GATT. We consider that this is not a matter for the TMB, whose jurisdiction is limited by Article 8.1 of the ATC to the examination of measures taken under the ATC and their conformity therewith. (We address further the relationship between the role of the TMB and that of panels in paragraphs 9.82 to 9.85).

9.17 In reconsidering our rulings of 25 September 1998, we find no substantive basis to call them into question.

4. Inadequacy of the Consultations

9.18 Turkey also raised a fourth procedural exception for which it did not request an immediate *in limine litis* ruling by the Panel. In its first submission, Turkey asserts that India has not sufficiently exhausted the consultations requirements of Article XXII of GATT 1994 and Article 4 of the DSU in order to bring about a mutually acceptable solution to the dispute.[254]

9.19 For Turkey, the principle of procedural economy as well as the spirit of the WTO dispute settlement mechanism require that panel procedures be considered as *ultima ratio* means to solve conflicts between Members for which they are unable to

[254] Turkey's arguments are further detailed in paras. 6.1, 6.2, 6.5 and 6.6 above.

find a negotiated solution. For Turkey, India failed to comply with this principle and the spirit of the DSU. While Turkey offered to enter into negotiations on the issues in dispute with India, India refused to enter into such negotiations, in as much as it refused to deal with the issues in dispute in consultations under Article XXII of GATT.

9.20 India responded[255] that on 21 March 1996, it requested formal consultations with Turkey under the DSU regarding the matter of the unilateral imposition of quantitative restrictions by Turkey on imports of a broad range of textile and clothing products from India as from I January 1996. This request was accepted by Turkey on 1 April 1996. In a letter confirming this, Turkey stated that it had agreed to enter into consultations "on textiles and clothing restrictions applied by Turkey" at a mutually acceptable time and venue. Further, Turkey considered that "the European Communities as our partner in the customs union should also be represented in the consultations". On 4 April 1996, India proposed that consultations should be held in Geneva on 18-19 April 1996, and stated that India could not accept Turkey's view that the European Communities should participate in these consultations since, under GATT and WTO practice, consultations under Article XXIII:1 of GATT 1994 were bilateral in nature. India requested that Turkey confirm the venue and time proposed for consultations to be held without the participation of the European Communities. On 16 April 1996, Turkey replied that "the Turkish authorities would be prepared to hold with their Indian counterparts the consultations requested by India ... on the understanding that representatives of the European Communities would also be participating. This meeting could be held on 18 April 1996 from 3:30 p.m. to 6:00 p.m. as suggested by India". India stated that despite this very short notice, it ensured the presence of its delegation at the consultations but the delegation of Turkey did not attend the scheduled meeting nor did it provide an explanation for its absence. India submitted that it sent another communication to Turkey, on 18 April 1996, proposing to enter into bilateral consultations on 19 April 1996. When India endeavoured to confirm the date and venue of the consultations, it was informed that Turkey was not in a position to enter into these consultations without the participation of the European Communities, and that this would be conveyed to India in writing by close-of-business on 19 April 1996. India submits that the communication from Turkey, dated 19 April 1996, was received on 22 April 1996.

9.21 India argued that its recourse to the provisions of GATT 1994 and the DSU regarding consultations was frustrated. Its request for bilateral consultations had been made in good faith, in full transparency and with a view to reaching a mutually satisfactory solution. For India, since Turkey did not enter into these consultations within the 30-day period provided for in Article 4.3 of the DSU, Turkey violated Articles 3 and 4 of the DSU, and in particular contravened the provisions of Article 3.10 of the DSU, and therefore the dispute remained unresolved.[256]

9.22 Firstly, we note that in *EC - Bananas III* the panel concluded that the private nature of the bilateral consultations means that panels are normally not in a position to evaluate how the consultations process functions, but could only determine

[255] India's arguments are further detailed in paras. 6.3, 6.4, 6.7 to 6.10 above.

[256] India added that the DSB was informed of this situation on 24 April 1996; WT/DSB/M/15, para. 3.

whether consultations, if required, did in fact take place.[257] In this case, the parties never consulted, as Turkey declined to do so without the presence of the European Communities.

9.23 In *Korea - Taxes on Alcoholic Beverages* the panel concluded that:

> "… the WTO jurisprudence so far has not recognized any concept of "adequacy" of consultations. The only requirement under the DSU is that consultations were in fact held, or were at least requested, and that a period of sixty days has elapsed from the time consultations were requested to the time a request for a panel was made. … We do not wish to imply that we consider consultations unimportant. Quite the contrary, consultations are a critical and integral part of the DSU. But, we have no mandate to investigate the adequacy of the consultation process that took place between the parties and we decline to do so in the present case."[258]

9.24 We concur with this statement. We note also that our terms of reference (our mandate) are determined, not with reference to the request for consultations, or the content of the consultations, but only with reference to the request for the establishment of a panel.[259] Consultations are a crucial and integral part of the DSU and are intended to facilitate a mutually satisfactory settlement of the dispute, consistent with Article 3.7 of the DSU. However, the only function we have as a panel in relation to Turkey's procedural concerns is to ascertain whether consultations were properly requested, in terms of the DSU, that the complainant was ready to consult with the defendant and that the 60 day period has lapsed before the establishment of a panel was requested by the complainant. We consider that India complied with these procedural requirements and therefore we find it necessary to reject Turkey's claim.

B. Main Claims of the Parties

9.25 India claims that the quantitative restrictions imposed by Turkey on imports of textile and clothing products from India since 1 January 1996 are inconsistent with Articles XI:1 and XIII of GATT and with Article 2.4 of the ATC. India also claims that Article XXIV does not constitute a defense to such violations.

9.26 Turkey, in response, claims that the restrictions it applies on imports of nineteen categories of certain textile and clothing products from India are justified under Article XXIV of GATT, as these measures were adopted pursuant to (and on the occasion of the formation of) its customs union with the European Communities.

9.27 Turkey considers that Article XXIV of GATT recognizes that WTO Members have a right to form customs unions and that this right provides such a regional trade

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[257] Panel Report on *EC - Bananas III*, paras. 7.18-7.19 (not appealed).

[258] Panel Report on *Korea - Taxes on Alcoholic Beverages*, upheld by the Appellate Body, adopted on 17 February 1999, WT/DS75, 84/R ("*Korea - Alcoholic Beverages*"), paras. 10.19, (not appealed).

[259] See for instance the Appellate Body Report on *EC - Bananas III*, paras. 139-144; the Appellate Body Report on *Brazil - Measures Affecting Desiccated Coconut*, adopted on 20 March 1997, WT/DS22/AB/R ("*Brazil - Desiccated Coconut*"), page 22; and the Appellate Body Report on *India - Patent,* paras. 86-96.

agreement with a "shield" from all other WTO obligations. In the context of invoking Article XXIV of GATT, Turkey argues that its customs union with the European Communities is consistent with Article XXIV in that 1) the new regime is overall less restrictive than its previous one, 2) the restrictions challenged by India are of a temporary nature, 3) the customs union has liberalized Turkey's trade with third countries, and 4) the customs union will be deepened further including in the area of trade legislation. In particular with reference to import restrictions, Turkey argues that 1) Article XXIV:5 provides a derogation from other GATT provisions in the case of the formation of a customs union, and 2) GATT does not prohibit all new restrictions which may be required by customs unions.

9.28 In addition, Turkey argues 1) that these measures constitute a "requirement" (by the European Communities and also of Article XXIV); that it adopt the European Communities' common commercial policy, including the arrangements relating to trade in textiles and clothing; 2) that there is no GATT-consistent alternative to these restrictions if it wants to include textile and clothing products (which constitute 40 per cent of Turkey's exports to the European Communities) in the customs union; and 3) that in this context, the WTO Agreement makes no distinction between the formation of a new customs union and accession to an existing customs union.

9.29 Turkey argues that, since it has formed a customs union with the European Communities which, under the ATC, is entitled to maintain import restrictions on the same 19 categories of textiles and clothing, Turkey's parallel import restrictions are not new restrictions in the sense of Article 2.4 of the ATC, being justified by Article XXIV. For Turkey, the said measures are therefore not inconsistent with Article 2 of the ATC. Finally, in its second submission, Turkey claims that India has not suffered any nullification of benefits, as its exports to Turkey have generally increased since the entry into force of the customs union.

9.30 In response to Turkey's argument that the provisions of Article XXIV constitute a derogation or complete defense (possibly as *lex specialis*) to all claims, India argues that the obligations under Articles XI:1 and XIII of GATT and 2:4 of the ATC are not modified by Article XXIV:5(a) of GATT 1994, which, according to India, requires Members forming a customs union not to raise the general incidence of regulations of commerce imposed on trade with third Members. As to Turkey's arguments that it was required to follow the EC commercial policy in the sector of textiles and clothing and that it had no alternative but to do so, India responds that the prohibitions of Articles XI and XIII of GATT and Article 2.4 of the ATC are not modified by Article XXIV:8(a)(ii) of GATT. For India, pursuant to Article XXIV:8(a)(ii), the European Communities and Turkey could have maintained different external textile policies at least for a certain period since their agreement is only an interim agreement and Turkey has not become a member of the European Communities. Turkey claims that its customs union with the European Communities was complete as of 1 January 1996 and is not an interim agreement or any form of transitional agreement, as defined by Article XXIV.

9.31 In response to Turkey's argument that the Panel should not substitute itself for the CRTA by examining the WTO compatibility of the Turkey-EC customs union, India agrees that it is not challenging the consistency of the Turkey-EC trade agreement with Article XXIV. Instead India states that it is requesting this Panel to rule that Turkey does not have the right to impose discriminatory restrictions on imports of textiles and clothing from India, irrespective of whether Turkey's agreement with

the European Communities is consistent with Article XXIV. In response to Turkey's allegation that India's rights have not been nullified or impaired by its textile and clothing policy, India challenges the accuracy of the statistics submitted by Turkey and argues that, in any case, Article 3.8 of the DSU establishes that any breach of a GATT obligation constitutes *prima facie* impairment and nullification of benefits, which have been considered to include benefits denied due to changes in competitive opportunities.

C. Measures at Issue

1. Identification of the Measures at Issue

9.32 India claims that the import restrictions in place since 1 January 1996 on 19 categories of textile and clothing products violate the provisions of Articles XI and XIII of GATT and Article 2.4 of the ATC.[260] We invited Turkey to confirm that the quantitative restrictions at issue are those listed in India's first submission and to provide us with the Official Gazette which published the establishment of such quantitative restrictions for the years 1996, 1997 and 1998. In response to a question from the Panel at the second substantive meeting, Turkey acknowledged that the quantitative restrictions in place correspond to the measures referred to by India in its first submission. Turkey noted that those quantitative restrictions had been notified to the WTO, i.e. to the CRTA and to the TMB. We conclude that the parties agree that the quantitative restrictions at issue are those listed by Turkey in its responses to the Panel's various questions on this issue and annexed to the present findings (see Annex to this report, Appendix 1).

2. Attribution to Turkey of the Measures at Issue

9.33 Although Turkey does not deny the existence of such quantitative restrictions on imports, it argues that since it duly notified its various trade agreements with the European Communities to the appropriate bodies of the GATT 1947 and of the WTO, it cannot be held individually liable for these quantitative restrictions as they result from the implementation of its customs union with the European Communities. Turkey argues that India has directed its complaint against Turkey concerning a measure taken by another entity (the Turkey-EC customs union or the European Communities). In Turkey's view, it is not individually responsible for acts that were collectively taken by the members of the Turkey-EC customs union through the institutions created by the agreement.

9.34 Turkey submits that the "nationality" of the measures at issue also relates to a fundamental aspect of the nature of a customs union. For Turkey, when two Members enter into a customs union, there is a fundamental change in the relationship between them and in their relationship with other WTO Members.

9.35 We comment briefly below on the issue of the responsibility of parties to a customs union *vis-à-vis* third countries. As to the question of "whose measures these

[260] Turkey, in its *in limine litis* preliminary request, claimed that the product coverage of India's request was not sufficiently detailed and precise. In our preliminary ruling of 25 September 1998 we rejected this claim by Turkey as further detailed in paras. 9.2 and 9.3 above.

import quantitative restrictions are?", three answers are possible: they are either Turkey's measures, the European Communities' measures, or the Turkey-EC customs union's measures.

9.36 As to whether the measures at issue are Turkish measures, we note that the measures were implemented through formal action by Turkey and that the measures were published by Turkey in its Official Gazette. The first Turkey-EC joint notification to the TMB refers to "details of certain quantitative limits introduced by Turkey"[261] and the second one to "details of changes in respect of quantitative limits applied by Turkey"[262] and both notifications list the measures at issue, i.e. restrictions imposed on 19 categories of textile and clothing products. In other words, the measures under examination were enacted, implemented and are now applied, by the Turkish government and do not impose any obligation on any other national or supranational authorities. Thus, on their face, the measures at issue appear to be measures taken by Turkey and enforceable on Turkish territory only.

9.37 We also note that the measures are applied by Turkey and that they are mandatory, i.e. they leave no discretion to Turkish authorities but to enforce the measure. It is customary practice of GATT/WTO dispute settlement procedures to address applied measures. In addition, previous adopted GATT panels have always considered that mandatory legislation of a Member, even if not yet in force or not applied[263], can be challenged by another WTO Member.

9.38 However, in view of Turkey's contention that these import restrictions are measures of another entity,[264] we proceed to address the issue of whether such measures can be those of the European Communities or of the Turkey-EC customs union.

9.39 While the European Communities also maintains restrictions against imports from India on the same 19 categories at issue, it does so pursuant to its "Council Regulation (EEC) 3030/93 on common rules for imports of certain textile products from third countries", adopted by the Council of the European Communities on 12 October 1993.[265] This regulation applies only to the European Communities' customs territory.[266] It is not enforceable in Turkey as an EC measure as such. On 7 January 1997 the European Communities notified the second stage of its integration programme to take effect by 1 January 1998; such notifications were made only with reference to

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[261] G/TMB/N/308. In the notification to the WTO the terms used are "details of the quantitative limits applied by Turkey in respect of imports of certain...", WT/REG22/7.

[262] G/TMB/N/326. In the notification to the WTO the terms used are "details of the quantitative limits applied by Turkey in respect of imports of certain..."; WT/REG22/8.

[263] See for instance the Panel Report on *United States - Taxes on Petroleum and Certain Imported Substances*, adopted on 17 June 1987, BISD 34S/136 ("*US - Superfund*"), paras. 5.2.1-5.2.2; Panel Report on *EEC - Regulation on Imports of Parts and Components*, adopted on 16 May 1990, BISD 37S/132, paras. 5.25-5.26; Panel Report on *United States - Measures Affecting Alcoholic and Malt Beverages*, adopted 19 June 1992, BISD 39S/206, para 5.39.

[264] See paras. 3.33 and 8.3 above.

[265] That regulation was adopted in the context of the MFA; this regulation was later amended in 1995, Regulation (EC) No. 1616/95 (OJ No. L154, 5.7.1995, p.3) to take into account Council regulation (EC) No 3036/94 establishing economic outward processing arrangements applicable to certain textiles and clothing products reimported into the Community after working or processing in certain third countries. See footnote 14 of Decision 1/95 (see WT/REG22/1).

[266] See documents G/TMB/N/60, notified on 28 February 1995.

the European Communities' quota levels (based on their previous 1990 level).[267] Thus, the measures at issue cannot be considered to be EC measures. Moreover, the European Communities itself stated that the measures had been adopted by Turkey, that Turkey itself was ensuring the surveillance of such quotas at its borders, and that the European Communities and Turkey have their respective systems of border control.[268]

9.40 As to the issue of whether the measures at issue should be considered to be measures of the Turkey-EC customs union as such, we note that according to the Permanent Court of International Justice[269], the assessment whether any customs union (or another legal entity) has a legal personality distinct from that of its constituent countries is to be based on an examination of the treaty forming such customs union and the relevant circumstances. Such determination will therefore always be made on a case by case basis. We note that the Turkey-EC customs union agreement does not have any legislative body which would have the constitutional authority to enact laws and regulations that would be, as such, applicable to the territory of the customs union. Under the Turkey-EC customs union, the only institutional body with legislative features is the Association Council, the powers of which were first defined in the Ankara Agreement.[270] Paragraph 1 of Article 22 of the Ankara Agree-

[267] In its notification (G/TMB/N/207), the European Communities consistently refers to categories of product that represent 17.99 per cent of 1990 EC imports (by volume) and therefore does not include any quantity covering the territory of Turkey. We note that the letter from European Communities Permanent Representative stated that "The European Community and Turkey form a customs union and have consulted prior to notifying their second stages of integration". This appears to refer to the consultation process under the Turkey-EC customs union prior to the identification of which products are to be integrated. It is also a recognition that each party to the customs union must adopt its own measures. (The European Communities' first integration process stage was notified as G/TMB/N/1.)

[268] See para. 4.3 above, third response of the European Communities to the Panel's questions: "There is thus no specific EC border control in respect of goods for which Turkey has quantitative restrictions, *the Turkish authorities having effected such control on entry of the goods* into free circulation in Turkey" (emphasis added). To the Panel's fourth question, the European Communities answered: "Turkey has adopted all the European Communities' relevant regulations concerning imports of textiles ... Thus the *basic administrative principles* are the same in *both parts of the customs union*. ... Thus, there is no administration or control of the overall EC/India and Turkey/India textile and clothing quotas at the EC/Turkey's borders. Once goods enter the customs *union pursuant to the parties' respective systems*, they are in free circulation... "(emphasis added). Since Turkey has its own specific quotas and so does the European Communities, Turkey and the European Communities must control their own import restrictions. This is to say that Indian textile and clothing products are not imported into Turkey on the basis of the European Communities' quantitative restrictions on Indian products, but rather only on the basis of the Turkish quantitative restrictions on Indian products (through the issuance of export licenses by India and import licenses by Turkey against the Turkish quota levels). Once entered into the customs union, say at the India/Turkey border, the products are described as being able to move freely into the EC, the same as Turkish products.

[269] *Customs Regime between Germany and Austria*, PCIJ, Series A/B, No. 41, at 49.

[270] Paragraph 1 of Article 22 of the Ankara Agreement reads as follows: "For the achievement of the aims laid down in the agreement and in the cases covered by the latter, the Association Council shall have the power to take decisions. Each of the two parties shall be bound to take the steps involved in the execution of the decisions adopted. The Association Council may also formulate any necessary recommendations" (GATT document L/2155/Add.1, p. 13). Article 23 of the Ankara

ment states that the Association Council shall have the power to take decisions. Although each of the two parties are "bound to take the steps involved in the execution of the decisions adopted", these decisions "shall be taken unanimously" (Article 23 of the Ankara Agreement) and there is no further enforcement process. The Turkey-EC Customs Union Joint Committee can only "carry out exchange of views and information, formulate recommendations to the Association Council and deliver opinions with a view to ensuring the proper functioning of the Customs Union" (Article 52 of the Decision 1/95 of the Turkey-EC customs union).[271] Article 55 imposes on Turkey and the European Communities the obligation to notify each other of the adoption of any new legislation that may affect each other or the functioning of the customs union. Article 58 also envisages the situation of "discrepancies between Community and Turkish legislation". This is a recognition that each party to the customs union may adopt measures, to some extent different, and which may not be fully consistent with one another; it provides confirmation of the ability of the parties to act independently and that Turkey maintains that sovereign right.[272] Since the actions of the Association Council require independent implementation by the parties to the customs union without any enforcement process either individually or jointly; since the Association Council cannot force the parties to act[273]; and since there is no

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Agreement specifies that both parties are represented in the Association Council and that its decisions "shall be taken unanimously".

[271] See WT/REG22/1.

[272] The Permanent Court of International Justice (PCIJ) concluded in *the Customs Regime between Germany and Austria*, that the wording of the customs union was determinant as to whether a member lost its sovereignty. An example of a customs union where member states appear to have retained full sovereignty and independence *vis-à-vis* third countries is the customs union between the Czech Republic and the Slovak Republic. It can be noted that in such a customs union, the parties have not created any autonomous institution capable of enacting legislation or providing for the legal personality of the customs union, independent and autonomous from that of each member state. Consequently, to take one example, when the Czech Republic and the Slovak Republic wanted to enter into a free trade agreement with Slovenia, Poland, Hungary and Romania, each of them (the Czech Republic and the Slovak Republic) signed individually and independently the so-called CEFTA. It is not the Czech-Slovak customs union, as an entity, which did so. The same is also true for the recent free trade agreement between Turkey and Lithuania, which is parallel to the EC-Lithuania free trade agreement. Again it is not the Turkey-EC customs union which concluded one single free trade agreement with Lithuania, but the EC and Turkey, individually, signed separate agreements. As far as the Turkey-EC custom union treaty is concerned, we have already concluded above, that the institutions existing in the context of the customs union do not have the legal capacity to legislate (there is only a provision that any legislation or measure adopted by either party (the EC or Turkey) must be notified to the other party and consulted upon.) The terms of the Turkey-EC customs union agreement provide no indication of a transfer of sovereignty of the member states either to an institution established under the customs union, nor to the EC. In WTO terms, unless a customs union is provided with distinct rights and obligations (and therefore some WTO legal personality, such as the European Communities) each party to the customs union remains accountable for measures it adopts for application on its specific territory. See also Jennings, R., Watts, A., *Oppenheim's International Law* (1996), 9th ed., Vol. 1 (Peace), Introduction and Part 1, p. 255.

[273] In the *Reparations for Injuries* case, the ICJ stated that, where a group of states claims to be a legal entity distinct from its members, the test is whether it was in "such a position that it possesses, in regard to its Members, rights which it is entitled to ask them to respect."(See ICJ Rep (1949), p.

other provision that would lead us to conclude that either of the two parties, or some collective entity on behalf of them, could enact legislation applicable to both of them; we consider the measures at issue taken, implemented and enforced by the Turkish government itself, applied on Turkish territory only, can only be Turkish measures.

9.41 Importantly, we note that the WTO dispute settlement system is based on Member's rights; is accessible to Members only; and is enforced and monitored by Members only.[274] The Turkey-EC customs union is not a WTO Member, and in that respect does not have any autonomous legal standing for the purpose of WTO law and therefore its dispute settlement procedures. Moreover, the European Communities' import restrictions appear *a priori* to be WTO compatible and could not be the object of any panel recommendation that the European Communities brings its measure into conformity with the WTO Agreement, as required by Article 19 of the DSU.

9.42 Finally, we note that in public international law, in the absence of any contrary treaty provision, Turkey could reasonably be held responsible for the measures taken by the Turkey-EC customs union. In the *Nauru* case one of the conclusions of Judge Shahabuddeen's separate opinion was:

> "… the [International Law Commission] considered, that *where States act through a common organ, each State is separately answerable for the wrongful act of the common organ*. That view, it seems to me, runs in the direction of supporting Nauru's contention that each of the three States in this case is jointly and severally responsible for the way Nauru was administered on their behalf by Australia, whether or not Australia may be regarded as technically as a common organ. …".[275] (Emphasis added.)

9.43 The International Law Commission (ILC) had stated in its commentaries to its adopted report:

> "A similar conclusion is called for in cases of parallel attribution of single course of conduct to several States, as when the conduct in question has been adopted by an organ common to a number of States. According to the principles on which the articles of chapter II of the draft are based, *the conduct of the common organ cannot be considered otherwise than as an act of each of the States whose common organ it is. If that conduct is not in conformity with an international obligation, then the two or more States will concurrently have committed separate, although identical, internationally wrongful acts*. It is self-evident that the parallel commission of identical offences by two

178 and also *Western Sahara* case (1975), p. 63; see Jennings, R., Watts, A., *Oppenheim's International Law* (1996), *Op.cit.*, p. 119.)

[274] See Appellate Body Report on *United States - Import Prohibition of Certain Shrimp and Shrimp Products*, adopted on 6 November 1998, WT/DS58/AB/R ("*US - Shrimp*"), para. 101.

[275] *Nauru* case, Separate Opinion of Judge Shahabuddeen, at 284. Clark, R., Book review of Nauru: Environmental Damage Under International Trusteeship (C. Weeramantry), *The International Lawyer* Vol. 28, No. 1, at 186.

> or more States is altogether different from participation by one of those States in an internationally wrongful act committed by the other."[276] (Emphasis added.)

3. Conclusion

9.44 In light of the foregoing, we conclude that the measures at issue are quantitative restrictions adopted by the Turkish government in 1996, 1997 and 1998 (and listed in the Annex to this report, Appendix 2) against 19 categories of textile and clothing products imported from India. Even if these measures are taken in the ambit of a customs union, they are implemented, applied and monitored by Turkey, for application in the Turkish territory only. Therefore they are Turkish measures.

D. Scope of the Dispute

9.45 We note that, at least initially, both parties argued explicitly that the Panel should not assess the compatibility of the Turkey-EC regional trade agreement with the provisions of Article XXIV. In its second submission, however, Turkey argues that the Panel cannot assess the WTO compatibility of any specific measure adopted in the context of the formation of a regional trade agreement, separately and in isolation from an assessment of the overall compatibility of this regional trade agreement with Article XXIV of GATT.

9.46 Turkey's main defense to India's claims of discriminatory quantitative restrictions is that the measures at issue were adopted as a consequence of its regional trade agreement with the European Communities which, it argues, is a fully complete customs union explicitly authorized and favoured by Article XXIV of GATT. For Turkey, Article XXIV of GATT, in allowing the formation of customs unions, necessarily authorizes measures such as those adopted by Turkey and challenged by India. For Turkey, the alignment of its textiles and trade policy with that of the European Communities is not only an integral part of such Turkey-EC customs union but is inherent and necessary for its formation in view of the important share of the textile and clothing sector in its trade with the European Communities. Turkey argues that the WTO compatibility of an Article XXIV type agreement, and all its related measures, is to be determined exclusively with reference to Article XXIV of GATT (and the 1994 Understanding on Article XXIV) and not by any other provisions of the WTO Agreement.

9.47 In response to Turkey's defense, India argues that the provisions of Article XXIV do not constitute a waiver from other WTO obligations, including the general prohibition against discriminatory import restrictions contained in Articles XI and XIII of GATT and Article 2.4 of the ATC.

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[276] See the *Yearbook of the International Law Commission*, 1978, Vol.II, Part Two, at 99. These commentaries were adopted by the Commission in its session of 8 May to 28 July 1978. Article 27 on state responsibility to which these commentaries refer was adopted at the ILC session of 6 May to 26 July 1996. These commentaries and the report were submitted in the same years to the United Nations General Assembly for its consideration.

9.48 Turkey's argument has both procedural and substantive aspects. Firstly, we must decide whether the WTO dispute settlement proceedings can be used to challenge measures adopted by one or more Members on the occasion of the formation of a customs union in which it (or they) participate. Secondly, if so, we must consider the extent to which a panel is authorized or needs to examine the overall consistency of the customs union with WTO provisions. Finally, we must determine whether the test for assessing the WTO compatibility of these specific measures is provided for in the provisions of Article XXIV only. If this is not the case, we will then need to examine the meaning of the provisions of Article XXIV to assess whether Article XXIV authorizes measures like those under examination. We deal with this final determination later in Section G below.

9.49 As to the first issue of whether the WTO dispute settlement procedures can be invoked to challenge a measure adopted on the occasion of the formation of a customs union, we note paragraph 12 of the Understanding on Article XXIV of GATT 1994 which provides:

> "12. The provisions of Articles XXII and XXIII of GATT 1994 as elaborated and applied by the Dispute Settlement Understanding may be invoked with respect to *any matters arising from the application* of those provisions of Article XXIV relating to customs unions, free-trade areas or interim agreement leading to the formation of a customs union or free-trade area." (emphasis added.)

9.50 We understand from the wording of paragraph 12 of the WTO Understanding on Article XXIV, that panels have jurisdiction to examine "any matters 'arising from' the application of those provisions of Article XXIV". For us, this confirms that a panel can examine the WTO compatibility of one or several measures "arising from" Article XXIV types of agreement, as also argued by the United States in its third-party submission.[277] This indicates that, although the right of WTO Members to form regional trade arrangements is "an integral part" of the set of multilateral disciplines of GATT and now WTO[278], the DSU procedures can be used to obtain a ruling by a panel on the WTO compatibility of any matters arising from such regional trade arrangements. For us, the term "any matters" clearly includes specific measures adopted on the occasion of the formation of a customs union or in the ambit of a customs union.

9.51 Thus, we consider that a panel can assess the WTO compatibility of any specific measure adopted by WTO Members at any time and we cannot find anything in the DSU, Article XXIV or the 1994 GATT Understanding on Article XXIV that would suspend or condition the right of Members to challenge measures adopted on the occasion of the formation of a custom union.

9.52 As to the second question of how far-reaching a panel's examination should be of the regional trade agreement underlying the challenged measure, we note that the Committee on Regional Trade Agreements (CRTA) has been established, *inter alia*, to assess the GATT/WTO compatibility of regional trade agreements entered

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[277] See paras. 7.116 to 7.118 above.

[278] See a similar parallel drawn by the Appellate Body in *United States - Measures Affecting Imports of Woven Wool Shirts and Blouses from India*, adopted on 23 May 1997, WT/DS33/AB/R ("*US - Shirts and Blouses*") at page 16, concerning the right to use transitional safeguard measures under the ATC.

into by Members, a very complex undertaking which involves consideration by the CRTA, from the economic, legal and political perspectives of different Members, of the numerous facets of a regional trade agreement in relation to the provisions of the WTO.[279] It appears to us that the issue regarding the GATT/WTO compatibility of a customs union, as such, is generally a matter for the CRTA since, as noted above, it involves a broad multilateral assessment of any such custom union, i.e. a matter which concerns the WTO membership as a whole.

9.53 As to whether panels also have the jurisdiction to assess the overall WTO compatibility of a customs union, we recall that the Appellate Body stated[280] that the terms of reference of panels must refer explicitly to the "measures" to be examined by panels. We consider that regional trade agreements may contain numerous measures, all of which could potentially be examined by panels, before, during or after the CRTA examination, if the requirements laid down in the DSU are met. However, it is arguable that a customs union (or a free-trade area) as a whole would logically not be a "measure" as such, subject to challenge under the DSU.[281]

9.54 We consider that the question of whether panels have the jurisdiction to assess the overall compatibility of a customs union is not in any event an issue on which it is necessary for us to reach a decision in this case; we reach this conclusion in light of paragraphs 9.51 to 9.53 above and in recognition of the principle of judicial economy, as initially developed in the *US - Wool Shirts*[282] case and qualified by the Appellate Body in the recent *Australia - Salmon* case[283], under which panels do not need to address all the claims and arguments raised by the parties to the dispute. We recall the distinction between claims and arguments (*EC - Hormones*[284]) and understand that some latitude is left to panels to address only arguments that they consider are relevant to resolve the dispute between the parties, which is the main purpose of DSU proceedings. Accordingly, we find that, in order to address the claims of India, it will not be necessary for us to assess the compatibility of the Turkey-EC customs union agreement with Article XXIV as such (in the sense of addressing all aspects of the customs union and all the measures adopted by Turkey and the European Communities in the context of their customs union agreement).

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[279] The mandate of the CRTA can be found in WT/L/127. See para. 2.7 above.

[280] Appellate Body Report on *Guatemala - Anti-Dumping Investigation regarding Portland Cement From Mexico*, adopted on 25 November 1998, WT/DS60/AB/R ("*Guatemala - Cement*"), paras. 76, 86.

[281] We are aware of the EC proposal contained in MTN.TNC/W/125 and the report of the 36th Meeting of the Trade Negotiating Committee MTN.TNC/40.

[282] Appellate Body Report on *US - Shirts and Blouses*, page 17.

[283] Appellate Body Report on *Australia - Measures Affecting Importation of Salmon*, adopted on 6 November 1998, WT/DS18/AB/R, para 223: "The principle of judicial economy has to be applied keeping in mind the aim of the dispute settlement system. This aim is to resolve the matter at issue and "to secure a positive solution to a dispute". To provide only a partial resolution of the matter at issue would be false judicial economy. *A panel has to address those claims on which a finding is necessary in order to enable the DSB to make sufficiently precise recommendations and rulings so as to allow for prompt compliance by a Member with those recommendations and rulings "in order to ensure effective resolution of disputes to the benefit of all Members*." (emphasis added).

[284] Appellate Body Report on *European Communities - Measures Concerning Meat and Meat Products* ("*EC - Hormones*"), adopted on 13 February 1998, WT/DS26, 48/AB/R, paras. 155-156; see also the Appellate Body Report on *EC - Bananas III*, paras. 145-147.

9.55 In our view, it will be sufficient for us to address the relationship between the provisions of Article XXIV and those of Articles XI and XIII of GATT and Article 2.4 of the ATC. We shall have to do so as India's claims are based on an alleged violation of those articles, and Turkey's defense is based on the application, and, in its view, the "primacy", of Article XXIV over those provisions. Our examination will be limited to the question whether in this case, on the occasion of the formation of the Turkey-EC customs union, Turkey is permitted to introduce WTO incompatible quantitative restrictions against imports from a third country, *assuming arguendo that the customs union in question is otherwise compatible with Article XXIV of GATT*. We shall thus limit ourselves to addressing the parties' arguments submitted in this context only and refrain from any discussion as to how an overall compatibility assessment of a customs union should be performed. Our analysis of Article XXIV is limited to defining, in particular, its relationship with Articles XI and XIII of GATT (and Article 2.4 of the ATC) and to ensuring that our interpretation of the WTO provisions applicable to the present dispute, does not prevent Turkey from exercising its right to form a customs union.

9.56 We reject therefore Turkey 's argument, in paragraph 9.45 above, to the extent that it would oblige us to assess the GATT/WTO compatibility of the Turkey-EC customs union in order to assess the compatibility of the specific measures at issue.[285]

E. Burden of Proof

9.57 The rules on burden of proof are now well established in the WTO and can be summed up as follows:

(a) it is for the complaining party to establish the violation it alleges;

(b) it is for the party invoking an exception or an affirmative defense to prove that the conditions contained therein are met; and

(c) it is for the party asserting a fact to prove it.[286]

9.58 It is therefore for India to demonstrate *prima facie* that Turkey's measures violate the provisions of Articles XI and XIII of GATT and Article 2.4 of the ATC. Turkey does not deny the existence of quantitative restrictions but submits an affirmative defense based on the application of Article XXIV of GATT. In response to a direct question by the Panel, Turkey stated that it does not invoke any defense other than that based on Article XXIV in support of its claim that it is not violating Articles XI or XIII of GATT, or Article 2.4 of the ATC. We note in this context that

[285] We consider that this Turkey-EC regional trade agreement falls under the ambit of Article XXIV for the purpose of the CRTA's examination. We are of the view that, for our purposes, we do not have to assess the precise relationship of the Turkey-EC agreement with Article XXIV, e.g. whether it is a free-trade agreement or a customs union or an interim agreement leading to a free-trade area or customs union. We recall that in this report, we shall refer to the Turkey-EC customs union without any assessment of the WTO nature of this Article XXIV type of arrangement.

[286] Panel Report on *Argentina - Measures Affecting Imports of Footwear, Textiles, Apparel and Other* Items, adopted on 22 April 1998, WT/DS56/R, paras. 6.34 - 6.40.

Hong Kong, China has argued that since Article XXIV was an exception invoked by Turkey, it was for Turkey to bear the burden of proof.[287]

9.59 Accordingly, we will first examine India's claims and the GATT/WTO treatment of import restrictions generally, and then more specifically in the sector of textiles and clothing. Secondly, we shall examine the applicability of Article XXIV and Turkey's defense based, in particular, on paragraphs 4, 5(a) and 8(a)(ii) of Article XXIV of GATT.

F. Claims under Articles XI and XIII of GATT and Article 2.4 of the ATC

9.60 India claims that the Turkish measures violate the provisions of Articles XI and XIII of GATT and Article 2.4 of the ATC. Turkey claims that its rights pursuant to Article XXIV of GATT prevail over any obligations contained in Articles XI and XIII of GATT and Article 2.4 of the ATC, and therefore India's claims should be rejected.

1. Articles XI and XIII of GATT

9.61 The wording of Articles XI and XIII is clear. Article XI provides that as a general rule (we note the wording of the title of Article XI: "*General Elimination* of Quantitative Restrictions"), WTO Members shall not use quantitative restrictions against imports or exports.

> "Article XI
>
> *General Elimination of Quantitative Restrictions*
>
> 1. No prohibitions or restrictions other than duties, taxes or other charges, whether made effective through quotas, import or export licences or other measures, shall be instituted or maintained by any Member on the importation of any product of the territory of any other Member or on the exportation or sale for export of any product destined for the territory of any other Member."

9.62 Article XIII provides that if and when quantitative restrictions are allowed by the GATT/WTO, they must, in addition, be imposed on a non-discriminatory basis.

> "Article XIII
>
> *Non-discriminatory Administration of Quantitative Restrictions*
>
> 1. No prohibition or restriction shall be applied by any Member on the importation of any product of the territory of any other Member or on the exportation of any product destined for the territory of any other Member, unless the importation of the like product of all third

[287] See para. 7.7 above. We note that Japan, Thailand and the Philippines also identified Article XXIV as an exception: see Japan's arguments in para. 7.23, Thailand's arguments in para. 7.100 and the Philippines' arguments in para. 7.36 above.

countries or the exportation of the like product to all third countries is similarly prohibited or restricted."

9.63 The prohibition on the use of quantitative restrictions forms one of the cornerstones of the GATT system. A basic principle of the GATT system is that tariffs are the preferred and acceptable form of protection. Tariffs, to be reduced through reciprocal concessions, ought to be applied in a non-discriminatory manner independent of the origin of the goods (the "most-favoured-nation" (MFN) clause). Article I, which requires MFN treatment, and Article II, which specifies that tariffs must not exceed bound rates, constitute Part I of GATT. Part II contains other related obligations, *inter alia* to ensure that Members do not evade the obligations of Part I. Two fundamental obligations contained in Part II are the national treatment clause and the prohibition against quantitative restrictions. The prohibition against quantitative restrictions is a reflection that tariffs are GATT's border protection "of choice". Quantitative restrictions impose absolute limits on imports, while tariffs do not. In contrast to MFN tariffs which permit the most efficient competitor to supply imports, quantitative restrictions usually have a trade distorting effect, their allocation can be problematic and their administration may not be transparent.

9.64 Notwithstanding this broad prohibition against quantitative restrictions, GATT contracting parties over many years failed to respect completely this obligation. From early in the GATT, in sectors such as agriculture, quantitative restrictions were maintained and even increased to the extent that the need to restrict their use became central to the Uruguay Round negotiations. In the sector of textiles and clothing, quantitative restrictions were maintained under the Multifibre Agreement (further discussed below). Certain contracting parties were even of the view that quantitative restrictions had gradually been tolerated and accepted as negotiable and that Article XI could not be and had never been considered to be, a provision prohibiting such restrictions irrespective of the circumstances specific to each case. This argument was, however, rejected in an adopted panel report *EEC - Imports from Hong Kong*.[288]

9.65 Participants in the Uruguay Round recognized the overall detrimental effects of non-tariff border restrictions (whether applied to imports or exports) and the need to favour more transparent price-based, i.e. tariff-based, measures; to this end they devised mechanisms to phase-out quantitative restrictions in the sectors of agriculture and textiles and clothing. This recognition is reflected in the GATT 1994 Understanding on Balance-of-Payments Provisions[289], the Agreement on Safeguards[290], the Agreement on Agriculture where quantitative restrictions were eliminated[291] and the

[288] Panel Report on *EEC - Quantitative Restrictions Against Imports of Certain Products from Hong Kong*, adopted on 12 July 1983, BISD 30S/129, ("*EEC - Imports from Hong Kong*").

[289] See for instance paras. 2 and 3 of the GATT 1994 Understanding on the Balance-of-Payments Provisions which provide that Members shall seek to avoid the imposition of new quantitative restrictions for balance-of-payments purposes.

[290] The Agreement on Safeguards also evidences a preference for the use of tariffs. Article 6 provides that provisional safeguard measures "should take the form of tariff increases" and Article 11 prohibits the use of voluntary export restraints.

[291] Under the Agreement on Agriculture, notwithstanding the fact that contracting parties, for over 48 years, had been relying a great deal on import restrictions and other non-tariff measures, the use of quantitative restrictions and other non-tariff measures was prohibited and Members had to proceed to a "tariffication" exercise to transform quantitative restrictions into tariff based measures.

Agreement on Textiles and Clothing (further discussed below) where MFA derived restrictions are to be completely eliminated by 2005.

9.66 The measures at issue, on their face, impose quantitative restrictions on imports and are applicable only to India.[292] We consider that, given the absence of a defense by Turkey (other than its defense based on Article XXIV of GATT) to India's claims that discriminatory import restrictions have been imposed, India has made a *prima facie* case of violation of Articles XI[293] and XIII of GATT.

2. Article 2.4 of the ATC[294]

9.67 India claims that the measures under examination violate Article 2.4 of the ATC, in that they constitute new measures not authorized by the ATC and for which there is no GATT justification. Turkey claims that the measures under examination are not new, since the European Communities had similar restrictions in place when Turkey and the European Communities formed their customs union, and such restrictions are justified by Article XXIV of GATT.

(a) Regulatory Framework of the ATC

9.68 The ATC provides for a maximum transitional period of ten years for the integration of all remaining quantitative restrictions in the sector of textiles and clothing that had been maintained under the old Multifibre Arrangement ("MFA"). Article 2 is the core of the ATC[295] and contains two key requirements for the transitional process that leads to the re-integration of the textiles and clothing sector into the general rules of GATT 1994. Paragraph 1 of Article 2 of the ATC requires that all former MFA or MFA-type restraints be notified to the TMB in order to be carried over into the ATC. Article 2.6 to 2.11, sets out the procedures for the progressive integration of the products covered by the ATC into GATT 1994 rules and disciplines. The ATC provides therefore exceptions to the general prohibitions contained

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[292] We note, however, that Turkey maintains other quantitative restrictions against textiles and clothing imports from other countries on the same and/or other products; see para. 6.12 above. See also WT/REG22/7.

[293] We note that the measures at issue do not qualify for any of the exceptions under Article XI of GATT.

[294] In interpreting the ATC and its importance in the WTO Agreement, it should also be clear from the object and purpose of the ATC, and from the well-known circumstances of the conclusion of the Uruguay Round, that the phasing out of the textile and clothing restrictions was a fundamental component of the WTO Agreement for developing countries.

[295] As discussed in paras. 2.25 to 2.30 above, trade in this sector of textile and clothing products was governed by special regimes outside the normal GATT rules: the Short Term Arrangement Regarding International Trade in Cotton Textiles (STA) in 1961, the Long Term Arrangement Regarding International Trade in Cotton Textiles (LTA) from 1962 to 1973 and the Arrangement Regarding International Trade in Textiles, also known as the Multifibre Arrangement or MFA, from 1974 to 1994. These special regimes essentially allowed for an extensive and complex system of bilateral import and export restrictions. The ATC provides for a set of rules, the purpose of which is that through a transitional process, embodied in the ATC, this sector is to be fully integrated into WTO rules by 1 January 2005. The two main avenues used by the ATC are 1) mandatory annual level increases of remaining quantitative restriction and 2) and an integration process by stages of all textile and clothing products into the general GATT rules.

in Articles XI and XIII against discriminatory quantitative restrictions in allowing some Members (those who had MFA restrictions in place and who have notified the TMB within 60 days of the entry into force of the WTO Agreement) to maintain such restrictions for a maximum period of 10 years. In that sense the MFA defined the reach of the general prohibition against quantitative restrictions in the area of textiles and clothing.

9.69 The lists of restrictions notified pursuant to Article 2.1 set the starting point for the treatment of the restraints carried over from the former MFA regime. Four WTO Members notified the TMB pursuant to Article 2.1 of the ATC: Canada, the European Communities, Norway and the United States. We consider that the notification requirement of 60 days referred to in Article 2.1 of the ATC is mandatory both for formal and substantive reasons. The wording of Article 2.1 is unequivocal with the use of the term "shall". Moreover, since the purpose of the ATC is to provide exceptions to the general application of Articles XI and XIII of GATT during an integration period to be completed by 1 January 2005, these exceptions should be interpreted narrowly.[296] Stemming from this provision, only the four Members above had the right to and did notify measures which allowed them to maintain MFA-derived quantitative restrictions for a maximum period of 10 years during which import quotas must increase annually until the products they cover are integrated into GATT. In the absence of an exception under the ATC or a justification under GATT, no new quantitative restrictions introduced by a Member can benefit from the exceptions provided for in Article 2.1 of the ATC after this 60 day period.

9.70 Article 2.4 of the ATC provides that:

> "4. The restrictions notified under paragraph 1 shall be deemed to constitute the totality of such restrictions applied by the respective Members on the day before the entry into force of the WTO Agreement. No new restrictions in terms of products or Members shall be introduced except under the provisions of this Agreement or relevant GATT 1994 provisions.[297] Restrictions not notified within 60 days of the date of entry into force of the WTO Agreement shall be terminated forthwith."

9.71 The prohibition on "new restrictions" must be interpreted taking into account the preceding sentence: "The restrictions notified under paragraph 1 shall be deemed to constitutes the *totality of such restrictions* applied by the respective Members on the day before the entry into force of the WTO Agreement". The ordinary meaning of the words indicates that WTO Members intended that as of 1 January 1995, the incidence of restrictions under the ATC could only be reduced. We are of the view that any legal fiction whereby an existing restriction could simply be increased and not

[296] See for instance in Panel Report on *Indonesia - Certain Measures Affecting the Automobile Industry*, adopted 23 July 1998, WT/DS54, 55, 59 and 64/R, ("*Indonesia - Autos*") (Not appealed), para. 14.92, where the period allowed for notification to the TRIMS Committee under Article 5 of the TRIMS Agreement, in order for a Member to benefit from the transition provisions of the TRIMS Agreement, was considered mandatory.

[297] [Footnote original]The relevant GATT 1994 provisions shall not include Article XIX in respect of products not yet integrated into GATT 1994, except as specifically provided in paragraph 3 of the Annex.

constitute a "new restriction", would defeat the clear purpose of the ATC which is to reduce the scope of such restrictions, starting from 1 January 1995 (but for the exceptional situations referred to in Article 2.4 of the ATC). Thus, we consider that, setting aside the possibility of exceptions and justifications mentioned in Article 2.4 of the ATC, any increase of an ATC compatible quantitative restriction notified under Article 2.1 of the ATC, constitutes a "new" restriction.

9.72 On 28 February 1995 (therefore within the 60 day period of Article 2.1 of the ATC), the European Communities notified its previous restrictions maintained under the MFA.[298] This notification referred to restrictions applicable only to EC territory. After the period of 60 days (under Article 2 of the ATC) the European Communities is prohibited from notifying any new restrictions or changes to existing and notified restrictions, except adopted in compliance with the ATC or any other provisions of GATT 1994. Apart from these special cases the European Communities is not entitled to notify any increase of its MFA derived restrictions. Immediately before the date of the entry into force of the ATC, Turkey was a member of the Multifibre Arrangement (as an exporting country) and did not maintain any restrictions pursuant to Article 4 of the MFA or notified under Article 7 or 8 of the MFA in force on the day before the entry into force of the WTO Agreement. Since Turkey did not have any MFA restrictions in place, it could therefore not make any notification pursuant to Article 2.1 of the ATC. Accordingly, any restrictions on textiles and clothing applied by Turkey appear on their face to be "new", as defined in Article 2.4 of the ATC with reference to those countries who had MFA restrictions and notified them within 60 days.

(b) Quantitative Restrictions Permitted under the ATC

9.73 The ATC allows new restrictions in the case of safeguard measures (Article 6 of the ATC) or pursuant to Articles 2.14 and 7 of the ATC when a Member does not comply with the requirements of the agreement. We note that there is no provision in the ATC for general exceptions or security exceptions nor any other provisions on regional trade agreements.

9.74 We note that on 27 February 1995[299] Turkey notified the first stage of its integration programme to the TMB; in doing so Turkey is entitled, pursuant to Article 6.1 of the ATC, to make use of the special safeguard mechanism. It should be noted that under the ATC the right to maintain MFA derived quantitative restrictions and the integration process by stages are not related. The provisions of the ATC make clear that the fact that a product has not yet been re-integrated into the general GATT rules does not in any manner imply a right to introduce new import restrictions under Article 2.1 of the ATC on such products. The main benefit for Members resulting from the notification of an integration programme within 6 months of the entry into force of the WTO Agreement, is the use of the special safeguard mechanism under the ATC. There is no relation between the safeguard provisions of the ATC and the right to introduce new quantitative restrictions under Article 2.1 of the ATC. On 27 December 1996, Turkey notified the second stage of its integration programme[300] to take effect on 1 January

[298] G/TMB/N/60.
[299] G/TMB/N/44.
[300] G/TMB/N/228.

1998. On the same day, Turkey also notified, early, the provisions of the third stage of its integration programme[301] to take effect on 1 January 2003. All these notifications relate to imports of textiles and clothing into Turkey only. (We also note that the products covered by the measures at issue are not listed therein.)

(c) The Turkish Measures under the ATC - are these New Measures?

9.75 Article 3.3 of the ATC provides for notification of "new restrictions" or "changes in existing restrictions". It reads as follows:

> "3. During the duration of this Agreement, Members shall provide to the TMB, for its information, notifications submitted to any other WTO bodies with respect to any *new restrictions or changes in existing restrictions* on textile and clothing products, taken under any GATT 1994 provision, within 60 days of their coming into effect." (emphasis added)

9.76 In their joint communication dated 7 November 1997[302], Turkey and the European Communities notified the TMB pursuant to Article 3.3 of the ATC:

> "In addition Turkey and the European Communities have the honour to copy to the Chairman of the Textiles Monitoring Body for information a communication to the Chairman of the Committee on Regional Trade Agreements (CRTA) annexed to which are details of certain quantitative limits *introduced by Turkey* in respect of imports of certain textile and clothing products into Turkey from certain WTO Members, and necessary to give effect to the Customs Union in conformity with the provisions of Article XXIV of GATT 1994." (emphasis added)

9.77 On 6 May 1998, the European Communities and Turkey sent a second notification under Article 3.3 of the ATC to the TMB,[303] which reads as follows:

> "Turkey and the European Communities … concerning details of changes in respect of the *quantitative limits applied by Turkey* in respect of imports of certain textile and clothing products from certain WTO Members in conformity with its commitments arising out of the customs union and with the provisions of Article XXIV of GATT 1994." (Emphasis added.)

9.78 In light of Article 3.3 of the ATC, Turkey (and the European Communities) must consider that these measures are either "new" or "changes" to existing restrictions. As discussed above,[304] the measures at issue can only be considered to be, in WTO terms, Turkish measures. Since Turkey did not have any restrictions in place on 1 January 1995 that it could change, any such import restriction is, by definition, "new" for Turkey in the sense of the ATC. In this regard we cannot accept Turkey's argument that its measures are not new because the European Communities (its cus-

[301] G/TMB/N/240.
[302] G/TMB/N/308.
[303] G/TMB/N/326.
[304] See para. 9.44 above.

toms union partner) had a similar measure in place. Conceivably, a change of geographical coverage could constitute a "change" to an "existing" restriction (as could be the case on the occasion of an enlargement of a customs union - an issue which in this case we do not need to address). But since the measures at issue were introduced and are applied by Turkey,[305] and in view of our previous conclusion that the measures at issue are not EC measures but Turkish measures,[306] Turkey's quantitative restrictions cannot be considered to be changes to the existing EC restrictions.

9.79 We need, however, to examine the possibility of exceptions or justifications under Article 2.4 of the ATC and whether, any such Turkish measures could otherwise be legitimized in the context of the application of an Article XXIV type of agreement, escaping thereby the prohibition of Article 2.4 of the ATC against the introduction of new restrictions.

9.80 In the absence of any ATC justification claimed for the Turkish measures and given the reference to Article XXIV in the Article 3.3 notification, it would seem that any such justification must be based on Article XXIV. We address below whether the formation of a customs union presents an opportunity to adopt measures which would otherwise be WTO incompatible, (unless, as noted by India, these are inherent to the very conclusion of the customs union.) We also consider the argument that if a WTO compatible measure was already in place for one Member forming the customs union, the other constituent member(s), in an effort to harmonize their trade policies, may be authorized to introduce a similar restriction, thereby legitimizing what would otherwise constitute a new restriction in the sense of the ATC. In Section G below, we shall develop our interpretation of the language of Article XXIV and the flexibility it may provide to Members forming such a customs union, namely in their efforts to adopt "substantially the same duties and other regulations of commerce". This possibility would not, in our view, change the nature of the restrictions at issue as being "new restrictions" in the sense of Article 2.4 of the ATC, in so far as Turkey is concerned. It remains to be decided whether Article XXIV authorizes the introduction of such new ATC restrictions.

9.81 Therefore, at this stage of our analysis, we consider that the measures at issue are new measures in the sense of Article 2.4 of the ATC.

(d) Jurisdiction of the TMB Versus that of the Panel

9.82 We refer to our preliminary ruling on the jurisdiction of the TMB in paragraph 9.15 above. In order to consider the claim of India under Article 2.4 of the ATC (and following our preliminary ruling of 25 September 1998), we now address further the issue of the relationship between the jurisdiction of the Panel and that of the TMB. We consider, based on the interpretation by the Appellate Body in *Guatemala - Cement*[307] with regard to the relationship between the DSU and the Anti-dumping Agreement, that the provisions of the ATC (providing jurisdiction to the TMB to examine measures applied pursuant to the ATC) and the provisions of the

[305] See also the European Communities' responses to the Panel's questions, referred to in footnote 268 above and paras. 4.2 and 4.3 above, where it was said by the European Communities that Turkey itself ensures the surveillance of its own quantitative restrictions at the Turkey/India border.

[306] See paras. 9.33 to 9.44 above.

[307] Appellate Body Report on *Guatemala - Cement,* para. 75.

DSU (providing jurisdiction for panels to interpret any covered agreement, including the ATC) may both apply together. Therefore even if the TMB has jurisdiction to determine what constitutes a "new" measure in the sense of the ATC and whether a violation of the ATC has taken place, we remain convinced that a panel is entitled to interpret the ATC to the extent necessary to ascertain whether Turkey benefits from a defense to India's claims under Articles XI and XIII of GATT based on the provisions of the ATC.

9.83 We consider, in any case, that the measures under examination are not measures applied pursuant to the ATC itself and therefore the ATC cannot provide such a defense. As discussed above, the ATC authorizes some exceptions to the general prohibitions against import restrictions contained in Articles XI and XIII of GATT (e.g., existing MFA restrictions notified within 60 days of the entry into force of the WTO Agreement (Article 2), safeguard measures pursuant to Article 6 of the ATC and measures adopted in the context of Articles 7 and 2.14 of the ATC).

9.84 On their face, the introduction of the Turkish measures do not correspond to any of the above situations, as noted also by Thailand in its third party submission[308]. We note that the ATC does not contain any provision dealing with regional trade agreements or any other general or specific exceptions. We conclude that in the present case, as acknowledged by the parties,[309] the measures at issue do not benefit from any circumstances specified in the ATC that would prevent the application of Article 2.4 of the ATC or Articles XI and XIII of GATT. We note also that Turkey has notified the said import restrictions to the TMB under Article 3.3 of the ATC which refers explicitly to "new restrictions or changes … taken under any GATT 1994 provision". Article 3.4 of the ATC suggests that the ATC envisages that non-ATC matters (such as those notified under Article 3.3 and the reverse notification pursuant to Article 3.4) will be dealt with "under relevant GATT 1994 provisions or procedures in the appropriate WTO body". Turkey does not claim that it benefits from an exemption to the prohibitions of Articles XI and XIII of GATT that is contained in the ATC, but rather one that derives from Article XXIV. It appears to us that the matter at issue involves a GATT provision rather than the ATC. The fact that the products under examination are textiles and clothing does not imply that it is the ATC exclusively which deals with the measures at issue. In fact GATT rules are generally applicable to all textile and clothing products and the ATC is applicable by exception principally to allow the maintenance for a limited period of time of MFA-derived quantitative restrictions and the use of the special safeguard mechanism.

9.85 Turkey's main defense is that its measures were adopted in the context of the formation of a customs union and are compatible with Article XXIV which is the only applicable provision. Clearly the interpretation of Article XXIV is not a matter covered by the provisions of the ATC, and could not fall under the exclusive jurisdiction of the TMB.[310] Having decided that the measures under examination are

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[308] See paras. 7.76 and 7.77 above.

[309] See para. 6.26 (for Turkey) and paras. 3.47 and 3.48 (for India) above.

[310] We recall the provisions of Article 8.1 of the ATC: " In order to supervise the implementation of this Agreement, to examine all measures taken under this Agreement and their conformity therewith, and to take the actions specifically required of it by this Agreement, the Textiles Monitoring Body ("TMB") is hereby established …".

Turkish measures and not EC measures, we find that the ATC does not provide any exception to the prohibitions against quantitative restrictions contained in Articles XI and XIII of GATT.

3. *Conclusions on India's Claims under Articles XI and XIII of GATT, and Article 2.4 of the ATC*

9.86 Consequently, unless the measures under examination are justified by Article XXIV (Turkey's defense that we examine below) they are inconsistent with the provisions of Articles XI and XIII of GATT and they would necessarily violate also Article 2.4 of the ATC.[311]

G. *Turkey's Defense Based on Article XXIV of GATT*

9.87 We shall now proceed to examine Turkey's defense based on the application of Article XXIV and determine whether it rebuts what appears to be *prima facie* evidence of violations of Articles XI and XIII of GATT and Article 2.4 of the ATC.

9.88 Turkey argues that the measures at issue do not violate Articles XI and XIII of GATT or Article 2.4 of the ATC because they were implemented in relation to the formation of its customs union with the European Communities, which it considers to be compatible with the provisions of Article XXIV of GATT. For Turkey, the provisions of Article XXIV are concerned with the scope of application of GATT, both generally and in particular circumstances. As such, Article XXIV should not be regarded as a "justification", a "defense", an "exception" or a "waiver". In Turkey's view, the special nature of Article XXIV is evidenced by the fact that Article XXIV is in Part III of GATT, and not in Part II together with other provisions on commercial policies. For Turkey, Article XXIV, paragraphs 5 to 9, is to be viewed as *lex specialis* for the rights and obligations of WTO Members at the time of formation of a regional trade agreement. In other words, in Turkey's view, the WTO consistency of the measures challenged by India depends on the WTO consistency of the Turkey-EC customs union (of which they are an integral part) and the WTO consistency of both the customs union and its measures is to be determined with reference to the provisions of paragraphs 5 to 9 of Article XXIV only and no other GATT provisions.

9.89 India considers that all GATT rules define the limits of applicability of the GATT. India is of the view that, if Turkey's argument were accepted, Members forming a customs union could legally circumvent the WTO procedural and substantive requirements with respect to quantitative restrictions, which the signatories of the WTO agreements agreed to permit only in exceptional circumstances. In respect of such Members, the WTO agreements could no longer operate as a legal framework providing effective assurances of market access and the WTO dispute settlement procedures would be rendered ineffective.

[311] The Panel is aware of the Appellate Body statement in *EC - Bananas III* that when two provisions are both applicable, a panel should proceed to apply the more specific provision first. However, such an exercise is not necessary here as what is examined is the relationship between Article XXIV and quantitative restrictions (either under Articles XI and XIII of GATT or the ATC).

9.90 In order to analyze Turkey's arguments, which we consider are properly labelled a defense[312] to India's claims, we firstly recall certain basic interpretative principles applicable in WTO dispute settlement proceedings. Secondly, we examine the provisions of Article XXIV generally. Thirdly, we consider the meaning of Article XXIV:5 and, finally that of Article XXIV:8, which constitute the heart of Turkey's defense to India's claims.

1. General Interpretative Principles

(a) Vienna Convention on the Law of Treaties

9.91 In its examination of Article XXIV, the Panel is guided by the principles of interpretation of public international law (Article 3.2 of the DSU) which include Articles 31 and 32 of the Vienna Convention on the Law of Treaties (VCLT). As provided for in these articles and as applied by panels and the Appellate Body, we interpret the provisions of Article XXIV using first the ordinary meaning of the terms of that provision, as elaborated upon by the 1994 Understanding on Article XXIV, in their context and in light of the object and purpose of the relevant WTO agreements. If need be, to clarify or confirm the meaning of these provisions, we may refer to the negotiating history, including the historical circumstances that led to the drafting of Article XXIV of GATT. We note also the prescription of Article XVI:1 of the WTO Agreement which provides that "... the WTO shall be guided by the decisions, procedures and customary practices followed by CONTRACTING PARTIES to GATT 1947 and the bodies established in the framework of GATT 1947".[313]

(b) WTO Rules on Conflicts

9.92 As a general principle, WTO obligations are cumulative and Members must comply with all of them at all times unless there is a formal "conflict" between them. This flows from the fact that the WTO Agreement is a "Single Undertaking".[314] On the definition of conflict, it should be noted that:

> "... a conflict of law-making treaties arises only where simultaneous compliance with the obligations of different instruments is impossible. ... There is no conflict if the obligations of one instrument are stricter than, but not incompatible with, those of another, or if it is possible to comply with the obligations of one instrument by refraining from exercising a privilege or discretion accorded by another."[315]

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[312] We note, from our research, that during the negotiation of Article XXIV, participants typically referred to Article XXIV as an "exception" for customs unions and free-trade areas. See also footnote 287 above.

[313] See Appellate Body Report on *Japan - Alcoholic Beverages*, p. 14, DSR 1996:I, 97.

[314] See the Appellate Body statement in *Brazil - Desiccated Coconut*, page 12, DSR 1997:I, 177, III B. The WTO is a single undertaking except for the plurilateral agreements for the non-signatories.

[315] Wilfred Jenks, "The Conflict of Law-Making Treaties", *The British Yearbook of International Law* (1953) at p. 426-427.

9.93 This principle, also referred to by Japan in its third party submission,[316] is in conformity with the public international law presumption against conflicts which was applied by the Appellate Body in *Canada - Periodicals*[317] and in *EC - Bananas III*[318], when dealing with potential overlapping coverage of GATT 1994 and GATS, and by the panel in *Indonesia - Autos*[319], in respect of the provisions of Article III of GATT, the TRIMs Agreement[320] and the SCM Agreement.[321] In *Guatemala - Cement*[322], the Appellate Body when discussing the possibility of conflicts between the provisions of the Anti-dumping Agreement[323] and the DSU, stated: "A special or additional provision should only be found to *prevail* over a provision of the DSU in a situation where adherence to the one provision will lead to a violation of the other provision, that is, in the case of a *conflict* between them."

9.94 We recall the Panel's finding in *Indonesia - Autos*, a dispute where Indonesia was arguing that the measures under examination were subsidies and therefore the SCM Agreement being *lex specialis,* was the only "applicable law" (to the exclusion of other WTO provisions):

> "14.28 In considering Indonesia's defence that there is a general conflict between the provisions of the SCM Agreement and those of Article III of GATT, and consequently that the SCM Agreement is the only applicable law, we recall first that in public international law there is a presumption against conflict.[324] This presumption is espe-

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316 See para. 7.22 above.

317 Appellate Body Report on *Canada - Certain Measures Concerning Periodicals*, adopted on 30 July 1997, WT/DS31/AB/R, ("*Canada - Periodicals*"), page 19.

318 Appellate Body Report on *EC - Bananas III*, paras. 219-222.

319 Panel Report on *Indonesia - Autos*, para. 14.28.

320 The Agreement on Trade-Related Investment Measures.

321 The Agreement on Subsidies and Countervailing Measures.

322 Appellate Body Report on *Guatemala - Cement*, para.65.

323 The Agreement on the Implementation of Article VI of GATT 1994.

324 [Footnote original]In international law for a conflict to exist between two treaties, three conditions have to be satisfied. First, the treaties concerned must have the same parties. Second, the treaties must cover the same substantive subject matter. Were it otherwise, there would be no possibility for conflict. Third, the provisions must conflict, in the sense that the provisions must impose mutually exclusive obligations. "... [T]echnically speaking, there is a conflict when two (or more) treaty instruments contain obligations which cannot be complied with simultaneously. ... Not every such divergence constitutes a conflict, however. ... Incompatibility of contents is an essential condition of conflict". (7 *Encyclopædia of Public International Law* (North-Holland 1984), page 468). The *lex specialis derogat legi generali* principle "which [is] inseparably linked with the question of conflict"(Idem., page 469) between two treaties or between two provisions (one arguably being more specific than the other), does not apply if the two treaties ".. deal with the same subject from different points of view or [is] applicable in different circumstances, or one provision is more far-reaching than but not inconsistent with, those of the other" (Wilfred Jenks, "The Conflict of Law-Making Treaties", *The British Yearbook of International Law* (BYIL) 1953, at 425 *et seq.*). For in such a case it is possible for a state which is a signatory of both treaties to comply with both treaties at the same time. The presumption against conflict is especially reinforced in cases where separate agreements are concluded between the same parties, since it can be presumed that they are meant to be consistent with themselves, failing any evidence to the contrary. See also E.W. Vierdag, "The Time of the "Conclusion" of a Multilateral Treaty: Article 30 of the Vienna Convention on the Law of Treaties and Related Provisions *", BYIL*, 1988, at 100; Sir Robert Jennings/Sir Arthur Watts (ed.), *Oppenheim's International Law*, Vol. I., Parts 2 to 4, 1992, at 1280; Sir Gerald Fitzmaurice, "The

> cially relevant in the WTO context[325] since all WTO agreements, including GATT 1994 which was modified by Understandings when judged necessary, were negotiated at the same time, by the same Members and in the same forum. In this context we recall the principle of effective interpretation[326] pursuant to which all provisions of a treaty (and in the WTO system all agreements) must be given meaning, using the ordinary meaning of words."

9.95 In light of this general principle, we will consider whether Article XXIV authorizes measures which Articles XI and XIII of GATT and Article 2.4 of the ATC otherwise prohibit. In view of the presumption against conflicts, as recognized by panels and the Appellate Body, we bear in mind that to the extent possible, any interpretation of these provisions that would lead to a conflict between them should be avoided.

(c) Principle of Effective Interpretation

9.96 Finally we would also like to recall the principle of effective interpretation[327] whereby all provisions of a treaty must be, to the extent possible, given their full meaning so that parties to such a treaty can enforce their rights and obligations effectively. We note that the Appellate Body has referred to this principle on several occasions.[328] We understand that this principle of interpretation prevents us from reaching a conclusion on the claims of India or the defense of Turkey, or on the related provi-

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Law and procedure of the International Court of Justice", *BYIL* , 1957, at 237; Sir Ian Sinclair, *The Vienna Convention on the Law of Treaties*, 1984, at 97.

[325] [Footnote original]In this context we note that the WTO Agreement contains a specific rule on conflicts which is however limited to conflicts between a specific provision of GATT 1994 and a provision of another agreement of Annex 1A. We do not consider this interpretative note in this section of the report because we are dealing with Indonesia's argument that there is a general conflict between Article III and the SCM Agreement, while the note is concerned with specific conflicts between a provision of GATT 1994 and a specific provision of another agreement of Annex 1A.

[326] Footnote original]"This would correspond to the ruling of the Appellate Body when it stated that a treaty may not be interpreted so as to reduce whole clauses to "inutility". See footnote 649 *supra*."

[327] The principle of effective interpretation or "l'effet utile" or in latin *ut res magis valeat quam pereat* reflects the general rule of interpretation which requires that a treaty be interpreted to give meaning and effect to all the terms of the treaty. For instance one provision should not be given an interpretation that will result in nullifying the effect of another provision of the same treaty. For a discussion of this principle see also the *Yearbook of the International Law Commission*, 1966, Vol II A/CN.4/SER.A/1966/Add.1 p. 219 and following. See also *E.g., Corfu Channel* Case, (1949) *I.C.J. Reports*, p. 24; *Territorial Dispute* Case (Libyan Arab Jamahiriya v. Chad), (1994) *I.C.J. Reports*, p. 23; *Oppenheim's International Law* (9th ed., Jennings and Watts eds., 1992), Volume 1, 1280-1281; P. Dallier and A. Pellet, *Droit International Public*, 5è éd. (1994) para. 17.2; D. Carreau, *Droit International* (1994), para. 369.

[328] See for instance the statement of the Appellate Body in *United States - Standards for Reformulated and Conventional Gasoline*, adopted on 20 May 1996, WT/DS2/AB/R ("*US - Gasoline*"):"An interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility"; also the Appellate Body Report on *Japan - Alcoholic Beverages,* p. 12; Appellate Body Report on *United States - Restrictions on Imports of Cotton and Man-Fibre Underwear*, adopted on 25 February 1997, WT/DS24/AB/R, p. 16.

sions invoked by the parties, that would lead to a denial of either party's rights or obligations.

2. Overview of Article XXIV of GATT

9.97 In examining of Article XXIV, we are well aware that regional trade agreements have greatly increased in number and importance since the establishment of GATT 1947 and today cover a significant proportion of world trade.[329] We have also undertaken a detailed analysis of the negotiating history of Article XXIV. We note that the wording of Article XXIV is of sub-optimal clarity and has been the object of various, sometimes opposing, views among individual contracting parties and Members and in the literature. We are also aware that the economic and political realities that prevailed when Article XXIV was drafted, have evolved and that the scope of regional trade agreements is now much broader than it was in 1948. Pursuant to the Vienna Convention on the Law of Treaties, we begin our analysis of the terms of Article XXIV together with those of GATT 1947, GATT 1994, the 1994 Understanding on Article XXIV in their context and in the light of the object and purpose of the WTO Agreement, GATT, the ATC and the relevant provisions on regional trade agreements.

9.98 As a means of increasing freedom of trade, Article XXIV recognizes that, subject to certain conditions, customs unions and free-trade areas between WTO Members are desirable. To this end Article XXIV provides for the possibility that Members forming a customs union may depart, as to the trade between themselves, from the most-favoured nation principle, in conformity with the conditions of Article XXIV.[330] There are a number of indications of the broad desirability of Article XXIV agreements as a means of increasing freedom of trade. For example, paragraph 4 of Article XXIV provides that:

> "The Members recognize the desirability of increasing freedom of trade by the development, through voluntary agreements, of closer integration between economies of the countries parties to such agreements."

9.99 Similarly, the preamble of the GATT 1994 Understanding on Article XXIV, which was added to GATT 1994 as a result of the Uruguay Round, reiterates that:

> "such contribution to the expansion of world trade may be made by closer integration between the economies of the parties to such agreements".

9.100 This is also reflected in paragraph 7 of the Singapore Ministerial Decision:[331]

> "7. We note that trade relations of WTO Members are being increasingly influenced by regional trade agreements, which have expanded vastly in number, scope and coverage. Such initiatives can

[329] We refer to our discussion in paras. 2.2 to 2.9 above.

[330] We note in this context the statement of the Appellate Body in *EC - Bananas III*, para. 191: "Non-discrimination obligations apply to all imports of like products, except when these obligations are specifically waived or are otherwise not applicable as a result of the operation of specific provisions of the GATT 1994, such as Article XXIV".

[331] See WT/MIN(96)/DEC.

promote further liberalization and may assist least-developed, developing and transition economies in integrating into the international trading system."

9.101 This recognition of the desirability of regional trade agreements is not without qualification, however. Article XXIV:4 appears also to recognize that some of these agreements may have detrimental effects and therefore the rest of paragraph 4 of Article XXIV provides:

> "They also recognize that the purpose of a customs union and a free-trade area should be to facilitate trade between constituent territories *and not to raise barriers to the trade of other Members with such territories*." (emphasis added)

9.102 This is reiterated in the preamble of the GATT 1994 Understanding on Article XXIV which provides that:

> *"Reaffirming* that the purpose of such agreements should be to facilitate trade between the constituent territories and *not to raise barriers to the trade of other Members with such territories*; and that in their formation or enlargement the parties to them should to the greatest possible extent avoid creating adverse effects on the trade of other Members;" (emphasis added)

9.103 The terms of Article XXIV thus confirm that WTO Members have a right, albeit conditional, to conclude regional trade agreements.

9.104 In this regard, Article XXIV:5 provides that:

> "Accordingly, the provisions of this Agreement [GATT 1994] shall not prevent, as between the territories of Members, the formation of a customs union or of a free-trade area or the adoption of an interim agreement necessary for the formation of a customs union or of a free-trade area; *Provided* that … :"

9.105 We note that, at the very beginning of Article XXIV:5, the use of the word "Accordingly" indicates that the conditional right to form a regional trade agreement has to be understood and interpreted within the parameters set out in paragraph 4, since the word "Accordingly" refers back to that paragraph, which is the only paragraph addressing customs unions and free-trade areas in Article XXIV that precedes paragraph 5. Thus, the purpose of such a regional trade agreement "should be to facilitate trade between constituent territories *and not to raise barriers to the trade of other Members with such territories*" (emphasis added). In addition, we note that paragraphs 5 (in its proviso), 6 and 8, in particular, contain requirements that such agreements must meet. We consider these requirements in more detail later.

9.106 With the intent of enabling Members as a whole to monitor the formation of such regional trade agreements, Article XXIV:7 provides that:

> "(*a*) Any Member deciding to enter into a customs union or free-trade area, or an interim agreement leading to the formation of such a union or area, shall promptly notify the Members and shall make available to them such information regarding the *proposed* union or

> area as will enable them to make such reports and recommendations to Members as they may deem appropriate."[332] (emphasis added)

Paragraph 7 of the GATT 1994 Understanding on Article XXIV provides that:

> "Review of Customs Unions and Free-Trade Areas
>
> 7. All notifications made under paragraph 7(a) of Article XXIV shall be examined by a working party in the light of the relevant provisions of GATT 1994 and of paragraph 1 of this Understanding. The working party shall submit a report to the Council for Trade in Goods on its findings in this regard. The Council for Trade in Goods may make such recommendations to Members as it deems appropriate."

9.107 Traditionally in GATT, regional trade agreements were examined by working parties. In the WTO, such agreements are now examined by the Committee on Regional Trade Agreements (CRTA).[333] In the history of GATT, except in the case of the 1994 customs union between the Czech Republic and the Slovak Republic, the CONTRACTING PARTIES were never able to conclude whether or not a regional trade agreement was fully compatible with GATT. Today, under the WTO, Members have yet to conclude that a regional trade agreement is in full compliance with the WTO Agreement. In short, virtually all working party reports on regional trade agreements have been inconclusive.[334]

9.108 We note also that Article XXIV:10 of GATT provides for the possibility of an approval by WTO Members of a regional trade agreement that would not be fully compatible with the provisions of Article XXIV, if such a proposed regional trade agreement respects the key provisions of Article XXIV ("provided that such proposals lead to the formation of a customs union or a free-trade area in the sense of this Article").

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[332] The rest of paragraph 7 reads: "(*b*) If, after having studied the plan and schedule included in an interim agreement referred to in paragraph 5 in consultation with the parties to that agreement and taking due account of the information made available in accordance with the provisions of subparagraph (a), the Members find that such agreement is not likely to result in the formation of a customs union or of a free-trade area within the period contemplated by the parties to the agreement or that such period is not a reasonable one, the Members shall make recommendations to the parties to the agreement. The parties shall not maintain or put into force, as the case may be, such agreement if they are not prepared to modify it in accordance with these recommendations."

[333] The examination of regional trade agreements is subject to the same law and similar modalities as they were under GATT; see para. 2.7 above.

[334] This is in part due to the GATT/WTO practice of decision-making by consensus whereby the consensus of contracting parties (including the parties to the regional trade agreement) was needed for a recommendation to be made in terms of Article XXIV:7(a). The impossibility for GATT CONTRACTING PARTIES and still today, WTO Members, to reach any such conclusion is also due, *inter alia*, to disagreement on the interpretation of Article XXIV.

3. *Article XXIV:5(a)*

(a) Arguments of the Parties

9.109 Turkey claims that Article XXIV:5 of GATT 1994 authorizes the formation of a customs union, as defined by Article XXIV:8(a), provided that the conditions of Article XXIV:5(a) are met. Turkey argues that the provisions of Article XXIV:5(a) should be read as permitting, at the time of the completion of a customs union, the introduction of restrictive regulations of commerce to the trade of third countries, provided that the overall incidence of duties and other regulations of commerce was not higher or more restrictive after the completion of the customs union than before. Turkey claims that the overall incidence of duties and other regulations of commerce of the constituent members of the Turkey-EC customs union is not higher or more restrictive after the completion of the customs union than before.

9.110 In Turkey's view, the fact that Article XXIV does not prohibit Members from introducing new restrictions is confirmed in the last sentence of paragraph 2 of the GATT 1994 Understanding on Article XXIV, which states, *inter alia*, that:

> "for the purposes of the overall assessment of the incidence of other regulations of commerce for which quantification and aggregation are difficult, the examination of individual measures, regulations, products covered and trade flows affected may be required".

9.111 For Turkey, if it had been the intention of Members to ban the imposition of new quantitative restrictions whenever a customs union was being instituted, the reference to "other regulations of commerce" in Article XXIV:5 would have been a redundant provision.

9.112 Turkey further argues that the derogation envisaged by Article XXIV:5 is not limited to a particular GATT rule, but encompasses all those rules from which a derogation is necessary to permit the formation of customs unions. In support of this argument, Turkey notes that the opening clause of Article XXIV:5 is drafted in language similar to the language used in the opening clause of Article XX: "the provisions of this Agreement shall not prevent the formation of customs unions provided that …". For Turkey, this wording demonstrates that the derogation refers to all the provisions of the GATT, and not just to those contained in Article II, which are more specifically mentioned in Article XXIV:6.[335]

9.113 For India, the terms of Article XXIV:5 do not provide a legal basis for measures otherwise incompatible with GATT/WTO rules. This provision merely authorizes the formation of a customs union or free-trade area, nothing else. Its terms consequently exempt from the other obligations under the GATT only measures inherent in the formation of a customs union or a free-trade area. For instance, a customs union or a free-trade area could only be formed by the granting of preferential treatment inconsistent with Article I and Article XXIV clearly provides a justification therefor. However, customs unions and free-trade areas could be formed without the introduction of new quantitative restrictions on imports from third Members inconsistent with Article XI of GATT. There is, in particular, nothing that requires Members forming a

[335] In this context, Turkey recalls that it had offered to enter into negotiations to address India's concerns with regard to the change in its external trade regime, but that India had not wished to participate in such negotiations.

customs union to impose new restrictions on imports from one particular third Member, inconsistently with Articles XI and XIII of GATT and Article 2.4 of the ATC.

9.114 India also refers the Panel to Article XXIV:6, as part of the context of paragraph 5, which recognizes that on the occasion of the creation of a customs union, tariff bindings may be increased. India argues that there is no corresponding mechanism for renegotiation and compensation for Members affected by the introduction or increase of quantitative restrictions which are otherwise WTO incompatible. For India, this is a logical consequence of the principle that increasing tariffs is not as such WTO incompatible, as tariffs are negotiable (and renegotiable under Article XXVIII), whereas quantitative restrictions are in general prohibited and may only be imposed in circumstances narrowly defined in the WTO agreements. Given that rules governing quantitative restrictions are fundamentally different from the rules governing tariffs, there is no basis to apply Article XXIV:6 by analogy to quantitative restrictions. Moreover, for India, paragraph 4 of the GATT 1994 Understanding on Article XXIV makes it explicit that paragraph 6 of Article XXIV establishes the procedures to be followed when a Member forming a custom union proposes to increase a bound rate of duty. Had the Uruguay Round negotiators meant to extend Article XXIV:6 to quantitative restrictions, they would have formulated this provision accordingly.

9.115 According to Turkey, it could not be inferred from the fact that Article XXIV:6 only refers to increases of customs duty rates that the intention behind Article XXIV:5(a) is to prohibit the introduction of restrictive measures as part of a common regulation of commerce of a customs union. For Turkey, such an interpretation would be difficult to reconcile with Article XXIV:5(a), which provides a test for the GATT consistency of a customs union requiring, *inter alia*, that regulations of commerce of a customs union shall not on the whole be more restrictive than the regulations of commerce applicable in the constituent territories prior to the formation of the customs union. For Turkey, it would make little sense to provide for an evaluation of the overall incidence of regulations of commerce if, as India asserts, the regulations of commerce of the Turkey-EC customs union cannot be determined by pre-existing restrictive measures applied by the European Communities.

(b) Analysis of Article XXIV:5(a)

(i) Ordinary Meaning of the Terms of Article XXIV:5(a)

9.116 Article XXIV:5(a) provides as follows:

> "5. Accordingly, *the provisions of this Agreement shall not prevent*, as between the territories of contracting parties, *the formation of a customs union* or of a free-trade area or the adoption of an interim agreement necessary for the formation of a customs union or of a free-trade area; *Provided* that:
>
> (*a*) with respect to a customs union, or an interim agreement leading to a formation of a customs union, the duties and other regulations of commerce imposed at the institution of any such union or interim agreement in respect of trade with contracting parties not parties to such union or agreement shall not on the whole be higher or more restrictive than the general incidence of the duties and regula-

> tions of commerce applicable in the constituent territories prior to the formation of such union or the adoption of such interim agreement, as the case may be;" (emphasis added)

9.117 With respect to tariffs, paragraph 2 of the GATT 1994 Understanding on Article XXIV makes it clear that it is the level of the "applied duties" that are to be taken into account by Members in their "evaluation under paragraph 5(a) of Article XXIV":

> "For this purpose the duties and charges to be taken into consideration shall be the applied rates".

9.118 By requiring an examination of changes in applied duties, the provisions of Article XXIV:5(a) are made unambiguously distinct from those in Article XXIV:6, since the level of applied duties, unlike bound tariffs, is not regulated in the WTO framework of rights and obligations. Since the analysis of applied duties is a basic tool in appraising the impact of actual border barriers on trade opportunities, we consider that the requirement of an overall assessment of the incidence of duties based on applied duties clearly points at the economic nature of the assessment under paragraph 5(a).

9.119 The same conclusion is applicable in relation to the overall assessment of the incidence of other (non-tariff) regulations of commerce, in respect of which paragraph 2 of the Understanding on Article XXIV provides:

> "… It is recognized that for the purpose of the overall assessment of the incidence of other regulations of commerce for which quantification and aggregation are difficult, the examination of individual measures, regulations, products covered and trade flows affected may be required."

9.120 Thus, the terms of paragraph 5(a) of Article XXIV, as elaborated upon and clarified by the GATT 1994 Understanding on Article XXIV, provide for an "economic" test for assessing whether a specific customs union is compatible with Article XXIV. In the context of the overall assessment of the potential trade impact of any such customs union, (a task envisaged to be performed by the WTO membership through the CRTA[336]), duties and all regulations which existed in one or more of the constituent members and/or form part of the customs union treaty must be taken into account. While there is no agreed definition between Members as to the scope of this concept of "other regulations of commerce", for our purposes, it is clear that this concept includes quantitative restrictions. More broadly, the ordinary meaning of the terms "other regulations of commerce" could be understood to include any regulation having an impact on trade (such as measures in the fields covered by WTO rules, e.g. sanitary and phytosanitary, customs valuation, anti-dumping, technical barriers to trade; as well as any other trade-related domestic regulation, e.g. environmental standards, export credit schemes). Given the dynamic nature of regional trade agreements, we consider that this is an evolving concept.

9.121 We note that the language of paragraph 5(a) of Article XXIV is general and not prescriptive. While it authorizes the formation of customs unions, it does not

[336] In this respect we note the standard terms of reference used by the Council for Goods for examining regional trade agreements, as set out in WT/REG3/1.

contain any provision that either authorizes or prohibits, on the occasion of the formation of a customs union, the adoption of import restrictions otherwise GATT/WTO incompatible, by any of the parties forming this customs union. For example, the terms of paragraph 5(a) do not permit or prohibit or otherwise regulate increases of bound tariffs, which is an issue dealt with in paragraph 6 of Article XXIV. Rather, paragraph 5(a) provides for an economic assessment (to be performed by the WTO membership as a whole) of the overall effect of the applied tariffs and other regulations of commerce resulting from the formation of the customs union.[337] While the wording of paragraph 5(a) assumes that, as a result of a customs union, some (applied) duties may be higher, and/or other regulations of commerce may be more restrictive than before, it does not specify whether such a situation may occur only through GATT/WTO consistent actions or may occur through GATT/WTO inconsistent actions. What paragraph 5(a) provides, in short, is that the effects of the resulting trade measures and policies of the new regional agreement shall not be more trade restrictive, overall, than were the constituent countries' previous trade policies.

9.122 In other words, we consider that the terms of paragraph 5(a) do not address the GATT/WTO compatibility of specific measures that may be adopted on the occasion of the formation of a new customs union. We note that the standard terms of reference used by the CRTA for the examination of regional trade agreements confirm that the CRTA, in its overall assessment, shall not determine the WTO compatibility of specific measures.[338] The terms of Article XXIV:5(a) only provide that, for a customs union to be compatible with Article XXIV of GATT and the 1994 GATT Understanding on Article XXIV, the overall impact of the applied tariffs and other regulations of commerce resulting from the formation of the customs union must not be more restrictive than that of its constituent members prior to its formation.

9.123 It is important to emphasize that this interpretation does not render paragraph 5(a) a nullity,[339] as suggested by Turkey. In terms of our reading of paragraph 5(a), it continues to play an important role in ensuring that the occasion of the formation of a customs union is not used to increase trade barriers overall, even if the parties' previous

[337] The assessment, with respect to applied tariffs, is based on two comparable trade-weighted averages of applied tariffs, calculated by the Secretariat in accordance with the methodology described in paragraph 2 of the Understanding: (a) an average representing the pre-customs union situation; and (b) another average reflecting the situation just after the formation of the customs union. To compute the figure under (a), all applied tariffs (by tariff line) of all parties to the customs union are averaged using - as weights - the corresponding values of their imports from non-preferential origins; the figure under (b) is obtained by averaging the tariffs (to be) applied by the customs union, using the same values as trade weights.

[338] "This implies that a working party established to examine a notification under paragraph 7(a) of Article XXIV has the mandate to examine the incidence and restrictiveness of *all duties and regulations of commerce, in particular those governed by the provisions of the Agreements contained in Annex 1A of the WTO Agreement*. However, it should be kept in mind that the purpose of an examination in the light of paragraph 5(a) of Article XXIV *would not be to determine whether each individual duty or regulation existing or introduced on the occasion of the formation of a customs union is consistent with all provisions of the WTO Agreement*; it would be to ascertain whether on the whole the general incidence of the duties and other regulations of commerce has increased or become more restrictive.", Understanding read out by the Chairman of the Council for Trade in Goods - 20 February 1995, WT/REG3/1 (emphasis added).

[339] See our discussion on the general rule of effective interpretation in para. 9.96 above.

concessions allowed such an increase (e.g., in the case of increased applied rates below tariff levels bound by all parties). Indeed, that purpose is in fact emphasized by the focus on "applied", and not on bound, tariff rates.

(ii) The Immediate Context of Article XXIV:5(a)

9.124 Our interpretation of the terms of Article XXIV:5(a) is supported by their context. That context in the first place consists of the other provisions of Article XXIV relating to regional trade agreements.

Article XXIV:5(b)

9.125 Our interpretation of paragraph 5(a) is also supported by the similar wording contained in paragraph 5(b) in relation to free-trade areas. In paragraph 5(b), which is concerned with free-trade areas, it is stated that "… the duties and other regulations of commerce maintained in *each* of the constituent territories … shall not be higher or more restrictive than the corresponding duties and other regulations of commerce existing in the same constituent territories …" (emphasis added). We note that the terms of paragraph 5(b) are very similar to those in paragraph 5(a). In free-trade areas, however, constituent members are not required to harmonize their other trade regulations with third countries. Therefore, constituent members of a free-trade area could not argue that the terms of paragraph 5(b) would authorize them to violate other provisions of the WTO Agreement in their efforts to harmonize their external trade policies, since they are not required to do so. Consequently, we see no basis for arguing that the terms of paragraph 5(a) authorize constituent members of a customs union to adopt GATT-inconsistent measures. The same terms being used in paragraphs 5(a) and 5(b) should not lead to different interpretations.

Article XXIV:4

9.126 We also note that Article XXIV:4 provides that the purpose of a customs union should not be to raise barriers to the trade of other Members. While not expressed as an obligation, paragraph 4 (and its elaboration in the fifth paragraph of the Preamble of the GATT 1994 Understanding on Article XXIV) argues against an interpretation of paragraph 5(a) that would read into that paragraph an exception to GATT rules that prohibit specific trade barriers. This view is also expressed by Japan and Hong Kong, China in their third party submissions.[340] With the use of the term "Accordingly", the language of paragraph 4 is specially relevant to the application and interpretation of the provisions in paragraph 5, and argues against any interpretation in favour of exceptions or deviations (not elsewhere foreseen) to the general GATT prohibition against the use of quantitative restrictions. This is also noted by the Philippines.[341]

Article XXIV:6

9.127 Furthermore, Article XXIV:6 provides that if a Member "proposes to increase any rate of duty inconsistently with the provisions of Article II, the procedure set forth in Article XXVIII shall apply". Thus, in the adoption of the common external

[340] See Japan's argument in para. 7.21 and Hong Kong, China's argument in para. 7.10 above.
[341] See para. 7.43 above.

tariff of a customs union, compensation is due if a pre-existing tariff binding is exceeded. We note that there is no parallel provision to compensate Members for the introduction of quantitative restrictions. In our view, this is the case because quantitative restrictions are generally prohibited by GATT/WTO, while increases of tariffs above their bindings, if re-negotiated, are WTO compatible.

9.128 We also consider that this reference to Article XXVIII in Article XXIV provides evidence of the application of the other GATT provisions to measures adopted on the occasion of the formation of a customs union. The purpose of such specific reference to Article XXVIII, is to allow for the re-negotiation of the tariff bindings outside the time and prior notification constraints of Article XXVIII (including Article XXVIII*bis* and the GATT 1994 Understanding on Article XXVIII).

Article XXIV:8

9.129 Another element relating to the context is the scope and ordinary meaning of the terms of sub-paragraph 8(a)(ii) which define how Members forming a customs union should act *vis-à-vis* third country Members. For our analysis of Article XXIV:8(a) we refer to our discussion in paragraphs 9.142 to 9.169 below, where we address Turkey's argument that it is required to adopt the EC's commercial trade policy including quantitative restrictions in the sector of textile and clothing products.

Article XXIV in Part III of GATT

9.130 An additional element relating to the context is the fact that Article XXIV is found in Part III of GATT, a section of GATT distinct from Part I and Part II. Part I contains the main foundations of GATT: the most-favoured nation clause (Article I) and the tariff commitments or bindings (Article II). Part II contains a set of disciplines, the purpose of which is mainly to ensure the effectiveness of the tariff commitments. This is evident from the prohibition against quantitative restrictions (Article XI) and the national treatment obligation (Article III). We note that Article XXIV is not listed with the general exceptions (Article XX) or the security exception (Article XXI), both of which are in Part II.

9.131 Turkey concludes from the positioning of Article XXIV in Part III, that Article XXIV constitutes a self-contained regime for the formation of regional trade agreements, i.e. if the requirements of Article XXIV are met, other GATT rules do not apply to measures related to the formation of a customs union.

9.132 We note that Part III contains different types of provisions, some of a more institutional nature (Article XXV for instance), others dealing with Members' basic rights, such as Article XXVIII, and Article XXIV. We also note that Article XXIV itself deals with various elements such as the territorial application of GATT, frontier traffic and customs unions and free-trade areas. We have examined thoroughly the negotiating history of Article XXIV which, however, is not instructive in this respect. There is no text associated with Part III that suggests that it is fundamentally different from Part II, although Parts II and III entered into force at different dates.[342] In the Havana Charter,

[342] We recall also that in the *European Communities - Measures Affecting the Importation of Certain Poultry Products,* adopted on 23 July 1998, WT/DS69/7, the Appellate Body concluded that the prohibitions contained in Article XIII were applicable to negotiations taking pace pursuant to Article

the provisions on regional trade agreements were included in the commercial policy chapter in a section on special provisions (among which were the general exceptions found today in Article XX of GATT). Yet we are not aware that the provisions of the Havana Charter on customs unions were thought to be fundamentally different from those of GATT. We can read that the drafters were of the view that customs unions and free-trade areas (a concept that came in later in the negotiations) were of the nature of this so-called "exception" but the discussions are not illuminating on the scope or even the nature of this provision and the relevance of its "location" in the GATT. We hesitate to draw from this examination the conclusion proposed by Turkey.

9.133 Moreover, the interpretation advanced by Turkey which pertains to propose a test as to the treatment of measures that are associated with the "formation" of a customs union, is problematic. The temporal and substantive breadth of this concept would be crucial to the interpretation of Article XXIV under Turkey's argument, yet Article XXIV does not define such a concept.[343] There are important difficulties in relation to the interpretation of the term "formation" when considered in relation to the present case.[344] For us this argument of Turkey is not substantiated and we therefore reject it.

(iii) Conclusion Based on the Ordinary Meaning of the Terms and their Immediate Context

9.134 We shall examine the wider context of Article XXIV:5(a) and 8(a) as well as the object and purpose of GATT and the WTO Agreement, together with the practice of GATT CONTRACTING PARTIES and WTO Members with regard to these provisions, after our examination of the wording of Article XXIV:8(a). So far, based on the ordinary meaning of the terms and their immediate context, we find that the language of Article XXIV:5(a) is not prescriptive as to whether a specific measure may be adopted on the occasion of the formation of a customs union. From the terms of Article XXIV:5(a) and their immediate context, we find that there is a basis for the provisions of the sub-paragraph 5(a) to be informed by, and interpreted consistent with, the language of paragraph 4 against the raising of trade barriers. Consequently, we find that there is no legal basis in Article XXIV:5(a) for the introduction of quantitative restrictions otherwise incompatible with GATT/WTO; the wording of sub-paragraph 5(a) does not authorize Members forming a customs union to deviate from the prohibitions contained in Articles XI and XIII of GATT or Article 2.4 of the ATC. We find that the terms of sub-paragraph 5(a) provide for a prohibition against the formation of a customs

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XXVIII, a provision also contained in Part III of GATT. Clearly provisions of Part III of GATT do not in themselves argue for a distinct regime from those contained in Part II of GATT.

[343] What would be the minimum required scope for measures to qualify as being part of the "formation"? Would all measures that lead to, or are alleged to lead to, harmonization of policies be covered? Should there be a minimum or maximum time-frame to determine such "formation" period? Should the formation be required to correspond to any announced transitional period of interim agreements?

[344] We note that Turkey's first agreement with the European Communities was signed on 12 September 1963; see paras. 2.10 to 2.13 above. We note in passing that this situation is not unusual and reflects the reality of the ways in which Article XXIV type agreements are negotiated and presented to the WTO Members. But it is also evident that the present wording of Article XXIV on interim agreements is not adequate and does not reflect the present realities of the way regional trade agreements are negotiated and presented to the CRTA.

union that would be more restrictive, on the whole, than was the trade of its constituent members (even in situations where there are no WTO-incompatible measures).

4. Article XXIV:8

(a) Arguments of the Parties

9.135 Turkey submits also that Article XXIV:8(a)(ii) requires it to apply to third countries the same regulations of commerce, including import restrictions as those applied by the European Communities to the same third countries, since the term *regulations of commerce* has traditionally been interpreted as incorporating quantitative restrictions.[345] For Turkey, this is precisely the reason why Article 12 of Decision 1/95 unequivocally envisages the wholesale adoption by Turkey of the European Communities' Common Commercial Policy Instruments, as well as the European Communities' Customs Code, in the area of textiles and clothing products, prior to the completion of the customs union. Article 12(1) specifies the external trade measures to be adopted by Turkey towards third countries, which constituted the critical mass of commercial policy regulations applied by the European Communities and appropriate measures are envisaged to prevent trade diversion to the European Communities over Turkey's customs territory.

9.136 In India's view, however, Article XXIV:8(a) merely defines the requirements to be fulfilled by a regional trade agreement to qualify as a customs union within the meaning of Article XXIV[346]. This provision could not reasonably be interpreted to imply that Members, in fulfilling that requirement, are entitled to ignore their WTO obligations, such as those prohibiting import restrictions from third Members. For India, Article XXIV:4 makes it clear that the purpose of a customs union is not to raise barriers to the trade of third countries.

9.137 India notes that while Turkey claims it is obliged by Article XXIV:8 to adopt common quantitative restrictions with the European Communities for textiles and clothing products, it is also claiming the right to follow divergent trade policy practices and to adopt different instruments in other areas. India notes in this respect differences *inter alia* in external trade policies on agriculture, steel and other sensitive industrial products, as well as in relation to anti-dumping, countervailing and safeguards measures. India also adds that there is additionally no requirement that Members fulfil the requirements of Article XXIV:8(a) immediately.

9.138 For Turkey, India's interpretation of Articles XXIV:5 and XXIV:8(a)(ii) is overly restrictive. Turkey is of the view that any interpretation of Article XXIV which could lead to the conclusion that in certain circumstances, WTO Members with diverging external trade regimes were legally inhibited from forming a customs union, is in contradiction with the objective clearly stated in Article XXIV:4.

9.139 Turkey submits further that, since, in order to qualify as a customs union, the Turkey-EC customs union must cover substantially all trade - as required by Article XXIV:8(a)(i) - it has obviously to cover trade in textiles and clothing products, which represents 40 per cent of Turkey's exports to the European Communities. For such

[345] See BISD 35S/293, para. 45.
[346] See India's argument in para. 6.86 and Turkey's response in para. 6.94 above.

trade in textiles and clothing to be covered, the constituent members of the Turkey-EC customs union must have common tariffs and a common foreign trade regime with other countries in accordance with Article XXIV:8(a)(ii). For Turkey, such common regulation of commerce, as determined by restrictive measures which the European Communities applies in conformity with WTO rules, must cover goods imported into the Turkey-EC customs union *via* Turkey. For Turkey, there is no alternative: in the context of the formation of its customs union with the European Communities, it was required to adopt the European Communities' external trade policy in textile and clothing products.

9.140 We understand that Turkey is referring to two different requirements: 1) the requirement that it adopt the European Communities' external textile policy in order to form a customs union compatible with Article XXIV:8(a)(ii), and 2) the requirement in its specific customs union agreement with the European Communities that it adopt that European Communities' policy. We shall examine the second requirement in paragraphs 9.178 to 9.182 of this Panel report.

(b) Analysis of Article XXIV:8(a)

9.141 We note Turkey's arguments that if it wants to exercise its right to form a customs union with the European Communities, it has no alternative but to adopt exactly the same external trade policy as that of the European Communities and consequently, if need be, it is authorized by the provisions of Article XXIV:8(a)(ii) to violate the prohibition of Articles XI and XIII of GATT (and Article 2.4 of the ATC). We shall first examine the wording of Article XXIV:8(a)(i) and XXIV:8(a)(ii) and consider whether these provisions require Turkey to do what it claims to be required to do, namely to violate Articles XI and XIII of GATT and Article 2.4 of the ATC. In this context we shall discuss the relationship between Article XXIV and Article XI of GATT. Finally, we will examine whether our interpretation of Article XXIV in the present case would prevent Turkey from exercising its right to form a customs union.

(i) The Terms of Paragraph 8(a)

9.142 Paragraph 8(a) of Article XXIV reads as follows:

> "8. For the purposes of this Agreement:
>
> (*a*) A customs union shall be understood to mean the substitution of a single customs territory for two or more customs territories, so that
>
> (i) duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated with respect to substantially all the trade between the constituent territories of the union or at least with respect to substantially all the trade in products originating in such territories, and,
>
> (ii) subject to the provisions of paragraph 9, substantially the same duties and other regulations of commerce are applied by each of the members of the union to the trade of territories not included in the union;"

It is accepted that quantitative restrictions, such as the measures at issue in this case, are "restrictive regulations of commerce" for the purposes of Article XXIV:8(a).

9.143 We note the definition of a customs union as being "the substitution of a single customs territory for two or more customs territories". The term "customs territory" is defined in paragraph 2 of Article XXIV as being:

> "For the purposes of this Agreement a customs territory shall be understood to mean any territory with respect to which separate tariffs or other regulations of commerce are maintained for a substantial part of the trade of such territory with other territories."

9.144 With regard to the external dimension of any such customs union, the implied ultimate (and ideal) situation is that a complete single common foreign trade regime is adopted by the constituent members of the customs union.

9.145 We note that sub-paragraph 8(a)(i) of Article XXIV governs the internal trade between constituent members of a customs union. Sub-paragraph 8(a)(ii) governs the trade of the constituent members with third countries, and not the trade between the constituent members themselves.

9.146 The terms of sub-paragraph 8(a)(i) offer some flexibility to the constituent members of a customs union as also noted by Hong Kong, China.[347] The standard is that "substantially all the trade between the constituent territories" must be fully liberalized among the constituent Members. This, in practice, can be accomplished only by providing preferential treatment to goods originating in the constituent territories.[348] We are mindful that sub-paragraph 8(a)(i) is not directly relevant to this case, as India's claims do not concern any preferential treatment accorded by Turkey and the European Communities to each other as part of their customs union, but rather with the treatment of their trade with non-members of the customs union, i.e. Turkey's imposition of quantitative restrictions on Indian textiles and clothing.[349] This is an issue mainly for consideration in light of Article XXIV:8(a)(ii), and the relationship between the two sub-paragraphs 8(a)(i) and 8(a)(ii).

9.147 In considering Turkey's Article XXIV:8(a) defense, we are mindful of the need to interpret Article XXIV in a manner to avoid conflicts with other WTO provisions (see paragraph 9.95 above). The issue we must consider now is whether Arti-

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[347] See para. 7.15 above.

[348] Thus, in our view, sub-paragraph 8(a)(i) authorizes, for example, the members of a customs union to grant each other treatment notwithstanding the provisions of Article I:1 of GATT. We note in this context the statement of the Appellate Body in *EC - Bananas III*, para. 191: "Non-discrimination obligations apply to all imports of like products, except when these obligations are specifically waived or are otherwise not applicable as a result of the operation of specific provisions of the GATT 1994, such as Article XXIV". This was also recognized in a prior non-adopted Panel Report on *EEC - Member States' Import Regimes for Bananas*, DS32/R, para. 358: " ... it [Article XXIV] merely provides them [contracting parties] with a justification for not applying to imports originating in such a union or area the restrictive import measures that they were permitted to impose under other provisions of the General Agreement".

[349] We are aware of the statement of the Appellate Body in the *EC - Computer Equipment* which should be understood in the context of the internal market of the EC : "96..... However, the European Communities constitutes a customs union, and as such, once goods are imported into any Member State, they circulate freely within the territory of the entire customs union. The export market, therefore, is the European Communities, not an individual Member State." This Appellate Body statement referred to the "constant prior practice" of the European Communities. However, we are not addressing the situation of the internal market of the European Communities or the trade relations between the European Communities and Turkey.

cles XI (and XIII) of GATT, on the one hand, and Article XXIV:8(a)(ii), on the other hand, may be interpreted so as to avoid a conflict requiring that one provision yields to the other. For the reasons explained below, we believe that, in this case, the flexibility inherent in sub-paragraph 8(a)(ii) allows for harmonious interpretation. That interpretation is in accordance with the context of the sub-paragraph 8(a)(ii) and the object and purpose of the WTO Agreement, and, at the same time, fully respects Turkey's right to enter into a customs union with other Members.

9.148 As Japan and Hong Kong, China stressed[350], we note at the outset that the terms of sub-paragraph 8(a)(ii) do not explicitly authorize Members of a customs union to violate GATT rules in their relations with non-constituent members. Nor do they implicitly require such a result. Indeed, the terms of sub-paragraph 8(a)(ii) allow for flexibility in the creation of a common commercial policy, as the standard used is that "substantially the same duties and other regulations of commerce are [to be] applied by each of the members of the [customs] union". We are aware that GATT CONTRACTING PARTIES and WTO Members have never reached agreement on the interpretation of the term "substantially" in the context of Article XXIV:8. The ordinary meaning of the term "substantially" in the context of sub-paragraph 8(a) appears to provide for both qualitative and quantitative components. The expression "substantially the same duties and other regulations of commerce are applied by each of the Members of the [customs] union" would appear to encompass both quantitative and qualitative elements, the-quantitative aspect more emphasized in relation to duties.[351]

9.149 We note also that sub-paragraphs 8(a)(i) and 8(a)(ii) address distinct but interlinked policies. Therefore, the inclusion of a sector within the coverage of a customs union, i.e. the removal of all trade barriers in respect of products of that sector between the constituent members of the customs union, does not necessarily imply that those constituent members must apply identical barriers or barriers having similar effects to imports of the same products from third countries.

9.150 We note, however, in the terms of sub-paragraph 8(a)(i), the possibility for parties to a customs union to maintain certain restrictions of commerce on their trade with each other, including quantitative restrictions ("...where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX"). This implies that even for "substantially all trade originating in the constituent countries" to be covered (here, for instance, textile and clothing products), certain WTO compatible restrictions can be maintained. This implies that internal quantitative restrictions can be used in the event that only one of the constituent territories has in place a restriction on imports from third countries. If such pre-existing import restrictions were WTO compatible, the maintenance of an internal import restriction between the two constituent countries would ensure that the protection afforded by the original WTO compatible quota would not be circumvented. The maintenance of such an internal restriction can obviate the need for identical external trade policies. We note also that the plain meaning of the wording used in these two sub-paragraphs implies a difference in approach between efforts at internal trade liberalization among constituent members of a cus-

[350] See Japan's argument in para. 7.25 and Hong Kong, China's argument in para. 7.16 above.

[351] We have also examined the French and Spanish versions of Article XXIV which confirm that flexibility is left to the constituent members.

toms union where the maintenance of some quantitative restrictions (as restrictive regulations of commerce) is explicitly permitted (see paragraph 8(a)(i)), and their respective external policies with third countries where paragraph 8(a)(ii) contains no specific authorization relating to the maintenance of quantitative restrictions.

9.151 Having said this, and recognizing such flexibility, many questions remain unanswered. We consider, however, that if the ideal situation were to be one where the policies of the constituent members are identical, there is nevertheless a wide range of possibilities left for Members to identify how they can form their customs union and to what extent and how, they should put in place their internal trade and their common foreign trade polices. Considering this wide range of possibilities, we are of the view that, as a general rule, a situation where constituent members have "comparable" trade regulations having similar effects with respect to the trade with third countries, would generally meet the qualitative dimension of the requirements of sub-paragraph 8(a)(ii). The possibility also exists of convergence across a very wide range of policy areas but with distinct exceptions in limited areas. The greater the degree of policy divergence, the lower the flexibility as to the areas in which this can occur; and vice-versa. In our view, our interpretation of sub-paragraph 8(a)(ii) allows Members to form a customs union, as in this case, where one constituent member is entitled to impose quantitative restrictions under a special transitional regime and the other constituent member is not.[352]

9.152 This interpretation seems to be confirmed by the effective practice of the Turkey-EC customs union. We note that in some sectors such as those relating to agriculture, steel etc, identical trade policies are not being applied by the constituent members. We note also that Decision 1/95 envisages that the European Communities may continue to apply its system of certificates of origin should Turkey fail to conclude agreements with third countries, similar to the agreements already in place between those countries and the European Communities.[353] Thus, there are administrative means, as stated by the United States[354], available to the European Communities and Turkey, and in particular rules of origin, as suggested by Hong Kong, China[355], in order to ensure that no trade diversion occurs, while respecting the parameters of sub-paragraph 8(a)(i) and at the same time of sub-paragraph 8(a)(ii), re-

[352] Our discussion of the flexibility offered by Article XXIV:8(a) is without prejudice to the further flexibility that may exist during the transition period of an interim agreement leading to a customs union.

[353] Article 12 of Decision 1/95 (WT/REG22/1) provides that: "2. In conformity with the requirements of Article XXIV of the GATT Turkey will apply as from the entry into force of this Decision, substantially the same commercial policy as the Community in the textile sector including the agreements or arrangements on trade in textile and clothing. The Community will make available to Turkey the cooperation necessary for this objective to be reached. 3.Until Turkey has concluded these arrangements, the present system of certificates of origin for the exports of textile and clothing from Turkey into the Community will remain in force and such products not originating from Turkey will remain subject to the application of the Communities Commercial Policy in relation to the third countries in question… In the absence of such modalities, the Community reserves the right to take, in respect of imports into its territory, any measure rendered necessary by the application of the said Arrangement."

[354] See the United States' argument in para. 7.112 above

[355] See Hong Kong, China's argument in para. 7.18 above.

calling that the two sets of policies under sub-paragraphs 8(a)(i) and 8(a)(ii) are distinct and the relationship between them is a flexible one.

9.153 Our interpretation of Article XXIV:8(a) is not such as to render Turkey's right to form a customs union a nullity. We note that Turkey's exports of textiles and clothing to the European Communities represent 40 per cent of its total exports to the European Communities. If Turkey wants to cover such trade and to ensure that it benefits from the advantages of the customs union, it can do so and comply with sub-paragraph 8(a)(i). In its discussion of the interpretation and application of sub-paragraph 8(a)(ii), Turkey's reference to the fact that textiles and clothing represents 40 per cent of its trade with the European Communities, is therefore of no relevance. With regard to its external trade policies, calculations based on import statistics provided by Turkey to the Panel show that, in 1995, 1996 and 1997, (a) textile and clothing imports from all non-EC countries (including WTO Members and non-Members) into Turkey represented between 8 and 9 per cent of Turkey's total imports from those countries[356]; (b) imports from non-EC countries of the products covered by all categories under restriction by Turkey represented 4.5 per cent of Turkey's total imports from those countries[357]; and (c) imports from non-EC countries of the products covered by the 19 categories under restriction from India represented less than 3 per cent of Turkey's total imports from those countries.[358] It should be noted that the figures in (b) and (c) above, include both imports from WTO Members and non-Members. Thus, a variation in policy relevant to WTO Members on at most 4.5 per cent of Turkey's external trade, in any event of a temporary nature,[359] could not be considered in this case to jeopardize the requirement of Article XXIV:8(a)(ii) that substantially the same regulations of commerce are to be applied by Turkey and the European Communities to third countries. The fact that this proportion of trade is regulated in a different way by Turkey, cannot be seen to contradict the requirements of Article XXIV:8(a)(ii). As noted above, we consider that it is for the CRTA to assess the GATT/WTO compatibility of customs unions such as the Turkey-EC customs union and that in any case our terms of reference do not request us to do so. We, for our part, have endeavoured to ensure that our interpretation is not such as to prevent Turkey from exercising its WTO right to form a customs union.

9.154 Independently of the fact that constituent members could agree that some of their foreign trade policies may not be identical, we consider that the terms of sub-paragraph 8(a)(ii) do not address the issue of whether an otherwise WTO incompatible import restriction could be introduced among the identical or different trade policies on formation of a customs union. In our view, the terms of Article XXIV:8(a)(ii) do not provide any authorization for Members forming a customs union to violate the prescriptions of Articles XI and XIII of GATT or Article 2.4 of the ATC.

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[356] See Table II.2 above.

[357] See paras. 2.41 and 2.42 above.

[358] This results from the fact that, Turkey as an important clothing manufacturer, imports mainly textile products and these are only partially represented in the restricted categories (only 6, out of the 19 categories, refer to textile yarn or fabrics). (See para. 2.46 above and Annex to this report, Appendix 1.)

[359] The European Communities' MFA-derived quantitative restrictions must be eliminated by 1 January 2005.

(ii) Immediate Context

9.155 The conclusion that Article XXIV:8(a)(ii) should be read as not authorizing the violation of Articles XI and XIII of GATT or Article 2.4 of the ATC in the circumstances of this case is supported by the same contextual analysis that we developed relating to paragraph 5(a) (see paragraphs 9.124 to 9.133 above), and in particular, our analysis of paragraphs 4 and 6 of Article XXIV.

(iii) Conclusion

9.156 We conclude, based on the ordinary meaning of its terms and their immediate context, that Article XXIV:8(a) does not address explicitly the issue of the GATT/WTO compatibility of the measures adopted by constituent members of a customs union in their effort to align substantially all their duties and regulations of commerce *vis-à-vis* third countries. In any case, we consider that, in this case, Article XXIV:8(a)(ii) does not authorize Turkey, in forming a customs union with the European Communities, to introduce quantitative restrictions on textile and clothing products that would be otherwise incompatible with GATT/WTO, nor does it require that Turkey introduce restrictions on imports of textiles and clothing which would be inconsistent with other provisions of the WTO Agreement.

(c) The Wider Context of Article XXIV:5 and 8 and the Object and Purpose of the Agreements

9.157 We consider that the wider context of sub-paragraphs 5(a) and 8(a) and Article XXIV generally, as well as the object and purpose of the WTO Agreement, and GATT 1994, including the GATT 1994 Understanding on Article XXIV, are also relevant to the interpretation of Article XXIV and confirm our interpretation of the provisions of sub-paragraphs 5(a) and 8(a) of Article XXIV.

9.158 We note that the Preamble to the GATT 1947 (now GATT 1994) provides that:

> "Recognizing that their relations in the field of trade …should be conducted with a view to … and *expanding the production and exchange of goods*," (emphasis added)

9.159 Such language suggests that a global objective of GATT 1947 was, and of GATT 1994 is, to increase trade by reducing (making less restrictive) tariffs and lowering non-tariff barriers. It is a dynamic objective. The use of regional trade agreements to achieve that objective is legitimized by the first sentence of Article XXIV:4:

> "The contracting parties recognize the desirability of *increasing freedom of trade* by the development, through voluntary agreements, of closer integration between the economies of the countries parties to such agreements." (emphasis added)

9.160 Already then it was clear to CONTRACTING PARTIES that the overall objective of GATT and for that matter, regional trade agreements, should not be to raise barriers to trade. This is also noted in the Philippines' submission.[360] This is reflected in the wording of the second sentence of paragraph 4 of Article XXIV:

[360] See para. 7.41 above.

> "They also recognize that the purpose of a customs union or of a free-trade area should be to facilitate trade between the constituent territories *and not to raise barriers to the trade of other contracting parties* with such territories." (emphasis added)

and in the Preamble to GATT 1947:

> "Being desirous of contributing to these objectives by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the *elimination of discriminatory treatment* in international commerce ..."(emphasis added)

9.161 At the conclusion of the Uruguay Round Members reiterated the same general objective and principles in the GATT 1994 Understanding on Article XXIV:

> *"Reaffirming* that the purpose of such agreements should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other Members with such territories; and that in their formation or enlargement the parties to them should to the greatest possible extent avoid creating adverse effects on the trade of other Members;"

and in the Preamble to the WTO Agreement:

> "Being desirous of contributing to these objectives by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the *elimination of discriminatory treatment* in international commerce ..." (emphasis added)

9.162 We also recall the Singapore Ministerial Declaration:

> "7. ... We reaffirm the primacy of the multilateral trading system, which includes a framework for the development of regional trade agreements, and we renew our commitment to ensure that regional trade agreements are complementary to it and consistent with its rules"

9.163 From the above cited provisions,[361] we draw two general conclusions for the present case. Firstly, the objectives of regional trade agreements and those of the GATT and the WTO have always been complementary, and therefore should be interpreted consistently with one another, with a view to increasing trade and not to raising barriers to trade, thereby arguing against an interpretation that would allow, on the occasion of the formation of a customs union, for the introduction of quantitative restrictions. Secondly, we read in these parallel objectives a recognition that the provisions of Article XXIV (together with those of the GATT 1994 Understanding on Article XXIV) do not constitute a shield from other GATT/WTO prohibitions, or a justification for the introduction of measures which are considered generally to be *ipso facto* incompatible with GATT/WTO. In our view the provisions of Article XXIV on regional trade agreements cannot be considered to exempt constituent members of a customs union from the primacy of the WTO rules. In this context we

[361] We note that the wording of Article V of GATS refers to the same concepts.

also note the Singapore Ministerial Declaration where Members stated: "We reaffirm the primacy of the multilateral trading system…".

(d) GATT/WTO Practice

9.164 Turkey also refers to the practice of the GATT CONTRACTING PARTIES to support its view that, on the occasion of the creation of a customs union, individual GATT contracting parties and now WTO Members have been authorized to introduce new, otherwise GATT/WTO incompatible, import restrictions.[362] Article 31.3(b) of the VCLT provides that the "context" of a provision to be interpreted, includes "any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation". Article XVI:1 of the Agreement Establishing the WTO provides that the WTO shall be guided by the customary practices followed by the CONTRACTING PARTIES.

9.165 We recall the statement of the Appellate Body in *Japan - Alcoholic Beverages*:[363]

> "Generally, in international law, the essence of subsequent practice in interpreting a treaty has been recognized as a "concordant, common and consistent" sequence of acts or pronouncements which is sufficient to establish a discernable pattern implying the agreement of the parties regarding its interpretation.[364] An isolated act is generally not sufficient to establish subsequent practice;[365] it is a sequence of acts establishing the agreement of the parties that is relevant.[366]"

9.166 After examination of GATT/WTO practice, and as noted by the United States[367] and the Philippines[368], it is quite evident that no consensus was reached, nor was any practice agreed upon regarding Article XXIV of GATT. For example in 1957, the Report of the Sub-Group B (Quantitative Restrictions) of the GATT Committee on the European Economic Community,[369] which examined the conformity of the Treaty of Rome with the provisions of Article XXIV, stated that:

> "4. Most members of the Sub-Group (…) [were of the] view [that] countries entering a customs union would continue to be governed by the provisions of Article XI prohibiting the use of quantitative restrictions as well as by the other provisions of the Agreement (…). Further, adherence to these provisions would in no case prevent the establishment of a customs union. Since paragraph 8 (*a*) (i) permitted where necessary the use of quantitative restrictions for balance-of-

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362 Turkey alludes to GATT practice, albeit not in great detail. See paras. 6.58 to 6.61 above.

363 Appellate Body Report on *Japan - Alcoholic Beverages*, pp. 12-13.

364 [Footnote original]Sinclair, *The Vienna Convention on the Law of Treaties* (2nd ed., 1984), p. 137; Yasseen, "L'interprétation des traités d'après la Convention de Vienne sur le Droit des Traités" (1976-III) 151 *Recueil des Cours* p. 1 at 48.

365 [Footnote original]Sinclair, *supra*., footnote 24, p. 137.

366 [Footnote original](1966) *Yearbook of the International Law Commission*, Vol. II, p. 222; Sinclair, *supra*., footnote 24, p. 138.

367 See para. 7.88 above.

368 See para. 7.107 above.

369 BISD 6S/68, pp. 78-79, adopted on 29 November 1957.

payments reasons, it followed that the use of quantitative restrictions by individual countries within the union for these reasons could not be regarded as preventing the formation of a customs union as defined in Article XXIV. (…)

6. (…). Moreover they [most members of the Sub-Group] pointed out that if paragraph 8 (*a*) (ii) were interpreted to require a common level of quantitative restrictions against third countries, this would be incompatible with the explicit permission in paragraph 8 (*a*) (i) for the use of quantitative restrictions within the system for balance-of-payments reasons since it would appear not to be practicable to have a common level of quantitative restrictions against third countries in a situation where countries within the customs union made use of their right to impose such restrictions against their partners. Moreover, the effect of such an arrangement would be that some country or countries in the union would be imposing quantitative restrictions not required by their own individual balance-of-payments position and would, therefore, be raising barriers to trade with other contracting parties."

9.167 Upon accession to the European Communities (Denmark, Ireland and United Kingdom in1973; Greece in 1982; Spain and Portugal in 1985; Austria, Finland and Sweden in 1994), those countries imposed new quantitative restrictions in accordance with the European Communities' commercial policy. These actions were not universally accepted by GATT CONTRACTING PARTIES. For example, it was the position of some of the GATT contracting parties that:

"… the accession [of Greece] was *not in conformity* with the relevant provisions of the General Agreement, *including those relating to the application and administration of quantitative restrictions*. Neither the EC nor Greece were waived in any respect under the provisions of Article XI and XIII of the GATT by concluding and implementing the Act." [370] (emphasis added)

9.168 In the Working Party that considered the accession of Portugal and Spain to the European Communities, some contracting parties[371] expressed their views as follows:

"Some delegations expressed concerns which related to the introduction in Portugal and Spain of new quantitative restrictions some of

[370] *Report of the Working Party on the Accession of Greece to the European Communities*, adopted on 9 March 1983, BISD S30/169, p. 186 (emphasis added). Reinforcing this point of view is a statement made by a member of the same Working Party Report regarding Greece's accession to the EC: "… [the] quotas [established under the EC common trade policy are] contrary to the provisions of Article XI and XIII and … neither the EC nor Greece [are] relieved of their obligations under these Articles by virtue of having concluded the Act." (p. 186). That member furthermore noted that all the "members [to that Working Party] therefore fully [reserve] their rights under the General Agreement following the accession of Greece to the European Communities" (pp. 188-189).

[371] *Report of the Working Party on the Accession of Portugal and Spain to the European Communities*, adopted on 19-20 October 1988, BISD 35S/293, p. 315.

> which were discriminatory and inconsistent with Articles XI, XIII and XXIV: 4…
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> …Since Article XXIV did not provide a waiver from obligations contained in Articles XI and XIII and did not allow or require a country acceding to a customs union to adopt the more restrictive trade régime of the customs union, they called on the Communities and Spain to eliminate all GATT inconsistent measures …".

9.169 In light of these positions taken by individual GATT contracting parties[372] before the entry into force of the WTO Agreement and therefore the ATC, we cannot conclude that there is "subsequent practice" (as that term is used in the VCLT) or "customary practices" (as used in Article XVI:1 of the WTO Agreement) that could be regarded as an agreement or acceptance (even implicit) that paragraphs 5(a) or 8(a)(ii) of Article XXIV authorize or require the introduction of otherwise GATT/WTO inconsistent measures upon the formation of a customs union. We recall, as noted in paragraph 9.71 above, that the ATC has put in place new disciplines regarding the introduction of quantitative restrictions in the sector of textiles and clothing whereby, as of 1 January 1995, the global level of quantitative restrictions in that sector could only decrease (setting aside the possibility for ATC compatible safeguards measures).

(e) Temporary Nature of the Turkish Quantitative Restrictions

9.170 Turkey also argues that because its import restrictions at issue are essentially temporary in nature, since under the ATC all quantitative restrictions should be phased out by 1 January 2005, it should be authorized to maintain them, even if they appear to be GATT/WTO incompatible.

9.171 We consider that the duration of quantitative restrictions does not alter the nature of such measures. The GATT/WTO prohibition against quantitative restrictions does not provide for any allowance for "short-time quantitative restrictions" or any similar time consideration. In the present case, a measure which is not in conformity with the WTO Agreement cannot become WTO compatible just because of its limited duration. We must therefore reject this latter argument by Turkey. Indeed, the transitional nature of the ATC and the possibility under Article XXIV to phase in a customs union argues against an exception in favour of temporary measures.

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[372] It is also worth recalling the conclusions of the following GATT Panel Report which, although not adopted, confirm that some contracting parties opposed interpretations such as those suggested by Turkey, thereby denying the existence of any international customary practice. In the non-adopted Panel Report on *EEC - Tariff Treatment of Citrus Products from Certain Mediterranean Countries,* L/5776, paras. 3.12-3.22, the EEC argued that the non-recommendations by Working Parties which had examined the Treaty of Rome itself and other related agreements constituted tacit acceptance by the CONTRACTING PARTIES as a whole as well as the individual contracting parties that these agreements were in conformity with the provisions of Article XXIV, and that therefore the United States could not contest its preferential trade agreement with the Mediterranean Region. The United States' statement in response to the European Communities' argument was that the failure of the CONTRACTING PARTIES to reject the agreements did not imply acceptance nor did it constitute a legal finding of GATT consistency with Article XXIV.

(f) The Absence of Recommendations Pursuant to Article XXIV:7 of GATT

9.172 Turkey also argues that the fact that no Article XXIV:7 recommendation has ever been made to parties to a customs union to change or abolish any import restrictions, and in particular that no such recommendation has ever been made in respect of the previous Turkey-EC trade agreements, suggests that its measures are therefore WTO compatible. Turkey adds that up until now no contracting party or a WTO Member ever challenged measures similar to those under examination.

9.173 We recall that the European Communities made a similar argument before the panel in *EEC - Imports from Hong Kong* when it argued that quantitative restrictions had been accepted by contracting parties, that their violation had become negotiable and that this was tantamount to a tolerance:

> "15.…This proved, according to the EC, that quantitative restrictions had become a general problem and had gradually come to be accepted as negotiable, and that Article XI could not and had never been considered to be a provision prohibiting residual restrictions irrespective of the circumstances specific to each case."

This argument was rejected by the panel. It further discussed the consequences of a situation where during many years there had been no challenge to such a measure:

> "28. With regard to Article XI … The Panel acknowledged that there exist quantitative restrictions which are maintained for other than balance-of-payments reasons. It recognized that restrictions had been in existence for a long time without Article XXIII ever having been invoked by Hong Kong in regard to the products concerned, but concluded that this did not alter the obligations which contracting parties had accepted under GATT provisions. Furthermore *the Panel considered it would be erroneous to interpret the fact that a measure had not been subject to Article XXIII over a number of years, as tantamount to its tacit acceptance by contracting parties*. In fact, contracting parties and in particular Hong Kong have made it clear that the discussions on quantitative restrictions which have taken place in the GATT over the years were without prejudice to the legal status of the measures or the rights and obligations of GATT contracting parties. The Panel observed that, while most of the measures had been notified to the GATT in the past, the measures on watches had not been notified.
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> 29. The Panel considered the argument put forward by the European Communities that the principle referred to as "the law-creating force derived from circumstances" could be relevant in the absence of law. It found, however, that in the present case such a situation did not exist, *and the matter was to be considered strictly in the light of the provisions of the General Agreement*." (Emphasis added)

9.174 We agree with these findings. We note that until the adoption of paragraph 12 of the GATT 1994 Understanding on Article XXIV, it was not always clear whether specific measures adopted on the occasion of the formation of a customs union, could be challenged under Article XXII and XXIII of GATT. We note also that with regard to the interpretation of Article XXIV, the difficulty in securing a definitive

interpretation from WTO Members because of the wide range of issues involved, and because Members are often parties to one or more regional trade agreements, and the rather unclear wording of Article XXIV, may explain the absence of challenges under GATT. However, we cannot draw any conclusion as to the GATT/WTO compatibility of the measures at issue on the basis of the absence of past challenges.

(g) Offer to Negotiate

9.175 Turkey also argues that it offered compensation to India which, contrary to 24 other exporting countries, has consistently declined to accept to enter into negotiations towards a mutually agreed solution. India responds that the introduction of GATT/WTO-inconsistent quantitative restrictions is generally prohibited by the WTO Agreement, and not otherwise authorized by Article XXIV, and that it cannot be forced to accept compensation for a WTO illegal measure.

9.176 We note that Article XXIV:6 provides for a special procedure for renegotiation of tariff increases. This provision does not refer to any form of compensation for the introduction of quantitative restrictions. Indeed, we consider that members cannot be forced to negotiate or accept compensation in respect of GATT/WTO incompatible quantitative restrictions. We also recall the conclusion of the panel in *EEC-Imports from Hong Kong* that quantitative restrictions prohibited by GATT, cannot be negotiated.

9.177 Therefore the Panel considers that the refusal of India to enter into negotiations with Turkey in respect of compensation does not undermine its right to challenge Turkey's measures.

(h) The Requirements of the Turkey-EC Customs Union Agreement Itself

9.178 Turkey also argues that it was "required"' by the very terms of its customs union agreement with the European Communities to adopt the WTO compatible import restrictions of the European Communities in the sector of textiles and clothing. In our view, however, a bilateral agreement between two Members, such as that between the European Communities and Turkey, does not alter the legal nature of the measures at issue or the applicability of the relevant GATT/WTO provisions.

9.179 We note also that Article 12.2 of Decision 1/95 (WT/REG22/1) provides:

> "2. In conformity with the requirements of Article XXIV of the GATT, Turkey will apply as from the entry into force of this Decision, *substantially the same commercial policy* as the Community in the textile sector including the agreements or arrangements on trade in textile and clothing. The Community will make available to Turkey the cooperation necessary for this objective to be reached."

It is clear to us that the italicized language indicates that Turkey has some flexibility under this provision.

9.180 We recall that in the *EC - Bananas III* dispute the European Communities raised similar arguments with regard to what it was required to do pursuant to the Lomé Convention with the ACP countries. The European Communities argued that the panel should not have examined the content of the Lomé Convention and should have deferred to the common understanding of the parties. In that case the panel and the Appellate Body did examine the Lomé convention (for the purpose of assessing

the scope of the Lomé waiver) and concluded that unless explicitly authorized by the waiver the provisions of the Lomé convention could not alter the rights and obligations of WTO Members including those of the European Communities.

9.181 We note in this context the relevance of Article 41 of the VCLT, which provides that:

> "Two or more parties to a multilateral treaty may conclude an agreement to modify the treaty as between themselves alone if … (b) the modification in question is not prohibited by the treaty and (i) does not affect the enjoyment by the other parties of their rights under the treaty or the performance of their obligations".

9.182 Consequently, even if the Turkey-EC customs union agreement did require Turkey to adopt all EC trade policies, an issue that we do not have to address, we consider that such requirement would not be sufficient to exempt Turkey from its obligations under the WTO Agreement.

(i) Further Considerations

9.183 Our analysis would not be complete without addressing the argument that when, prior to forming the customs union, a constituent member has a WTO right, that Member may, on the occasion of the formation of a customs union, "pass" or "extend" such right to the other constituent members. We find that this proposition cannot be sustained for the following reasons.

9.184 We note that such a legal fiction or concept is not referred to in Article XXIV, in the WTO Agreement or in public international law.[373] The WTO system of rights and obligations provides, in certain instances, flexibility to meet the specific circumstances of Members. For instance, the ATC has grand-fathered certain MFA derived rights regarding import restrictions for specific Members and Articles XII, XIX, XX and XXI of GATT authorize Members, in specific situations, to make use of special trade measures. We consider that, even if the formation of a customs union may be the occasion for the constituent member(s) to adopt, to the greatest extent possible, similar policies, the specific circumstances which serve as the legal basis for one Member's exercise of such a specific right cannot suddenly be considered to exist for the other constituent members. We also consider that the right of Members to form a customs union is to be exercised in such a way so as to ensure that the WTO rights and obligations of third country Members (and the constituent Members)

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[373] See for instance, O'Connell, *The Law of State Succession*, Cambridge Press, 1956, Chapter V Extension of Treaties of the Successor State to Territory Incorporated where the author concludes that "… it would appear that treaties do not extend, as a general rule, and in the absence of clear intention to the contrary, to territories which remain after their incorporation invested with some degree or other of autonomy. The Permanent Mandates Commission reported in 1923 that 'the special international conventions entered into by a State do not apply *de jure* to territories in regard to which the state in question had been entrusted with a mandate, even when those conventions are applicable to contiguous territories placed under the sovereignty of the same state". See also Lasok, D., Lasok K., *Law and Institutions of the European Union* (1996), 6th ed., Vol.1; Jennings and Watts, *Oppenheim's International Law* (1996), 9th ed., Vol 1 (peace), Parts 2 to 4, p. 1261; Resolution on the White Paper "Preparing the Associated Countries of Central and Eastern Europe for Integration into the Internal Market of the Union", COM (95)0163-C4-0166/95, OJ No C141, p. 135, 1996/05/13; and Articles 15 and 29 of the VCLT.

are respected, consistent with the primacy of the WTO, as reiterated in the Singapore Declaration.

9.185 On a further matter, we have provided above our legal analysis of Article XXIV:8(a)(ii). We would add a brief general observation on Turkey's claim that it was "required" to adopt exactly the same trade policies as those of the European Communities and consequently that the provisions of Article XXIV do not leave any alternative to Members which intend to form a customs union. If we were to hypothesize such a complete lack of flexibility in the terms of Article XXIV, and that Turkey's foreign trade regime in consequence had to be completely and immediately identical to that of the European Communities, in order to comply with the provisions of Article XXIV:8(a)(ii) (and further assuming that, as in the present case, the European Communities can but is not obliged to maintain quantitative restrictions on textiles and clothing whereas Turkey cannot), it would imply that the European Communities would have to align its textiles and clothing regime to that of Turkey and immediately phase-out its import restrictions. This would go against the clear wording of Article XXIV in that it would arguably prevent Turkey from exercising its right to form a customs union with the European Communities because in practice it appears inconceivable that the European Communities would proceed with such a customs union if the "price" were to be that it must phase out its quantitative restrictions regularly notified to the TMB (and eventually, as a result, have to raise tariffs substantially in order to maintain the same overall level of protection). Turkey itself has noted[374] that such a scenario "is almost certainly not feasible". We recall the international law principle of effective interpretation whereby all provisions of a treaty must be given their full meaning and must ensure the overall consistency of the treaty and its effective application. We consider that Members have a right, albeit conditional, to form regional trade agreements. Therefore, Turkey's argument cannot be sustained since it would produce the above absurd result, i.e. that the European Communities would be forced to choose between its ATC rights and a customs union with Turkey. Consequently, there must be another realistic interpretation of Article XXIV, and there is, that reconciles the various interests of Members. In our view, the conclusion we have reached does so, and respects legal principles of 1) interpretation against conflicts and 2) for an effective interpretation of treaties.

5. Conclusion

9.186 We have considered the proposition that Article XXIV is *lex specialis* and is purported to be a self-contained regime insulated from the other provisions of GATT and the WTO Agreement. We are not convinced by this argument. The relationship between Article XXIV and GATT/WTO seems to us to be self-evident from the wording and context of Article XXIV.

9.187 The wording of Article XXIV:4 refers to the objectives of Article XXIV, in the same terms as used in the Preamble to GATT 1947 (now GATT 1994); the same objectives are repeated in the GATT 1994 Understanding on Article XXIV and in the Preamble of the WTO Agreement. Paragraph 6 also refers to the provisions of Article XXVIII and provides specific procedures for the re-negotiation of tariff bindings,

[374] See para. 6.111 above.

confirming thereby the applicability of other GATT provisions. To us, this confirms the nature of the WTO Agreement, as a single undertaking and that the provisions of Article XXIV are to be applied together with and not separately from the rest of the WTO Agreement. The Appellate Body has indeed repeated on several occasions that the WTO Agreement contains several obligations which must be complied with simultaneously, unless there is a conflict between the said provisions. Moreover we have noted that the wording of Article XXIV:4, with its reference to "should not raise barriers to trade" which appeared in GATT 1947, has continued to be determinative of the parameters of Article XXIV as evidenced by the wording of the GATT 1994 Understanding on Article XXIV and the Singapore Ministerial Declaration.

9.188 With regard to the specific relationship between, in the case before us, Article XXIV and Articles XI and XIII (and Article 2.4 of the ATC), we consider that the wording of Article XXIV does not authorize a departure from the obligations contained in Articles XI and XIII of GATT and Article 2.4 of the ATC. We base our findings on the nature of the conditional right established in Article XXIV as opposed to the clear and unambiguous obligation in Article XI prohibiting the use of quantitative restrictions, notwithstanding the specific contrary practice which has in the past existed in the sector of textiles and clothing but which the ATC represents a collective commitment to terminate. As further discussed above, we consider that it is possible, and even necessary in order to avoid a conclusion that would lead to politically and economically absurd results, to interpret the provisions of Article XXIV in such a way as to avoid conflicts with the prescriptions of Articles XI and XIII of GATT, and Article 2.4 of the ATC.

9.189 As we have noted, paragraphs 5 and 8 of Article XXIV provide parameters for the establishment and assessment of a customs union, but in doing so allow flexibility in the choice of measures to be put in place on the formation of a customs union. In this context we recall the use of the terms "substantially all the trade" and "substantially the same duties and other regulations of commerce". While the meaning of these terms is not precisely clear in relation to what and how much constitute "substantially", they do confirm clearly that in both cases the standard is not all. These provisions do not, however, address any specific measures that may or may not be adopted on the formation of a customs union and importantly they do not authorize violations of Articles XI and XIII, and Article 2.4 of the ATC. Moreover, we note that paragraph 6 of Article XXIV provides for a specific procedure for the renegotiation of tariffs which are increased above their bindings upon formation of a customs union; no such provision exists for quantitative restrictions. To the Panel, if the introduction of WTO inconsistent quantitative restrictions were intended to be negotiable on the formation of a customs union, it would seem odd to us that an explicit procedure would exist for changes in GATT's preferred form of trade barrier (i.e. tariffs), while no procedure would be provided for negotiation of compensation connected with imposition of otherwise GATT inconsistent measures. We draw the conclusion that even on the occasion of the formation of a customs union, Members cannot impose otherwise incompatible quantitative restrictions.

9.190 We have further considered, in the context of these conclusions on Turkey's defense based on Article XXIV, the scope of flexibility allowed for in Article XXIV. However, this flexibility does not allow for the introduction of measures otherwise incompatible with the WTO Agreement. We consider that means for securing the objectives of Turkey in relation to the specific circumstances of forming its customs union

with the European Communities, exist in the form of alternatives (e.g. increased tariffs, rules of origin, early phase-out, tariffication) to the imposition of quantitative restrictions imposed against imports from third countries, thereby interpreting Article XXIV in such a way as to avoid such conflict with other WTO provisions. In particular, our interpretation of paragraph 8(a)(ii) allows parties to form a customs union, as in this case, where one constituent member is entitled to impose quantitative restrictions under a special transitional regime and the other constituent is not.

9.191 Finally, we recall that the prohibitions against quantitative restrictions in the sector of textiles and clothing constitute a fundamental feature of the WTO Agreement which argues strongly against the introduction of any new such restrictions in that sector. Moreover, considering the flexibility offered by the possibility of "interim agreements" under Article XXIV[375] and the inherently transitional nature of quantitative import restrictions in the sector of textiles and clothing, we find that Turkey was in a position to avoid the violations of Articles XI and XIII[376] of GATT, and Article 2.4 of the ATC.

9.192 Consequently, we reject Turkey's defense that Article XXIV allows it to introduce, upon the formation of its customs union with the European Communities, quantitative restrictions on 19 categories of textile and clothing products, in violation of Articles XI and XIII of GATT and Article 2.4 of the ATC.

H. The Absence of Nullification and Impairment

9.193 In its second submission, Turkey also submits an additional defense to India's claims. Turkey argues that even if the Panel were to conclude that Turkey's measures violated provisions of the GATT and/or the ATC, India's claims should still be rejected as imports of textile and clothing products from India into Turkey have increased since the entry into force of the Turkey-EC customs union. For Turkey, India has, therefore, not suffered any nullification or impairment of its WTO benefits.

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[375] For the purpose of this dispute we need not to address further the distinction between an "interim agreement" leading to a customs union and a completed customs union. We indeed state in footnotes 241 and 285 that we do not have to assess the precise relationship of the Turkey-EC agreement with Article XXIV, e.g. whether it is a free-trade agreement or a customs union or an interim agreement leading to a free-trade area or customs union. In this dispute, Turkey claims that its regional trade agreement with the European Communities is a completed customs union. We therefore limit our discussion to responding to Turkey's defence and, as we state in paras. 9.146 to 9.151 above even for completed customs unions, we are of the view that Article XXIV:8(a) leaves flexibility to constituent members of a customs union so that Turkey did not have to violate Articles XI, XIII of GATT and Article 2.4 of the ATC.

[376] We note that even if the quantitative restrictions imposed by Turkey were to be justified under Article XXIV, such a justification of quantitative restrictions introduced in violation of Article XI of GATT could not necessarily permit a violation of Article XIII of GATT. The ATC authorizes discriminatory quantitative restrictions (contrary to Article XIII). In this case the quantitative restrictions imposed by Turkey are not imposed pursuant to the ATC (see our conclusion in para. 9.80). They were not imposed under Article 2.1, or Article 6 as a safeguard measure, or otherwise under any other explicit provision of the ATC. Even if Article XXIV were to justify a violation of Article XI of GATT, such quantitative restrictions would still have to respect the prescriptions of Article XIII. In light of the principle of judicial economy, we consider, however, that we do not need to discuss further, India's claims pursuant to Article XIII of GATT.

9.194 Turkey argues that Article 3.8 of the DSU implies (a) that a proceeding brought by a complaining party against a violation of a WTO rule is and remains based on the purpose to protect benefits against nullification or impairment and (b) that a violation of a WTO rule is not in and by itself a nullification or impairment of benefits of a Member complaining about such violation; a violation constitutes only a presumption of nullification or impairment. For Turkey, this is in line with the fact that many domestic jurisdictions require an "interest to sue", i.e. a complainant must show more than that its right was breached. Similarly in international law a complainant must show a legal interest.[377] Turkey argues that WTO law requires that an alleged breach of a Member's right must have an economic impact on the complaining Member.

9.195 Turkey urges the Panel to ignore the conclusions of the panel in *US - Superfund*, and of the Appellate Body in *EC - Bananas III*. Turkey adds that a such presumption of nullification and impairment, in case of a breach of a WTO obligation, does not exist under the GATS[378] or for prohibited subsidies under the SCM Agreement[379] and should, therefore, not be considered a general principle of WTO law.

9.196 For Turkey, India's claims must fail since, according to Turkey, the quantities that could be exported by India under the restrictions of the Turkey-EC customs union exceed, on the average by 134 per cent, India's exports to Turkey in 1994, i.e. the last full year before the tariff reductions provided by the Turkey-EC customs union took place. Turkey also submits that India's exports of the textile products covered by the measures challenged, in the years 1996-1998, remained significantly below the possibilities opened under these measures. In 1996, for 12 out of the 19 categories the amounts licensed remained below 50 per cent of the quotas, and for 8 out of these 19 categories even below 10 per cent. In 1997 for 6 out of the 19 categories the amounts licensed remained below 50 per cent of the quotas. In 1998 for 9 out of 19 categories the amounts licensed remained below 50 per cent of the quotas.[380]

9.197 Finally, Turkey also argues that in rejecting Turkey's offer to negotiate a bilateral limitation on textile and clothing imports (contrary to what some other 24 countries have done), India has itself broken the chain of causation between the measures challenged and the nullification and impairment. For Turkey, there is a general principle of law according to which one may not seek redress for harm that one has brought onto oneself by not taking measures that would have prevented or at least mitigated the harm caused by another party.[381]

9.198 India challenges the accuracy and the relevance of the data submitted by Turkey. India submits that during the year that preceded the imposition of Turkey's restrictions, exports of the clothing items that are now restricted had grown by 57 per cent compared to the previous year. During the year immediately following the imposition of the measures, they declined by 74 per cent. In respect of textiles the situa-

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[377] Turkey refers to *South West Africa Cases* (Second Phase) ICJ [1966], p. 47; *Barcelona Traction Light and Power Co. Ltd* , ICJ [1970], p. 32.

[378] The General Agreement on Trade in Services.

[379] The Agreement on Subsidies and Countervailing Measures.

[380] See paras. 6.146 and 6.164 above.

[381] See para. 6.168 above.

tion is even more extreme: the growth rate in the year prior to the introduction of the measures was 200 per cent and the decline in the subsequent year 48 per cent.[382]

9.199 India also insists that the presumption mentioned in Article 3.8 of the DSU is not rebuttable by the submission of evidence alleging no actual adverse effects of the measure. India refers the Panel to the evolution of this principle in GATT law starting with the 1960 decision of the CONTRACTING PARTIES when it was decided that a GATT-inconsistent measure was presumed to cause nullification or impairment and that it was up to the party complained against to demonstrate that this was not the case.[383] This principle was taken over in the dispute settlement procedures adopted at the end of the Tokyo Round,[384] and is now reflected in Article 3.8 of the DSU. For India, the "adverse impact" of a violation cannot be determined on the basis of the actual impact of the violation on trade flows. India refers the Panel to the adopted Panel Report on *Japan - Leather* in which Japan had argued that, since the quotas had not been fully utilized, they had not restrained trade and had consequently not caused a nullification or impairment of benefits accruing under Article XI of the GATT. The panel rejected the argument on the grounds that:

> "The existence of quantitative restrictions should be presumed to cause nullification or impairment not only because of any effect it had on the volume of trade but also for other reasons, e.g., it would lead to increased transaction costs and would create uncertainties which could affect investment plans."[385]

For India, this ruling indicates that a demonstration that no adverse trade impact had as yet occurred was insufficient to rebut the presumption. In its view, the rationale of prohibiting quantitative restrictions requires a demonstration that there was no potential future impact.

9.200 India refers also to the *US - Superfund* decision, the reasoning of which, the Appellate Body in *EC - Bananas III* stated, was applicable to the European Communities' obligations under Articles III, XI and XIII of the GATT 1994. For India, the Appellate Body thereby rejected the argument of the European Communities that the benefits accruing to the United States under these provisions had not been impaired because the United States had not exported a single banana to the European Communities, nor was in a position to do so.

9.201 Article 3.8 of the DSU provides that:

> "In cases where there is an infringement of the obligations assumed under a covered agreement, the action is considered *prima facie* to constitute a case of nullification or impairment. This means that there is normally a presumption that a breach of the rules has an adverse impact on other Members parties to that covered agreement, and in such cases, it shall be up to the Member against whom the complaint has been brought to rebut the charge."

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[382] See paras. 6.148 and 6.159 above.

[383] BISD S11/99-100.

[384] Paragraph 5 of the Annex to the Understanding on Dispute Settlement adopted on 28 November 1979.

[385] Panel Report on *Japan - Measures on Imports of Leather*, adopted on 15/16 May 1984, BISD 31S/94, ("*Japan - Leather*"), p. 113.

9.202 We recall that in *EC - Bananas III*,[386] the Appellate Body confirms that the principles established in *US - Superfund*:

> "... a demonstration that a measure has no or insignificant effects would not be a sufficient demonstration that the benefits accruing under that provision had not been nullified or impaired even if such a rebuttal were in principle permitted."[387]

are still most relevant to violations of provisions of GATT 1994.

9.203 We note that some of the statistics provided by Turkey appear to refer to the trade effects of Turkey's entire import policy on textile and clothing products, including the reduced tariffs on some categories. Other statistics refer to the impact of Turkey's import policy in general resulting from the creation of the customs union.[388] With reference to the specific statistics on the 19 categories under restrictions, these statistics show, and both parties agree, that imports of textiles and clothing from India into Turkey significantly declined in 1996 after a substantial increase in 1995.[389] Turkey argues, however, that the year 1995 is atypical because it had already begun to lower its import tariffs in preparation for the entry into force of the customs union.[390] India challenges this assertion[391] and argues that the level of its exports of textiles and clothing into Turkey was influenced by the evolution of the market itself as well as by the import regimes of other countries. In support of its view, India argues that for the non-restricted categories, its exports to Turkey also increased substantially in 1995 but did not decline in 1996.[392]

9.204 We are of the view that it is not possible to segregate the impact of the quantitative restrictions from the impact of other factors. While recognizing Turkey's efforts to liberalize its import regime on the occasion of the formation of its customs union with the European Communities, it appears to us that even if Turkey were to demonstrate that India's overall exports of clothing and textile products to Turkey have increased from their levels of previous years, is would not be sufficient to rebut the presumption of nullification and impairment caused by the existence of WTO incompatible import restrictions. Rather, at minimum, the question is whether exports have been what they would otherwise have been, were there no WTO incompatible quantitative restrictions against imports from India. Consequently, we consider that even if the presumption in Article 3.8 of the DSU were rebuttable, Turkey has not provided us with sufficient information to set aside the presumption that the introduction of these import restrictions on 19 categories of textile and clothing products has nullified and impaired the benefits accruing to India under GATT/WTO.

9.205 As to Turkey's allegations that India has not fully utilized the quotas under examination[393], we recall the conclusion of the adopted panel report in *Japan* -

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386 Appellate Body Report on *EC - Bananas III*, para. 253.
387 Panel Report on *US - Superfund*, para. 5.1.9.
388 See paras. 6.139 to 6.147 above.
389 See paras 2.43 and 2.44, and Tables II.4 and II.5 above.
390 See para. 6.147 above.
391 See paras. 6.148 and 6.149 above.
392 See para. 6.148 above and Table II.4 above.
393 See para. 6.164 above.

Leather that the existence of quantitative restrictions should be presumed to cause nullification or impairment even if quotas are not fully utilized because they lead to increased transaction costs and would create uncertainties which could affect investment plans (or in this case, trade).

9.206 As to Turkey's arguments that India's refusal to accept compensation has broken the chain of causation, we consider that although parties should clearly favour a mutually acceptable settlement of their dispute as provided for under the DSU, such a solution must be one that is "mutually" acceptable. We can only take note that India considered that the offers by Turkey and the European Communities were not acceptable to it. We recall that when a WTO Member considers that its rights have been nullified by the actions of another Member it is entitled to initiate dispute settlement procedures envisaged in the DSU.[394] We reject therefore Turkey's argument that India's nullification and impairment of its WTO benefits have resulted from India's own action or absence thereof.

I. Our Main Findings Recalled

9.207 Without prejudice to our detailed analysis above, it may be helpful to provide a brief overview of our main findings. We have found that the measures at issue were Turkish measures, as they were adopted by the Turkish government at a date different from the EC measures, and they were applied and enforced by Turkey alone. In this context we ruled that the European Communities was not an essential party to this dispute, although we invited it to submit to us any relevant facts or arguments that it deemed appropriate. We found that the measures at issue had not been introduced under the ATC, but rather, as submitted by Turkey, in the context of the formation of its customs union with the European Communities. Therefore the matter at issue is not for the TMB and we have jurisdiction to adjudicate on it. We have also found that the measures were "new measures" pursuant to Article 2.4 of the ATC and that, unless they could be justified under a GATT provision, the discriminatory quantitative restrictions imposed by Turkey against the imports of 19 categories of textiles and clothing imports from India, would violate Articles XI and XIII of GATT and consequently Article 2.4 of the ATC.

9.208 We then proceeded to examine Turkey's defense based on Article XXIV of GATT. In this context, we decided that we had jurisdiction to examine any specific measure adopted by a WTO Member in the context of a customs union but that, in this case, we did not need, and indeed we were asked by the parties not to assess the overall WTO compatibility of the Turkey-EC customs union. We have found that, as a general principle, Turkey was bound, at all times, by all WTO obligations, unless there was a conflict between any provisions. Since the wording of Articles XI and XIII of GATT and Article 2.4 of the ATC is clear in prohibiting the introduction of quantitative restrictions such as those at issue, we examined the terms of Article XXIV to decide whether Turkey could be exempted from the application of these

[394] See for instance the Appellate Body Report on *US - Shirts and Blouses*, p. 13, DSR 1997:I, 334, IV, where it is stated: "If any Member should consider that its benefits are nullified or impaired as the result of circumstances set out in Article XXIII, then dispute settlement is available"; see also the Appellate Body Report on *EC - Bananas III*, paras. 136 and 252-253.

prohibitions. We found that the provisions of paragraphs 5 and 8 of Article XXIV did not authorize any violation of the WTO obligations, other than the MFN obligation. Indeed, these paragraphs do not provide any indication as to the type of measure to be used in the formation of a customs union but rather provide guidelines for the overall assessment of regional trade agreements. We have therefore concluded that Article XXIV did not authorize the violation of Articles XI and XIII of GATT or Article 2.4 of the ATC. While reaching this conclusion on the basis of the wording of the provisions at issue, we have endeavoured to ensure that our interpretation did not render Turkey's right to form a customs union with the European Communities a nullity, since pursuant to Article XXIV:8(a)(ii), constituent members to a customs union are required to adopt substantially the same regulations of commerce. We found that this standard leaves flexibility to the constituent members. In any event, in the present case, taking into account, *inter alia*, the share of trade affected by the type of measures at issue (quantitative restrictions on textiles and clothing), we found that there were WTO compatible alternatives available to Turkey if it wanted to conclude a customs union with the European Communities. Finally we found that even if the presumption of nullification of Article 3.8 of the DSU were rebuttable, Turkey had not submitted evidence that the benefits accruing to India under the ATC and GATT had not been reduced or nullified by the introduction of WTO incompatible quantitative restrictions.

X. CONCLUSIONS

10.1 We conclude that the measures adopted by Turkey on 19 categories of textile and clothing products are inconsistent with the provisions of Articles XI and XIII of GATT and consequently with those of Article 2.4 of the ATC. We reject Turkey's defense that the introduction of any such otherwise GATT/WTO incompatible import restrictions is permitted by Article XXIV of GATT.

10.2 Under Article 3.8 of the DSU, in cases where there is infringement of the obligations assumed under a covered agreement, the action is considered *prima facie* to constitute a case of nullification or impairment of benefits under that agreement. Accordingly, we conclude that, to the extent that Turkey has acted inconsistently with the provisions of covered agreements, as described in the preceding paragraph, it has nullified or impaired the benefits accruing to the complainant under those agreements.

10.3 The Panel *recommends* that the Dispute Settlement Body request Turkey to bring its measures into conformity with its obligations under the WTO Agreement.

ANNEX

Appendix 1 Categories of Turkey's imports of textile and clothing products from India under restriction

Group	Product	Description
IA	1	Cotton yarn, not put up for retail sale.
IA	2	Woven fabrics of cotton, other than gauze, terry fabrics, pile fabrics, chenille fabrics, tulle and other fabrics.
IA	2a	Of which: Other than unbleached or bleached
IA	3	Woven fabrics of synthetic fibres (discontinuous or waste) other than narrow woven fabrics, pile fabrics (including terry fabrics) and chenille fabrics
IA	3a	Of which: Other than unbleached or bleached
IB	4	Shirts, T-shirts, lightweight fine knit roll, polo or turtle necked jumpers and pullovers (other than of wool or fine animal hair), undervests and the like, knitted or crocheted
IB	5	Jerseys, pullovers, slip-overs, waistcoats, twinsets, cardigans, bed-jackets and jumpers (other than jackets and blazers), anoraks, windcheaters, waister jackets and the like, knitted or crocheted
IB	6	Men's or boys' woven breeches, shorts other than swimwear and trousers (including slacks), women's or girls' woven trousers and slacks, of wool, of cotton or of man-made fibres; lower parts of tracksuits with lining, other than category 16 or 29, of cotton or of man-made fibres
IB	7	Women's or girls' blouses, shirts and shirt-blouses, whether or not knitted or crocheted, of wool, of cotton or man-made fibres
IB	8	Men's or boys' shirts, other than knitted or crocheted, of wool, cotton or man-made fibres
IIA	9	Terry towelling and similar woven terry fabrics of cotton; toilet linen and kitchen linen, other than knitted or crocheted, of terry towelling and woven terry fabrics, of cotton
IIA	20	Bed linen, other than knitted or crocheted
IIA	23	Yarn of staple or waste artificial fibres, not put up for retail sale
IIA	39	Table linen, toilet and kitchen linen, other than knitted or crocheted, other than of terry towelling or similar terry fabrics of cotton
IIB	15	Women's or girls' woven overcoats, raincoats and other coats, cloaks and capes; jackets and blazers, of wool, of cotton or of man-made textile fibres (other than parkas) (of category 21)
IIB	24	Men's or boys', night shirts, pyjamas, bathrobes, dressing gowns and similar articles, knitted or crocheted Women's or girls' night dresses, pyjamas, negligees, bathrobes, dressing gowns and similar articles, knitted or crocheted
IIB	26	Women's or girls' dresses, of wool, of cotton or of man-made fibres
IIB	27	Women's or girls' skirts, including, divided skirts
IIB	29	Women's or girls' suits and ensembles, other than knitted or crocheted, of wool, of cotton or of man-made fibres, excluding ski suits; women's or girls' tracksuits with lining, with an outer shell of an identical fabric, of cotton or of man-made fibres

Source: Government of Turkey, Decree No. 95/6815, concerning the *Surveillance and Safeguard Measures for Imports of Certain Textile Products*, dated 30 April 1995 and published in the *Official Gazette* of 1 June 1995, Annex I.

Appendix 2 **Size of Turkey's import quotas on textile and clothing products from India, by product categories, in 1996, 1997 and 1998**

Product Category	Unit	1996	1997	1998
1	kgs	7,372,000	7,372,000	7,761,800
2	kgs	752,000	752,000	786,800
2a	kgs	104,000	104,000	121,000
3	kgs	16,000	16,000	17,800
3a	kgs	15,000	15,000	16,700
4	pieces	8,000	8,000	9,000
5	pieces	4,000	4,000	4,600
6	pieces	4,000	4,000	4,600
7	pieces	4,000	4,000	4,300
8	pieces	4,000	4,000	4,300
9	kgs	4,000	4,000	4,600
20	kgs	4,000	4,000	4,600
23	kgs	480,000	480,000	558,100
39	kgs	4,000	4,000	4,700
15	pieces	4,000	4,000	4,700
24	pieces	4,000	4,000	4,700
26	pieces	4,000	4,000	4,500
27	pieces	4,000	4,000	4,500
29	pieces	4,000	4,000	4,600

Source: *Official Gazette* of 19 December 1995, 13 March 1996, 13 June 1996, 25 September 1996, 7 December 1996, 12 June 1997 and 18 December 1997.

Appendix 3a **India's exports to Turkey, by textiles and clothing categories under restriction, in 1994-1997**

Product Category	**Value** (Thousand US$)				**Volume** (Thousand kilos/pieces)			
	1994	1995	1996	1997	1994	1995	1996	1997
Textiles								
1	11,380	27,270	16,050	15,790	3,840	7,291	5,074	5,197
2, incl. 2a	1,160	9,350	3,130	2,250	273	2,331	894	648
3, incl. 3a	70	230	1,200	840	6	21	143	139
9	0	2,250	590	0	0	386	140	
20	0	20	40	280	0	2	2	29
23	1,350	2,720	670	400	526	818	226	147
39	0	0	20	10	0	0	1	0
Sub-total	*13,960*	*41,840*	*21,700*	*19,570*				
Clothing								
4	0	0	0	0	0	0	0	0
5	0	0	10	5	0	0	1	0
6	1	1	1	11		1	1	3
7	3	41	21	29	1	14	8	9
8	194	18	2	16	27	4	0	2
15	3	3	3	8	1	1	0	2
24	0	0	0	0	0	0	0	0
26	16	293	28	144	2	49	10	23
27	35	36	26	62	7	14	10	23
29	0	4	13	22	0	1	3	4
Sub-total	252	396	104	297				

Source: Government of India.

Appendix 3b Turkey's imports from India, by textiles and clothing categories under restriction, in 1994-1997

Product Category	**Value** (Thousand US$)				**Volume** (Thousand kilos/pieces)			
	1994	**1995**	**1996**	**1997**	**1994**	**1995**	**1996**	**1997**
Textiles								
1	9,644	31,679	22,505	24,997	3,002	7,931	6,714	8,247
2, incl. 2a	1,506	6,353	5,843	3,898	344	1,390	1,372	878
3, incl. 3a	216	466	447	76	31	112	98	16
9	0	0	965	0	0	0	200	0
20	6	8	0	58	0	1	0	3
23	1,525	6,975	1,826	1,462	581	1,844	563	590
39	53	48	65	36	3	4	4	5
Sub-total	*12,949*	*45,530*	*31,651*	*30,528*				
Clothing								
4	76	1	1	0	15	1	0	0
5	0	9	8	9	0	8	0	3
6	*1*	*1*	*4*	*3*	*0*	*1*	*1*	*0*
7	*5*	*26*	*35*	*26*	*1*	*16*	*5*	*2*
8	29	14	9	31	5	4	1	1
15	7	9	21	8	2	1	1	1
24	0	0	0	0	0	0	0	0
26	1	46	156	24	0	9	21	3
27	14	42	10	21	3	13	2	3
29	0	4	108	8	0	1	15	1
Sub-total	*133*	*153*	*352*	*131*				

Source: Government of Turkey.

Appendix 4a Share of India in Turkey's imports of textile and clothing products subject to QRs, by product category, in 1994-1997 (percentages based on import quantities)

Product category	1994	1995	Average 1994-1995	1996	1997	Average 1996-1997	Average 1994-1997
1	5.66	13.52	9.78	15.61	20.07	17.79	13
2	1.15	2.86	2.21	3.54	2.27	2.90	2.5
2a	0.78	3.83	2.81	2.02	0.81	1.38	0.4
3	0.49	0.93	0.78	0.73	0.09	0.36	0.5
3a	1.26	2.62	2.10	0.89	0	0.37	0.96
4	7.38	0.15	1.49	0.02	0	0.01	0.38
5	0	0	1.82	0	0	0.18	0
6	0.06	0.19	0.14	0.08	0.03	0.05	0.07
7	1.74	16.89	10.13	0.82	0.3	0.53	1.6
8	8.26	4	5.72	0.29	0.35	0.32	1.51
9	0	0	0.00	7.92	0	2.93	1.44
15	3.79	2.99	3.50	0.32	0.22	0.26	0.74
20	0.6	3.93	1.81	0	2.75	1.31	1.39
23	15.37	21.99	19.93	9.07	14.06	11.09	11.42
24	0	0	0.00	0	0	0.00	0
26	0.95	20.32	14.42	4.79	0.68	2.88	3.76
27	15.98	26.60	23.28	0.7	1.06	0.87	3.28
29	0.18	11.20	4.39	14.62	0.54	7.96	7.44
39	4.81	1.57	2.29	2.04	2.16	2.11	2.18

Source: Government of Turkey, Under-Secretariat for Foreign Trade.

Appendix 4b Turkey's protection rates, for the categories of textiles and clothing products subject to restrictions *vis-à-vis* India, in 1994-1997

Product category	Protection rates (in per cent)				Percentage change 1996/1993
	1993	1994	1995	1996	
1	25.1	19.8	13.4	5.36	-78.63
2	37.9	30.8	28.9	9.41	-75.17
3	37.9	26	20	10.12	-73.31
4	35	28	22.4	12.62	-63.95
5	35	28	22.4	13.18	-62.35
6	35	28	22.4	13.4	-61.71
7	35	28	22.4	13.4	-61.71
8	35	28	22.4	12.5	-64.29
9	36.3	26	21.5	10.43	-71.26
15	35	28	22.4	13.4	-61.71
20	35	28	22.4	12.5	-64.29
23	26	20	15.6	7.5	-71.15
24	35	28	22.4	13.09	-62.61
26	35	28	22.4	13.4	-61.71
27	35	28	22.4	13.4	-61.71
29	35	28	22.4	13.4	-61.71
39	35	28	22.4	12.5	-64.29
Av. 19	*34.31*	*26.98*	*21.66*	*11.74*	*-65.78*

Source: Government of Turkey, Under-Secretariat for Foreign Trade.