# *UNITED STATES – SUBSIDIES ON UPLAND COTTON*

**Recourse to Article 21.5 of the DSU by Brazil**

**(WT/DS267)**

**FIRST SUBMISSION AND**

**REQUEST FOR PRELIMINARY RULINGS OF**

**THE UNITED STATES OF AMERICA**

December 15, 2006

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## I. INTRODUCTION

1. On April 21, 2005, the United States notified the Dispute Settlement Body ("DSB") of its intentions to implement the recommendations and rulings in *United States – Subsidies on Upland Cotton* (WT/DS267). The United States has followed through with its intentions.

2. On February 8, 2006, the United States enacted legislation to repeal the Upland Cotton Domestic User Marketing Certificate (or "Step 2") Program. That program terminated as of the end of the 2005 marketing year for upland cotton (i.e., July 31, 2006).

3. The Step 2 program had been found to be, *per se*, WTO-inconsistent on the grounds that it mandated payments to exporters that constituted export subsidies inconsistent with Article 3.1(a) of the *Agreement on Subsidies and Countervailing Measures* ("*SCM Agreement*") and Article 10 of the *Agreement on Agriculture*.[1] The program was subject to a second finding of *per se* WTO-inconsistency because it was found to mandate payments to domestic users of upland cotton that constituted import substitution subsidies prohibited under the *SCM Agreement*.[2] In addition, payments under the Step 2 program were a substantial component of the basket of payments made in marketing year[3] ("MY") 1999-2002 that Brazil claimed caused present serious prejudice. The original panel found that the collective effect of these payments had caused serious prejudice to the interests of Brazil in the same period.[4]

4. Termination of the Step 2 program resulted in an substantial loss to exporters and domestic users of U.S. upland cotton. Payments under the program had ranged between US$182 and US$582 million per year since fiscal year ("FY") 2000. Brazil had argued in the original proceeding that during 1999-2002 "Step 2 payments reached levels of as much as 10.23 cents per pound, averaging 10.5 percent of the market value of U.S. upland cotton in MY 2002."[5] In its claims against payments made under the Step 2 program in MY 1999-2002, Brazil claimed, relying on its "expert in the operation of world cotton markets,"[6] that "Step 2 payments ensure that the United States has a major influence and competitive edge on world prices," thereby "enabl[ing] the United States to act as the 'driver' of world prices."[7] Moreover, Brazil claimed in the original proceeding that, of the measures challenged as being actionable subsidies, payments under th Step 2 program had the largest effects on U.S. exports and the second largest

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[1] *Upland Cotton (Panel)*, paras. 8.1(e)(I)-8.1(e)(iii); *Upland Cotton (AB)*, para. 763(d)(ii).

[2] *Upland Cotton (Panel)*, paras. 8.1(f); *Upland Cotton (AB)*, para. 763(d)(I). The panel declined to address Brazil's third *per se* claim – an actionable subsidy claim – against the Step 2 program and certain other programs. That claim was made with respect to the (1) Step 2, (2) marketing loan, (3) direct payment, (4) counter-cyclical payment, and (5) crop insurance programs. *See Upland Cotton (Panel)*, para. 7.1506(i).

[3] The "marketing year" for upland cotton in the United States is August 1 to July 31 of each year.

[4] *Upland Cotton (Panel)*, paras. 7.1416; 8.1(g)(i). The Panel declined to address a third set of actionable subsidy claims with respect to payments "mandated" to be made in 2003-2007.

[5] Brazil Appellee Submission, para. 741, n. 1059.

[6] *United States – Subsidies on Upland Cotton*, WT/DS267, Statement of Brazil at the Resumed First Substantive Meeting of the Panel with the Parties, para. 61 (7 October 2003)

[7] *United States – Subsidies on Upland Cotton*, WT/DS267, Statement of Andrew McDonald at the Resumed First Substantive Meeting of the Panel with the Parties, para. 22 (7 October 2003).

effects on world market prices in each of the marketing years 1999 through 2002.[8] Brazil predicted that the Step 2 payments would have the *largest* effects on prices in the future years.[9]

5. The Step 2 program was not the only program that the United States ceased to operate. It also ceased issuing guarantees under two export credit guarantee programs; namely, the CCC Intermediate Export Credit Guarantee Program ("GSM 103") and the Supplier Credit Guarantee Program ("SCGP").[10] In the underlying proceeding, these were two of three export credit guarantee programs that were found to have constituted export subsidies under the *SCM Agreement* and *Agreement on Agriculture*.[11] Whereas the United States had been issuing applications for GSM-103 and SCGP guarantees covering hundreds of millions of dollars of export transactions in recent years, the United States now issues *no* guarantees under either of the two programs.

6. The third export credit guarantee program at issue in the underlying proceeding, the CCC Export Credit Guarantee Program ("GSM 102") remains in operation today, but in substantially modified form. On 1 July 2005, the United States implemented administrative changes designed to respond to the key finding in the underlying proceeding that the export credit guarantee programs had been provided at premium rates which were inadequate to cover the long-term operating costs and losses of the programs. It was this finding that, in the view of the panel, had rendered the programs export subsidies within the meaning of the SCM Agreement[12] and the *Agreement on Agriculture*.[13]

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[8] Brazil Further Submission, Annex I, pp. 35 and 36 and Table I.4.

[9] Brazil Further Submission, Annex I, p. 36.

[10] These three export credit guarantee programs are described in paragraphs 7.236 *et. seq.* in the panel report and paragraphs 586-589 of the Appellate Body's report in the original proceeding.

[11] *Upland Cotton (Panel)*, para. 8.1(d); *Upland Cotton (AB)*, 763(e). The programs were found to be WTO-inconsistent to the extent that they provided export credit guarantees in respect of exports of (a) certain agricultural products (including upland cotton) for which the United States did not have export subsidy reduction commitments in its Schedule of Concessions (what the panel in the original proceeding terms "unscheduled" products) and (b) rice, for which the United States did have scheduled export subsidy reduction commitments but at levels that the panel found had been exceeded. *Upland Cotton (Panel)*, para. 8.1(d)(i).

[12] *See Upland Cotton (Panel)*, para. 8.1(d)(i) ("United States export credit guarantees under the GSM 102, GSM 103 and SCGP export credit guarantee programs are provided by the United States government at premium rates which are inadequate to cover long-term operating costs and losses of the programmes within the meaning of item (j) of the Illustrative List of Export Subsidies in Annex I of the *SCM Agreement*, and therefore constitute *per se* export subsidies prohibited by Articles 3.1(a) and 3.2 of the *SCM Agreement*.")

[13] The panel in the underlying proceeding considered that the *SCM Agreement* – in particular, item (j) of the Illustrative List of Export Subsidies – provided "contextual guidance" for its interpretation of "export subsidies" in Article 10.1 of the *Agreement on Agriculture*. *Upland Cotton (Panel)*, para. 7.799. Following this logic, the panel determined that export credit guarantees under the GSM 102, GSM 103, and SCGP programs were provided at premium rates which were inadequate to cover the long-term operating costs and losses of the programs and, therefore, constituted "export subsidies" both under item (j) of the Illustrative List of Export Subsidies in *SCM Agreement* and Article 10.1 of the *Agreement on Agriculture*. *Upland Cotton (Panel)*, paras. 7.867, 7.870.

7. Specifically, to address the finding, the United States restructured the programs to increase premiums and reduce the potential for payments for defaults. The United States developed and implemented a new fee structure under which the amount of premiums charged would be increased based on risk, as well as the repayment term and repayment frequency under the guarantee. The United States increased stated fees, on average, by 46 percent. On a trade-weighted basis, for GSM-102, fees increased by 23 percent over fiscal year 2004, the last full fiscal year in which the prior fee schedule applied.[14] In addition, to avoid issuing guarantees to countries presenting a high risk of default, the United States reclassified 22 previously eligible countries into an ineligible risk category.[15]

8. Even without the dramatic fee increase and reclassification, however, U.S. budget figures have been showing that over the last 14 fiscal years, the United States' export credit guarantee programs not only charged premia adequate to cover long-term operating costs and losses, *but in fact generated a significant profit*.[16] Indeed, as explained below, for the 1999-2002 cohorts,[17] the export credit guarantee programs show a *negative* subsidy, net of all re-estimates, of more than US$750,000,000.[18] For cohorts 1992-2005, there is also a negative subsidy of close to US$200,000,000.[19]

9. As the United States explained in the original proceeding, a negative subsidy indicates that the United States earned a *profit* on the export credit guarantee programs in these amounts. That is, consistent with the arguments and analysis the United States presented to the panel in the original proceeding, the financial data reflecting the actual performance of the programs (and not just, or primarily, estimates of future performance), demonstrate that the premia charged under the export credit guarantee programs were far more than "adequate" to cover the long-term operating costs and losses of the programs even before any modifications were made to implement the DSB's recommendations and rulings.

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[14] *See* Summary of FY 2006 Export Credit Guarantee Program Activity for GSM-102 as of September 30, 2006 (Exhibit US-60) and Summary of FY 2004 Export Credit Guarantee Program Activity for GSM-102 as of September 30, 2004 (Exhibit US-61) (compare relative percentage increase of fees to GSM-102 registration values).

[15] *See* Country Risk Category for the GSM-102 and Supplier Credit Guarantee Programs (as of July 1, 2005) (Exhibit US-2). The 22 countries were: Algeria, Azerbaijan, Benin, Bolivia, Bosnia-Herzegovina, Burkina Faso, Cameroon, Cote D'Ivoire, Gambia, Guyana, Honduras, Kenya, Lebanon, Mali, Nicaragua, Niger, Nigeria, Pakistan, Tanzania, Uganda, Vietnam, and Yemen. Of these, two have subsequently returned to eligibility (Burkina Faso and Pakistan). In addition, two additional countries have been removed from eligibility (Belize and Paraguay), and 5 others are newly eligible (Azerbaijan, Georgia, Honduras, Macedonia, and Uganda).

[16] *See* Section V below.

[17] As the panel noted in the original proceeding, a "cohort" is all loan guarantees of a programme for which a subsidy appropriation is provided for a given fiscal year. For example, all guarantees issued during fiscal year 2002 comprise a distinct cohort. *Upland Cotton (Panel)*, para. 7.812, n.959.

[18] *See* Section V below.

[19] *See* Section V below.

10. Nonetheless, the combination of the U.S. reforms has had a dramatic effect. Under the prior fee schedule, applicable throughout 2004, registered guarantees totaled US$3.71655 billion. In FY 2006, this declined to US$1.363 billion.[20]

11. Brazil claims that notwithstanding these steps, "the measures taken by the United States to comply with the recommendations and rulings of the DSB in some respects do not exist, and to the extent they do exist, are not consistent with the *Agreement on Agriculture* and the *SCM Agreement*." As discussed below, Brazil's claims are without basis.[21]

## II. PROCEDURAL HISTORY

12. The procedural history of this dispute up through the initial panel phase is set forth in paragraphs 1.1-1.8 of the panel report in *Upland Cotton*. On 8 September 2004, the panel circulated its final report, which included recommendations and rulings pertaining to measures found to be (a) prohibited subsidies and (b) actionable subsidies.[22]

13. Both the United States and Brazil appealed certain of the Panel's findings. The Appellate Body circulated its report on 3 March 2005. The Appellate Body largely upheld the Panel's recommendations and rulings on both prohibited and actionable subsidies.[23]

14. On 18 August 2006, Brazil requested the establishment of a panel under Article 21.5 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* ("DSU").[24] On 28 September 2006, the DSB established this Panel to consider Brazil's claims.[25]

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[20] *See* Summary of FY 2006 Export Credit Guarantee Program Activity for GSM-102 as of September 30, 2006 (Exhibit US-60) and Summary of FY 2004 Export Credit Guarantee Program Activity for GSM-102 as of September 30, 2004 (Exhibit US-61).

[21] Given the time available for this submission, the United States has not addressed Brazil's contingent claim of threat of serious prejudice. The United States notes, however, that Brazil makes many of the same factual arguments in that context as with respect to its "present" serious prejudice claims. The U.S. demonstrates below that those arguments are without basis; this applies with equal force to the same arguments made in the context of "threat." In addition to these factual failings, Brazil's legal theory of threat is also without basis. The United States will address these issues in its forthcoming submission.

[22] *See Upland Cotton (Panel)*, para. 8.3. The Panel also reached conclusions about the applicability of Article 13 of the *Agreement on Agriculture* – the so-called "Peace Clause" provision – and whether it would exempt the measures challenged by Brazil from certain actions under the *General Agreement on Tariffs and Trade 1994* and the *SCM Agreement*. *See Upland Cotton (Panel)*, paras. 8.1(a), 8.1(b), 8.1(c), 8.1(d)(i), 8.1(d)(ii), 8.1(e)(ii). As those conclusions are not at issue in this dispute, they are not discussed in detail above.

[23] *See Upland Cotton (AB)*, paras. 552 (Step 2 payments to domestic users), 584 (Step 2 payments to exporters), 674 (export credit guarantees), and 496 (actionable subsidy).

[24] WT/DS267/30 (18 August 2006). Note that "informal consultations" were requested and held.

[25] *See* WT/DS267/31 (1 November 2006).

## III. FACTUAL BACKGROUND

15. On 21 March 2005, the DSB adopted the Panel and Appellate Body reports.[26] At the DSB meeting of 21 April 2005, the United States stated that it intended to implement the recommendations and rulings of the DSB in a manner respecting U.S. WTO obligations.[27]

16. On 30 June 2005, before the date set by the Panel for implementation of the recommendations and rulings relating to the measures found to be prohibited subsidies, the United States announced a number of changes to the three export credit guarantee programs that were designed to implement the DSB's recommendations and rulings and would take effect as of 1 July 2005. First, the United States announced that the Commodity Credit Corporation ("CCC"), the U.S. government authority responsible for administering the export credit guarantee programs, "will no longer accept applications for payment guarantees under the . . . GSM-103 [program]."[28]

17. Second, the United States announced that the CCC:

> [W]ill use a risk-based fee structure for the GSM-102 and SCGP programs. Fee rates will be based on the country risk that CCC is undertaking, as well as the repayment term (tenor) and repayment frequency (annual or semi-annual) under the guarantee. For the GSM-102 program, country risk will be based on the country of the foreign obligor (opening bank), as determined by the CCC. For the SCGP, country risk will be based on the country of the foreign obligor (importer), as determined by the CCC.[29]

18. Third, to limit potential risk exposure, the United States excluded certain high risk countries from eligibility under the SCGP and GSM-102 programs altogether. As a result of this change, at least 22 previously eligible countries were classified in an ineligible risk category for the program.[30]

19. On July 5, 2005, the United States submitted a legislative package to the U.S. Congress that included, *inter alia*, a proposal to repeal Step 2 program. As noted above, that program had

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[26] Dispute Settlement Body – Minutes of Meeting, WT/DSB/M/186, 21 March 2005, para. 57 (referring to the Appellate Body Report in WT/DS267/AB/R and to the Panel Report in WT/DS267/R and Corr. 1).

[27] Dispute Settlement Body – Minutes of Meeting, WT/DSB/M/188, 18 May 2005, para. 36.

[28] *See* U.S. Department of Agriculture Program Announcement, "Notice to GSM-103 Program Participants" (June 30, 2005) (Exhibit BRA-503).

[29] *See* "USDA Announced Changes to Export Credit Guarantee Programs to Comply With WTO Findings" (June 30, 2005) (Exhibit BRA-502).

[30] *See* Country Risk Category for the GSM-102 and Supplier Credit Guarantee Programs (as of July 1, 2005) (Exhibit US-2).

been found in the underlying proceeding to provide export and import substitution subsidies prohibited under the *SCM Agreement*, as well as an export subsidy in breach of the *Agreement on Agriculture.* Moreover, payments made under the program in MY 1999 to 2002 had been subject to an actionable subsidy finding.[31]

20. Beginning on October 1, 2005, the United States ceased issuing export credit guarantees under the SCGP.[32] In an "Advance Notice of Proposed Rulemaking," the United States solicited proposals regarding possible reforms to the SCGP "to reduce the risk of default, improve the ability to effect a collection on defaulted obligations, and consider alternative program mechanisms and forms of payment obligations that are consistent with commercial export practices."[33] As expressed in the notice, this process was motivated by concerns about the past performance of the program and an interest in continuing to evaluate all available options in light of the DSB's recommendations and rulings.[34] At present, the United States has no plan to resume the SCGP either in the same or different form.

21. The United States also moved forward the legislation repealing the Step 2 program. That legislation had been incorporated into a budget reconciliation bill pending before the U.S. Congress. The U.S. House of Representatives passed the reconciliation bill on 19 December 2005 and the U.S. Senate passed the bill two days later on 21 December 2005. However, for reasons having to do with minor remaining differences between the Senate- and House-passed legislation (unrelated to the issues in this dispute), the U.S. House of Representatives was required to vote a second time on the legislation. The second vote was held on 1 February 2006, at which time it was passed again and cleared for signature by the President. The legislation – called the Deficit Reduction Act of 2005 – was then signed into law on February 8, 2006.[35]

## IV. REQUEST FOR PRELIMINARY RULINGS

22. Article 21.5 of the DSU limits the scope of this proceeding to the resolution of disagreements as to "the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings [of the DSB]." The Appellate Body emphasized in *Canada – Aircraft (21.5 Brazil)* that "[p]roceedings under Article 21.5 do not concern just *any* measure of a Member of the WTO; rather, Article 21.5 proceedings are limited to those 'measures *taken to comply* with the recommendations and rulings' of the DSB."[36] Accordingly, "[i]f a *claim* challenges a *measure* which is not a 'measure taken to comply,' that *claim* cannot

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[31] *Upland Cotton (Panel)*, para. 8(g)(I).

[32] Brazil First Written Submission, para 340, fn. 520 and Exhibit BRA-513.

[33] Advance Notice of Proposed Rulemaking, 71 Fed. Reg. 3790 (24 January 2006) (Exhibit US-3).

[34] Advance Notice of Proposed Rulemaking, 71 Fed. Reg. 3790 (24 January 2006) (Exhibit US-3).

[35] *See* Fact Sheet: President Bush Signs the Deficit Reduction Act (available at www.whitehouse.gov/news) (8 February 2006).

[36] *Canada – Aircraft (21.5 Brazil) (AB)*, para. 36 (emphasis in orginal).

properly be raised in Article 21.5 proceedings."[37]

23. Brazil makes several claims that challenge measures that are not "measures taken to comply" with the recommendations and rulings of the DSB in this proceeding: (a) claims against GSM 102 export credit guarantees in respect of exports of pig meat and poultry meat; (b) claims against the marketing loan and counter-cyclical payment programs under the FSRI Act; and (c) claims regarding compliance in past periods with respect to a measure that Brazil asserts no longer exists. As these claims "cannot properly be raised" in this proceeding, the United States respectfully requests that the Panel reject the claims.

## A. BRAZIL'S CLAIMS RELATING TO GSM 102 GUARANTEES IN RESPECT OF EXPORTS OF PIG MEAT AND POULTRY MEAT ARE OUTSIDE THE SCOPE OF THIS PROCEEDING

24. Brazil claims that the "the United States has applied the GSM 102 program in a manner that results in circumvention of the United States' export subsidy commitments for unscheduled products and three scheduled products – rice, *pig meat* and *poultry meat*."[38] Brazil asserts further that "[a]s a result, the United States is not due the full protection of the safe harbor accorded by the exception in the opening clause of Article 3.1 of the *SCM Agreement*, and the prohibition in Articles 3.1(a) and 3.2 applies."[39] Brazil then claims that the GSM-102 guarantees in respect of exports of pig meat and poultry meat are also inconsistent with Articles 3.1(a) and 3.2 of the *SCM Agreement*.[40]

25. These claims are outside the scope of this DSU Article 21.5 proceeding to the extent that they relate to GSM 102 guarantees in respect of exports of pig meat and poultry meat. Brazil concedes that the DSB's recommendations and rulings did *not* relate to GSM 102 guarantees in respect of exports of either pig meat or poultry meat.[41] They applied with respect to "United States export credit guarantees under the GSM 102, GSM 103 and SCGP export credit guarantee programs . . . in respect of exports of upland cotton and other unscheduled agricultural products, and in respect of *one scheduled product (rice)*."[42]

26. Indeed, the panel expressly found that GSM 102 guarantees in respect of "exports of unscheduled agricultural products not supported under the programmes and other scheduled agricultural products" – including pig meat and poultry meat – "have *not* been applied in a manner which either results in, or which threatens to lead to, circumvention of United States

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[37] *EC – Bed Linen (21.5 India) (AB)*, para. 78 (emphasis in original).

[38] Brazil First Written Submission, para. 350 (emphasis added).

[39] Brazil First Written Submission, para 459.

[40] Brazil First Written Submission, para. 460.

[41] Brazil First Written Submission, para 331.

[42] *Upland Cotton (Panel)*, para. 8.1(d)(i) and 8.3(b).

export subsidy commitments within the meaning of Article 10.1 and that they therefore are *not inconsistent* with Article 8 of the Agreement on Agriculture."[43] The panel found that, as a result, Article 13(c)(ii) of the *Agreement on Agriculture* also exempted those export credit guarantees from Brazil's claims on the basis of Article 3 of the *SCM Agreement*.[44] Accordingly, the panel made no recommendations regarding GSM 102 guarantees in respect of pig meat and poultry.

27. Brazil appealed the panel's application of Article 10.1 of the *Agreement on Agriculture* with respect to export credit guarantees in respect of exports of pigmeat and poultry, alleging that "the Panel failed to apply" the correct reasoning with respect to those measures.[45] Although the Appellate Body ultimately agreed, it concluded that there were insufficient uncontested facts to permit it to "complete the legal analysis to determine whether the United States' export credit guarantees to poultry meat and pig meat have been applied in a manner that 'results in' circumvention of the United States' export subsidy commitments."[46] GSM 102 guarantees in respect of exports of pig meat and poultry meat have, thus, never been found to be WTO-inconsistent nor been subject to any DSB recommendation.

28. Brazil's argument that it is "entitled" to "re-assert" its claims in respect of these GSM 102 guarantees is without merit.[47] Brazil suggests that because it "successfully appealed" the panel's findings with respect to GSM 102 guarantees in respect of exports of pig meat and poultry meat, "the DSB *did not adopt a finding* that the ECG programs are not inconsistent with Article 10.1 of the Agreement on Agriculture, and Brazil is entitled to re-assert this claim in these proceedings."[48] That statement by Brazil misses the point, however. The question is *not* whether Brazil has the right to assert a claim concerning GSM 102 guarantees in respect of exports of pig meat and poultry meat; instead, the question is whether Brazil has the right to assert such a claim in this DSU Article 21.5 proceeding. The fact that the original panel's findings were reversed changes nothing about the fact that the Appellate Body made no findings against those guarantees and the DSB thus issued no rulings and recommendations addressed to them. Thus, Brazil's argument cannot be made in a proceeding under Article 21.5 of the DSU. That provision clearly sets out the scope of compliance proceedings. The expedited proceedings of DSU Article 21.5 are to decide disagreements as to "the existence or consistency with a

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[43] *Upland Cotton (Panel)*, para. 8.1(d)(ii) (Emphasis added).

[44] Article 13(c)(ii) of the *Agreement on Agriculture* provides that measures considered to be export subsidies are "exempt from actions based on Article XVI of *GATT 1994* or Articles 3, 5 and 6 of the Subsidies Agreement" if they "conform fully" to Part V of that agreement. Articles 8, 9, and 10 comprise Part V of the Agreement on Agriculture. Brazil and the United States agreed – and the Panel accepted – that "export credit guarantees are not included in the non-exhaustive list of export subsidies in Article 9.1, and that Article 10 of the Agreement on Agriculture is the relevant provision." *Upland Cotton (Panel)*, para. 7.789.

[45] Other Appellant's Submission of Brazil, para. 207 (2 November 2004).

[46] *Upland Cotton (AB)*, para. 694.

[47] Brazil First Written Submission, para. 451, n. 623.

[48] Brazil First Written Submission, para. 451, n. 623.

covered agreement of measures taken to comply with the recommendations and rulings [of the DSB]"; Article 21.5 proceedings are *not* for the "re-assertion" of claims concerning measures with respect to which "the DSB *did not adopt a finding*."[49]

29. Brazil's claims under Articles 10.1 and 8 of the *Agreement on Agriculture* are, thus, outside the scope of this proceeding to the extent that they relate to GSM 102 guarantees in respect of exports of pig meat and poultry meat. As Brazil's claims under Articles 3.1(a) and 3.2 of the *SCM Agreement* apply "[a]s a result" of the alleged breach of Articles 10.1 and 8 of the *Agreement on Agriculture*, those claims too are outside the scope of this proceeding to the same extent.

30. For these reasons, the United States respectfully requests the Panel to find that (1) GSM 102 guarantees in respect of exports of pig meat and poultry meat are not measures taken to comply with the recommendations and rulings of the DSB; (2) GSM 102 guarantees in respect of exports of pig meat and poultry meat are not measures within the scope of this proceeding; (3) Brazil's claims under Articles 10.1 and 8 of the Agreement on Agriculture relating to such guarantees are outside the scope of this proceeding; and (4) Brazil's claims under Articles 3.1(a) and 3.2 of the SCM Agreement relating to such guarantees are not within the scope of this proceeding.

## B. BRAZIL'S CLAIMS IN RESPECT OF THE MARKETING LOAN AND COUNTER-CYCLICAL PAYMENT "PROGRAMS" ARE OUTSIDE THE SCOPE OF THIS PROCEEDING

31. Brazil's claims of serious prejudice and threat of serious prejudice appear to be against the marketing loan and counter-cyclical payment programs under the FSRI Act. To the extent that they are, they are outside the scope of this proceeding.[50]

32. In the case of its actionable subsidy claims in the original proceeding, Brazil clearly distinguished between claims against programs *per se* and claims against specific payments under the programs. Brazil's claims fell into three categories – claims of (a)"present" serious prejudice with respect to payments made in MY 1999 to 2002[51]; (b) threat of serious prejudice with respect to payments that were allegedly "mandated" to be made in MY 2003 to 2007;[52] and

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[49] Brazil First Written Submission, para. 451, n. 623.

[50] Brazil First Written Submission, para. 461(B) and (D). To the extent that they are *not* against the marketing loan and counter-cyclical payment programs, the United States reserves the right to submit further arguments as to whether the measures are properly the subject of this Article 21.5 proceeding.

[51] *Upland Cotton (Panel)*, para. 3.1(vi). In the case of Brazil's "present" serious prejudice claims under Articles 5(c) and 6.3(d) of the *SCM Agreement*, the Panel understood Brazil as alleging that the relevant period was MY 1999 through MY 2001.

[52] *Upland Cotton (Panel)*, para. 3.1(vii). In the case of Brazil's threat of serious prejudice claims under Articles 5(c) and 6.3(d) of the *SCM Agreement*, the Panel understood Brazil as alleging that the relevant period was MY 2002-2007.

(c) threat of serious prejudice against the provisions of the FSRI Act and ARP Act of 2000, *per se*, to the extent that they provided for the aforementioned subsidies in respect of upland cotton.[53]

33. Asked to identify specifically the "measures" it was challenging (and where those appeared in Brazil request for panel establishment), Brazil clarified that:

> Brazil's . . . Panel Request . . . challenges two types of domestic support 'measures' provided to upland cotton and various different types of export subsidy measures. The first type of domestic support "measure" is the *payment* of subsidies for the production and use of upland cotton. These *payments* were and continue to be made between MY 1999 to the present (and will be made through MY 2007) through the various statutory and regulatory instruments listed on pages 2-3 of Brazil's Panel Request. Brazil referred to these payments at pages 2-3 of the Panel Request as *'subsidies and domestic support provided under' or 'mandated to be provided' under the various listed statutory and regulatory instruments*. . . .Brazil's "Further Submission" on 9 September 2003 will provide considerable detail concerning the effects of the subsidies provided and mandated to be provided by the United States. *It is these effects in respect of which Brazil seeks relief with respect to the first type of domestic support measures*.
>
> A second type of domestic support "measure" challenged by Brazil are *legal instruments as such*. The "legislative and regulatory provisions, by number and letter, in respect of which Brazil seeks relief" are those involving the 2002 FSRI Act and the 2000 Agricultural Risk Protection Act . . . .[54]

34. In response to further questioning about whether Brazil was challenging the "'subsidies' themselves, the subsidy programmes or the legal/regulatory provisions for the grant or maintenance of those subsidies, or something else," Brazil acknowledged that its *per se* claims against the provisions of the FSRI Act and ARP Act of 2000 were synonymous with claims against "subsidy programs":

> Brazil does not believe that there is any difference between the "subsidy programmes" and the 'legal/regulatory provisions' for the grant or maintenance of the subsidies. With respect to Brazil's "per se" claim, it challenges as "mandatory" the legal/regulatory provisions for the grant or maintenance of the subsidies."[55]

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[53] *Upland Cotton (Panel)*, para. 3.1(viii).

[54] Answers of Brazil to Questions from the Panel, para. 15-16 (11 August 2003).

[55] Brazil's Answers to Additional Questions Following Second Panel Meeting, para. 31-32 (20 January 2004).

35. The panel made a finding of WTO-inconsistency only in connection with *one* of Brazil's actionable subsidy claims – the claim of "present" serious prejudice under Articles 5(c) and 6.3(c) of the *SCM Agreement* against certain payments made in MY 1999-2002.[56] The panel found, specifically, that:

> [T]he effect of the mandatory price-contingent United States subsidy measures – marketing loan programme *payments*, user marketing (Step 2) *payments*, MLA *payments* and CCP *payments* – is significant price suppression in the same world market within the meaning of Article 6.3(c) of the SCM Agreement constituting serious prejudice to the interests of Brazil within the meaning of Article 5(c) of the SCM Agreement.[57]

Having made this finding, the panel recommended that the United States "take appropriate steps to remove the adverse effects or . . . withdraw the subsidy."[58]

36. The panel specifically either rejected or declined to address Brazil's other claims; its two other "present" serious prejudice claims in respect of certain payments made in MY 1999-2002,[59] its three "threat" of serious prejudice claims against certain payments allegedly "mandated" to be made in MY 2003-2007,[60] and the three *per se* threat claims in respect of certain programs (including the marketing loan and counter-cyclical payment programs). Brazil did not appeal those decisions.

37. Thus, the marketing loan and counter-cyclical payment programs were not subject either to any finding of WTO-inconsistency or any DSB recommendations. Brazil has not argued otherwise. Instead, Brazil simply takes the liberty of redrafting the findings of the panel in the original panel, substituting "program" for "payments" and eliminating reference to market loss assistance ("MLA") payments altogether.[61] In effect, Brazil assumes that the panel's conclusion was the following:

> [T]he effect of the mandatory price-contingent United States subsidy measures – marketing loan programmes ~~payments~~, user marketing (Step 2) ~~payments~~

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[56] *Upland Cotton (Panel)*, para. 8.1(g)(i).

[57] *Upland Cotton (Panel)*, para. 8.1(g)(i).

[58] *Upland Cotton (Panel)*, para. 8.3(d).

[59] These were Brazil's claims under Articles 5(c) and 6.3(d) of the *SCM Agreement* and Article XVI of the GATT 1994. *See Upland Cotton (Panel)*, paras. 7.1465 and 7.1476, respectively.

[60] These were claims under Article 5(c) and 6.3(c) and 6.3(d) of the *SCM Agreement*, as well as a claim under Article XVI of the GATT 1994. *Upland Cotton (Panel)*, paras. 7.1504 and 7.1505.

[61] For MLA payments, the panel specifically stated that "Brazil's claims regarding expired programmes only concern payments made under them . . . Brazil does not make claims regarding any expired legislation *per se* (unlike its claims regarding current measures)." *Upland Cotton (Panel)*, para. 7.530.

> programs, ~~MLA payments~~ and CCP ~~payments~~ programs – is significant price suppression in the same world market within the meaning of Article 6.3(c) of the SCM Agreement constituting serious prejudice to the interests of Brazil within the meaning of Article 5(c) of the SCM Agreement.[62]

38. Brazil then assumes that the DSB's recommendation that the United States "take appropriate steps to remove the adverse effects or . . . withdraw the subsidy" applies to the measures in its redrafted finding.[63] Brazil is not entitled to change the panel's findings and the DSB recommendations in this way.

39. The only basis that Brazil hints at for its assumption is the following language in the panel report:

> Because the Panel's "present" serious prejudice findings include findings of inconsistency that deal with the FSRI Act of 2002 and subsidies granted thereunder in MY 2002, the United States is obliged to take action concerning its present statutory and regulatory framework as a result of our "present" serious prejudice finding. We recall that, pursuant to Article 7.8 of the SCM Agreement, the United States is under an obligation to "take appropriate steps to remove the adverse effects or . . . withdraw the subsidy.[64]

39. However, as Brazil concedes, this is *not* a recommendation.[65] Nor could it be. Brazil did not even claim that the effect of any programs was "present" serious prejudice. Brazil's *per se* claims against the programs was limited to claims of threat of serious prejudice.[66] As panels may only make findings on claims that a complaining party actually makes,[67] the DSB's recommendations and rulings regarding "present" serious prejudice cannot be understood to apply with respect to the programs, *per se*.

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[62] *Upland Cotton (Panel)*, para. 8.1(g)(i).

[63] *Upland Cotton (Panel)*, para. 8.3(d).

[64] Brazil First Written Submission, para. 32 (citing *Upland Cotton (Panel)*, para. 7.1501).

[65] Brazil First Written Submission, para. 32.

[66] *Upland Cotton (Panel)*, para. 7.1507..

[67] *See e.g., Chile – Price Bands (AB)*, para. 173. In that dispute, the Appellate Body found that although "the [Panel's] terms of reference were broad enough to have included a claim under the second sentence of Article II:1(b)" the complaining party, Argentina, had not "articulate[d] a claim under that sentence; nor did Argentina submit any arguments on the consistency of Chile's price band system with the second sentence." *Chile – Price Bands (AB)*, para. 173. The Appellate Body concluded that, as a consequence "the second sentence of Article II:1(b) was not the subject of a claim before the Panel. Because it made a finding on a provision that was not before it, the Panel, therefore, did not make an objective assessment *of the matter before it*, as required by Article 11. Rather, the Panel made a finding on a matter that was *not* before it. In doing so, the Panel acted *ultra petita* and inconsistently with Article 11 of the DSU." *Chile – Price Bands (AB)*, para. 173 (emphasis in original).

40. In fact, wholly apart from the fact that Brazil's claims in respect of the programs, *per se*, were not claims of "present serious prejudice," the United States notes that the Panel made none of the factual findings that Brazil argued were necessary to support the *per se* claim. For example, Brazil had argued that, in order to make an affirmative finding of WTO-inconsistency against the challenged programs, *per se*:

> [T]he Panel needs to evaluate whether the U.S. subsidies will *necessarily threaten to cause serious prejudice* at price levels below the trigger prices of the U.S. subsidies. Second, the Panel needs to consider whether the U.S. subsidies *threaten to cause serious prejudice even at price levels at which only crop insurance subsidies and direct payments are made*."[68]

41. Similarly, Brazil asked the Panel "to find that the mandatory provisions of the 2002 FSRI Act and the 2000 ARP Act together with their implementing regulations, as listed above, *cannot be applied in a WTO consistent manner*."[69]

42. The Panel neither conducted the requested evaluations, nor made any findings along the lines requested by Brazil. Thus, even if Brazil's claims against the programs had been claims of "present" serious prejudice – and they clearly were not – the Panel made none of the factual findings that Brazil *itself* argued were necessary to establish the claims. As Brazil implicitly acknowledges, absent such findings there was no basis for a conclusion that the programs, *per se*, were WTO-inconsistent, and therefore the original panel did not make any findings (and the DSB did not make any recommendations and rulings) addressed to those programs.

43. Under these circumstances, Brazil's claims against the marketing loan and counter-cyclical payment programs are not within the scope of this proceeding. They do not relate to "the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings [of the DSB]." Accordingly, under Article 21.5 of the DSU, these claims "cannot properly be raised" here.

44. For these reasons, the United States respectfully requests the Panel to find that (1) the marketing loan payment program and the counter-cyclical payment program are not measures to which the recommendations and rulings of the DSB were addressed; (2) the marketing loan payment program and the counter-cyclical payment program are not measures within the scope of this proceeding; and (3) Brazil's claims relating to the marketing loan payment program and the counter-cyclical payment program under Articles 5 and 6 of the SCM Agreement are not within the scope of this proceeding.

## C. BRAZIL'S CLAIMS AGAINST THE MARKETING LOAN PROGRAM AND THE COUNTER-

[68] Brazil Further Submission, para. 426 (9 September 2003) (emphasis added).

[69] Brazil Further Submission, para. 435-436 (9 September 2003).

**CYCLICAL PROGRAM ARE OUTSIDE THE SCOPE OF THIS DISPUTE BECAUSE THESE MEASURES WERE NOT "TAKEN TO COMPLY" UNDER ARTICLE 21.5**

45. As just described, the marketing loan payment program and the counter-cyclical *programs* are not measures to which the DSB recommendations and rulings were addressed since those recommendations and rulings were against *payments* made under these programs (that is, the recommendations and rulings concerned the programs as applied and not as such). Furthermore, Brazil's claims against these measures would be outside the scope of these proceedings in any event: as Brazil acknowledges, the programs have not been changed, in response to DSB recommendations and rulings or otherwise.

46. Article 21.5 applies only with respect to a disagreement as to the existence or consistency of a measure taken to comply. Consequently, a complaining Member in an Article 21.5 proceeding may not bring claims of inconsistency with a covered agreement respect to an unchanged measure that was not taken to comply. In particular, Brazil may not renew claims made in the original proceeding against a measure which is the same measure as in the original proceeding.[70] Any such claims would need to be brought in a separate, new dispute settlement proceeding. (Indeed, much as in subsection A above, the question is *not* whether Brazil has the right to assert a claim concerning these programs at all, the question is whether Brazil has the right to assert such a claim in this DSU Article 21.5 proceeding.)

47. As discussed by the panel in *EC – Bed Linen 21.5,*[71] this conclusion makes good sense. It respects the differences between an original proceeding and an Article 21.5 proceeding. An Article 21.5 proceeding is designed to address issues concerning implementation of the relevant DSB recommendations and rulings. There has already been a full opportunity to present facts and arguments concerning the claims and defenses of the parties, and the touchstone is the DSB recommendations and rulings. Moreover, under an original proceeding, a Member has an opportunity to bring its measure into compliance within a reasonable period of time. We would not expect Brazil to argue that after an Article 21.5 proceeding, a Member found to have acted inconsistently with its WTO obligations should receive a second reasonable period of time to comply.

48. In this proceeding, Brazil raises claims against the marketing loan payment program and the counter-cyclical programs that it made in the original proceeding, including claims of serious

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[70] *See* Appellate Body Report, *European Communities – Anti-Dumping Duties on Imports of Cotton-Type Bed Linen from India, Recourse to Article 21.5 of the DSU by India,* WT/DS141/AB/RW, adopted April 24, 2003, ("*EC – Bed Linen 21.5 (AB)*"), para. 87 (India not permitted to renew unsuccessful claims against unchanged aspects of existing measure, which were not a measure taken to comply).

[71] Panel Report, *European Communities – Anti-Dumping Duties on Imports of Cotton-Type Bed Linen from India – Recourse to Article 21.5 of the DSU by India,* WT/DS141/RW, para. 6.40 (adopted 24 April 2003, as modified by the Appellate Body Report, WT/DS141/AB/RW) ("*EC – Bed Linen (21.5) (Panel)*").

prejudice under Articles 5(c) and 6.3(c) and threat of serious prejudice under Articles 5(c) and 6.3(d) – measures that have not changed and are not "measures taken to comply." Brazil may not in these Article 21.5 proceedings again make these claims against unchanged measures. The United States therefore respectfully requests that the Panel make a preliminary ruling that claims against these programs are outside the scope of this Article 21.5 proceeding.

## D. BRAZIL'S CLAIMS THAT THERE WERE NO MEASURES TAKEN TO COMPLY IN A PAST PERIOD ARE NOT WITHIN THE SCOPE OF THE PROCEEDING

49. Assuming (incorrectly) that the DSB's actionable subsidy-related recommendations and rulings relate to the Step 2, marketing loan, and counter-cyclical *programs*, Brazil asserts that the United States took no measures to comply with those recommendations and rulings until the repeal of the Step 2 program on 1 August 2006.[72] Brazil claims that "it is undisputed that the United States failed to take measures to comply in a timely fashion"[73] and seeks a finding that there was a period in the past (21 September 2005 to 31 July 2006) in which no "measure taken to comply" existed.[74]

50. This claim is not within the scope of this proceeding. Article 21.5 of the DSU provides, in relevant part, that "where there is disagreement as to the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings [of the DSB] such dispute shall be decided through recourse to these dispute settlement procedures." As a threshold matter, Brazil does not even assert a disagreement. To the contrary, Brazil alleges that what it is claiming is "undisputed."[75] If that were true, that alone would take the claim out of the scope of this Article 21.5 proceeding; DSU Article 21.5 only authorizes recourse to its expedited dispute settlement procedures where there is "*disagreement*." Furthermore, Brazil does not dispute that measures taken to comply do exist (indeed, in this panel proceeding Brazil is challenging U.S. measures taken to comply). So again, there is no "disagreement" (as required by Article 21.5) over the "existence" of measures taken to comply.

51. In addition, the terms of reference under DSU Article 21.5 are limited; Article 21.5 applies only to specific types of disputes – those over the "existence" of a measure taken to comply or the "consistency with a covered agreement" of such a measure.[76] DSU Article 21.5 does not provide that the task of the Panel is to decide – or, rather, declare – whether measures were taken to comply "in a timely fashion." In fact, DSU Article 21.5 does not refer to the issue of "timeliness" of implementation at all.

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[72] Brazil First Written Submission, para. 40.

[73] Brazil First Written Submission, para. 46.

[74] Brazil First Written Submission, para. 46.

[75] Brazil First Written Submission, para. 46.

[76] *Canada – Aircraft (AB) (21.5 – Brazil)*, para. 40.

52. In fact, by "timely fashion," Brazil means within the six-month period provided for in Article 7.9 of the *SCM Agreement*.[77] However, Article 7.9 of the *SCM Agreement* says nothing about the task of a panel established pursuant to DSU Article 21.5, it does not contain any cross reference to DSU Article 21.5, and is not itself referenced by DSU Article 21.5. Rather, as Brazil acknowledges,[78] Article 7.9 of the *SCM Agreement* deals with the different question of when and under what conditions the DSB may authorize a complaining Member to take countermeasures in disputes involving subsidies found to have caused adverse effects.[79] Thus, neither provision directs the Panel to make a determination as to whether a Member implemented actionable subsidy-related recommendations and rulings within the "six-month period provided for in Article 7.9 of the *SCM Agreement*."[80]

53. Not only is there no textual basis for an exercise such as the one Brazil is seeking but it would seem contrary to the statement in DSU Article 3.7 that "the aim of the dispute settlement mechanism is to secure a positive solution to a dispute." Given that, by Brazil's own admission, the factual situation that existed in the period 1 August 2005 to 31 July 2006 no longer exists, given the repeal of the Step 2 program, it is difficult to see what "positive solution" can be "secured" by addressing allegedly undisputed claims in respect of that period.

54. Prior Article 21.5 panels have, thus, properly examined the issue of compliance based on the facts as they stand at the time the matter was referred to them. In *United States – Shrimp*, for example, the panel explained that:

> [t]he Panel takes the view that it should take into account all the relevant facts occurring until the date the matter was referred to it. By applying this approach, an Article 21.5 panel can reach a decision that favours a prompt settlement of the dispute.[81]

55. Similarly, in *EC – Bed Linens*, the panel explained that:

> [i]t appears India considers that we must make two decisions on the existence or consistency of measures taken to comply – one as of the end of the reasonable period of time, and one as of the date of establishment of the Panel. We do not consider that it would be either necessary or appropriate, as a matter of judicial

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[77] *See e.g.,* Brazil First Written Submission, para. 42.

[78] Brazil First Written Submission, para. 41.

[79] Under Article 7.9 of the *SCM Agreement*, the consequence of failing to take "appropriate steps to remove the adverse effects of the subsidy or withdraw the subsidy within six months from the date when the DSB adopts the panel report or Appellate Body report" is the complaining Member may be authorized to take countermeasures.

[80] *See e.g.,* Brazil First Written Submission, para. 42.

[81] *United States – Shrimp (Panel) (21.5 – Malaysia)*, para. 5.13.

economy, to first examine whether compliance had occurred as of the end of the reasonable period of time, and second consider compliance as of the later date. [82]

56. For the reasons set out above, Brazil's claim that "the United States failed to take measures to comply in a timely fashion" is not within the scope of this proceeding.[83] The United States respectfully requests that, even aside from the fact that the marketing loan program and counter-cyclical program are not within the scope of this proceeding, the Panel find that (1) there is no disagreement between the parties as to the existence of measures taken to comply with the DSB's actionable subsidy-related recommendations and rulings and (2) Brazil's claim that there were no U.S. measures taken to comply between 22 September 2005 and 31 July 2006 is not within the scope of this proceeding.[84]

## V. ARGUMENT REGARDING EXPORT SUBSIDIES CLAIMS

57. Brazil makes two claims with respect to the export credit guarantees. First, Brazil argues that the changes that the United States made to implement the DSB's recommendations and rulings in respect of export credit guarantees failed to bring the guarantees issued subsequent to 1 July 2005 under the GSM-102 program into conformity with U.S. WTO obligations.[85] Brazil argues that the United States has provided these export credit guarantees "in a manner that results in circumvention of the United States' export subsidy commitments"[86] inconsistently with Articles 10.1 and 8 of the *Agreement on Agriculture*. According to Brazil, "to the extent of" this alleged inconsistency with the *Agreement on Agriculture*, the U.S. measures are not consistent with Articles 3.1 and 3.2 of the *SCM Agreement*.[87]

58. Second, Brazil claims that "with respect to [export credit guarantees] issued under the GSM-102, GSM 103, and SCGP programs prior to 1 July 2005, but still outstanding subsequent to 1 July 2005, the United States has taken no action whatsoever to withdraw the subsidy and otherwise bring itself into conformity with its obligations."[88] On this basis, Brazil asserts that "with respect to these outstanding [export credit guarantees], measures taken to comply do not exist."[89]

59. As a threshold matter, it is important to note that Brazil does not challenge the GSM 103

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[82] *EC – Bed Linen (Panel) (21.5 – India)*, para. 6.28.

[83] Brazil First Written Submission, para. 46.

[84] Brazil First Written Submission, para. 38.

[85] Brazil First Written Submission, para. 13, 335-36.

[86] Brazil First Written Submission, paras. 13, 337.

[87] Brazil First Written Submission, paras. 13, 337.

[88] Brazil First Written Submission, para. 336.

[89] Brazil First Written Submission, para. 336.

or SCGP *programs*, or guarantees issued pursuant to those programs after July 1, 2005.[90] While Brazil appears to challenge GSM-102 export credit guarantees issued both before 1 July 2005 (that are "still outstanding") and after 1 July 2005, it is unclear whether Brazil is challenging the GSM-102 *program* itself. Some of Brazil's arguments make reference to the GSM-102 program.[91] However, the United States recalls Brazil's clarification in the original proceeding that "program" means "the 'legal/regulatory provisions' for the grant or maintenance of" domestic support payments.[92] The United States assumes that Brazil's position is the same with respect to export credit guarantees. Given that Brazil does not make any arguments about the "the 'legal/regulatory provisions' for the grant or maintenance of" export credit guarantees in its first written submission, the United States assumes that Brazil does *not* challenge the GSM-102 program itself.[93]

## A. Export Credit Guarantees Have Been Provided Under the GSM-102 Program Subsequent to 1 July 2005 Consistently with U.S. WTO Obligations

60. There is no basis for Brazil's claim that, notwithstanding the U.S. measures taken to comply, export credit guarantees were provided subsequent to 1 July 2005 under the GSM-102 program in a manner inconsistent with Articles 3.1 and 3.2 of the *SCM Agreement* and Articles 10.1 and 8 of the *Agreement on Agriculture*. Indeed, Brazil has even submitted a report by the International Cotton Advisory Committee ("ICAC") noting that "the US government modified its export credit guarantee programs on July 1st, 2005, *so that they now comply with the WTO ruling*."[94]

61. The United States notes again, in this regard, that Brazil's claims with respect to GSM 102 export credit guarantees in respect of exports of poultry meat and pigmeat are outside the scope of this proceeding. Therefore, the United States addresses only Brazil's claims with respect to GSM-102 export credit guarantees issued in respect of exports of unscheduled products and one scheduled product, rice.

### 1. The United States Has Not Provided Export Credit Guarantees

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[90] Brazil First Written Submission, para. 338-39.

[91] *See e*.g., Brazil First Written Submission, paras.13, 407 et seq.

[92] Brazil's Answers to Additional Questions Following Second Panel Meeting, paras. 31-32 (20 January 2004) ("Brazil does not believe that there is any difference between the "subsidy programmes" and the "legal/regulatory provisions" for the grant or maintenance of the subsidies. With respect to Brazil's "per se" claim, it challenges as "mandatory" the legal/regulatory provisions for the grant or maintenance of the subsidies.").

[93] Brazil's Answers to Additional Questions Following Second Panel Meeting, paras. 31-32 (20 January 2004) ("Brazil does not believe that there is any difference between the "subsidy programmes" and the "legal/regulatory provisions" for the grant or maintenance of the subsidies. With respect to Brazil's "per se" claim, it challenges as "mandatory" the legal/regulatory provisions for the grant or maintenance of the subsidies.").

[94] "Cotton: Review of the World Situation", International Cotton Advisory Committee at 11 (May-June 2006) (BRA-485) (emphasis added).

## Inconsistently With Articles 3.1(a) and 3.2 of the *SCM Agreement*

62. Article 3.1 of the *SCM Agreement* provides that "except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited: (a) 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. . . ." Item (j) of the Illustrative List of Export Subsidies in Annex I "illustrates"[95] the conditions under which export credit guarantees may be considered export subsidies. Specifically, item (j) identifies as an export credit guarantee: "[t]he provision by governments . . . of export credit guarantee . . . programmes . . . at premium rates which are inadequate to cover the long-term operating costs and losses of the programmes." In other words, item (j) illustrates the difference between those governmental export credit guarantees that are export subsidies and those that are not. And item (j) illustrates that the difference is whether the premium rates are inadequate to cover the long-term operating costs and losses of the program. This is the same distinction relied upon by the original panel and was the basis for the DSB recommendations and rulings with which the United States was to comply.[96]

63. The export credit guarantees under the GSM-102 program are not export subsidies within the meaning of item (j) because the United States charges premium rates that are more than adequate to cover the long-term operating costs and losses of the program.

64. Brazil asserts that its "claim" under item (j) is in the "alternative" and that the Panel need only reach it if it "finds that GSM 102 [export credit guarantees] are not export subsidies by virtue of the fact that they are 'financial contributions' that confer 'benefits' and that are export contingent, under Articles 1.1 and 3.1(a) of the *SCM Agreement*."[97] Brazil's approach makes no sense. It would lead to the fatally flawed result that a measure that was specifically found to fall outside the definition of an export subsidy could then be found to be an export subsidy. In other words, for Brazil the items in the Illustrative List do not illustrate what is an export subsidy but rather are in addition to the measures that are defined as export subsidies.

65. Brazil's approach also does not comport with the text of the *SCM Agreement* or Brazil's own arguments in other disputes[98] that, in the case of measures identified in the Illustrative List,

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[95] Oxford English Dictionary, p. 1311 (Exhibit US-24) ("Illustrate" means, *inter alia*,"shed light on, light up, illumine" and "make clear, elucidate, explain; esp. clarify or support using examples, give an example or illustration of, exemplify.")

[96] *See Upland Cotton (Panel)*, para. 8.1(d)(I).

[97] Brazil First Written Submission, para. 363. The United States notes that, in the original proceeding, the panel confirmed that Brazil could not invoke "the elements of Articles 1 and 3.1(a) of the *SCM Agreement*" as a "separate claim." *Upland Cotton (Panel)*, para. 6.31.

[98] *Brazil – Aircraft (AB)*, para. 14 (Brazil argued in that dispute that "[u]nder the express terms of item (k), government payment in support of export credit constitutes a prohibited export subsidy only in so far as they are used to secure a material advantage in the field of export credit terms. It follows, a contrario, that they do not

it is the specific provisions of the Illustrative List – and not the general subsidy provisions in Articles 1.1 and 3.1(a) – that govern when the measures may be considered export subsidies.

66. Instead, the analysis in this proceeding should proceed from item (j). As noted above, the DSB recommendations and rulings with respect to these programs were based on item (j); in other words, that is the item that the DSB found was to provide guidance to the United States in determining how to implement the DSB's recommendations and rulings. Furthermore, item (j) is the item that most directly addresses the issue in this dispute. Accordingly, in this case, it is item (j) that provides the basis for assessing whether or not GSM -102 export credit guarantees are export subsidies within the meaning of Articles 3.1(a) and 3.2 of the SCM Agreement.

67. Brazil asks the Panel to overlook the fact that the panel in the original proceeding specifically *declined* to address Brazil's alleged "claim" under Articles 1 and 3.1(a) of the *SCM Agreement*.[99]

68. Brazil "item (j) in the alternative" formulation assumes that a measure could be found *not* to be an export subsidy under the general definitional elements of "export subsidy" under Articles 1 and 3.1(a) of the *SCM Agreement* but nonetheless be found to be an "export subsidy" within the meaning of item (j) of the Illustrative List. In so doing, Brazil ignores the text of Article 1 of the *SCM Agreement*, which provides that "*[f]or the purpose of this Agreement*, a subsidy shall be deemed to exist if . . . there is a financial contribution by a government . . . and a benefit is thereby conferred."[100] Article 3.1(a) of the *SCM Agreement* expressly includes as subsidies "within the meaning of Article 1" any "subsidies contingent . . . upon export performance, *including those illustrated in Annex I*."[101]

69. Similarly, the *SCM Agreement* refers to Annex I as providing an "Illustrative" List of Export subsidies.[102] "Illustrative" means, *inter alia,* "serving or tending to illustrate or make clear."[103] "Illustrate," in turn, has a number of meanings including "shed light on, light up, illumine" and "make clear, elucidate, explain; esp. clarify or support using examples, give an example or illustration of, exemplify."[104] This last definition of "illustrate" is especially relevant

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constitute prohibited export subsidies if they are not used to secure a material advantage in the field of export credit terms.")

[99] *Upland Cotton (Panel)*, para. 6.31.

[100] Emphasis added.

[101] Emphasis added.

[102] *See also* Article 3.1(a) which explains that "subsidies contingent in law or in fact, whether solely or as one of several other conditions, upon export performance" include those "illustrated" in Annex I and that these are "subsidies within the meaning of Article 1."

[103] Oxford English Dictionary, p. 1311 (Exhibit US-24).

[104] Oxford English Dictionary, p. 1311 (Exhibit US-24).

here because it highlights two different and important characteristics of the "Illustrative List of Export Subsidies." On one hand, the Illustrative List "clarifies" how the general definition of export subsidy in Articles 1 and 3.1(a) applies in the case of particular measures (here, export credit guarantees). At the same time, however, it clarifies the application of the general definition by "using examples" and, thus, is not an exhaustive list of the measures that can constitute export subsidies within the meaning of Articles 1 and 3.1(a).

70. The ordinary meaning of "illustrate," therefore, fully supports the interpretation that item (j) "makes clear" how the Article 1/3.1(a) definition applies in respect of that type of measure. Indeed, item (j) would hardly serve to "make clear" when an export subsidy exists in the case of export credit guarantees if it applied a *different* definition of "export subsidy" than that in Articles 1 and 3.1(a), as Brazil's approach assumes.

### (a) Export Credit Guarantees Under the GSM 102 Program Are Consistent With Item (j) of the Illustrative List

71. Reviewing item (j), the panel in the original proceeding noted that:

> [I]n order objectively to assess premiums in relation to long-term operating costs and losses, we believe it is . . . appropriate for us to take into account aspects of the structure, design and operation of the measure before us. We are entitled to inquire whether the programme, including in terms of the premiums charged, was set up in such a way that the total of all premiums would be likely to cover the total of all operating costs and losses under the programme.[105]

72. The panel in the original proceeding found that the premia charged under the U.S. export credit guarantee programs were "not geared toward ensuring adequacy to cover long-term operating costs and losses."[106] The panel noted, in particular, that the fees were "not risk-based" and that "a country's risk classification has no impact on the premiums payable."[107] In this regard, the panel considered relevant the "methodology used and relied upon by the United States government to assess the estimated long-term net cost to the United States government of export credit guarantees"[108] and the net result of the re-estimate process used in such methodology.[109] The United States used this guidance in implementing the DSB's recommendations and rulings.

#### *(I) The New Risk-Based Fee Structure Is Designed to Cover Long-*

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[105] *Upland Cotton (Panel)*, para. 7.805

[106] *Upland Cotton (Panel)*, para. 7.859

[107] *Upland Cotton (Panel)*, para. 7.861

[108] *Upland Cotton (Panel)*, para. 7.843

[109] *Upland Cotton (Panel)*, para. 7.854

### *Term Operating Costs and Losses*

73. The United States has taken a number of steps to ensure that the graduated risk-based fee structure covers long-term operating costs and losses of the GSM 102 program.

74. As reflected in the fee schedules for the program, fees increase with both risk category and tenor (the length of the loan). Specifically, higher premia are also assessed in respect of obligors in higher-risk countries. Fees increase with each of 6 eligible risk categories. All risk outside those 6 categories is wholly ineligible.[110] Fees also increase with tenor. Concurrent with publication of the revised risk-based schedules on the USDA website, the United States explained that "CCC intends that the premia generated under the new risk-based structure will be sufficient to ensure that they cover long-term operating costs and losses."[111] Across all programs, the United States increased fees, on average, by 46 percent. On a trade-weighted basis, for the GSM-102 program alone, fees increased by 23 percent over fiscal year 2004, the last fiscal year in which the prior fee schedule exclusively applied.[112]

75. In addition, the United States reclassified into an ineligible risk category, a large number of countries previously eligible under the programs. Countries eligible before 1 July 2005 that are now ineligible for export credit guarantees include: Algeria, Belize, Benin, Bolivia, Bosia-Herzegovina, Cameroon, Cote D'Ivoire, Gambia, Guyana, Kenya, Lebanon, Mali, Nicaragua, Niger, Nigeria, Paraguay, Tanzania, Vietnam, and Yemen.[113] This step too aimed to reduce the risk exposure of the export credit guarantee programs.

76. Finally, the United States ceased operating the SCGP program as of 1 October 2005. In connection with that, on 23 January 2006, the U.S. Department of Agriculture issued an Advance Notice of Public Rule-Making to solicit input on, *inter alia*, how to revise the Supplier Credit Guarantee Program to achieve an even greater level of fiscal prudence than reflected in the changes effected July 1, 2005.[114] To date, the United States has taken no further action with respect to the program. Thus, the United States has not issued any guarantees under the SCGP program since September 30, 2005.

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[110] "GSM-102 Guarantee Fee Rate Schedule" (Exhibit BRA-505).

[111] "FAQs: Risk-Based Fees" (Exhibit BRA-501)

[112] *See* Summary of FY 2006 Export Credit Guarantee Program Activity for GSM-102 as of September 30, 2006 (Exhibit BRA-513) and Summary of FY 2004 Export Credit Guarantee Program Activity for GSM-102 as of September 30, 2004 (Exhibit BRA-510).

[113] These are in addition to those countries that were already ineligible under the programs on July 1, 2005.

[114] Advance Notice of Proposed Rulemaking, 71 Fed. Reg. 3790 (24 January 2006) (Exhibit US-3); *see* "USDA Invites Comments on Options to Reform the Supplier Credit Guarantee Program" (23 January 2006) (Exhibit BRA-514).

77. The changes made to implement the DSB's recommendations and rulings bolster other disciplines already in place. For example, as Brazil notes, under the only remaining export credit guarantee program, GSM-102, a guarantee can be issued in respect of a transaction only if it the foreign bank involved is an approved bank.[115] Some countries that are currently listed as potentially eligible for GSM-102 export credit guarantee transactions are actually *de facto* ineligible, because no banking institution in the country is CCC approved. These countries include: Albania, Aruba, Azerbaijan, British Virgin Islands, Cayman Islands[116], Chile[117], China, Georgia, Grenada, Guadeloupe, Honduras, Lesotho, Macedonia, Malaysia, Mozambique, Netherlands Antilles, Papua New Guinea, Singapore, St. Lucia, St. Vincent/Grenadines, Swaziland, Thailand, Uruguay, and Vanuatu.

78. Recall also that under the GSM-102 program the obligor is always a bank not in the United States.[118] CCC establishes internal bank limits to govern exposure to potential defaults by such obligor banks in individual transactions.[119] CCC conducts an independent analysis of *each* foreign bank in order to establish the risk rating for such bank and the resulting bank limit.[120]

79. Brazil argues that because fees for CCC guarantees do not vary according to the

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[115] Brazil First Written Submission, paras. 354-355, n. 537. This had not been the case with respect to the SCGP program, under which the United States took the risk of default by an importer.

[116] Certain Cayman branches of banks whose home country offices are located elsewhere may issue letters of credit, but as a further indicator of the fiscal prudence inherent in the program, for risk purposes, CCC considers such letters of credit as issued by the headquarters bank, and considers the associated risk as that of the riskier home country bank.

[117] Brazil indicates that Corpbanca of Chile is a CCC-approved foreign bank. Brazil First Written Submission, para. 416, n. 586. This is no longer true. No Chilean banks are currently approved. *See* FAS Online, GSM Program Foreign Bank Obligors available at http://www.fas.usda.gov/excredits/foreignbanks.html (Exhibit US-4).

[118] *Upland Cotton (Panel)*, paras. 7.242-243

[119] *See, e.g.*, U.S. Answers to Panel's Questions following Second Session of the First Panel Meeting, para. 57 (October 27, 2003).

[120] The U.S. government applies eleven sovereign and nine non-sovereign risk categories for use by U.S. government agencies and programs subject to the Federal Credit Reform Act of 1990. CCC uses the same risk category methodology to classify foreign banks it approves for the GSM-102 program. In conducting its analysis of individual foreign banks to establish the respective credit limits, CCC begins by determining the sovereign and non-sovereign ratings for the country in which that foreign bank is located. Generally, if a bank is itself considered to be sovereign, then it will not be rated better than the sovereign country rating. Similarly, if a bank is considered non-sovereign, then it generally will not be rated better than the non-sovereign rating for its country. This is a guideline, as from time to time specific facts may justify a rating of a bank better than the country of its domicile. CCC then conducts an independent analysis of the foreign bank to establish an internal rating for such bank. Such independent analysis evaluates the capital adequacy, the asset quality, the management, the earnings, and the liquidity of the foreign bank.

particular foreign bank obligor, CCC "ignores" foreign obligor risk.[121] This is simply inaccurate. It is similarly inaccurate to assert that "the CCC appears to assume that foreign banks involved in the GSM-102 transactions have a credit rating that is identical to that of the sovereign."[122] To the contrary, CCC establishes an exposure limit with respect to each such bank. Once such limit is attained, no further guarantees of obligations of that bank are issued.

80. In short, the risk-based and tenor-based modifications to the fee structure, together with the elimination of the riskiest countries, the longer term GSM 103 export credit guarantee program, and the SCGP program reflect that the structure, operation, and design of the programs as a whole are aimed at receiving premia adequate to cover long-term operating costs and losses. Indeed, as discussed below, current budget accounting data reveal that the fee structure in place during the original panel proceeding *itself* proved premia adequate to cover long-term operating costs and losses. The modifications to the fee structure and risk eligibility under the program serve to provide a further favorable margin.

### *(ii) Financial Data in the U.S. Budget Reflect that Premia Are Adequate to Cover Long-Term Operating Costs and Losses*

81. In addressing the question of whether premium rates under the United States export credit guarantee programs are inadequate to cover long-term operating costs and losses, pursuant to item (j) of the Illustrative List of Export Subsidies in Annex I of the *SCM Agreement*, the panel explained that "[i]n general terms, the test for determining whether an export credit guarantee program satisfied the terms of item (j) is the net cost to the government, as the service provider."[123]

82. The U.S. government uses a "net present value" approach to budget accounting for its export credit guarantee programs throughout the federal government.[124] The net present value analysis attempts to calculate the value today of a future stream of income or cost, and under its budget accounting approach, the U.S. government identifies an annual "cost" in terms of the "net present value" associated with its export credit guarantee programs.[125]

83. As the United States explained in the original proceeding, "a positive net present value means that the United States government is extending a 'subsidy' to borrowers; *a negative present value means that the program generates a 'profit'* (excluding administrative costs) to the

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[121] Brazil First Written Submission, para. 409

[122] Brazil First Written Submission, para. 416.

[123] *Upland Cotton (Panel),* para. 7.804 and fn. 952. See also, Appellate Body Report, *Canada-Dairy (Article 21.5 - New Zealand and US)*, para. 93

[124] *Upland Cotton (Panel)*, para. 7.842.

[125] *Upland Cotton (Panel),* para. 7.842

United States government."[126] The budget process establishes an initial estimate of this figure, but in accordance with the Federal Credit Reform Act of 1990, the federal statute governing budget accounting of all U.S. government export credit activity, "such 'estimates' are subject to re-estimations over the lifetime of the guarantees involved."[127]

84. In its review in the original proceeding, the panel noted that the cumulative result of the re-estimate process yielded a "positive subsidy of approximately US$230 million,"[128] and that, "netting re-estimates against original subsidy estimates on a cohort-specific basis yields a positive subsidy, which reveals that over the long-term the United States government anticipates that it may not break even with its export credit guarantee programmes."[129]

85. The United States noted that, notwithstanding the positive US$230 million subsidy estimate at the particular point examined by the panel, over the lifetime of the guarantees that were under consideration an overall favorable re-estimate of US$1.9 billion had occurred, the trend for all cohorts of guarantees was uniformly favorable, and over time the US$230 million figure would be supplanted with a figure reflecting profitability of the programs.[130] The panel nevertheless concluded: "We have not been persuaded that cohort re-estimates over time, will necessarily not give rise to a net cost to the United States government."[131]

86. The United States can now confirm that even without (a) the suspension of the GSM 103 program and SCGP and (b) the significant modification of the fee structure and eligibility under the programs, current budgetary data incorporating experience of the programs now confirms that premia charged under the *superseded* fee structure were themselves adequate to cover long-term operating costs and losses.

87. The following table reflects budget data published in the 2007 United States Government Budget, Federal Credit Supplement.

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[126] *Upland Cotton (Panel)*, para. 7.842; OMB Circular A-11, section 185.2, pp. 185-3 and 185-4 (Exhibit BRA-116) (emphasis added).

[127] *Upland Cotton (Panel)*, para. 7.843

[128] *Upland Cotton (Panel)*, para. 7.852

[129] *Upland Cotton (Panel)*, para. 7.854

[130] *Upland Cotton (Panel)* para. 7.853

[131] *Upland Cotton (Panel)*, para. 7.853.

## United States Government Budget Subsidy Reestimates and Reestimates by Cohort GSM-102/GSM-103/Supplier Credit Guarantee Programs

| **Cohort** | **Original Subsidy Estimate** (US$) | **Total Reestimates**[132] | **Subsidy Estimate Net of Reestimates** |
|---|---|---|---|
| 1992 | 267426000[133] | -716768399 | -499342399 |
| 1993 | 171786000[134] | -358624058 | -186838058 |
| 1994 | 122921000[135] | -133746048 | -10825048 |
| 1995 | 113000000[136] | -160155549 | -47155549 |
| 1996 | 328000000[137] | -389662651 | -61662651 |
| 1997 | 289000000[138] | -283372693 | 5627307 |
| 1998 | 301000000[139] | -281573526 | 19426474 |
| 1999 | 158000000[140] | -180555025 | -22555025 |
| 2000 | 195000000[141] | -206587469 | -11587469 |
| 2001 | 103000000[142] | -109880176 | -6880176 |
| 2002 | 97000000[143] | -87884000 | 9116000 |
| **Subtotal 1992-2002** | **2146133000** | **-2908809594** | **-762676594** |
| | | | |
| 2003 | 170000000[144] | -51948589 | 118051411 |

[132] 2007 U.S. Government Budget Credit Supplement: Table 8 – Loan Guarantees: Subsidy Reestimates, p. 43 http://www.whitehouse.gov/omb/budget/fy2007/pdf/cr_supp.pdf (Exhibit US-5).

[133] CCC Export Loans Program Account line 00.02; p. 383 (Exhibit BRA-125).

[134] CCC Export Loans Program Account line 00.02; p. 156 (Exhibit BRA-126).

[135] CCC Export Loans Program Account line 00.02; p. 161 (Exhibit BRA-95).

[136] CCC Export Loans Program Account line 00.02; p. 175 (Exhibit BRA-94).

[137] CCC Export Loans Program Account line 00.02; p. 174 (Exhibit BRA-93).

[138] CCC Export Loans Program Account line 00.02; p. 105 (Exhibit BRA-92).

[139] CCC Export Loans Program Account line 00.02; p. 111 (Exhibit BRA-91).

[140] CCC Export Loans Program Account line 00.02; p. 110 (Exhibit BRA-90).

[141] CCC Export Loans Program Account line 00.02; p. 116 (Exhibit BRA-89).

[142] CCC Export Loans Program Account line 00.02; p. 118 (Exhibit BRA-88).

[143] CCC Export Loans Program Account line 00.02; p. 107 (Exhibit BRA-127).

[144] 2005 U.S. Government Budget Appendix: CCC Export Loans Program Account, line 00.02; p. 117 (Exhibit US-6).

| | | | |
|---|---|---|---|
| 2004 | 457000000[145] | -122837724 | 334162276 |
| 2005 | 152000000[146] | -8086873 | 143913127 |
| **Subtotal 2003-2005** | 779000000 | -182873186 | 596126814 |
| | | | |
| **Total** | **2925133000** | **-3091682780** | **-166549780** |

88. As shown above, the current United States budget data now reflects that for the cohorts 1992-2002, subsidy estimates and re-estimates by cohort, show a negative subsidy net of all re-estimates, of US$762,676,594. For cohorts 1992-2005, the figure is also a negative subsidy: US$166,549,780. These numbers indicate that the United States has earned a *profit* on its programs in these amounts.

89. In addition, with respect to the only extant export credit guarantee program (GSM-102), the budget data also reflects that for every fiscal year cohort since 1992 the net lifetime re-estimates have been negative:[147]

| **GSM-102 Cohort** | **Net lifetime reestimate amount** |
|---|---|
| FY 1992 | -438889000 |
| FY 1993 | -274634000 |
| FY 1996 | -181562000 |
| FY 1997 | -185504000 |
| FY 1998 | -271657000 |
| FY 1999 | -178437000 |
| FY 2000 | -206879000 |
| FY 2001 | -113592000 |

[145] 2006 U.S. Government Budget Appendix: CCC Export Loans Program Account, line 00.02; p. 116 (Exhibit US-6).

[146] 2007 U.S. Government Budget Appendix: CCC Export Loans Program Account, line 00.02; p. 115; (Exhibit BRA-544).

[147] 2007 U.S. Government Budget Credit Supplement: Table 8 – Loan Guarantees: Subsidy Reestimates, p. 43 http://www.whitehouse.gov/omb/budget/fy2007/pdf/cr_supp.pdf (Exhibit US-5). Note that this table does not include cohorts 1994 and 1995. These cohorts were closed during fiscal year 2004, and are no longer subject to the reestimation process. However, the final subsidy estimate, net of reestimates, for these cohorts (all programs) was negative, as reflected above in the table showing the subsidy estimates net of reestimate. The budget data was not developed for the three programs individually. The overall subsidy estimate net of reeestimate for the 1994 and 1995 cohorts shows that after all transactions related to these cohorts were closed, they reflected profitability.

| | |
|---|---|
| FY 2002 | -102537000 |
| FY 2003 | -58460000 |
| FY 2004 | -102189000 |
| FY 2005 | -22806000 |

90. The current aggregate U.S. budget accounting data for all programs means that, for the fourteen-year period commencing with fiscal year 1992, the export credit guarantee programs, under the fee structure *preceding* the changes implemented on July 1, 2005, received hundreds of millions of dollars more in premia and interest than required to pay out in operating costs and losses, including interest.

91. The negative subsidy amounts reflected in the Federal Credit Supplement do not include administrative expenses. However, Brazil and the United States agreed in the original proceeding that a 10-year figure for administrative expenses is approximately US$39 million. Inclusion of such amounts does not change the overall profitability of the program reflected in the negative subsidy amounts.[148]

92. As the panel noted in the original proceeding, these are results of "a methodology used and relied upon by the United States government to assess the estimated long-term net cost to the United States government of export credit guarantees." The panel also noted that "actual historical experience is a 'primary factor' on which estimates are based."[149]

93. The profitability of the programs is not unexpected. In the original proceeding, the United States noted that "the trend for all cohorts is uniformly favorable as compared to the original subsidy amount." The United States also submitted data that "the 1992-1996 and 1999 'cohorts' indicate profitability."[150] The United States made similar arguments in anticipation of closing the cohorts for 1994 and 1995, as well as that "it is reasonable to expect that, in the fullness of time, the data will . . . reflect further negative re-estimates for cohorts 2001 and 2002."[151] The panel in the original proceeding considered that there was insufficient evidence at that time that "cohort estimates over time will necessarily not give rise to a net cost to the United States government"[152] or that the figures "will necessarily evolve towards, and conclude as, zero

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[148] *Upland Cotton (Panel),* paras. 7.840, 7.852; Exhibits BRA-133 and US-66. See also Brazil's Comments on U.S. 22 December Answers, paras. 101, 106, 124, 153; Statement of Brazil, First Panel Meeting (July 22, 2003), para. 132. In paragraph 7.842 of the Panel Report, the panel in the original proceeding refers to an *annual* increase in costs of approximately US$39 million for administrative expenses. This is an error.

[149] *Upland Cotton (Panel),* para. 7.843

[150] *Upland Cotton (Panel),* para. 7.853

[151] *Upland Cotton (Panel),* para. 7.853, fn. 1028

[152] *Upland Cotton (Panel),* para. 7.853

or a negative figure."[153]

94. The additional data that has become available as more cohorts have closed confirm that there is not a net cost to the U.S. government.[154] For cohorts 1992-2002, the Federal Credit Supplement reflects an overall negative subsidy (profitability) of US$762,676,594. The 1994 and 1995 cohorts have closed. They reflect profitability, respectively, of US$10.825 million and US$47.156 million. The 2000 and 2001 cohorts currently reflect profitability of US$11.6 million and US$6.9 million, respectively. Indeed, of the 11 cohorts during 1992-2002, only 3 currently reflect a loss: 1997, 1998, and 2002,[155] and those are small.

95. As indicated in the panel's report in the original proceeding, these periods of time are reasonable and appropriate for making determinations in respect of whether the premia now charged are adequate to cover "long-term" operating costs and losses.[156] Brazil has acknowledged that a 10-year period of time is appropriate and adequate for these purposes.[157] Indeed, the current data reflect profitability of the programs not only over each 10-year period for which data are available, but also over a 14-year period (fiscal years 1992-2005).

96. Brazil concurs that the negative subsidy amounts in the Federal Credit Supplement reflect overall profitability of the programs.[158]

97. Brazil, furthermore, has argued that the United States' "Federal Credit Reform Act cost formula" is an "ideal basis on which to determine whether the CCC's export credit loan guarantee programs are offered at premium rates that are inadequate to cover the long-term operating costs and losses of the programs, within the meaning of item (j) of the Illustrative List of Export Subsidies."[159]

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[153] *Upland Cotton (Panel),* para. 7.853, fn. 1028.

[154] Compare U.S. Answers to Panel's Questions Following First Meeting, paras. 160-163 (11 August 2003); U.S. Rebuttal Submission (August 22, 2003), para. 154, 171, 175; U.S. Further Submission, para. 144 (30 September 2003); U.S. Answers to Panel's Questions Following Second Session of the First Panel Meeting (October 27,2003), para. 51; U.S. Further Rebuttal Submission, para. 196 (November 18, 2003); U.S. Answers to Panel's Questions Following Second Panel Meeting, paras. 90-104 (December 22, 2003); U.S. Comments to Brazil's Answers to Panel Questions Following the Second Panel Meeting, paras. 81-82 (January 28, 2004).

[155] The large negative re-estimates evident for each of cohorts 1997, 1998, and 2002 indicate that the favorable result seen for the other cohorts is likely ultimately to be manifest for these 3 years as well

[156] *Upland Cotton (Panel),* para. 7.833.

[157] *Upland Cotton (Panel),* para. 7.830; Brazil's Comments on U.S. 22 December Answers, para. 151 (28 January 2004).

[158] Statement of Brazil, First Panel Meeting, para. 126 (22 July 2003). *See also*, Brazil's Comments on U.S. Rebuttal Submission, paras. 56, 67 (27 August 2003).

[159] Statement of Brazil, First Panel Meeting, para. 129 (July 22, 2003). Brazil has similarly characterized the Federal Credit Reform Act formula as "a true reflection of cost." Rebuttal Submission of Brazil, para. 112 (August 22, 2003).

98. The United States reiterates that these financial results showing that the programs charged premium rates *more than* adequate to cover the long-term operating costs and losses of the programs were generated by the export credit guarantee programs as previously configured and examined by the original panel. The current measures, adopted to implement the DSB recommendations and rulings based on the original panel's findings, include: (1) termination of the longer term export credit guarantee program (GSM-103) altogether; (2) termination of the Supplier Credit Guarantee Program; (3) elimination of the highest risk countries altogether from eligibility under the GSM-102 program; (4) adoption of a graduated, risk-based fee structure at fees generally substantially higher than those previously in place under the GSM-102 program.[160] The only remaining program is the CCC Export Credit Guarantee Program (GSM-102) program under the revised fee structure, with risk of the highest risk countries foreclosed. Clearly, the program as modified can only result in even more favorable financial results. Premia are designed to do more than merely "offset" costs and losses.[161]

99. The original panel indicated that examination of the past performance of the program and examination of the structure, operation, and design of the measure can be mutually reinforcing, and that the Panel's determinations with respect to the U.S. export credit guarantee programs should be based upon the evidence as a whole.[162]

### *(iii) Brazil's Assertions Regarding the U.S. Budget Data Are Incorrect*

100. Brazil incorrectly asserts that "the United States does not itself believe that the new GSM-102 fee schedule (coupled with new SCGP fees and discontinuation of GSM 103, both of which presumably have a positive fiscal impact) will result in income sufficient to absorb losses on new cohorts of ECGs for which that fee schedule applies."[163] For reasons discussed above, this is entirely untrue.[164]

101. Brazil emphasizes that the current U.S. budget reflects an estimated "guaranteed loan subsidy"[165] for GSM-102 of US$125 million for the 2006 cohort of guarantees and US$114

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[160] The United States notes that its administrative termination of the GSM-103 program, the administrative determination of ineligibility of the highest-risk countries, and the operational suspension of the Supplier Credit Guarantee Program further corroborate the United States' prior assertions and the conclusions of the panel in the original proceeding that the statutory bases for the programs do not render CCC unable to "stem or otherwise control the flow" of its export credit guarantees. See *Upland Cotton (Panel),* paras. 7.887-7.892.

[161] *See Upland Cotton (Panel),* para. 7.866

[162] *Upland Cotton (Panel)*, paras. 6.28, 7.808

[163] Brazil First Written Submission, para. 420, 433.

[164] Consistent with the profit experience reflected in the data, as of December 15, 2006, CCC has also experienced no defaults in respective of the 2005, 2006 or 2007 cohorts.

[165] "Subsidy" in this context is used in the sense of subsidy cost within the meaning of the United States Federal Credit Reform Act of 1990, rather than in the sense of Article 1 of the SCM Agreement. See *Upland Cotton (Panel),* para. 7.842, fn. 1021.

million for the 2007 cohort. However, Brazil has repeatedly acknowledged before that in the U.S. budget such "original estimates were too high."[166]

102. Despite this acknowledgment, Brazil returns to the same points it made in the original proceeding – which the United States has rebutted. Specifically, Brazil effectively asks again that, if the United States' data routinely ends up reflecting profitability in the program, "why does [CCC] continue to offer original [subsidy] estimates that are so high?"[167]

103. As the United States explained in the prior proceeding, the original "subsidy" estimate in a budget year occurs well before virtually any activity in the program has occurred in that fiscal year.[168] The original "subsidy" estimate, furthermore, begins with an historically overly-optimistic projection of actual use of the program. CCC is then required to use the government-wide estimation rules, including mandated risk assessment country grades, without regard to the actual experience specific to the CCC export credit guarantee programs.[169]

104. In the original proceeding, the United States submitted tables reflecting the routine initial overestimation of utilization of the export credit guarantee programs in a particular cohort and the resulting commensurate and corresponding overestimation of guaranteed loan subsidy estimates.[170] This systematic overestimation persists. Exhibits US-7 and US-8 update the information previously provided in para. 148 of the U.S. Further Submission (30 September 2003) to reflect the corresponding figures in the 2005, 2006, and 2007 budgets. For example, the US$125 million estimate for the 2006 cohort is based on an estimated program level for such cohort of US$2.485 billion.[171] In fact, actual sales registrations for 2006 were nearly 50 percent lower, at only US$1.363 billion.[172]

### (b) Brazil Fails To Demonstrate That GSM 102 Export Credit Guarantees Leave Recipients In a Better Position Than They Would Have Been In If They Had Been In the Market

105. The fact that item (j) correctly illustrates that GSM 102 export credit guarantees are not

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[166] Second Oral Statement of Brazil (7 October 2003), para. 70; Brazil Comments on U.S. Rebuttal Submission (27 August 2003), para. 60

[167] Brazil Comments on U.S. Rebuttal Submission (27 August 2003), para. 62

[168] U.S. Further Submission (30 September 2003), para. 146.

[169] U.S. Further Submission (30 September 2003), para. 147; *See, also, e.g,* Exhibit BRA-158, page 10

[170] U.S. Further Submission (30 September 2003), para. 148 (including tables therein). The program subsidy estimates in the tables contained in such paragraph 148 set forth "guaranteed loan subsidy" amounts in line 00.02 of the respective U.S. budget pages in the Exhibits of Brazil. In the current budget (Exhibit BRA-544), this figure is further disaggregated in line 233001 to display the corresponding figure for GSM-102.

[171] Exhibit BRA-544, line 215001

[172] Exhibit BRA-513, page 3

export subsidies is confirmed by the fact that, as discussed below, Brazil fails to demonstrate that the GSM 102 export credit guarantees confer a "benefit" within the meaning of Article 1.1(b) of the *SCM Agreement*.

106. Before turning to Brazil's arguments, it is useful to review briefly the nature and role of a GSM 102 guarantee in a particular transactions. As Brazil acknowledges, the GSM-102 program requires a foreign bank to issue a dollar-denominated, irrevocable documentary letter of credit in favor of a U.S. exporter.[173] Rather than pay the full amount of the letter of credit upon presentation of the requisite documents, the foreign bank is permitted to re-pay the dollar-denominated obligation over time (not to exceed 3 years) to the U.S. financial institution that has paid the exporter upon presentation of the documents required for payment under the letter of credit.[174]

107. From the perspective of the foreign bank obligor, under the GSM-102 program, it is procuring financing from a U.S. financial institution at a cost of funds without a requirement to provide collateral or other security to the lender. The foreign obligor has no particular interest in the existence of a U.S. government guarantee, or a guarantee of any kind. The foreign obligor cares about how much it will cost altogether in fees and interest to borrow the amount it requires. From the perspective of the lender, the question is its risk-appetite and willingness to lend with or without some version of security, collateral, or guarantee. These are the commercial interests involved.

#### *(I) Commercial Financing is Often Readily Available to CCC-approved Bank Obligors Without U.S. Government Guarantees*

108. As its first theory that the GSM-102 confers a "benefit," Brazil argues that:

> GSM-102 operates solely in circumstances where a foreign bank could not, without the U.S. government's assistance, secure the credit necessary to on-lend to its customer, the purchaser of U.S. agricultural exports. In those circumstances, absent GSM 102 assistance from the U.S. government, exports of U.S. agricultural products would not occur.[175]

109. On this basis, Brazil argues that "there is 'no comparable commercial loan absent the government guarantee,' within the meaning of Article 14(c) of the SCM Agreement. A benefit is therefore conferred on the recipient *per se*, pursuant to Article 1.1(b) of that Agreement."[176]

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[173] Brazil First Written Submission, para. 354.

[174] *See generally* Brazil First Written Submission, paras. 354-355.

[175] Brazil First Written Submission, para. 357

[176] Brazil First Written Submission, para. 375.

110. Although Brazil quotes the hortatory language of the GSM-102 program regulations,[177] in fact scores of the CCC-approved foreign bank obligors enjoy an investment grade credit rating. Even many of the banks that Brazil has noted have a rating lower than that of their own country rating enjoy an investment grade,[178] and credit is available to such banks from commercial sources for their own purposes, including lending for agricultural import transactions. The question of financing for such institutions would be one of price and terms, not total unavailability.

### *(ii) Private Sector Commercial Products Comparable to the GSM-102 Program are Available in the Marketplace*

111. Brazil on the basis of assertions by a paid consultant that "there is no comparable commercial product [to the GSM-102 program] available from private/market sources."[179] Brazil's consultant emphasizes the pertinent characteristics of the program as providing a guarantee "(a) against default by a foreign bank on (b) a letter of credit issued by it to (c) finance a specific commercial transaction."[180] The consultant also emphasizes as allegedly distinguishing characteristics that "the program covers credit terms of up to 3 years"; "the product guarantees payments due from approved foreign banks to exporters or financial institutions" and "typically, 98% of the principal and a portion of the interest are covered by the guarantee."[181]

112. Brazil's assertions are not accurate. Under the Trade Finance Facilitation Program of the Inter-American Development Bank ("IDB"), the IDB approves guarantees of letter of credit obligations of issuing banks in amounts up to *100 percent* of *individual transactions.*[182] This program is available "to support trade-related transactions (*up to three years*) of banks operating in IDB Borrowing Member Countries." The obligations that the IDB guarantees include: "(I) documentary credit and documentary collection instruments issued by banks in borrowing member countries (Issuing Banks) and confirmed by leading banks active in international trade finance (Confirming Banks), and (iii) pre-export financing provided to the Issuing Banks by the

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[177] Even a cursory examination of the Standard's and Poor's Ratings submitted by Brazil (Exhibit BRA-540) demonstrates that the GSM-102 program is available for Hong Kong and Korean banks, as just 2 examples, with short-term ratings of A- or better in an A or AA rated market. Clearly, commercial lenders would be willing to lend to these investment grade banks and others. Indeed, investment grade generally applies to institutions rated BBB- or better, of which several appear in the Standard's and Poor's Ratings.

[178] Standard and Poor's Credit Ratings as of 27 September 2006 (Exhibit BRA-540).

[179] Brazil First Written Submission, Annex III, para. 8.

[180] Brazil First Written Submission, Annex III, para. 7.

[181] Brazil First Written Submission, Annex III, para. 6.

[182] *See* Inter-American Development Bank press release, 30 November 2006 (emphasis added) http://www.iadb.org/NEWS/articledetail.cfm?artID=3462&language=EN&arttype=PR (Exhibit US-11).

Confirming Bank."[183] Each issuing bank has an exposure limit under this facility of up to US$40 million.

113. The IDB explained in its 30 November 2005 press release, for example, that:

> Under the program the IDB issues guarantees to international banks (confirming banks) to mitigate the risk from eligible Latin American and Caribbean banks (issuing banks) in export and import contracts with tenors of up to three years.
>
> To date the TFFP has a network of approximately 20 issuing banks in 11 countries in this region and around 70 confirming banks belonging to 32 international banking groups from 25 countries around the world. Through these financial institutions the IDB has issued guarantees for nearly US$70 million in support of 80 individual trade transactions totaling US$95 million.[184]

114. Similarly, the Global Trade Finance Program of the International Finance Corporation ("IFC") "offers confirming banks partial *or full* guarantees to cover *payment risk on banks* in the emerging markets. These *guarantees are transaction-specific* and apply to: letters of credit; trade-related promissory notes and bills of exchange; bid and performance bonds; advance payment guarantees."[185] This facility also provides tenors of up to three years.[186]

115. For example, on February 15, 2006, the IFC, the "*private-sector arm* of the World Bank Group, concluded in Bangladesh the first transaction under its Global Trade Finance Program[]. The transaction supports the confirmation by American Express Bank of a letter of credit (LC) issued by Dhaka Bank, for the import of cotton into Bangladesh. IFC's guarantee provided 100 percent risk coverage."[187] The very first transaction under this program in October, 2005

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[183] *See* Inter-American Development Bank Private Sector Department Annual Newsletter, p.5 http://www.iadb.org/pri/PDFs/Newsletter.pdf (Exhibit US-10).

[184] *See* Inter-American Development Bank press release, 30 November 2006 (emphasis added) http://www.iadb.org/NEWS/articledetail.cfm?artID=3462&language=EN&arttype=PR (Exhibit US-11).

[185] Inter-American Development Bank press release, 30 November 2006 (emphasis added) http://www.iadb.org/NEWS/articledetail.cfm?artID=3462&language=EN&arttype=PR (Exhibit US-11).

[186] *See* International Finance Corporation description of Global Trade Finance Program http://www.ifc.org/ifcext/gfm.nsf/Content/TradeFinance (Exhibit US-12) and Global Trade Finance Program "What We Offer" http://www.ifc.org/ifcext/gfm.nsf/Content/TF-WhatWeOffer. (Exhibit US-13).

[187] *See* International Finance Corporation press release: "IFC Announces First Global Trade Finance Deal in Bangladesh," 17 February 2006 (emphasis added) (Exhibit US-14) available at http://www.ifc.org/ifcext/media.nsf/content/SelectedPressRelease?OpenDocument&UNID=D5C2936F834D516E8525713E005C8243.

involved the importation of another agricultural commodity, canola (rapeseed), into Pakistan.[188]

116. The IFC Global Trade Finance Program is available in at least 14 markets in which even the CCC does not accept foreign-bank obligor risk.[189]

117. The European Bank for Reconstruction and Development (EBRD) offers its own Trade Facilitation Program to over 100 issuing banks in 28 countries in central and Eastern Europe.[190] Through this program, "the EBRD provides [unconditional] guarantees to international confirming banks. In so doing, it takes the political and commercial payment risk of transactions undertaken by issuing banks in the countries where the EBRD operates." It provides "guarantees of up to 100 percent of the face value of the underlying trade finance instruments." Like the programs of the IFC and IDB, guarantees may be used to secure payment of letters of credit from the issuing bank.[191] The EBRD clearly extends its guarantees in respect of agricultural export transactions where even CCC is unwilling to take on risk.[192]

118. The EBRD provides its unconditional guarantees for "any genuine trade transaction" for tenors up to 3 years in the following markets: Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Georgia, Kazakhstan, Romania, Russia, and Ukraine.[193] EBRD operates in 28 countries.[194] Of these, CCC does not even offer any guarantees in Armenia, Belarus, Bosnia and Herzegovina, Kyrgyzstan, Moldova, Mongolia, Serbia and Montenegro, Tajikistan, Turkmenistan, and Uzbekistan. CCC also has not approved any banks in Albania, Azerbaijan, Georgia, and Macedonia, effectively excluding those countries from the program. EBRD charges.

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[188] *See* International Finance Corporation press release: "IFC Announces Milestone Global Trade Finance Transaction with ABN AMRO," (11 October 2005) (Exhibit US-15) available at http://www.ifc.org/ifcext/media.nsf/content/SelectedPressRelease?OpenDocument&UNID=23F1611EF14C56E88525709700506D10.

[189] *See* IFC Global Trade Finance Program: Issuing Banks in Program (Exhibit US-16) http://www.ifc.org/ifcext/gfm.nsf/Content/TF-BanksintheProgram. Such markets include Argentina, Armenia, Bangladesh, Bolivia, Indonesia, Kenya, Lebanon, Malta, Mauritania, Moldova, Mongolia, Nigeria. Tanzania, and Uganda.

[190] *See* EBRD sector factsheet: Trade Facilitation Programme (Exhibit US-17) available at http://www.ebrd.com/pubs/factsh/themes/trade.pdf.

[191] *See* "About the [EBRD] trade facilitation programme" http://www.ebrd.com/apply/trade/about/index.htm (Exhibit US-18).

[192] EBRD Trade Faciliation Programme brochure. Case Study 1: a guarantee of a Moldova bank on a wheat import transaction. http://www.ebrd.com/pubs/finance/tfp.pdf (Exhibit US-19).

[193] *See* EBRD sector factsheet: Trade Facilitation Programme, pp. 1, 3. http://www.ebrd.com/pubs/factsh/themes/trade.pdf (Exhibit US-17).

[194] EBRD Trade Faciliation Programme brochure, p. 3 (lists 27 countries) available at http://www.ebrd.com/pubs/finance/tfp.pdf (Exhibit US-19). List of eligible issuing banks, however, lists XacBank of Mongolia available at http://www.ebrd.com/apply/trade/contact/issue.pdf (Exhibit US-20).

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131. These examples from three different markets illustrate that, contrary to Brazil's suggestions, export credit guarantees under the program do not necessarily place recipients in a better position than they would have been in the market. The guaranteed transactions are not necessarily less costly than alternative and analogous sources of funds from which recipient banks can then on-lend for agricultural imports or other purposes.

### *(iii) Under These Circumstances, in a Proceeding Under Part V, Article 14(c) Would Have Required the Finding That GSM 102 Export Credit Guarantees Do Not Provide Any "Benefit"*

132. Brazil relies on Article 14(c) of the *SCM Agreement* as the basis of its argument that the GSM-102 program presently confers a benefit.[196] Even leaving aside that Article 14(c) applies, by its terms, only "for purposes of Part V" of the *SCM Agreement*, the United States notes that the article states that:

> [A] loan guarantee by a government shall *not* be considered as conferring a benefit *unless* there is a difference between the amount that the firm receiving the guarantee pays on *a loan* guaranteed by the government and the amount that the firm *would pay* on *a comparable commercial loan* absent the government guarantee. In this case the benefit shall be the difference between these two amounts adjusted for any differences in fees.[197]

133. The language of Article 14(c) presumes that a benefit does *not* exist in the absence of a particularized showing that the overall cost, including fees, of *a loan* guaranteed by the government is less than that the firm receiving the guarantee would pay on a *comparable* commercial loan. Brazil has made no attempt to provide such specific information on individual loan costs and fees or to identify comparable commercial loans and their terms.

134. Instead, Brazil has made the sweeping and erroneous assertion that obligors on loans guaranteed under the GSM-102 program can *never* obtain any other financing of any kind. Brazil incorrectly asserts that the "GSM-102 program operates solely in circumstances in which credit would not otherwise be available to finance the export of U.S. agricultural goods" and where "*no loan* would have been available without the government guarantee - because, for instance, the foreign obligor is not considered by the market to be creditworthy - a benefit exists

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[196] Brazil First Written Submission, para. 371-375.

[197] Emphasis added.

*per se.*"[198] Brazil asserts that GSM-102 is exclusively "for use in situations in which a foreign obligor would not otherwise be able to secure financing at all - not just financing on less attractive terms, but no financing at all."[199] As shown above, this premise is simply not factually true. Brazil has the burden of providing the facts it asserts and it fails to do so here. Furthermore, as demonstrated using the specific transactions detailed by Mr. Fernandez of CoBank, financing is not only available to the obligors, but it is available on terms less costly than that available under GSM-102.

135. Brazil makes no attempt to examine commercial financing available to CCC-approved foreign obligors. Brazil simply assumes none is available. In such circumstances, Article 14(c) requires a finding that the GSM-102 guarantee program shall not be considered to confer a benefit.

136. Brazil also suggests that an appropriate method of assessing "benefit" is to compare the relative cost of a government guarantee to that of another guarantees (i.e., to compare fees of different guarantees). There is, first, no textual basis for Brazil's suggested approach. Moreover, Brazil's approach would appear to ignore the myriad reasons why fees might be different for different guarantees, including the different nature of loans guaranteed, the different types of products involved, the different services provided, the different organizational principles and aims of the institution. A difference in fees does not necessarily reflect that any "benefit" is being conferred. Brazil, however, ask the Panel to consider fees alone to make a determination of "benefit." Brazil has shown no basis for its proposed approach.

137. Brazil applies its own flawed approach examining, to the exclusion of all other cost elements of relevant loan transactions, the alleged difference in costs of a government guarantee and an alternative guarantee in the "marketplace." Even for these purposes, Brazil offers only the statement of its consultant and a comparison of Ex-Im Bank fees, without considering other guarantees in the marketplace, such as those available through the IFC, IDB, and EBRD. The United States notes, for example, that EBRD guarantee fees can be as low as US$100.[200]

138. Brazil notes that "the marketplace provides an appropriate basis for comparison in determining whether a 'benefit' has been 'conferred'."[201] In this context, the "marketplace" contemplated under the *SCM Agreement* is not the cost of obtaining a guarantee for a one-off transaction on the export of agricultural commodities,[202] but rather the total cost of funds at which borrowers and lenders are willing to enter commercial loans, the proceeds of which can then be made available by the foreign bank borrower to "on-lend[] to its customer, the buyer of

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[198] Brazil First Written Submission, para. 373.

[199] Brazil First Written Submission, para. 375.

[200] EBRD sector factsheet: Trade Facilitation Programme, p. 3 (Exhibit US-17).

[201] Brazil First Written Submission, para. 370, citing *Canada - Aircraft (AB)*, para. 157.

[202] Brazil First Written Submission, para. 371.

U.S. agricultural exports, enabling the transaction to proceed."[203]

### 2. The United States Has Not Provided Export Credit Guarantees Under the GSM-102 Program Inconsistently With Articles 10.1 and 8 of the *Agreement on Agriculture*

139. Brazil also fails to demonstrate that GSM-102 export credit guarantees are export subsidies that have been provided subsequent to 1 July 2005 in circumvention of U.S. obligations under Articles 10.1 and 8 of the *SCM Agreement*.

140. 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 and with the commitments as specified in that Member's Schedule." Further, Article 10.1 of the *Agreement on Agriculture* prohibits the provision of export subsidies (other than those listed in Article 9.1) "in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments."

141. While Article 1(e) of the *Agreement on Agriculture* defines "export subsidies" as "subsidies contingent upon export performance," there is no further elaboration as to the kinds of measures that meet this definition. Accordingly, the panel in the original proceeding found that the *SCM Agreement* – which also includes provisions dealing with export subsidies – could provide useful "contextual guidance."[204] The panel explained that

> We see no reason to read the term "contingent upon export performance" in the Agreement on Agriculture differently from the same term in the SCM Agreement for the purposes of this dispute. The two Agreements use precisely the same words to define "export subsidies." We therefore believe that it is appropriate for us to seek contextual guidance in that provision of the SCM Agreement for our interpretation of the term "contingent upon export performance" in the Agreement on Agriculture in the particular circumstances of this dispute.[205]

142. The fact that the GSM-102 export credit guarantees are not export subsidies within the meaning of item (j) is relevant and support a finding that GSM-102 export credit guarantees are not export subsidies for purposes of Articles 8 and 10.1 of the *Agreement on Agriculture*.[206]

## B. THE UNITED STATES HAS "TAKEN ACTION" TO WITHDRAW THE SUBSIDY WITH RESPECT TO GSM-102, GSM 103, AND SCGP EXPORT CREDIT GUARANTEES ISSUED

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[203] Brazil First Written Submission, para. 355.

[204] *Upland Cotton (Panel)*, para. 7.799.

[205] *Upland Cotton (Panel)*, para. 7.700.

[206] *See Upland Cotton (Panel)*, para. 7.946.

**PRIOR TO 1 JULY 2005**

143. There is also no basis for Brazil's claim that the United States has not "taken action" to withdraw the subsidy with respect to GSM-102, GSM 103 and SCGP export credit guarantees issued prior to 1 July 2005 that are "still outstanding." First, CCC has no further contingent liability under SCGP, as no guarantees were issued after September 30, 2005, the period to ship has expired, and the period of coverage was only 180 days. In other words, there are no export credit guarantees "still outstanding" under the SCGP program.

144. In addition, the United States did take action with respect to any export credit guarantees that are "still outstanding" under the GSM-103 program by changing the cost and fee structure of the entire portfolio of programs of which they are part. The subsidy that the panel found in the original proceeding was "the provision by [a] government[] of export credit guarantee . . . programmes at premium rates which are inadequate to cover the long-term operating costs and losses of the programmes."[207] In making this finding, the panel in the original proceeding considered the operating costs and premiums charged under the GSM-102, GSM-103, and SCGP together.

145. As explained above, the United States complied with its obligation to withdraw the subsidy with respect to the programs by lowering the long-term operating costs and losses of the programs. For example, the United States reclassified certain high risk countries into an ineligible category under the GSM-102 and SCGP programs and ceased issuing guarantees under the GSM-103 and, later, SCGP programs. At the same time, the United States began assessing premiums under a new risk-based fee structure designed to cover the long-term operating costs and losses of the programs. As a result of these changes, the United States ceased to provide "export credit guarantee . . . programmes at premium rates which are inadequate to cover the long-term operating costs and losses of the programmes." The United States, thus, withdrew the subsidy. Brazil's claim, in other words, is incorrect as a matter of fact.

## VI. ARGUMENTS REGARDING ACTIONABLE SUBSIDIES CLAIMS

146. As discussed above, the panel's finding of "present" serious prejudice in the original proceeding applied to a package of payments made under the Step 2, marketing loan, and counter-cyclical payment programs in 1999-2002. Those payments were, thus, the only measures subject to the DSB's recommendation under Article 7.8 of the SCM Agreement that the United States "take appropriate steps to remove the adverse effects or . . . withdraw the subsidy." While Brazil claims that the United States has failed to comply with this recommendation, and renews its allegations of "present" serious prejudice, it submits no evidence whatsoever as to the present effects, if any, of the measures that were subject to the original panel's actionable subsidy finding. Brazil, thus, appears to concede that the package of

[207] Item (j) of the Illustrative List of Export Subsidies in Annex I of the *SCM Agreement*.

payments made in 1999-2002 under the Step 2, marketing loan, and market loan assistance or counter-cyclical payment programs no longer have any effect.

147. Brazil does, however, present a number claims based on the incorrect assumption that the DSB recommendation applied in respect of what it terms the "basket of measures" comprising the Step 2, marketing loan, and counter-cyclical payment *programs*. Specifically, Brazil claims that "the U.S. measure taken to comply (i.e., the repeal of the Step 2 program) leaves a new 'basket of measures' [i.e., the marketing loan and counter-cyclical payment programs] that still causes serious prejudice to the interests of Brazil, within the meaning of Articles 5(c) and Article 6.3 of the SCM Agreement."[208] According to Brazil, the "effect" of this "new basket of measures" is (a) "significant price suppression" of the world market price for cotton within the meaning of Article 6.3(c) of the *SCM Agreement*; and (b) an increase in the U.S. world market share that is inconsistent with Article 6.3(d) of the *SCM Agreement*. Brazil also asserts a claim that the marketing loan and counter-cyclical payment programs threaten to cause serious prejudice within the meaning of Article 5 and 6.3(c) of the *SCM Agreement*, which is "contingent" on the Panel's rejection of Brazil's claims of "present" serious prejudice.[209]

148. For the reasons discussed above, the United States considers that both these claims and the measures to which they relate are outside the scope of this proceeding and has asked the Panel to make preliminary rulings to this effect. Nonetheless, without prejudice to those requests, the United States demonstrates below that Brazil's claims also fail to withstand scrutiny. Specifically, Brazil fails to substantiate its arguments in support of the claim that the effects of the elimination of the Step 2 program are "modest." These arguments are also undermined by Brazil's arguments in the original proceeding. In addition, Brazil fails to make a *prima facie* case that the marketing loan and counter-cyclical payment programs are causing serious prejudice to Brazil's interests either in the sense of "significant price suppression" under Article 6.3(c) or increased market share under Article 6.3(d) of the *SCM Agreement*. Finally, Brazil has no basis for its contingent claim of threat of serious prejudice.

## A. BRAZIL FAILS TO SUBSTANTIATE ITS ARGUMENTS THAT THE EFFECTS OF ELIMINATING THE STEP 2 PROGRAM ARE "RELATIVELY MODEST"

149. Brazil claims that the elimination of the Step 2 program is insufficient to meet the U.S. obligation "to remove the adverse effects [of]"[210] the subsidy found to cause serious prejudice in the original proceeding. However, the arguments that Brazil presents in support of this claim are

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[208] Brazil First Written Submission, para. 54.

[209] The United States also notes that Brazil purports to make two claims regarding U.S. compliance in the period September 22, 2005 to August 1, 2006. *See* Brazil First Written Submission, paras. 39-46 and 315-332. For the reasons discussed above in Section IV, the United States considers that those claims are not properly before the Panel. Accordingly, the United States does not address them here.

[210] *Upland Cotton (Panel)*, para. 8.3(d).

flawed and undermined by Brazil's arguments in the original proceeding.

### 1. Operation of the Step 2 Program and the Challenges Brazil Raised In the Original Proceeding

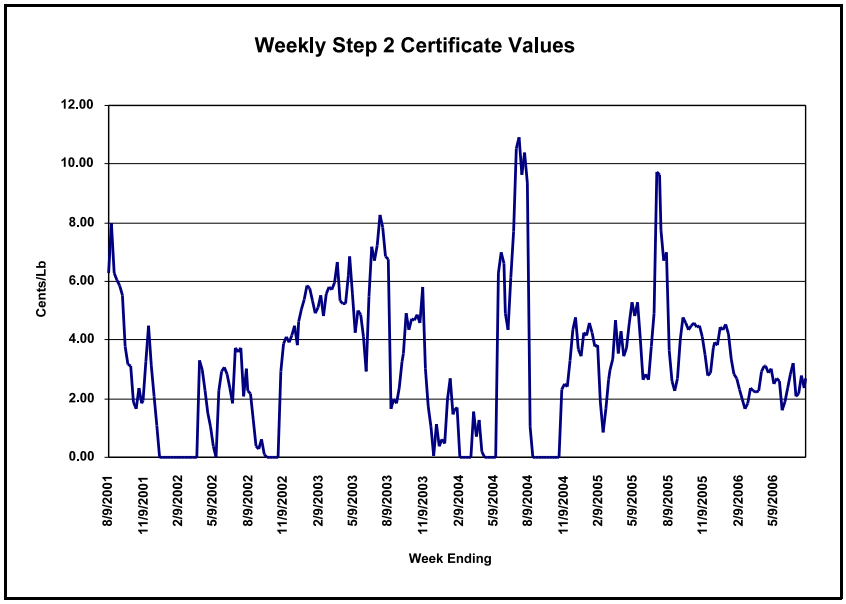
150. Before addressing Brazil's arguments about the effects of eliminating the Step 2 program, the United States reviews briefly how that program operated prior to its elimination in August 2006. As context, the United States also reviews the claims and arguments that Brazil made in the underlying proceeding against the Step 2 program and payments thereunder, as well as the resolution of those claims by the original panel.

151. ***Operation of the Step 2 Program:*** Under the FSRI Act of 2002, the U.S. Secretary of Agriculture ("Secretary") issued Step 2 payments for documented purchases by domestic users of upland cotton produced in the United States and sales for export of such U.S. cotton by exporters. Step 2 payments were available when U.S. prices for upland cotton were high relative to the prices of foreign cotton. More precisely, payments were made in any week following a consecutive four-week period when the lowest price quotation for United States cotton delivered to Northern Europe exceeded the Northern Europe price quotation, and the adjusted world price did not exceed 130 percent of the marketing loan rate for upland cotton.[211] Payments would be made in certificates or cash to domestic users or exporters at a rate per pound equal to the difference between the two price quotations during the fourth week of the period.[212]

152. The weekly Step 2 rates for the last five years are shown in the chart below.

[211] Under this calculation, the payments would have been eliminated if the adjusted world price was above 69.68 cents/lb, but this did not happen in any period during which the FSRI Act was in effect.

[212] *See* Section 1207 of the 2002 Farm Security and Rural Investment Act (Exhibit BRA-29).




Source: Farm Service Agency, USDA

153. ***Review of Brazil's Challenges Against the Step 2 Program and Payments:*** Brazil made a total of 21 separate claims against the Step 2 program and payments in the original proceeding (the most claims made against any of the challenged measures). Specifically, Brazil claimed that:

(a) the Step 2 program was WTO-inconsistent, as such, because it mandated export-contingent payments in breach of the prohibition on export subsidies in Article 3.1(a) of the *SCM Agreement*;[213]

(b) the Step 2 program was, as such, inconsistent with Article 3.1(b) of the *SCM Agreement* because it mandated payments contingent on the use of U.S. cotton in breach of the prohibition on import substitution subsidies;[214]

(c) the Step 2 program mandated payments to exporters that were provided in breach of the export subsidy provisions in Article 9.1 of the *Agreement on Agriculture*;[215]

(d) the Step 2 program mandated payments to domestic users in breach of Article III:4 of the *GATT 1994*;[216]

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[213] *Upland Cotton (Panel)*, para. 3.1(ii).

[214] *Upland Cotton (Panel)*, para. 3.1(v).

[215] *Upland Cotton (Panel)*, para. 3.1(ii).

[216] *Upland Cotton (Panel)*, para. 3.1(v).

(e) Step 2 payments and payments under other programs provided during 1999-2002, *individually* and collectively, "have caused, cause and continue to cause 'serious prejudice' to Brazil's interests" by:

(I) significantly suppressing upland cotton prices in the United States, world and Brazilian markets in violation of Articles 5(c) and 6.3(c) of the *SCM Agreement*;

(ii) increasing the United States share of the upland cotton world market in violation of Articles 5(c) and 6.3(d) of the *SCM Agreement*; and

(iii) resulting in the United States having more than an equitable share of world export trade in violation of Articles XVI:1 and XVI:3 of the GATT 1994;[217]

(f) Step 2 payments and payments under other programs provided during 2003-2007, *individually* and collectively, "threaten to cause serious prejudice" to Brazil's interests as follows:

(I) threat of significantly suppressing upland cotton prices in the United States, world and Brazilian markets in violation of Articles 5(c) and 6.3(c) of the SCM Agreement;

(ii) threat of increasing the United States share of the upland cotton world market in violation of Article s 5(c) and 6.3(d) of the SCM Agreement; and

(iii) threat of the United States continuing to have more than an equitable share of world export trade in violation of Articles XVI:1 and XVI:3 of the GATT;[218] and

(g) the Step 2 program (and others, individually and collectively), as such, breached Articles 5(c) and 6.3(c) and (d) of the *SCM Agreement* and Articles XVI:1 and XVI:3 of the *GATT 1994* for the period MY 2002-2007 as they "necessarily threaten to cause serious prejudice where market conditions require their joint payment. In addition, they cause threat of serious prejudice even when market conditions are such that only crop insurance and direct payments are made."[219]

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[217] *Upland Cotton (Panel)*, para. 7.1108.

[218] *Upland Cotton (Panel)*, para. 7.1478.

[219] *Upland Cotton (Panel)*, para. 7.1507.

154. ***Resolution of Brazil's Claims Against the Step 2 Program and Payments In the Original Proceeding:*** The panel in the original proceeding agreed with Brazil on all but one of the prohibited subsidy claims against the Step 2 program as well as on the claim under the *Agreement on Agriculture*.[220] With respect to the actionable subsidy claims made by Brazil, the panel agreed that the effect of Step 2 payments made in 1999-2002, when considered together with the effect of marketing loan payments and market loss assistance (1999-2001) or counter-cyclical (2002) payments in the same period, was "significant price suppression in the same world market within the meaning of Article 6.3(c) of the SCM Agreement constituting serious prejudice to the interests of Brazil within the meaning of Article 5(c) of the SCM Agreement."[221] The panel either declined to address or rejected Brazil's 15 other actionable subsidy claims in respect of Step 2 payments and the Step 2 program.

155. In connection with the prohibited subsidy findings against the Step 2 program, the panel recommended that the United States withdraw the subsidy pursuant to Article 4.7 of the *SCM Agreement*.[222] The Panel also recommended that the United States either "take appropriate steps to remove the adverse effects or ... withdraw the subsidy" found to be causing serious prejudice (i.e., the package of payments made in 1999-2002 under the Step 2, marketing loan, and market loss assistance or counter-cyclical payment programs).[223]

156. To implement the DSB's recommendations and rulings in respect of the Step 2 program, the United States eliminated the program as of 1 August 2006.

### 2. Brazil's Arguments About the "Relatively Modest" Impact of Removal of the Step 2 Program Are Without Merit

157. This brings us to the arguments that Brazil makes in the present proceeding relating to the Step 2 program. Brazil argues that the elimination of the Step 2 program is insufficient to "remove the adverse effects [of] . . . or withdraw"[224] the subsidy found to be causing serious prejudice. Specifically, despite having considered the effects of the Step 2 program and payments to be of sufficient consequence to warrant making 21 separate claims in respect of them, Brazil now suggests that the elimination of the Step 2 program may have "relatively

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[220] The Panel exercised judicial economy in respect of Brazil's claim that the Step 2 program mandated payments to domestic users in breach of Article III:4 of the *GATT 1994*. *Upland Cotton (Panel)*, para. 7.1106.

[221] *Upland Cotton (Panel)*, para. 8.1(g)(I).

[222] *Upland Cotton (Panel)*, para. 8.3(b) and (c). Article 4.7 of the *SCM Agreement* provides that "If the measure in question is found to be a prohibited subsidy, the panel shall recommend that the subsidizing Member withdraw the subsidy without delay. In this regard, the panel shall specify in its recommendation the time-period within which the measure must be withdrawn."

[223] *Upland Cotton (Panel)*, para. 8.3(d). The Panel also recommended that the United States bring the Step 2 program into conformity with the *Agreement on Agriculture* to the extent that it mandated payments to exporters. *Upland Cotton (Panel)*, para. 8.3(b).

[224] *Upland Cotton (Panel)*, para. 8.3(d).

modest" effects on the market.[225] Indeed, Brazil goes even further and asserts that "the elimination of the Step 2 program will likely have *no impact* on the level of U.S. production or exports" and "*little positive impact* on the world price for cotton in the long term."[226] These arguments are unsubstantiated and do not square with the arguments Brazil made in the original proceeding.

### (a) Eliminating the Step 2 Program Likely Does Not Result In An Increase In the Counter-cyclical Payment Rate But Does Result In Lower Marketing Loan Payments

158. The primary basis for Brazil's argument that the effects of eliminating the Step 2 program are "relatively modest" appears to be that eliminating the program "*lower[s]* U.S. domestic price levels" and thereby "trigger[s] *larger* price-contingent counter-cyclical payments. In other words, repealing the Step 2 program may *enhance* the adverse effects caused by counter-cyclical payments."[227] Brazil suggests that such alleged "enhance[d] . . . adverse effects" would offset any positive impact on world prices of eliminating the Step 2 program.

159. Brazil does not explain, however, that at the season average farm price that is projected there *cannot* be any appreciable increase in the counter-cyclical payment rate in this current marketing year. Brazil also fails to explain that the elimination of the Step 2 program is actually likely to result in *smaller* marketing loan payments and, thus, *diminishes* any adverse effects that Brazil alleges that program is having on world market prices.

#### *(i) The Counter-cyclical Payment Rate Likely Not to Increase Appreciably As A Result of Eliminating the Step 2 Program*

160. While Brazil raises the specter of an increase in the counter-cyclical payment rate due to a drop in U.S. farm prices following elimination of the Step 2 program, Brazil does not explain that this is unlikely to happen in the current year (i.e., in the year that is relevant for Brazil's "present" serious prejudice claims). Indeed, as no counter-cyclical payment rates have yet been announced, Brazil cannot substantiate any claims relating to the "present."

161. Under the FSRI Act of 2002, counter-cyclical payments are calculated based on the difference between a 72.4 cent/lb "Target Price" and an "Effective Price" as follows:[228]

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[225] Brazil First Written Submission, paras. 202-205.

[226] Brazil First Written Submission, para. 206 (quoting Brazil First Submission, Annex II, paras. 41-43).

[227] Brazil First Written Submission, para. 197.

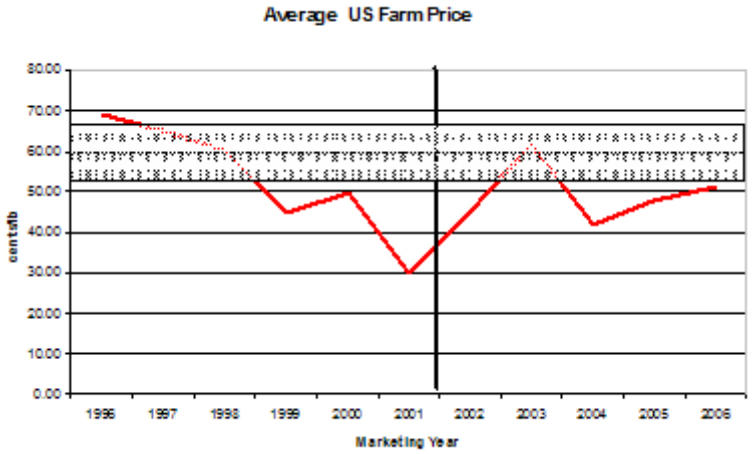
[228] Section 1104, Farm Security and Rural Investment Act of 2002 (BRA-29).

CCP = payment rate * 85% of base acres * payment yield

payment rate = Target Price – Effective Price
= $0.724 - (Direct Payment rate + higher of marketing loan rate or season average farm price)
= $0.724 - ($0.0667 + higher of $0.52 or season average farm price)
= $0.6573 - (higher of $0.52 or season average farm price)

162. According to this formula, the season average farm price is part of the base used to determine counter-cyclical payments only if the average farm price is above the marketing loan rate (52 cents/lb). Thus, if U.S. prices are *below* the marketing loan rate, the elimination of the Step 2 program – and any consequent decline in farm prices[229] – cannot have *any* effect on the level of counter-cyclical payments; the counter-cyclical payment rate remains fixed at the maximum level of 13.73 cents/lb. At the same time, the counter-cyclical payment rate is zero if the season average farm price is *above* 65.73 cents/lb. Therefore, if, after elimination of the Step 2 program, farm prices are above 65.73 cents/lb, elimination of the program *also* will have no effect on counter-cyclical payments.

163. The window between these two thresholds is shown as the shaded rectangle in the graph below, which shows current and past season average farm prices. Elimination of the Step 2 program can only have an effect on the level of counter-cyclical payments if it results in the season average farm price being pushed down within this window.




[229] The panel in the original proceeding explained that the Step 2 payments made in 1999-2002 "contribute[d] to artificially higher prices for United States upland cotton in the way of eliminating any positive difference between United States internal prices and international prices of upland cotton" and, thus, "tend[ed] to enhance the demand for United States upland cotton and raise the price received by upland cotton producers." *Upland Cotton (Panel)*, para. 7.1298-99. Consistent with that, one of the effects of *eliminating* the Step 2 program would be a *drop* in the prices received by U.S. cotton producers.

Source: USDA, Agricultural Marketing Service[230]

164. As shown above, the actual season average farm price has only been in the relevant price window for three of the last ten years.[231] Indeed, since MY 2003, the average farm price has been below the lower 52 cents/lb threshold. Under those conditions, there would be no effect on the counter-cyclical payment rate if farm prices were to decline; the rate would remain at 13.73 cents/lb.

165. According to FAPRI projections – specifically, the July update to FAPRI's 2006 baseline upon which Brazil's economist relies for his own modeling[232] – the season average farm price will similarly be below the 52 cents/lb threshold in this marketing year.[233] As the 2006 FAPRI baseline already accounts for the elimination of the Step 2 program, it is necessary to adjust the price projections to account for the possibility that farm prices might have been higher if the Step 2 program were still in place. This adjustment can be made using the FAPRI estimates of the annual impact on U.S. farm prices of eliminating the Step 2 program, to which Brazil itself cites.[234]

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[230] Compiled Statistics (Exhibit US-25).

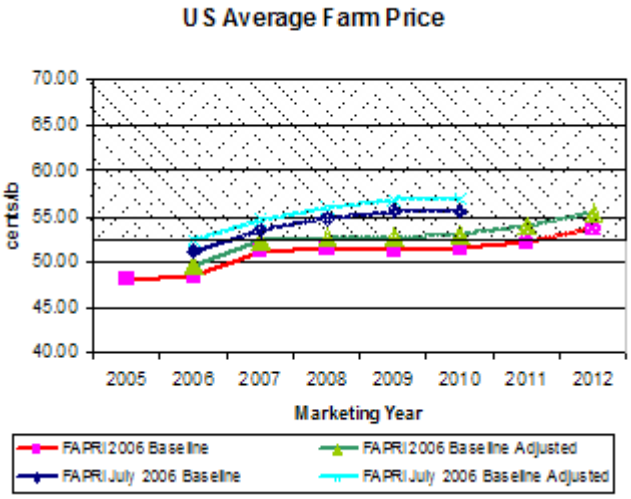
[231] The United States notes the misleading discussion of this historical season average farm price data in Brazil's first written submission. Specifically, referring to the period covered by the chart above, Brazil observes – selectively – that "in each of the last nine marketing years, the average U.S. farm price has been below the counter-cyclical payment trigger price [(i.e., 65.73 cents/lb)]." According to Brazil, "[i]t is, therefore, unlikely that domestic prices will rise to the level where counter-cyclical payments will *not* compensate U.S. producers for a fall in domestic prices following the withdrawal of the Step 2 program." Brazil First Written Submission, para. 199 (emphasis in original). Brazil does not clarify that in *most* of this period – including the most recent marketing years – the season average farm price was *also* below the lower threshold (i.e., 52 cents/lb) and therefore would also not have been affected by any drop in U.S. farm prices. To the extent any conclusion can be drawn about likely prices on the basis of the pricing data for "each of the last nine marketing years," the proper conclusion is not the one drawn by Brazil. Rather, the historical data would suggest that "[i]t is . . . unlikely that domestic prices will rise to the level where counter-cyclical payments *will* compensate U.S. producers for a fall in domestic prices following the withdrawal of the Step 2 program."

[232] Brazil First Written Submission, Annex I at 42 ("For 2007, and 2008 I used FAPRI projected prices. . . .") and 48 ("For marketing years 2007 and 2008, I use the price projections for those years released in the July 2006 Update of the FAPRI Agricultural Outlook.")

[233] FAPRI July 2006 Baseline Update for U.S. Agricultural Markets, at 6 (Exhibit BRA-479). The United States also shows the projections from FAPRI's earlier "full" 2006 baseline because FAPRI warns that the July update is much more limited than the original baseline and should be used with some caution. *See* FAPRI July 2006 Baseline Update for U.S. Agricultural Markets, at 1 (Exhibit BRA-479).

[234] Brazil First Written Submission, para. 203. Brazil asserts that "researchers at the University of Missouri . . . using the FAPRI model . . . predict that that [sic] withdrawal of Step 2 payments would *decrease* the U.S. farm price by an average of 1.2 cent per pound, or about 3 percent." In fact, the "researchers at the University of Missouri" found an average decrease of 1.26 cents/lb. The United States has used the actual annual FAPRI impact estimates – which are higher than the "average of 1.2 cent per pound" asserted by Brazil – in adjusting the 2006 baseline prices.

166. Both the season average farm prices projected by FAPRI and the adjusted average farm price projections are shown in the chart below. As shown, the projected average farm price for MY 2006 – even as adjusted to reflect the higher U.S. prices that might likely have prevailed if the Step 2 program were still in effect – is only a fraction of a cent higher than the threshold. This is the extent of the effect that a season average farm price resulting from elimination of the Step 2 program could have on the counter-cyclical payment rate in the current marketing year.




Source: FAPRI Baselines[235]

167. The evidence that Brazil submits is consistent with this analysis. Specifically, Brazil cites to two cost evaluations of the reconciliation legislation that included repeal of the Step 2 program,[236] one prepared by the U.S. Congressional Budget Office ("CBO")[237] and the other prepared by FAPRI.[238] While both evaluations conclude that elimination of the Step 2 program could result in higher government outlays under the counter-cyclical payment program, they do not specify when such an increase might occur; certainly, neither evaluation suggests that such an increase will occur in the current marketing year. In fact, the CBO projections are of *total* possible government outlays *over the next decade* (*i.e.,* FY 2006-1015) and FAPRI estimates are for the whole period FY 2006-2010.

168. It is important to note, in this regard, not just the timing but also the magnitude of any

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[235] FAPRI 2006 Baseline (Exhibit US-26); FAPRI July 2006 Baseline Update for U.S. Agricultural Markets (Exhibit BRA-479); FAPRI, "Impacts of Commodity and Conservation Reserve Program Provisions in House and Senate Reconciliation Bills," FAPRI-UMC Report #15-05, December 2005 (Exhibit BRA-484).

[236] Brazil First Written Submission, paras. 201-04.

[237] Brazil First Written Submission, paras. 201-03.

[238] Brazil First Written Submission, para. 203.

possible future increase in the counter-cyclical rate and in particular the limited extent to which any increase in counter-cyclical payments could "offset" price declines as a result of the elimination of the Step 2 program. A cent decrease in the farm price is felt on every pound of cotton produced on each acre planted to cotton. In MY 2003 to MY 2005, the average yield was 819 lbs/acre.[239] By contrast, the effect of a one cent increase in the counter-cyclical payment rate is much more diffuse. Counter-cyclical payments are only paid in respect of historical yields, which were only 638 lbs/acre on average between MY 2003 and 2005. Moreover, payments are made only on 85 percent of base acres. Thus, a one cent decrease in the farm price could only be offset by a 0.66 cent increase in the CCP rate.[240]

169. FAPRI projects that the approximately 1.4 cents/lb change in the season average farm price resulting from the elimination of the Step 2 program would translate into a US$2.30/acre increase in the counter-cyclical payment rate over the course of MY 2006 to 2010. At the same time, as discussed below, FAPRI projects a US$2.25/acre *decrease* in the marketing loan as a result of eliminating the Step 2 program. These changes almost perfectly cancel each other out. By contrast, FAPRI projects that the elimination of the Step 2 program decreases *market returns* by almost US$9.00/acre.

170. In short, Brazil has not shown that there is any "present" increase in counter-cyclical payments as a result of elimination of the Step 2 program. Moreover, even in future years, any possible increase is likely to be small and less than the price effect of the elimination of the step 2 program, especially when one takes into account the likely concurrent *decrease* in marketing loan payments. The United States turns to that issue next.

#### *(ii) Elimination of the Step 2 Program Likely Results In Lower Marketing Loan Payments Even in the Current Marketing Year*

171. While Brazil asserts the possibility of higher counter-cyclical payments as a result of eliminating the Step 2 program, and even though the effect on marketing loan payments is addressed in *each* of three studies that Brazil cites, Brazil fails to mention that eliminating the Step 2 program will likely result in *lower* marketing loan payments.[241]

172. The marketing loan program makes loans available to producers after harvest to prevent market disruption caused by many producers selling immediately after harvest, when prices are

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[239] U.S. Production, Supply and Distribution (Exhibit US-27).

[240] 85% of base acres * actual yield/payment yield (638 lb/819lb) = 0.66.

[241] Brazil cites to the following three studies in its discussion of the effects of eliminating the Step 2 program – (a) the December 2005 FAPRI study entitled "Impacts of Commodity and Conservation Reserve Program Provisions in House and Senate Reconciliation Bills;" (b) the 19 October 2005 CBO cost estimate of the Agricultural Reconciliation Act of 2005 (as approved by the Senate Committee on Agriculture, Nutrition, and Forestry); and (c) the May-June 2005 ICAC paper entitled "Cotton: Review of the World Situation." *See* Brazil First Written Submission, paras. 191-209.

typically lowest, for cash-flow reasons. Loans are made at a rate fixed by statute and are nonrecourse, such that if prices fall below the loan rate the producer may simply forfeit the crop or repay the loan at lower price (which is called the "Adjusted World Price" or "AWP"). The difference between the loan rate and the AWP is referred to as a "marketing loan gain." Alternatively, a producer may forego the loan and choose to receive a "loan deficiency payment" in the amount of the difference between the loan rate and a lower AWP. "Marketing loan gains" and "loan deficiency payments" are collectively referred to herein as "marketing loan payments."

173. An increase in world market prices will result in a corresponding increase in the AWP, which is calculated on the basis of the former. As marketing loan payments are equal to the difference between the marketing loan rate and the AWP, the effect of a *rise* in world market prices – and thus a consequent rise in the AWP – will be a corresponding *decline* in the amount of marketing loan payments.

174. The FAPRI study that Brazil cites projects an increase of approximately 0.4 cent/lb in the AWP as a result of the elimination of the Step 2 program and a corresponding US$2.25/acre decline in the amount of marketing loan payments.[242] To put this increase in the AWP in perspective, it is useful to consider that, with the AWP projected to rise to 51.4 cents/lb in MY 2007, the amount of the marketing loan payment will only be approximately 0.6 cents/lb.[243] A 0.4 cents/lb decrease in the amount of a marketing loan payment, when the total payment is only 0.6 cents/lb or less, can hardly be described as a relatively "modest" effect of eliminating the Step 2 program.

175. The CBO study to which Brazil cites also estimates that elimination of the Step 2 program will result in lower marketing loan payments.[244] While CBO projects that the resulting reduction in government outlays will only be US$17 million over the FY 2006-2015 period, that is consistent with the overall drop in estimated marketing loan outlays resulting from the projected rise of the AWP over the period.

176. Finally, Brazil cites certain research by the International Cotton Advisory Council ("ICAC") for the proposition that "the revenue guarantee represented by counter-cyclical and marketing loan payments implies that the elimination of Step 2 payments will have no significant impact on farmers' revenue from producing upland cotton."[245] Like Brazil, the basis for the ICAC's conclusion to this effect was its assumption that "direct support to U.S. farmers may

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[242] FAPRI, "Impacts of Commodity and Conservation Reserve Program Provisions in House and Senate Reconciliation Bills," FAPRI-UMC Report #15-05, December 2005 (Exhibit BRA-484).

[243] FAPRI July 2006 Baseline Update for U.S. Agricultural Markets, at 6 (Exhibit BRA-479)

[244] Congressional Budget Office Cost Estimate: Agricultural Reconciliation Act of 2005, CBO, 20 October 2005, accessed October 2006 at http://www.cbo.gov/ftpdocs/68xx/doc6830/HseAgRecon.pdf. (Exhibit BRA-482).

[245] Brazil First Written Submission, para. 204.

increase" as a result of elimination of the Step 2 program.[246] ICAC, however, considered that the increase would come from *higher* marketing loan payments.[247] In September 2006, the ICAC published a correction (which Brazil has not submitted in this proceeding), explaining that its estimate of higher marketing loan payments was "in error" and that, in fact, these payments could decline as a result of elimination of the Step 2 program:

> The Secretariat confused movements in the U.S. farm price with movements in the Adjusted World Price (AWP). Loan Deficiency Payments are calculated as the difference each week between the loan rate and the AWP, not the difference between the loan rate and U.S. farm prices. Since the AWP is based on quotes published in Cotton Outlook for cotton from many origins delivered to North Europe adjusted for transportation costs and quality differences, changes in U.S. farm prices are only indirectly linked to changes in the AWP. In fact, *it is possible that as a result of the elimination of Step 2, the AWP could rise even as U.S. farm prices fall, resulting in smaller Loan Deficiency Payments to U.S. growers*. [The earlier Memorandum] incorrectly indicated that the elimination of Step 2 will automatically result in increased payments from other components of the U.S. farm program.[248]

177. The ICAC's corrected analysis is consistent with that of the CBO and FAPRI regarding the impact that elimination of the Step 2 program will likely have in reducing marketing loan payments. Brazil errs by failing to account for this effect in its analysis.

178. In sum, Brazil cannot invoke an increase in the counter-cyclical payments rate to support its argument that the impact of eliminating the Step 2 program is "relatively modest." Brazil has offered no evidence of such an increase in the current marketing year and the evidence indicating that there may be such an increase in future years shows that any increase would be small. In addition, Brazil fails to take into account that the elimination of the Step 2 program *is* projected to cause a decline – including in the current marketing year – in the amount of marketing loan payments. Thus, rather than "*enhanc[ing]* the adverse effects caused by counter-cyclical payments,"[249] as Brazil alleges, elimination of the Step 2 program is likely to *minimize* any adverse effects that Brazil claims are being caused by the marketing loan program. Any positive effect of reducing the amount of marketing loan payments, in turn, further amplifies the impact on the market of eliminating the Step 2 program.

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[246] "Cotton: Review of World Situation," ICAC, May-June 2006 (Exhibit BRA-485).

[247] International Cotton Advisory Commission, "Correction to Memorandum 805: Impact of the Elimination of Step 2 Payments" (28 September 2006) (Exhibit US-28); International Cotton Advisory Commission "Impact of the Elimination of Step 2 Payments" Memorandum 805 (13 July 2006) (Exhibit US-28).

[248] International Cotton Advisory Commission, "Correction to Memorandum 805: Impact of the Elimination of Step 2 Payments" (28 September 2006) (Exhibit US-28).

[249] Brazil First Written Submission, para. 197.

### (b) Brazil's Efforts to Demonstrate the "Modest" Effects on the Market of Eliminating the Step 2 Program Are Undermined By Its Own Arguments In the Original Panel Proceeding

179. While professing to continue to view the Step 2 program as having significant price suppressive effects "in and of itself," Brazil attempts to introduce evidence to demonstrate the opposite. Brazil cannot have it both ways.

180. Notably, in the thousands of pages that Brazil submitted in the original proceeding, Brazil neither argued nor submitted any evidence to suggest – as it does now – that "elimination of the Step-2 program will likely have *no impact* on the level of U.S. production and export,"[250] that there is "no statistical correlation between weekly Step 2 payments and export shipments,"[251] or that "Step-2 elimination will have *little positive impact* on the world price for cotton in the long-term."[252] To the contrary, Brazil argued unequivocally *against* such an assessment of the effects of the Step 2 program. And, in fact, the panel in the original proceeding made key factual findings in consideration of those arguments; including that Step 2 payments "*stimulate production* and *exports* and result in *lower world market prices* than would prevail in their absence."[253] The findings in the original proceeding formed the basis for the compliance by the United States with the DSB recommendations and rulings. Furthermore, not only is the United States entitled to rely on those findings as guidance for its implementation, but those findings are taken as a given for purposes of this Article 21.5 proceeding. Brazil cannot now declare those findings of the original panel to be wrong or of no effect.

181. First, Brazil states that "[b]ecause the United States has claimed that elimination of Step 2 constitutes sufficient implementation of the adverse effects-related recommendations and rulings of the DSB, Brazil demonstrates the much larger size of the marketing loan and counter-cyclical payments compared to the much smaller Step 2 payments."[254] Brazil fails, however, to explain how such a "demonstration" of the relative *size* of payments – which Brazil appears to measure in terms of government outlays – responds to a claim regarding the *effect* of eliminating the Step 2 program. The United States recalls, in this regard, that Brazil had argued against even *quantifying* the challenged payments in the original proceeding.[255] Rather, notwithstanding the different sizes of the payments, Brazil argued that it was appropriate to characterize each of them generically as "very large."[256] Brazil has not explained why it takes a different approach here.

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[250] Brazil First Written Submission, para. 206.

[251] Brazil First Written Submission, para. 204.

[252] Brazil First Written Submission, para. 206.

[253] *Upland Cotton (Panel)*, para. 7.1299 (emphasis added).

[254] Brazil First Written Submission, para. 53. *See also* Brazil First Written Submission, paras. 112 and 119.

[255] *Upland Cotton (AB)*, para. 98.

[256] Brazil Appellee Submission, para. 464.

182. Indeed, the reasoning that Brazil provided for its earlier position would seem to be equally valid here. Specifically, Brazil explained that:

> [A] serious prejudice analysis by a WTO panel calls 'for a qualitative and, to some extent, quantitative analysis of the existence and nature of the subsidy and the serious prejudice caused.' Its focus is on the 'effects' of the subsidies, *not their magnitude, amount or value*."[257]

183. As an example, Brazil pointed to the panel's rejection of Brazil's serious prejudice claims against the production flexibility contract ("PFC"), direct payment ("DP"), and crop insurance subsidies in the original proceeding on the basis that Brazil had not "established that the significant price suppression . . . found [to exist] was 'the effect of' these non-price-contingent subsidies within the meaning of Article 6.3(c)."[258] As Brazil explained, "the [original] Panel's analysis demonstrates that even billions of dollars in particular types of subsidies provided to upland cotton producers (such as PFC, DP and crop insurance subsidies) may not be sufficient to cause a particular type of serious prejudice."[259] Clearly then, under Brazil's own analysis, a "demonstration" of the size of Step 2 payments relative to marketing loan payments and counter-cyclical payments is not a sufficient basis to allege that the effects of the elimination of the Step 2 program are "modest."[260]

184. Brazil also asserts that "repeal of the Step 2 program will have, at most, a modest downward impact on U.S. upland producers' revenue and, consequently, production."[261] However, according to Brazil's earlier arguments, impacts on "revenue and, consequently, production," are only one way in which, in Brazil's view, Step 2 payments could have affected world market prices:

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[257] Brazil Appellee Submission, para. 458.

[258] *Upland Cotton (Panel)*, para. 7.1350.

[259] Brazil Appellee Submission, para. 493.

[260] Brazil has recognized this before. Although Step 2 payments were smaller than counter-cyclical payment (or market loss assistance payments) and marketing loan payments even in period examined in the original proceeding (MY 1999-2002) – on average "only 13.7 percent of the magnitude of the three price-contingent subsidies," according to Brazil – Brazil's economist ascribed to them a price effect substantially greater than their relative size would suggest. Brazil First Written Submission, para. 112. Of the five subsidies against which Brazil made claims of significant price suppression, next to marketing loans, Step 2 payments were claimed to have the greatest effect on prices. *See e.g., Upland Cotton (Panel)*, para. 7.1205, n. 1327. Brazil's economist predicted that Step 2 payments would have even larger relative impacts in the out years (MY 2003-2007). For MY 2006, for example, Brazil's economist predicted that Step 2 payments would have a larger impact on world prices than either counter-cyclical payment or marketing loan payments. In MY 2007, Step 2 payments were expected to account for almost half of the alleged price impact.

[261] Brazil First Written Submission, para. 202. To the extent that this argument assumes a higher counter-cyclical payment rate as a result of eliminating the Step 2 program, the United States notes again that Brazil has offered no evidence that such offsets will occur in the current marketing year or that such offsets will not be minimal.

> The United States . . . asserts that "world prices are relatively unaffected" by the *production effects* of the Step 2 program. Again, the United States is wrong. The United States completely ignores the effects on world prices from the *export-enhancing nature* of the Step 2 program, which it does not dispute. Additionally, the United States overlooks that a removal of the Step 2 program would reduce *expected producer prices*, and would reduce U.S. production, which, in turn, would lead to higher world market prices. Professor Sumner analyzed this effect thoroughly.[262]

185. In this proceeding, however, Brazil appears to give short shrift to those other factors. In fact, Brazil now introduces evidence to suggest that the Step 2 program may not have had an "export-enhancing nature" after all. Specifically, Brazil presents an ICAC assessment that there is "no statistical correlation between weekly Step 2 payments and export shipments."[263] Moreover, Brazil cites the statement of its market expert, Andrew MacDonald, who now indicates that "the elimination of the Step-2 program will likely have *no impact* on the level of U.S. production or exports."[264] These assertions cannot be reconciled with Brazil's unequivocal arguments in the original proceeding, for example, that:

- "Step 2 export payments directly stimulate U.S. exports and permit U.S. exporters to export high-cost U.S. upland cotton with the effect of suppressing A-Index prices."[265]

- "[T]he express aim of the U.S. Step 2 program is to enhance the competitiveness of U.S. upland cotton. Numerous market reports confirm the actual effects of the program in enhancing U.S. upland cotton exports and discouraging imports of upland cotton into the United States. . . ."[266]

- "Had significant volumes of U.S. upland cotton not received Step 2 export payments, U.S. exports and, thus, the amount of U.S. upland cotton competing with Brazilian cottons would have been lower."[267]

- "Professor Sumner's Step 2 analysis is . . . completely consistent with the overwhelming evidence that Step 2 export and domestic subsidies have

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[262] Brazil Appellee Submission, paras. 743-44.

[263] Brazil First Written Submission, para. 204.

[264] Brazil First Written Submission, para. 206 (emphasis added).

[265] Brazil Further Submission, para. 17.

[266] Brazil Appellee Submission, para. 771.

[267] Answers of Brazil to Questions from the Panel After 2nd Meeting, para. 132 (22 December 2003).

significant production, *export*, and world price effects."[268]

186. Indeed, the United States recalls that, in the context of Brazil's claims that the Step 2 program mandated export-contingent payments in breach of Article 9.1 of the *Agreement on Agriculture* and Articles 3.1(a) and 3.2 of the *SCM Agreement*, Brazil urged the panel to reject U.S. arguments that the Step 2 program simply provided support to U.S. upland cotton farmers, not an incentive to export.[269] Brazil argued that "it is difficult to imagine how a subsidy could be *more* of an export subsidy than the Step 2 export provisions. . . .[The program] plays an important role in stimulating and maintaining the present record high U.S. upland cotton world export market share. . . ."[270] Under Brazil's analysis in the original proceeding, Brazil cannot credibly suggest that elimination of the Step 2 program has "modest" or "no" effects on exports.

187. Finally, Brazil also cites to the assessment of Andrew MacDonald, Brazil's expert in "trade in cotton in the world market," as saying that "today international cotton prices *could* be somewhat higher in the absence of Step-2" but "Step-2 elimination will have *little positive impact* on the world price for cotton in the long-term."[271] Leaving aside the question of the relevance of "long-term" effects to Brazil's claim that eliminating the Step 2 program is insufficient to remove the alleged *present* serious prejudice, Mr. MacDonald's equivocation regarding the impact of the Step 2 program on prices contrasts with the unequivocal assessment he provided for purposes of the original proceeding. There, Mr. MacDonald explained that "[as a result of the Step 2 program] U.S. cotton can always be offered at a price that is lower than the offers of most producers in the world."[272] In view of this, Mr. MacDonald identified the Step 2 program as one of only three factors – the other two being the relative size of U.S. production and exports and the transparency of the U.S. market – that allegedly "enable[d] the United States to act as the 'driver' of world prices."[273]

188. While Mr. MacDonald's statement for purposes of this proceeding retains an almost identical discussion of the other two factors, there is no mention of the key role that Mr. MacDonald once attributed to the Step 2 program in the U.S. ability to "drive" world market prices. Rather, now, Mr. MacDonald finds it "difficult to assess" whether world market prices

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[268] Brazil's Comments on U.S. Model Critique, para. 9 (20 January 2004).

[269] *See e.g.,* Brazil's Rebuttal Submission to the Panel Regarding the "Peace Clause" and Non-Peace Clause Related Claims," paras. 123-128 (22 August 2003).

[270] Brazil's Rebuttal Submission to the Panel Regarding the "Peace Clause" and Non-Peace Clause Related Claims," para. 128 (22 August 2003) (emphasis in original).

[271] Brazil First Written Submission, para. 206 and Annex II, paras. 41-42 (emphasis added). Indeed, the relevance of this assertion about what may or may not happen to the world market price for cotton "in the long-term." is not even clear given that Brazil cites it in the context of its *present* significant price suppression claim .

[272] Brazil First Written Submission, Annex II, para. 31.

[273] Brazil First Written Submission, Annex II, para. 31. For purposes of comparison, the United States submits Mr. MacDonald's earlier statement together with his new statement in Exhibit US-29.

have even being affected by the elimination of the Step 2 program.

189. These arguments are simply not credible when compared to the arguments that Brazil made in the original proceeding.

### (c) Data From August-October 2006 Do Not Support Brazil's Claim that Elimination of the Step 2 Program Has Had "Modest" Effects

190. Brazil also points to USDA estimates that planted area went up 7 percent in the spring of MY 2006 in support of its argument that elimination of the Step 2 program has had "relatively modest" effects.[274] According to Brazil, "the knowledge that Step 2 payments would be repealed from 1 August 2006 onward does not appear to have had any significant impact on upland cotton plantings."[275]

191. First, it is unclear how Brazil can draw such a conclusion simply based on the estimated increase in planted acreage. Even if one were to accept, *arguendo*, that U.S. producers somehow "knew" ahead of time that the U.S. Congress would pass the reconciliation bill,[276] the effect of this knowledge on planting cannot be known unless there is evidence of what cotton plantings might have been in the spring of MY 2006 had producers *not* had the knowledge Brazil attributes to them. Brazil fails either to supply such evidence or to explain why it is appropriate to assume that planted acreage would not have increased even *more* than 7 percent in the latter situation.

192. Second, under Brazil's analysis, this consideration of production effects is not sufficient to understand the effects of the elimination of the Step 2 program on world market prices. In Brazil's words, this "completely ignores the effects on world prices from the *export-enhancing nature* of the Step 2 program. . . ."[277] Brazil's analysis would suggest, therefore, that it is important to consider also what has happened to U.S. exports since elimination of the Step 2 program.

193. In that regard, the United States notes that, despite entering MY 2006 with more than 6 million bales of cotton stocks and a harvest progress that was ahead of the normal pace, current exports of U.S. cotton are sharply below recent levels. For example:

- U.S. exports for MY 2006 are only half the level observed at the same time last year.[278]

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[274] Brazil First Written Submission, paras. 205, 208.

[275] Brazil First Written Submission, para. 208.

[276] This would have taken some amount of clairvoyance, given that the legislation passed by only one vote in both the U.S. House and Senate.

[277] Brazil Appellee Submission, para. 744.

[278] Weekly Export Performance Report (Exhibit US-30).

- Total U.S. export commitments – both sales and shipments – are currently approximately 46% below last year's level and 34% below the 5-year average.[279]

- To date, current export commitments represent only 24% of total exports projected for MY 2006. Normally, export commitments at this time of year, exceed 40% of total projected exports.[280]

- The U.S. share of world exports is projected to fall to 37% in MY 2006, down from 41% in MY 2004 and 43% in MY 2005.[281]

194. There is a "temporal coincidence" between these developments in U.S. exports and the elimination of the Step 2 program. Yet, Brazil has not accounted for them. Nor has Brazil addressed the most recent price trends, which show that world market prices are higher now than year-ago levels, while U.S. prices – as reflected by the New York futures market – are running well below those levels.

195. In short, to the extent that it is even possible to draw conclusions from the data available for the first three months of MY 2006, the data do not appear to support Brazil's conclusion that elimination of the Step 2 program has had "relatively modest" effects on production, exports, and world prices.

## B. BRAZIL DOES NOT DEMONSTRATE THAT THE MARKETING LOAN OR COUNTER-CYCLICAL PAYMENT PROGRAMS MANDATE A BREACH

196. Brazil appears to be challenging, as such, the U.S. marketing loan and counter-cyclical payment "programs,"[282] which the United States understands to be the "legal/regulatory provisions" for the grant or maintenance of the subsidies. As Brazil has recognized both in this dispute and others,[283] "[i]t is established under WTO law that a Member can only challenge measures of another Member *per se* if such measures mandate a violation of the WTO Agreement."[284] This is an articulation of the mandatory/discretionary distinction, which has been

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[279] Weekly Export Performance Report (Exhibit US-30).

[280] Weekly Export Performance Report (Exhibit US-30).

[281] December WASDE Estimates (Exhibit US-31).

[282] *See* Brazil First Written Submission, para. 461(B).

[283] *See e.g., Canada – Aircraft II (Panel)*, paras. 7.56-7.58 ("Given that Brazil's claims are in respect of the programmes as such, the mandatory/discretionary distinction would traditionally apply. . . .There is . . . no disagreement between the parties regarding the applicability of the mandatory/discretionary distinction.").

[284] Brazil First Submission in Original Panel Proceding, para. 244 (citing *US – 1916 Act (AB)*, para. 88).

consistently applied in GATT and WTO dispute settlement proceedings[285] and which was recognized by the panel in the original proceeding.[286]

197. While Brazil acknowledges that the mandatory/discretionary distinction applies in the case of a challenge to programs, as such, Brazil has not shown that the "legal/regulatory provisions" for the grant or maintenance of marketing loan and counter-cyclical payments mandate a breach of Articles 5(c) and 6.3(c) or 6.3(d) of the *SCM Agreement*, which are the provisions of the *SCM Agreement* under which Brazil makes its actionable subsidy claims.[287]

198. As noted above, Article 5(c) of the *SCM Agreement* provides that "[n]o Member should cause, through the use of any subsidy referred to in paragraphs 1 and 2 of Article 1, adverse effects to the interests of other Members, i.e. . . .serious prejudice to the interests of another Member." Footnote 13 to Article 5(c) clarifies that "serious prejudice" "includes threat of serious prejudice."

199. Article 6.3(c) of the *SCM Agreement* elaborates that "[s]erious prejudice in the sense of paragraph (c) of Article 5 may arise in any case where one or several of the following apply. . . the effect of the subsidy is . . . significant price suppression . . . in the same market." Article 6.3(d) provides that serious prejudice may also arise where "the effect of the subsidy is an increase in the world market share of the subsidizing Member in a particular subsidized primary product or commodity as compared to the average share it had during the previous period of three years and this increase follows a consistent trend over a period when subsidies have been granted."

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[285] *See, e.g.,* Panel Report, *United States – Measures Treating Export Restraints as Subsidies*, WT/DS194/R, adopted 23 August 2001, paras. 8.4 - 8.131 (finding that certain provisions of the U.S. countervailing duty law did not mandate action inconsistent with provisions of the SCM Agreement, and describing the mandatory/discretionary distinction as a "classical test" with longstanding historical support); and Panel Report, *United States – Anti-dumping and Countervailing Measures on Steel Plate from India*, WT/DS206/R, adopted 29 July 2002, paras. 7.88 - 7.89 (similar).

[286] *See e.g., US – Upland Cotton (Panel)*, para. 7.333 ("WTO panels have developed a relatively consistent approach to the so-called mandatory/discretionary distinction whereby a WTO Member's law as such can be challenged before a WTO panel if the law mandates WTO-inconsistent behaviour. WTO panels have generally found that a law is WTO-inconsistent if they find that it mandates WTO-inconsistent behaviour. If, on the other hand, the law provides the executive branch of a Member's government with discretionary authority to act in a WTO-consistent manner, then WTO panels have generally found that the law is not WTO-inconsistent.") The panel in the original proceeding did, however, appear to confuse the application of the mandatory/discretionary distinction with the separate question presented in the *US – Corrosion-Resistant Steel Sunset Review* dispute of whether something could be challenged as a "measure" under the WTO Agreements if it had no binding effect. *See e.g., US – Upland Cotton (Panel)*, para. 7.336 (citing to the Appellate Body's analysis in *US – Corrosion-Resistant Steel Sunset Review* as to whether the U.S. Sunset Policy Bulletin could be challenged as a 'measure' given that it did not bind the U.S. Department of Commerce in any way ).

[287] Brazil's Answers to Additional Questions Following Second Panel Meeting, para. 31-32 (20 January 2004).

200. Thus, in order to show that the marketing loan and counter-cyclical payment programs mandate a breach of Article 5(c) of the *SCM Agreement* (whether in terms of "present" or "threat" of serious prejudice), Brazil would have to show that the "legal/regulatory provisions" for the grant or maintenance of marketing loan and counter-cyclical payments mandate that the United States "cause, through the use of [marketing loan and counter-cyclical payments], adverse effects to the interests of [Brazil], i.e., . . . . serious prejudice to Brazil's interests." More specifically, Brazil would have to demonstrate that the provisions themselves mandate actions that will necessarily cause the kind of effects alleged by Brazil under Articles 6.3(c) and 6.3(d).

201. Brazil fails even to address this requirement in its first written submission, let alone make the demonstrations necessary to establish a *prima facie* case of breach against the marketing loan and counter-cyclical payment programs, as such. In fact, Brazil cannot bear this burden. Sections 1101-1108 and 1201-1205 of the FSRI Act of 2002, which provide for counter-cyclical payments and marketing loan payments, respectively, simply set out the conditions under which the two types of payments may be made.[288] As demonstrated in the original panel proceeding, in order to determine whether particular subsidies cause or threaten to cause serious prejudice it is necessary to undertake a thorough factual analysis. The effects of any subsidy will depend on a number of factors, including conditions of competition and what other factors are at play. There is no basis to believe that such payments, when and if they occur, will necessarily "cause, through the use of [marketing loan and counter-cyclical payments], adverse effects to the interests of [Brazil], i.e., . . . . serious prejudice to Brazil's interests." Any conclusion to the contrary would be purely speculative.

202. Thus, Sections 1101-1108 and Sections 1201-1205 of the FSRI Act of 2002 are not, as such, inconsistent with Articles 5(c) and 6.3(c) or 6.3(d) of the *SCM Agreement*. Brazil has provided no evidence to the contrary.

## C. BRAZIL FAILS TO MAKE A *PRIMA FACIE* CASE OF WTO-INCONSISTENCY UNDER ARTICLES 5(C) AND 6.3(C) OF THE *SCM AGREEMENT*

203. Even leaving aside Brazil's failure to provide a basis for a finding against the marketing loan and counter-cyclical payment programs, as such, Brazil fails to demonstrate that these programs do not have the effects that Brazil attributes to them. As discussed below, Brazil fails to make a *prima facie* case that "the effect" of these programs is "significant price suppression" within the meaning of Article 6.3(c) of the *SCM Agreement*.

### 1. The Structure, Design, and Operation of the Marketing Loan and Counter-cyclical Payment Programs Do Not Support Brazil's Claim of Significant Price Suppression

[288] *See* Farm Security and Rural Investment Act of 2002 (Exhibit BRA-29).

### (a) The Counter-cyclical payment program

204. Brazil asserts that "the nature" of the counter-cyclical payment program, "in terms of [its] structure, design and operation" provides evidence of a causal link between the program and the alleged present "significant price suppression."[289] In support of this, Brazil cites to the conclusion of the panel in the original proceeding that "[w]e agree with the view of the USDA economists that, due to their market-price contingency, counter-cyclical payments may influence production decisions indirectly by reducing total and per unit revenue risk associated with price variability in some situations."[290] Brazil also cites the panel's statement that "[w]e have confirmed a strong positive relationship between upland cotton (base acre) producers receiving annual payments and upland cotton production."[291]

205. Brazil does not explain, however, that at the time the original panel reviewed the counter-cyclical payment program, there was no empirical evidence regarding its operation. This is because the period examined by the panel to determine the effects of the various programs challenged by Brazil was MY 1999-2002. The FSRI Act of 2002, which authorized counter-cyclical payments for the first time, came into effect on May 13, 2002, at which time most upland cotton in the United States had either been planted or the decision to plant had been made. Thus, in the period examined there was no actual experience upon which to draw in forming conclusions about the effects of counter-cyclical payments on production. Indeed, even the USDA study on which the panel relied noted that "[t]here is no available research that provides quantitative measures of the potential impacts" of counter-cyclical payments and that, as a result, the study could provide only a "qualitative discussion of some of the[] *potential* influences."[292]

206. Since then, useful research has been conducted – for example, examining production effects in the Midwest and Northern Plains among corn, soybean and wheat producers – that

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[289] Brazil First Written Submission, para. 120.

[290] Brazil First Written Submission, para. 128 (citing *Upland Cotton (Panel)*, para. 7.1302.

[291] Brazil First Written Submission, para. 128 (citing *Upland Cotton (Panel)*, para. 7.1302.

[292] "The 2002 Farm Act: Provisions and Implications for Commodity Markets" at 14 (Paul C. Westcott, C. Edwin Young and J. Michael Price) (Exhibit BRA-42) (emphasis added). The United States notes, in this regard, that the USDA study concluded that there were no *direct* effects on production:

> *Counter-cyclical payments under the 2002 Farm Act are essentially decoupled from an individual farmer's planting decisions* since they are paid on a constant, pre-determined quantity for the farm (equal to 85 percent of a fixed acreage base times a fixed CCP payment yield) and *they are not affected by a farmer's current production*. The expected marginal revenue of a farmer's additional output is the expected market price (augmented by marketing loan benefits when prices are relatively low), *so counter-cyclical payments do not affect production directly through expected net returns*. Thus, *production decisions at the margin are based on market price signals and are not directly influenced by the counter-cyclical payments*.

"The 2002 Farm Act: Provisions and Implications for Commodity Markets" at 14 (Paul C. Westcott, C. Edwin Young and J. Michael Price) (Exhibit BRA-42) (emphasis added).

permits a more robust basis for assessment of the economic effects of counter-cyclical payments (including an updated study by Paul Westcott – one of the authors of the 2002 study relied upon by Brazil and the panel in the original proceeding). These recent studies find no evidence that counter-cyclical payments are the cause of any significant changes in plantings. In contrast, there continues to be substantial evidence showing that decoupled payments, such as counter-cyclical payments, are capitalized into land values and land rents.[293] This, and available data that show shifts in cotton acreage as recipients of counter-cyclical payments for upland cotton base acres plant alternative crops or no crops at all, and as other farmers who do not hold upland cotton base acres choose to produce upland cotton, confirm that there is no basis to ascribe production-distorting effects to counter-cyclical payments.

### *(I) Research Based on Recent Empirical Data Does Not Support Brazil's Claim That Counter-Cyclical Payments Have Significant Trade-Distorting Effects*

207. Recall that U.S. upland cotton base holders receive counter-cyclical payments based on what was historically grown on their farms. No production of any particular crop is necessary to receive the payment – hence, they are decoupled from production. The level of payment is the same regardless of whether the producer grows cotton or a competing crop such as corn, wheat, sorghum, soybeans, or rice, whether he instead grazes the land to cattle, or whether he plants no crop (placing the land in a conserving use).

208. In such circumstances, one would expect the producer to seek to maximize profits, subject to good agricultural practices, and decide which crop to plant based on expected returns offered by the market or government payments above operating (variable) costs. If the producer expects greater returns from an alternative crop such as corn or soybeans, then he will choose to plant that crop instead of cotton; if returns from cotton are expected to be greater, he will plant cotton. If there is no crop offering a positive return above variable costs, then the producer will maximize profits, or in this case minimize any losses, by not planting any crop on those acres. Decoupled payments would not figure in this decision because such payments will be paid to the producer regardless of the program crop that is planted or whether any crop is planted at all.

209. Brazil argues, however, that counter-cyclical payments distort the normal planting decision on the basis that "reduc[ed] per unit revenue risk associated with price variability" may "in some situations" indirectly influence the production decision.[294] Most economists agree, however, that *any* type of payment could, by increasing wealth, affect risk preferences and hence

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[293] For example, see Abler, David, and David Blandford. A Review Of Empirical Studies Of The Acreage And Production Response To US Production Flexibility Contract Payments Under The Fair Act And Related Payments Under Supplementary Legislation, Directorate For Food, Agriculture And Fisheries Committee For Agriculture, OECD, Paris, AGR/CA/APM(2004)21/FINAL (March 25, 2005) available at http://www.oecd.org/dataoecd/15/15/34997377.pdf. (Exhibit US-32)

[294] Brazil First Written Submission, para. 130.

production.[295] And, consistent with this, most of the available studies find that counter-cyclical payments – like direct payments (which the panel in the original proceeding found *not* to have any significant price suppressive effects) – affect farm-level risk and thus may have some effect on production.[296] So, the question must be one of degree. But that question of degree is an important one. In the *Agreement on Agriculture* Members agreed that payments may be made for domestic support yet have no or at most minimal trade-distorting effects or effects on production. Annex 2 to that agreement provides a whole list of payments that meet that criteria, despite the fact that they would affect farm-level risk and thus have some effect on production. It just would not be an effect of a degree recognized under the WTO.

210. A 2005 study by Lin and Dismukes examined possible production impacts of counter-cyclical payments, specifically through an analysis of risk and wealth effects, and found only minimal effects. The study investigated the role of risk in farmers' acreage decisions for major field crops in the North Central region by revisiting an earlier study by Chavas and Holt and testing the effects of wealth and revenue risk on supply response. The study found limited effects on supply response. While an increase in initial wealth would lead to greater crop acreage, consistent with decreasing absolute risk aversion, the resulting increase in the acreage of the crops was estimated at less than 1 percent.[297]

211. A 2005 study by Paul Westcott – an author of the 2002 study cited by the panel in the original proceeding – also concluded that the effects of counter-cyclical payments on production are likely limited. He noted also that in the case where the expected season average price is below loan rates (i.e. the counter-cyclical payment is expected to be at the maximum), counter-cyclical payments operate no differently than fixed payments (like direct payments):

> If farmers expect prices to be below loan rates (as occurred for rice and cotton in 2002/03), the CCP's are at their maximum levels and become more like "fixed" payments. Research has shown that fixed payments act like general income transfers to farm household and have only small effects on output.[298]

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[295] Hennessy, D., "The Production Effects of Agricultural Income Support Policies Under Uncertainty." *American Journal of Agricultural Economics* 80(1998):46-57 (Exhibit US-33).

[296] Young, C. Edwin, Anne Effland, Paul Westcott and Demcey Johnson. *US Agricultural Policy: Overview and Recent Analyses*. Presented at 93rd seminar of the European Association of Agricultural Economists, "Impacts of Decoupling and Cross Compliance on Agriculture in the Enlarged EU," September 22-23, 2006, Prague, Czech Republic, p. 7. (Exhibit US-40)

[297] Lin, William and Robert Dismukes, "Supply Response Under Risk: Implications for Counter-Cyclical Payments' Production Impact," Review of Agricultural Economics, forthcoming. An earlier version of the paper can be found at "Risk Considerations in Supply Response: Implications for Counter-Cyclical Payments' Production Impact," Selected Paper, American Agricultural Economics Association (July 2005) (Exhibit US-34).

[298] Paul A. Westcott, "Counter-Cyclical Payments Under the 2002 Farm Act: Production Effects Likely to be Limited" (3rd Quarter 2005) (Exhibit US-35).

The following table shows that, at the time of planting, FAPRI was projecting in every year except 2004 that the expected counter-cyclical payment rate for upland cotton would be at the maximum level. Moreover, the expected value for counter-cyclical payments was at the maximum payment rate for most of the out years (i.e. future marketing years) as well. Thus, the payments effectively operated much like fixed direct payments over this period.[299]

**Projected CCP payments at time of planting**

| FAPRI baseline | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|
| July 2002[300] | 0.137 | 0.137 | 0.137 | 0.137 | 0.137 | 0.137 | 0.124 |
| March 2003[301] | --- | 0.137 | 0.137 | 0.137 | 0.137 | 0.137 | 0.137 |
| March 2004[302] | --- | --- | 0.084 | 0.103 | 0.111 | 0.116 | 0.116 |
| March 2005[303] | --- | --- | --- | 0.137 | 0.137 | 0.137 | 0.137 |

212. The economic literature regarding counter-cyclical payments is consistent with other recent literature, discussed below, that examines the effects of decoupled payments generally. Some studies, for example, have examined the effects of decoupled payments at the farm household level. The direct effect of all decoupled payments is to raise the overall income and economic well-being of farm households. A farm household can decide to use these transfers in the farm operation or for non-farm alternatives such as consumption, savings, and nonagricultural investments. These resource allocation decisions of the household are important for determining the potential indirect effects of decoupled payments on production decisions.

213. A 2006 report by Young, Effland, Westcott and Johnson, for example, reviewed a number of studies examining the effects of decoupled payments on consumption of goods versus leisure and the trade-offs between savings and investment. The authors found little evidence that the introduction of decoupled payments encouraged additional on-farm labor or led to additional

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[299] The United States uses the FAPRI estimates here rather than December futures prices because counter-cyclical payments are based on season-average farm prices, not farm prices at the time of harvest. The FAPRI baseline provides an estimate of farm-season prices, and therefore future counter-cyclical payments, that would have been available to farmers at the time of planting.

[300] "FAPRI 2002 U.S. Baseline Briefing Book" FAPRI-UMC Technical Data Report 02-02. July 2002, p. 19 (Exhibit US-36).

[301] "FAPRI 2003 U.S. Baseline Briefing Book" FAPRI-UMC Technical Data Report 04-03, March 2003, p. 25 (Exhibit US-37).

[302] "FAPRI 2004 U.S. Baseline Briefing Book" FAPRI-UMC Technical Data Report 01-04, March 2004, p. 29 (Exhibit US-38).

[303] "FAPRI 2005 U.S. Baseline Briefing Book" FAPRI-UMC Report 02-05, March 2005, p. 29 (Exhibit US-39).

farm-level investment.[304] Similarly, a 2005 study by Goodwin and Mishra using acreage response models built from farm-level data for a sample of U.S. Corn Belt farmers found little evidence of acreage effects from decoupled payments.[305] While these studies do not relate specifically to counter-cyclical payments, they provide valuable insights about the farm-level effects of payments that are decoupled from production.

214. While Brazil purports to "update[ the] evidence and arguments that the original panel relied on,"[306] it does not discuss these studies. Instead, Brazil refers solely to two studies, both of which it cited in the original proceeding. The first is the same 2002 USDA study referred to in the original panel report, which specifically provided that "[t]here is no available research that provides quantitative measures of the potential impacts" of counter-cyclical payments and that, as a result, the study could provide only a "qualitative discussion of some of the[] *potential* influences."[307] The other is a an OECD study from the same period which notes that "[t]he impact of the 2002 Farm Act, as it is estimated in this section, *strongly depends on a number of assumptions*, most notably on *the degree of the farmer's risk aversion*, and the *settings on world markets as indicated by international commodity prices*."[308] Neither study, thus, was based on empirical evidence. Those studies are not as relevant as the new studies discussed above that are based on facts about the actual operation of the counter-cyclical program, not "assumptions" about the program or "potential" effects.

### *(ii) Significant Amounts of Decoupled Payments Are Capitalized Into Higher Land Values*

215. Not only is there little evidence that counter-cyclical payments have significant effects on production but, as the United States explained in the original proceeding, much of the increase in wealth from farm payments accrues to non-operator landlords.[309] Decoupled payments under both the counter-cyclical payment and direct payment programs are paid in respect of base acres. However, payments are made to farm *operators* rather than the *owners* of the farmland. According to available data from USDA's Agricultural Resource Management Survey, an

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[304] Young, C. Edwin, Anne Effland, Paul Westcott and Demcey Johnson. *US Agricultural Policy: Overview and Recent Analyses*. Presented at 93rd seminar of the European Association of Agricultural Economists, "Impacts of Decoupling and Cross Compliance on Agriculture in the Enlarged EU," September 22-23, 2006, Prague, Czech Republic, p. 7 (Exhibit US-40).

[305] Goodwin, B. and A. Mishra. "Another Look at Decoupling: Additional Evidence on the Production Effects of Direct Payments."*American Journal of Agricultural Economics* 87(5):1200-1210, 2005 (Exhibit US-41).

[306] Brazil First Written Submission, para. 29.

[307] "The 2002 Farm Act: Provisions and Implications for Commodity Markets" at 14 (Paul C. Westcott, C. Edwin Young and J. Michael Price) (Exhibit BRA-42) (emphasis added).

[308] "Agricultural Policies in OECD Countries," Monitoring and Evaluation 2003, Highlights at 22 (BRA-5) (emphasis added).

[309] Further Rebuttal Submission of the United States of America, para. 75 (18 November 2003).

estimated 44 percent of all farmland operated in 2003 was rented.[310] This number is even higher for commercial crop farms – i.e., crop farms in which total sales exceeded $250,000. In that case, close to 60 percent of total acres is rented by operators.[311] This has significant implications for the distribution of decoupled farm payments.

216. Where land is rented, some amount of the value of decoupled payments is transferred from operators to the owners of base acres in the form of higher rents and sales values. In the original proceeding, the United States submitted substantial research relating to the PFC program which concluded that:

> Decoupled payments clearly increase the well-being of the operators who receive them, but only when they are owners of base acres. Otherwise, land markets allow a pass-through of payments from operators to landowners, via modified rental arrangements. Despite uncertainty over future policy, land values already reflect the market's expectations about future program benefits.[312]

217. As Brazil has acknowledged, the panel in the original proceeding specifically agreed that the benefits of some of the payments – specifically, the decoupled production flexibility contract, direct, market loss assistance and counter-cyclical payments – had been "captured," by land-owners and, thus, not "passed-through," to producers.[313]

218. This is confirmed in a 2005 review of the effects of decoupled payments on land values by Abler and Blandford:

> Empirical work suggests that PFC and MLA payments had a significant effect on land values and rental rates. Given the importance of the rental market for land in the United States, it appears that there was a relatively high "pass-through" of the additional income generated by the payments to landowners, many of whom are not the actual operators of the land. It appears that the payments primarily had the effect of increasing the value of the principal fixed asset in agriculture—land.[314]

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[310] Hoppe, Robert and David Banker. "Structure and Finances of US Farms: 2005 Family Farm Report." Economic Research Service Economic Information Bulletin No.12, May 2006. (Exhibit US-67)

[311] Young, C. Edwin, Anne Effland, Paul Westcott and Demcey Johnson. *US Agricultural Policy: Overview and Recent Analyses*. Presented at 93rd seminar of the European Association of Agricultural Economists, "Impacts of Decoupling and Cross Compliance on Agriculture in the Enlarged EU," September 22-23, 2006, Prague, Czech Republic, p. 7 (Exhibit US-40).

[312] Burfisher, M. and J. Hopkins. "Farm Payments: Decoupled Payments Increase Households' Well-Being, Not Production." *Amber Waves,* Vol. 1, Issue 1, (February 2003): 38-45, at 45 (Exhibit US-42)

[313] Brazil Appellee Brief, para. 602 (citing *Upland Cotton (Panel)*, para. 7.1226).

[314] Abler, David, and David Blandford. A Review Of Empirical Studies Of The Acreage And Production Response To US Production Flexibility Contract Payments Under The Fair Act And Related Payments Under Supplementary Legislation, Directorate For Food, Agriculture And Fisheries Committee For Agriculture, OECD,

219. The recent economic literature thus not only confirms what both the United States and the panel in the original proceeding have noted about decoupled payments passing-through to non-operator landlords, but also suggests that a very substantial portion of the payments are being distributed in this way. What this indicates, in other words, is that a substantial portion of decoupled payments are being disposed of in a way that cannot have any effect on production. Thus, to the extent that counter-cyclical payments have any significant effects on production at all – and the recent empirical evidence indicates that they do not – these effects are minimized by the fact that a large part of the payments is not going to producers but rather to non-operator landlords.

### *(iii) Data Comparing Base to Planted Acreage Does Not Demonstrate That Counter-cyclical Payments Have Significant Effects on Production*

220. Finally, Brazil argues that "there is every reason to believe" that there is a "strong positive relationship" between holders of upland cotton base acres holders and upland cotton production. Brazil asserts this alleged "strong positive relationship" to support its argument that counter-cyclical payments have significant production-distortive effects. In other words, in Brazil's view, if there are producers today who were producing cotton at the time the historical base acres were fixed, this is to be understood as evidence that counter-cyclical payments *induced* the continued production of cotton. This argument is without basis.

221. There is nothing remarkable about the fact that some producers who farmed cotton in the past continue to farm cotton today, especially in the United States, where certain parts of the country – many southern States, for example – have a strong tradition of growing cotton due to such factors as favorable weather and natural endowments. It is not surprising, therefore, that there is some overlap between current and historic upland cotton production. Indeed, the United States recalls that Brazil submitted statements by Brazilian producers in the original proceeding that indicated that, even in Brazil, many cotton farmers have a long history of cotton farming and continued to farm cotton even through low-price periods.[315]

222. What is notable, however, is that the data[316] show that counter-cyclical payments do not induce recipients to continue planting cotton. For example, a significant portion of U.S. upland cotton planted acreage (over MY 2002-2005, average of about 17 percent) is on farms with

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Paris, AGR/CA/APM(2004)21/FINAL (March 25, 2005) (Exhibit US-32)

[315] *See e.g.,* Brazil Further Submission, Annex III, p. 1 ("Cotton is one of the crops that I have grown in the State of Mato Grosso since first arriving in 1986. . . The low prices during the last couple of years have forced me to cut back on production somewhat and not follow my original plans to increase the are I plant to cotton"); p.7 ("I . . . declare that I have grown cotton for over 20 years on my property. . . .In the last few years, if prices were higher, I certainly would have increased my planted area, however, unfortunately, I am unable to invest in a crop who's return is lower than others")

[316] From individual farms reporting acreage to the Farm Service Agency.

cotton planted acreage that exceeds cotton base acres, or, indeed, on farms with no cotton base acres at all.

223. Looking at farms that have upland cotton base acres (and thus may receive cotton counter-cyclical payments), the data also show that the payments do not induce recipients to continue planting. Taking the cotton base acres on each U.S. farm up to the number of acres planted to cotton on that farm, the United States calculates that for all U.S. farms the ratio of such cotton base acres to total base acres was only 60 percent in MY 2002-2005.

224. Put differently, traditional U.S. cotton farms receiving cotton counter-cyclical payments planted approximately 40 percent fewer cotton acres over MY2002-2005 than they had in the period used to calculate cotton base acres. This decline in cotton planted acres on traditional U.S. cotton farms reflects the fact that other factors, such as weather and competing crops drive planting.

**Upland cotton plantings on upland cotton base acres (1,000 acres)**

| Item | MY 2002 | MY 2003 | MY 2004 | MY 2005 |
|---|---|---|---|---|
| Number of cotton base acres up to the number of cotton planted acres: | | | | |
| on farms with fewer cotton planted acres than base acres | 5,997 | 6,092 | 6,024 | 5,646 |
| on farms with more cotton planted acres than base acres | 5,423 | 5,016 | 5,017 | 5,509 |
| Total cotton base acres up to cotton planted acres (a) | 11,420 | 11,108 | 11,041 | 11,155 |
| Total cotton base acres (b) | 18,558 | 18,784 | 18,724 | 18,521 |
| Ratio of (a) total cotton base acres up to cotton planted acres to (b) total cotton base acres | 61.5% | 59.1% | 59.0% | 60.2% |
| Planted cotton acres on farms in excess of their base acres (c) | 1,603 | 1,596 | 1,679 | 1,957 |
| Planted cotton acres on farms with no cotton base acres (d) | 519 | 408 | 492 | 690 |
| Total planted cotton acres (c) on farms in excess of their base acres and (d) on farms with no cotton base acres | 2,121 | 2,004 | 2,171 | 2,647 |
| Total planted cotton acres | 13,542 | 13,112 | 13,196 | 13,802 |
| Ratio of planted cotton acres of farms in excess of their base acres and on farms with no cotton base acres to total planted cotton acres | 15.7% | 15.3% | 16.5% | 19.2% |

Source: USDA/FSA data.

225. If Brazil were correct that counter-cyclical payments induce payment recipients to continue planting cotton, one would expect to see farms with base acres planting cotton at levels similar to their historical planted acres. The fact that payment recipients only planted approximately 60 percent of their historical cotton acreage (that is, base acres) in MY 2002-2005 is strong evidence that a significant number of producers do in fact use the planting flexibility afforded by the counter-cyclical program and that counter-cyclical payments do not induce recipients to continue planting cotton.

### (b) Brazil Does Not Demonstrate That Marketing Loan Payments Are Having Significant Production-Distorting Effects

226. Brazil asserts that "U.S. cotton producers respond to the *expected* prices and *expected* rates of subsidy that apply at the time planting and other key decisions are made in the production cycle."[317] In the context of the potential impact of marketing loans, Brazil acknowledges that, again, the question is one of expectations – "[t]he magnitude of the impact on incentives to produce cotton is equal to the *expected* difference between the loan rate, which is known at planting time, and the grower's *expectations* at the time of planting about the AWP for cotton that will apply when the grower makes that marketing loan transaction."[318] Brazil oversimplifies the assessment that a producer makes at the time of planting, for example, by failing to address expectations about competing crops. However, Brazil does correctly note that the question is one of farmers' expectations of future returns.

227. Production decisions for a given marketing year commence at the beginning of the corresponding calendar year when producers obtain financing loans contingent on production of a particular crop, purchase seed for the appropriate crop, and arrange for planting materials and activities. These arrangements are followed by planting itself. For example, cotton produced during MY 2006 resulted from production decisions made at the beginning of calendar year 2006, normally in the January to March period (that is, before planting).

228. Brazil disregards its own hired economist's explanation as to how to determine whether marketing loan payments have had any effects on planting decisions. That is, as Dr. Sumner recognizes, it is important to consider the *expectations* of farmers at planting both as to prices for the harvested crop and of payments.[319] However, even as Brazil purports to address how the alleged price effects have resulted from the "structure, design, and operation" of the marketing loans, Brazil simply recites studies by USDA economists pointing out what the United States readily acknowledges,[320] that marketing loan programs have "*potential* production-influencing effects."[321] In addition – again disregarding its own hired economist's explanations about farmer's expectations – Brazil submits a chart showing that the *actual* AWP rates in MY 1999-present have in many years been below the loan rate. Since farmers did not know at the time of planting what the *actual* AWP would be during the marketing year commencing up to seven months later, however, Brazil's chart says nothing about whether the marketing loan program actually affected farmers' planting decisions from MY 1999 to the present.

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[317] Brazil First Written Submission, Annex I, para. 36 (emphasis added).

[318] Brazil First Written Submission, Annex I, para. 58 (emphasis added).

[319] Brazil First Written Submission, Annex I, para. 58 (emphasis added).

[320] *See e.g.,* Further Rebuttal Submission of the United States of America, paras. 173-174 (18 November 2003).

[321] Brazil First Written Submission, para. 126 (citing Exhibit BRA-222 ("Analysis of the U.S. Commodity Loan Program with Marketing Loan Provisions," USDA, AER 801, p. 6)) (emphasis added).

229. To answer that question it is necessary to examine the planting decisions made by U.S. producers in the light of the conditions as they existed as of the time of planting for each marketing year (*i.e.*, in January-March).[322] Brazil's "present" serious prejudice claims relate to the current marketing year (2006), and it is possible to evaluate price expectations during the planting decision period using futures data from January through March 2006.

230. New York futures prices at the time of planting for harvest season contracts can be an important tool for assessing producers' expectations regarding future returns. As Brazil's cotton market expert, Andrew MacDonald, has explained "[t]rading [in the New York Cotton Exchange's futures market] is conducted with price levels reflecting the daily perception of the market participants worldwide on *how prices of cotton will develop in the future*, as well as in the near and medium-term."[323] The average New York futures price in January-March 2006 represents, in general, the futures price that the farmer would have had in mind as he made his planting decisions for MY 2006. The average futures price in this period for harvest season contracts (December delivery) was 59.35 cents/lb. This is well above the loan rate of 52 cents/lb. Even adjusted to take into account expected transportation expenses, the expected price is above the loan rate.

231. In other words, for the present marketing year (MY 2006), the evidence shows that U.S. producers planted for the expected market price. Payments under the marketing loan program did not figure in this decision, as U.S. producers *did not expect* when they planted that they would receive these payments upon harvest. Under these conditions, it cannot be said that the marketing loan distorted U.S. producers' production decisions.

| **Harvest Futures Prices at Planting Time Compared to Marketing Loan Rate (cents per pound)** | | | | | |
|---|---|---|---|---|---|
| | MY2002 | MY2003 | MY2004 | MY2005 | MY2006 |
| Futures Price | 42.69 | 59.12 | 67.44 | 52.9 | 59.35 |
| Expected Cash Price 1/ | 37.69 | 54.12 | 62.44 | 47.9 | 54.35 |
| Loan Rate | 51.92 | 51.92 | 51.92 | 52 | 52 |

1/ Futures price minus 5 cent cash basis.

232. While earlier marketing years are not the subject of Brazil's "present" serious prejudice claim, a review of those years confirms that, even in other marketing years, producers have planted for expected market prices, not expected payments. This was true, for example, for MY 2003 and MY 2004.

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[322] *See e.g.* Cotton Percent Planted, 15 Selected States (Exhibit US-44) showing that planting usually starts in early April. Most planting decisions are, thus, made before this, in January-March.

[323] Brazil First Written Submission, Annex II, para. 15.

233. As the period of investigation in the original proceeding covered MY 2002, the United States looked closely at farmers' planting decisions in MY 2002 in that proceeding. The United States acknowledged that "[i]n marketing year 2002, harvest season futures prices at the time of planting had fallen below the loan rate. In this marketing year, then, there is at least the possibility that producers were planting for the loan rate and not for the harvest season expected price."[324] However, the decline in acreage at that time was greater than one would have expected to see if producers had been planting for the loan rate. Moreover, the acreage shifts were consistent with those in the rest of the world. That evidence suggested that U.S. producers were, in fact, responding to market signals even in that year.[325]

234. Although expected futures prices were above the loan rate in MY 2005, the expected cash price (i.e., excluding expected expenses) was slightly below it. Thus, in that year too, there was some possibility – albeit small – that producers might have planted for the loan rate. As USDA explains in its review of the market situation in MY 2005, however, other factors drove producers' planting decisions in that year. Indeed, these factors explain why U.S. cotton plantings went up in MY 2005 despite the fact that the December futures were lower in that year than the year before. USDA explains that "*excellent planting moisture–mainly in the Southwest–and the record yields obtained in 2004/05 led to increased cotton area*. . . .Upland area gains were seen mainly in the Delta region–*partly reflecting the impact of Asian rust on soybeans*."[326]

235. Thus, even in those past years in which the marketing loan program might have had an effect on planting, information about actual planting decisions show that they were, in fact, shaped by market factors, not the expectation of marketing loan payments. Moreover, in the present marketing year, as expected prices were higher than the marketing loan rate, the marketing loan program did not figure into producers' planting decision.

### (c) Brazil Does Not Demonstrate That the Size of Outlays Under the Marketing Loan and Counter-cyclical Payment Programs "Support the Existence of a Causal Link"

236. While Brazil does not provide any empirical evidence that demonstrates that the "structure, design, and operation" of the marketing loan and counter-cyclical payment programs are such as to cause significant production-distorting effects, it does emphasize what Brazil terms variously the "large," "very large," "huge," and "massive" government outlays under the marketing loan and counter-cyclical payments programs.[327] Brazil cannot substitute characterizations of the magnitude of outlays under the programs for actual analysis of their "structure, design, and operation."

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[324] Further Rebuttal Submission of the United States of America, para. 173 (18 November 2003).

[325] Further Rebuttal Submission of the United States of America, paras. 173-174 (18 November 2003).

[326] Cotton and Wool Situation and Outlook Yearbook at 2 (November 2005) (BRA-448).

[327] Brazil First Written Submission, paras. 243-44, 283.

237. The labeling of outlays as "large," "very large," "huge," "massive" – or, now, in the case of Step 2 payments, "relatively modest" – does little to advance the analysis of the effect of the programs on world market prices. As Brazil has explained, "very large untargeted subsidies can have small effects, while a highly-targeted subsidy can have much greater effects relative to its size."[328] It is simply not meaningful to address the size of outlays under the marketing loan and counter-cyclical payment programs apart from an actual examination of their structure, design, and operation.

238. Brazil asserts that "[t]he continued high magnitude of U.S. marketing loan and counter-cyclical payments for upland cotton supports the existence of a causal link between these two subsidies and significant price suppression in the world market for upland cotton."[329] However, it provides no credible basis for this assertion. Rather, Brazil simply asserts the "enormous advantage" that the marketing loan and counter-cyclical payment program provide to U.S. producers and exporters to "secure sales."[330] Brazil provides no evidence of this "enormous advantage." Moreover, payments under these programs are paid to producers, not exporters and, in the case, of counter-cyclical payments, not even tied to production of upland cotton. Brazil fails to explain how, in light of this, the marketing loan and counter-cyclical payment programs provide U.S. producers and exporters with an "enormous advantage to secure sales in the world market."[331]

239. Indeed, the sole source Brazil cites, in this regard, is the statement by its own cotton market expert that "large contracts for sales of upland cotton are won or lost based on differences of cents per pound."[332] Brazil asserts on this basis that "U.S. producers or exporters receiving high levels of subsidies have the flexibility to cut their prices to maintain and even increase market share."[333] Brazil appears to suggest, in other words, that U.S. exporters use marketing loan and counter-cyclical payments (that are, however, paid to U.S. producers) to undercut foreign cotton prices. Brazil does not, however, provided no evidence to show that is the case. In fact, as the panel observed in the original proceeding, during MY 1999-2002 it was *Brazilian* prices that generally undercut U.S. prices for upland cotton, not the other way around.[334] Brazil has not shown that the situation has changed in more recent marketing years.

240. More importantly, Brazil does not explain the relevance of these assertions to its claims

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[328] Brazil Appellee Submission, para. 485 (16 November 2004).

[329] Brazil First Written Submission, para. 119.

[330] Brazil First Written Submission, paras. 114 and 115.

[331] Brazil First Written Submission, para. 115.

[332] Brazil First Written Submission, para. 114.

[333] Brazil First Written Submission, para. 114.

[334] *Upland Cotton (Panel)*, para. 7.1315, n. 1430 ("We observe, in passing, evidence in Exhibit BRA-383 which indicates that, for MY 1999 - MY 2002, the average price (cents per pound) for exports of United States upland cotton was 45.33, while, for Brazil, it was 44.65.")

of present *significant price suppression.* The United States recalls that Brazil argued in the original proceeding that claims of price undercutting should not be confused with claims of price suppression.[335] As Brazil has not made any claim of price undercutting here, it is unclear what relevance its assertions regarding undercutting would have, even if they had been substantiated (which they were not).

241. In short, Brazil has provided no legitimate basis for its assertion that the size of government outlays under the marketing loan and counter-cyclical payment programs "supports the existence of a causal link between these two subsidies and significant price suppression in the world market for upland cotton." Moreover, as explained, the size of government outlays alone says nothing about their effect, if any, on world market prices.

### 2. The Facts Demonstrate That U.S. Producers and Exporters Have Reacted to Market Signals And Are Not "Insulated" By the Marketing Loan and Counter-cyclical Payment Programs

242. Brazil' claim of significant price suppression depends in great part on its argument that the marketing loans and counter-cyclical payment programs "fuel" plantings and production by "insulating" U.S. producers and exporters from normal market signals. As shown below, however, the facts do not support that argument. To the contrary, the evidence clearly show that U.S. producers and exporters respond in much the same way to market signals as their foreign counterparts.

#### (a) Stable U.S. Shares of World Production and Exports Confirm That the Marketing Loan and Counter-cyclical Payment Programs Are Not Insulating U.S. Producers from Market Signals

243. Brazil itself identifies a significant flaw in its claim that U.S. producers are insulated from world market signals because of the marketing loan and counter-cyclical payment programs under the FSRI Act – specifically, that U.S. share of world production has been *stable* over the life of the Act.[336] This is shown in the chart below.

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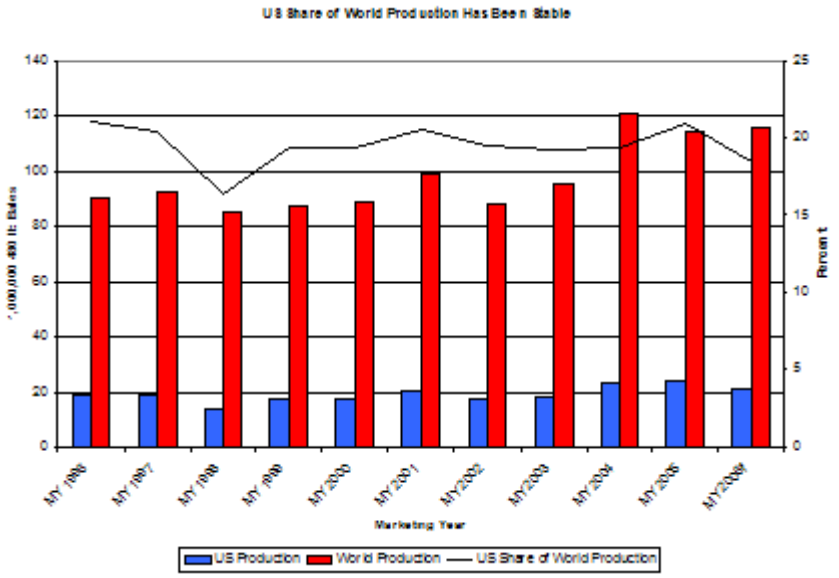
[335] Statement of Brazil at the Second Substantive Meeting of the Panel with the Parties, para. 13 (2 December 2003).

[336] Brazil First Written Submission, para. 90 and Figure 2.




Source: USDA, PS&D[337]

244. The stable U.S. market share reflects the fact that U.S. production has increased and decreased in much the same way as production elsewhere in the world, undermining Brazil's claims that the marketing loan and counter-cyclical payment programs have "insulated" U.S. producers from world market price signals.[338] Indeed, if U.S. producers *were* cut off from market signals, as Brazil alleges, one would expect that in times of anticipated low prices, foreign production would fall off but U.S. producers – allegedly expecting "large," "very large," "huge," or "massive" U.S. government payments under the marketing loan and counter-cyclical payments programs[339] – would continue to plant and produce at artificially high levels.[340] That has not been case (as shown in the chart above).

245. To the contrary, the chart shows that U.S. share of world production has remained between 19-20 percent during the entire period in which the FSRI Act has been in effect.

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[337] U.S. Production Supply and Distribution (Exhibit US-27); World Production Supply and Distribution (Exhibit US-27).

[338] *See e.g.*, Brazil First Written Submission, paras. 134, 137.

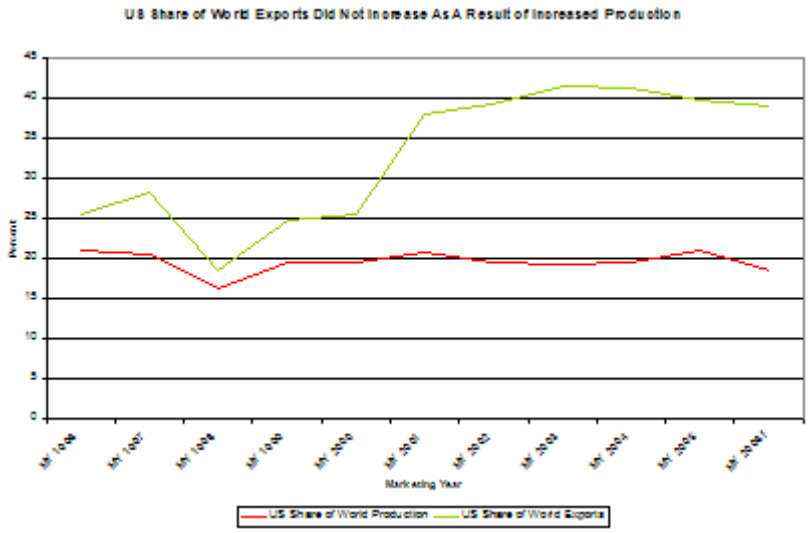
[339] Brazil First Written Submission, paras. 243-244.

[340] If U.S. producers were to increase or maintain their plantings at the same time that foreign planting declined – or even if U.S. producers *decreased* their plantings, but less so than their foreign counterparts – they would substantially increase their share of world production. Indeed, this is what Brazil suggests in its first written submission. Brazil First Written Submission, para. 115 ("U.S. producers and exporters can afford to produce and successfully market their upland cotton even at low world market prices because the U.S. Government makes up the difference in the U.S. producers' bottom-line revenue. Brazilian and other non-subsidized producers do not have that luxury.")

Indeed, it stayed in that same general range even in the period of the FAIR Act of 1996. The notable exception was MY 1998 when, due to weather and a number of other factors, U.S. share of world production fell to approximately 16 percent. This relative stability even in the earlier marketing years contradicts Brazil's argument that because payments were "larger" in MY 2004-2005 than in "earlier periods investigated by the original panel" their "[distortive] effects, if anything, have increased."[341] Even leaving aside that marketing loan payments and counter-cyclical payments made in MY 2004-2005 were *not* larger than those made in all of the "earlier periods," there is no evidence of any "increased effect" on U.S. share of production in those years that would support Brazil's argument.

246. A second fact undermining Brazil's claim of market insulation is that U.S. share of world *exports* has been stable over the life of the FSRI Act. Under Brazil's "market insulation" theory, one would expect that artificial levels of U.S. planting and production – allegedly "fueled" by marketing loan and counter-cyclical payment payments – would translate into increasing world export market share for U.S. producers and exporters. By contrast, foreign producers, under Brazil's theory, would have been more sensitive to low expected prices and would have adjusted their production accordingly. They, therefore, would have less upland cotton for export than U.S. producers and, accordingly, would lose export market share to U.S. producers and exporters.

247. This is not what one sees when one examines actual export data. As shown in the chart below, U.S. share of world exports has been relatively stable in the period from MY 2002 to 2005.




[341] Brazil First Written Submission, para. 124.

Source: USDA, PS&D[342]

248. The last two years of this period (MY 2004 and 2005) are especially important because, as discussed above, Brazil alleges that in those years U.S. marketing loan and counter-cyclical payment increased substantially. According to Brazil, total marketing loan and counter-cyclical payment amounted to $444 million in MY 2003, $2,755 million in MY 2004, and $2,170 million in MY 2005.[343] Yet, while payments increased – *by 580 percent* between MY 2003 and MY 2004 by Brazil's calculation – U.S. share of world exports declined by 0.2 percent. This indicates that, contrary to Brazil's allegations, U.S. exports were affected by the changes in the marketplace in MY 2004 in the same way as exports of foreign producers. The marketing loan and counter-cyclical payment to U.S. producers simply do not appear to have had the kind of impact on exports that Brazil alleges.

249. While much of the increase in U.S. export market share between MY 1999 to 2002 occurred before under the FSRI Act, it is useful to consider the reasons for that increase as well; that also provides useful insight regarding the market factors that have shaped U.S. planting, production and export behavior. As shown above, in the MY 1999 to 2002 period, U.S. producers and exporters increased their share of world exports from approximately 18 to 39 percent. While U.S. share of world exports increased, however, U.S. share of world *production* did not. In other words, U.S. producers were not increasing their production relative to foreign producers in order to gain market share, as Brazil has suggested.[344] Rather, a greater proportion of U.S. production was being exported. The reason for this, as Brazil's own cotton association depicts in the chart below, was the decline in U.S. mill use resulting from the declining competitiveness of the U.S. textile industry and increasing U.S. imports of textiles and clothing in the same period.

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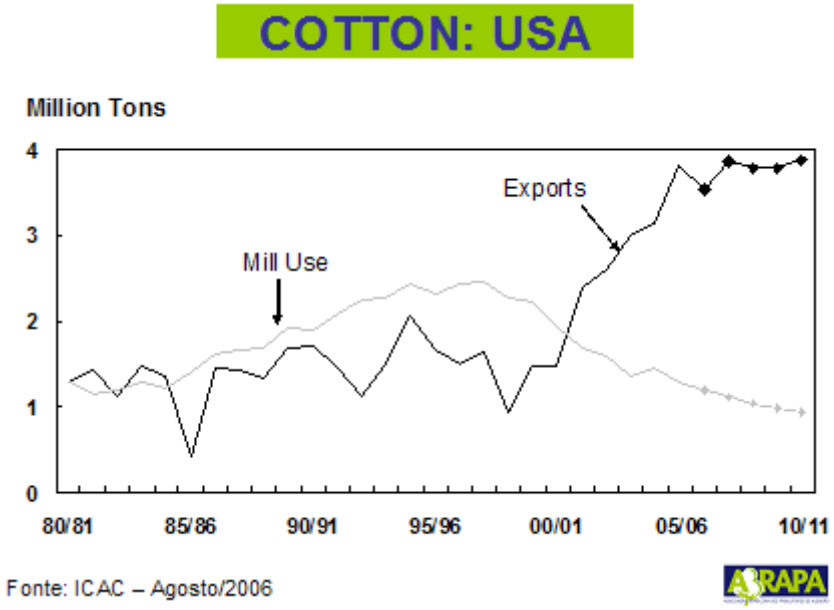
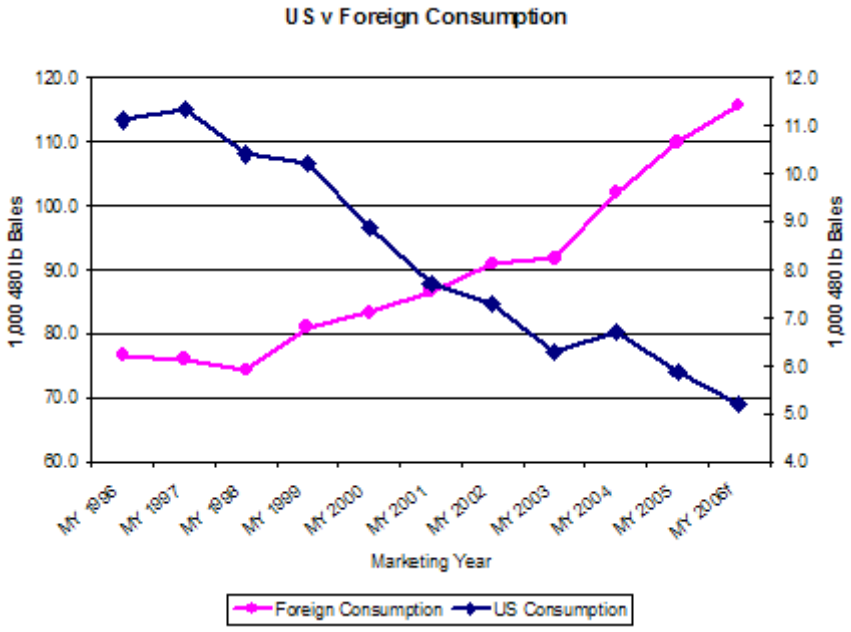
[342] U.S. Production Supply and Distribution (Exhibit US-27); World Production Supply and Distribution (Exhibit US-27).

[343] Brazil First Written Submission, para. 111, Table 6. This is even counting Brazil's misallocated counter-cyclical payment figures for cotton.

[344] Brazil First Written Submission, para. 182.




250. Further, as shown in the chart below, as mill consumption fell in the United States, foreign consumption increased. The increase in U.S. exports was, therefore, not really the result of flagging demand in the United States but, rather, a shift in this demand from the United States to other countries.



Source: USDA, PS&D[345]

251. Brazil does not conduct any meaningful analysis of these factors. Instead, Brazil asserts that the stability of the U.S. share of production and exports is *itself* evidence that marketing loan and counter-cyclical payment are artificially stimulating U.S. planting, production and exports and, thus, suppressing prices.[346] The sole basis for Brazil's conclusion, however, is its own theory that "*[b]ut for* the effect of price-contingent U.S. marketing loan and counter-cyclical payments, it would be expected that non-subsidized producers, such as those in Brazil and West and Central African countries, would have significantly increased their share of production and exports in the world market."[347] Brazil is simply assuming its own conclusion – *i.e.*, "stable U.S. share of world production and export proves that U.S. support payments cause price suppression because without the price suppression caused by U.S. support payments U.S. share of world production and exports would not be stable." This is not a legitimate basis for Brazil's claim.

252. In sum, neither U.S. production nor U.S. export behavior exhibits the market "insulation" that Brazil alleges. Rather, the fact that U.S. share of world production and exports has been stable over the entire period that the FSRI Act has been in effect suggests just the contrary; that market signals were being received – and heeded – by U.S. producers and exporters in a manner consistent with producers and exporters elsewhere.

### (b) Brazil Fails to Demonstrate the Alleged "Strong Link" Between Marketing Loan and Counter-cyclical Payments and U.S. Planted Acreage, Production, and Exports

253. Brazil claims to demonstrate a "strong link between high levels of U.S. subsidies and continued high levels of U.S. planted acreage, production and exports during MY 2002-2005."[348] However, it does not actually do so. Rather, Brazil asserts that this link can be gleaned indirectly by what it asserts is the *absence* of a "link" between "prices, on the one hand, and [U.S.] planted acreage, production, and exports, on the other hand. . . ."[349] That, according to Brazil, is further evidence of market insulation and of price suppression resulting from the marketing loan and counter-cyclical payment programs.

254. First, Brazil's arguments do not appear to be internally consistent. On the one hand, Brazil asserts that there is *no link* between prices and U.S. acreage, production and exports. But, on the other hand, it argues that "the United States is the single most important market

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[345] U.S. Production Supply and Distribution (Exhibit US-27); Foreign Production Supply and Distribution (Exhibit US-27).

[346] Brazil First Written Submission, para. 94.

[347] Brazil First Written Submission, para. 94.

[348] Brazil First Written Submission, para. 137.

[349] Brazil First Written Submission, para. 145.

*influencing* world market prices."[350] Moreover, Brazil names the U.S. market "the single most important market in influencing cotton prices throughout the market."[351] If the latter were true, one *would* expect to see a link between prices and U.S. planted acreage, production, and exports; specifically, that shifts in the latter would cause shifts in the former. Yet Brazil submits evidence at the same time to prove that is *not* the case. Brazil does not clarify how these arguments can be reconciled.

255. Second, Brazil's analysis of the sensitivity of U.S. planted acreage, production, and exports to prices is flawed. In particular, Brazil fails to take into account certain basic facts of upland cotton production. Most importantly, Brazil's analysis disregards the fact that a cotton farmer makes *a single key production decision* in each marketing year; that is, the decision to plant, whether cotton, a competing crop, some mix of crops, or nothing at all (for example, to put the farm to conserving uses).[352] At the time he makes that decision (in January-March in the United States), the farmer cannot *know* what final prices and final costs will be at the time he harvests and markets his crop (around December in the United States). Any number of factors – for example, future supply, demand, yields, weather, labor and input prices, changes in technology, government support, and marketing efforts – could have an impact on his final revenue. The farmer needs to weigh, as best he can, all of those various factors in making his planting decisions. Brazil does not proper account for this process in its comparisons of U.S. planted acreage, production and exports to prices.

256. ***Comparison of planted acreage to NY futures prices for cotton:*** Brazil argues that "examination of changes in futures prices and amount of planted acreage supports the finding that U.S. upland cotton farmers continue to be immune from market forces. . . ."[353] In so doing, however, Brazil improperly reduces the complex planting decision to a single consideration – the NY futures price for cotton at the time of harvest. Given that the cotton futures prices is *not* the sole basis for a farmer's planting decision, it is not surprising that U.S. planted acreage does not correlate with the futures prices in Brazil's chart.

257. To justify its flawed approach, Brazil suggests that *the United States* has argued before that it is appropriate to consider the NY futures price of cotton alone in assessing planting decisions.[354] This is a misrepresentation of the U.S. position; the United States has never made

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[350] Brazil First Written Submission, para. 89 (emphasis added).

[351] Brazil First Written Submission, Annex II, para. 23.

[352] The farmer may make further production decisions after planting, for example whether or not to harvest the crop. That decision will depend on factors such as whether the marginal cost of bringing the crop to harvest is greater than the price he expects to receive for the harvested crop.

[353] Brazil First Written Submission, para. 142.

[354] Brazil First Written Submission, para. 141 ("Brazil recalls that the United States argued before the original panel and the Appellate Body about the importance of farmers' price expectations and, in particular, the importance of the futures market in guiding these expectations.").

such an argument. To the contrary, the United States has argued that:

> It is important to recognize that the cotton price alone does *not* determine grower intentions. Many growers, in United States and elsewhere, have several alternative crops to consider. Northern hemisphere growers, and the marketing outlets with which they interact, are typically looking at the harvest time futures prices during a window early in the calendar year. Thus, *during January, February and March growers would be looking at the levels of the upcoming December futures contract on cotton, September futures contract for corn, and November futures contract for soybeans*.[355]

258. In fact, to demonstrate this, the United States calculated a ratio of soybean futures to cotton futures. As soybeans are a main competing crop to cotton in many U.S. states, the United States considered that the ratio would provide a simple way of estimating the relative attractiveness of planting cotton.[356] The United States explained that the correlation between this ratio and cotton plantings demonstrated "that U.S. cotton farmers are responsive to expectations about market prices for cotton and competing crops. That is, the level of U.S. cotton planted acreage *corresponds to the relative attractiveness of cotton compared to competing crops*."[357] Brazil is not only aware of this U.S. position, it has even agreed with it.[358]

259. As *neither* party considers it appropriate to compare planted acreage to cotton futures alone as a test of the responsiveness of U.S. producers to market signals, that comparison does *not* "support[] the finding that U.S. upland cotton farmers continue to be immune from market forces. . . ."[359] To the contrary, as shown in the chart below, a comparison of U.S. planted acreage to the same cotton-to-soybean ratio used by the United States in the original proceeding demonstrates, again, that U.S. cotton producers react to price expectations for competing crops, as well as other factors.[360] As shown, generally, when the expected cotton futures price is high relative to the expected soybean futures price, planted acreage tends to go up. When the opposite is true – and the ratio is small – cotton planted acreage tends to go down.

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[355] U.S. Further Submission, para. 64 (September 20, 2003) (emphasis added).

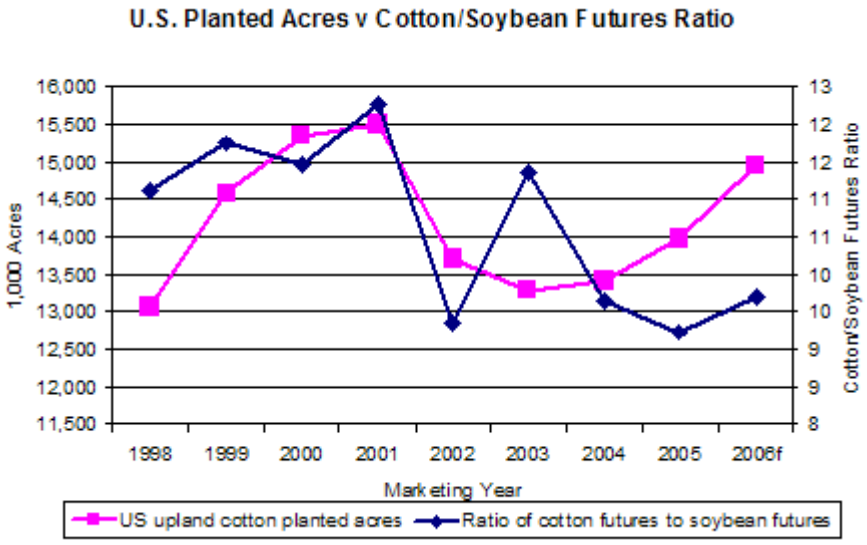
[356] U.S. Appellant Submission, para. 171-173 (28 October 2004).

[357] U.S. Appellant Submission, para. 171 (28 October 2004) (emphasis added).

[358] *See e.g.,* Brazil Appellee Submission, para. 689 (stating that an examination of farmers' planting decisions would "depend on [examining] projected or expected net returns from planting upland cotton, as compared to planting some other crop.").

[359] Brazil First Written Submission, para. 142.

[360] The futures prices used are the January-March average for December cotton and November soybeans futures contracts. (These are the most comparable contracts: there are no November cotton or December soybeans contracts.) Planting decisions are generally taken in the January-March period. December futures prices for cotton and November futures prices for soybeans show what the market expects prices to be when the crop is harvested and brought to market.




Source: USDA, NASS, CYBOT and NYBOT[361]

260. This is, of course, a simplified analysis. There are other crops that could also be considered as alternatives. Moreover, there are other, extraneous factors that could affect the farmer's decision. The divergence seen above between the cotton-to-soybean futures ratio and planted acreage in MY 2003 is a good example. In that year, upland cotton looked quite attractive compared to soybeans based on consideration of their respective futures prices. However, upland cotton planted acreage did *not* increase, as the ratio would suggest. The reason for this was unusually poor weather at time of planting. In fact, as the following USDA acreage report details, farmers *had* planned to plant more upland cotton (and USDA had based its acreage estimates accordingly). However, many were simply prevented from doing so.

> Producers in the Southeastern States (Alabama, Florida, Georgia, North Carolina, South Carolina, and Virginia) planted 3.25 million acres of upland cotton, a decrease of 7 percent from the previous year and 2 percent less than they had originally intended in March. Cool, wet weather throughout the planting season led to delayed plantings, replanting, or abandoning plans for cotton entirely. Upland growers in the Delta States (Arkansas, Louisiana, Mississippi, Missouri, and Tennessee) planted 3.58 million acres, 15,000 acres less than a year ago and 6 percent less than their original intentions. Persistent rains and cool weather in northern areas of the Delta delayed planting or prevented it altogether. Many growers were forced to replant or switch to other crops.[362]

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[361] Compiled Statistics – Prices & Futures (Exhibit-25).

[362] USDA Acreage Report at 34-35 (30 June 2003) (Exhibit US-62) (emphasis added).

261. This shows that while harvest season New York cotton futures are a good proxy for farmers' price expectations, they are not *alone* the basis for the planting decisions that farmers ultimately make. Those decisions are based on any number of additional factors, including expected prices of competing crops and weather. Brazil's assertion that it demonstrates the alleged "insulation" of U.S. producers through its comparison of planted acreage to New York cotton futures alone is simply without merit.

262. ***Comparison of U.S. upland cotton production to farm price:*** In its comparison of upland cotton production to U.S. farm prices, Brazil again ignores certain fundamental facts. First, Brazil once again assumes, incorrectly, that planting decisions could be explained through an examination of cotton prices alone.

263. Second, in comparing U.S. upland cotton production in a marketing year to the average U.S. farm price for the *same* marketing year, Brazil assumes that U.S. farmers *know* at the time that they plant (in January-March of a given year) what the actual farm price will be in the upcoming marketing year, which does not even start until August.[363] Brazil's premise is that, if there were no marketing loan and counter-cyclical payment programs, one would find U.S. production correlating to the actual average farm price in that marketing year. However, as U.S. farmers cannot see into the future but, rather – as Dr. Sumner acknowledges – can only react to the *expected* harvest-season price of cotton, Brazil's premise is simply not valid.[364]

264. Third, as Brazil has acknowledged, "producers do not decide on production, but on plantings. Ultimate production is affected by weather and other factors affecting yields."[365] For example, in MY 2004 and MY 2005 U.S. upland cotton producers saw dramatic increases in yields due to a number of factors including use of improved varieties and exceptionally good weather. As shown below, the growing conditions in those years were much better than in the two preceding years (MY 2002 and 2003). A U.S. cotton farmer simply could not *know* what the growing conditions would be and certainly had little control over that process.

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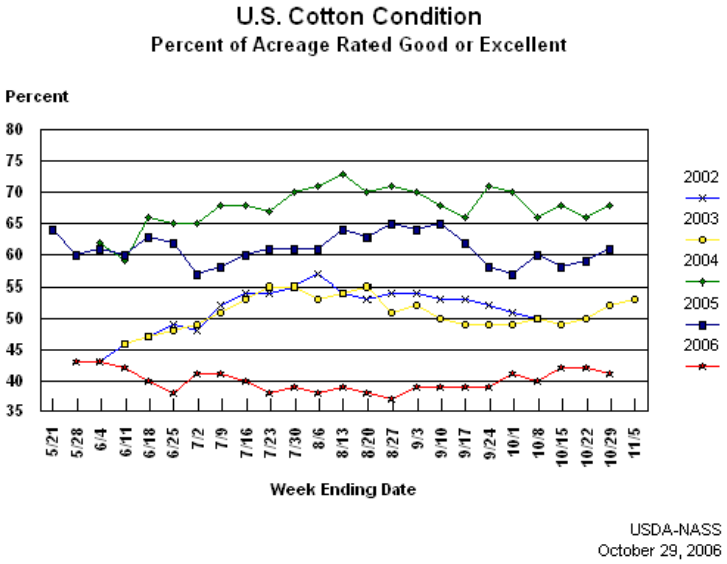
[363] Farm prices for a marketing year are the prices for upland cotton *actually sold* in that marketing year, regardless of when the cotton was planted and/or harvested.

[364] Brazil First Written Submission, Annex I, para. 36 ("U.S. cotton producers respond to the *expected prices* . . . that apply at the time of planting . . . .")

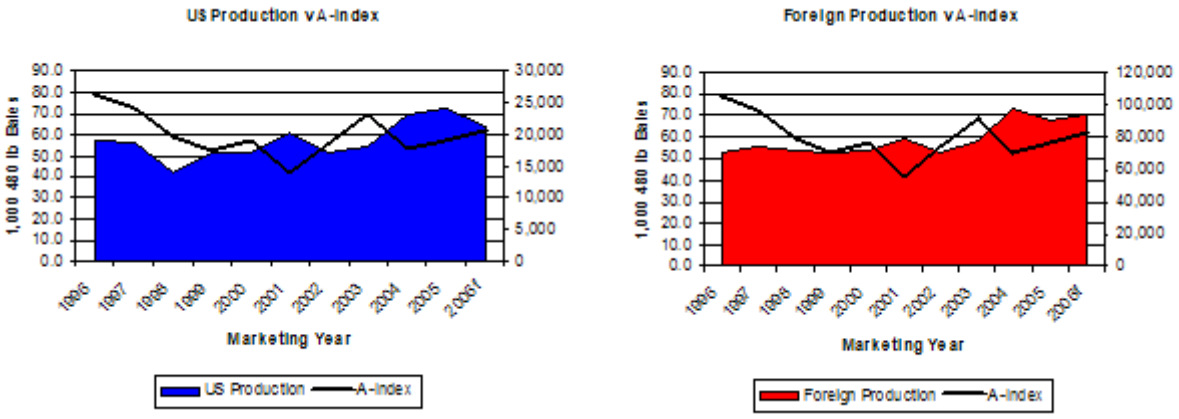
[365] Brazil Appellee Brief, para. 706, n. 995. Brazil's assertions were made in support of its argument that U.S. *share* of production is not a relevant consideration. That argument is not sound; as discussed above, U.S. share of production provides valuable information regarding the decisions of U.S. producers relative to others. Where, over the course of a decade, U.S. production moves in the same way as production in the rest of the world, it cannot be dismissed as a remarkably long-standing coincidence of the various factors affecting production. Rather, it is important evidence that the production *decisions* made by U.S. producers are consistent with those made by producers in the rest of the world.

While Brazil's assertions above are incorrect with regard to the relevance of U.S. share of production, they do serve to explain, however, why it is not meaningful to consider *absolute* levels of production in assessing the alleged effect of U.S. marketing loan and counter-cyclical payment, as Brazil is now attempting to do.




265. Indeed, if one compares both U.S. and foreign production to movements in the A-Index,[366] the same alleged "absence" of a "link" between absolute production levels and prices is apparent in both cases. The similarity in responsiveness (or non-responsiveness), which is shown in the charts below, does not mean that *all* producers are insulated from market price signals, as Brazil's analysis would suggest (or at least Brazil has not alleged that it does). Rather, it just confirms that, for the reasons above, the comparison of cotton production in a marketing year to the actual prices in that year is flawed.

[366] The United States uses the A-Index because the U.S. farm price is not the price for foreign-grown cotton. However, given that Brazil considers that there are "broad similarities" between the U.S. farm price and the A-Index, it presumably considers the comparison of U.S. and foreign production to the A-Index to be analogous to the comparison Brazil makes above between U.S. production and farm prices. Brazil First Written Submission, para. 97.




Source: USDA, PS&D[367] & USDA, Agriculture Marketing Service Reports[368]

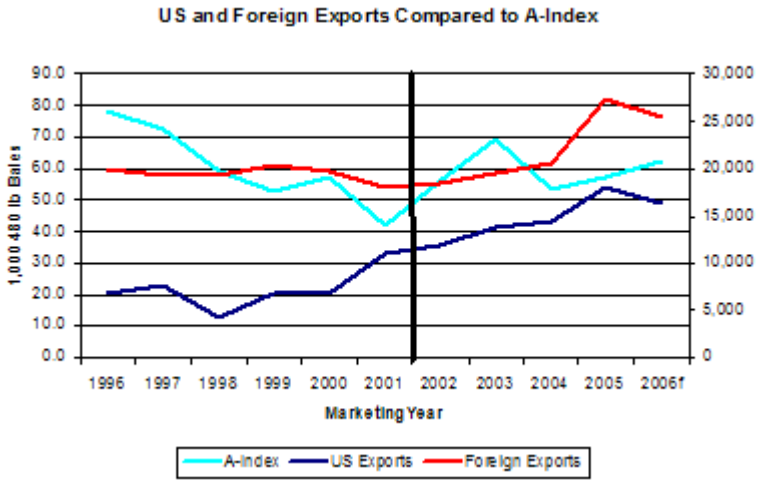
266. ***Comparison of U.S. upland cotton exports and farm price:*** The third of Brazil's comparisons – between annual U.S. upland cotton export levels and the average farm price[369] for the marketing year – fails to take into account the important developments in the U.S. textile and apparel industry – the main U.S. consumer of upland cotton – that were responsible for the changes in U.S. export patterns in the period MY 1998 to 2002.

267. The United States explained above in Section VI.C.2, that U.S. share of world exports has been stable since MY 2002. In other words, since MY 2002, U.S. exporters have reacted to market conditions in the same general way as foreign exporters. This is evident in the chart below, which shows both U.S. and foreign export volumes trending upwards from MY 2002 to 2004, increasing more sharply from MY 2004 to 2005, and both projected to decline in MY 2006.

[367] U.S. Production Supply and Distribution (Exhibit US-27); Foreign Production Supply and Distribution (Exhibit US-27).

[368] Compiled Statistics – Prices (Exhibit US-25).

[369] The farm price is the price that farmers actually receive for their cotton during a particular marketing year.




Source: USDA, PS&D[370] & USDA, Agriculture Marketing Service Reports[371]

268. As shown above, U.S. and foreign export trends diverged in the period from MY 1998 to MY 2002. The reason for this, however, was not "insulation" due to marketing loan and counter-cyclical payments. Rather, as discussed above, the reason was the dramatic decline in U.S. mill use and the contemporaneous increase in foreign consumption. That is, the relevant market conditions for U.S. exporters changed during this period. With decreased U.S. cotton mill use, a greater supply was available for export, at the same time that foreign demand was growing for that cotton. Thus, while Brazil correctly notes that exports – both U.S. and foreign – do not move in lock-step with prices, this is not evidence of market insulation but, rather, demonstrates that cotton prices are only one of the factors that could affect absolute levels of exports.

269. In sum, none of Brazil's comparisons establish that U.S. producers are "insulated" from market forces. This, together with the evidence above of stable U.S. share of world market production and exports over the life of the FSRI Act indicate that the marketing loan and counter-cyclical payment programs do *not* have the kind of planting-, production- and export-inducing effects that Brazil alleges.

### 3. "Absolute" Increases in U.S. Production Are "the Effect" of Improvements In Yields, Not the Marketing Loan and Counter-cyclical Payment Programs

270. Brazil argues erroneously that increasing "*absolute*" volumes of U.S. production of

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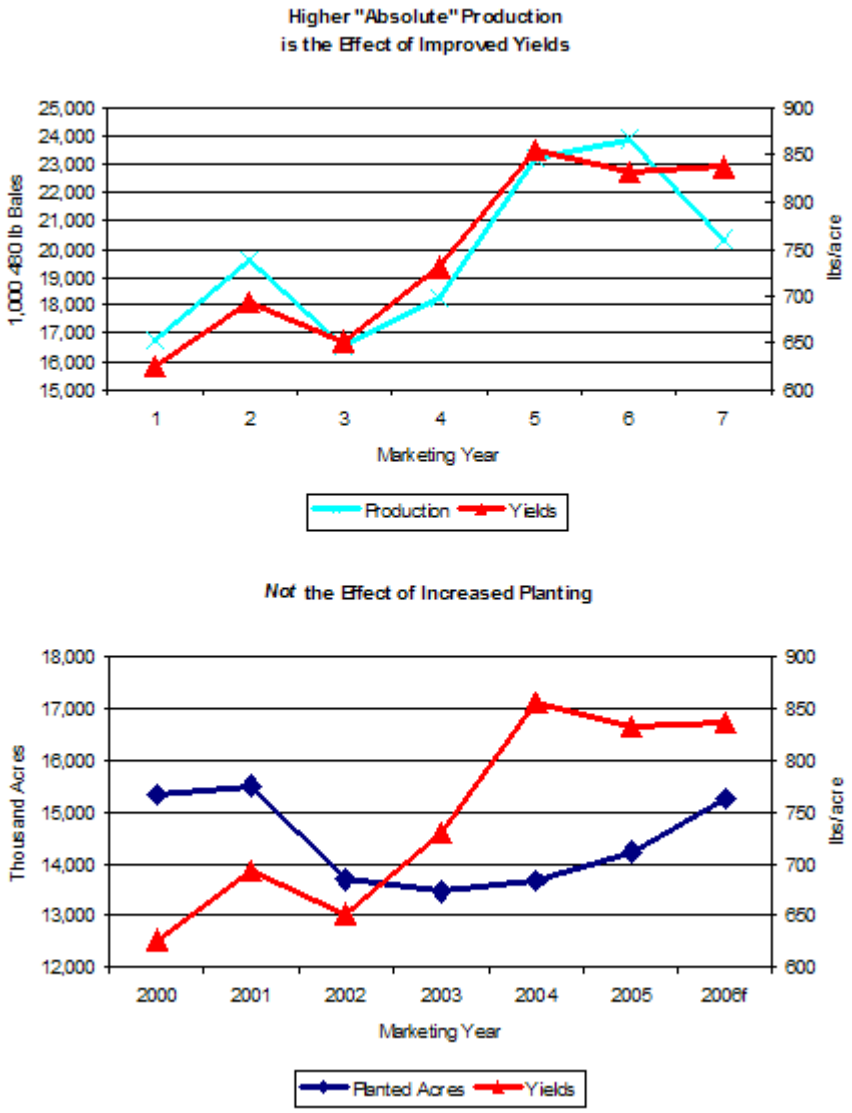
[370] U.S. Production Supply and Distribution (Exhibit US-27); Foreign Production Supply and Distribution (Exhibit US-27).

[371] Compiled Statistics – Prices (Exhibit US-25).

upland cotton from MY 2002-2005 are indicative of the trade-distortive effects of the U.S. marketing loan and counter-cyclical payment program.[372] That argument is untenable.

271. As an initial matter, it is important to understand clearly the reason for the increasing *absolute* volumes of production. As shown below, U.S. producers experienced record yields in the period from MY 2002 though 2004. The improvement in yields resulted from such factors as above-average weather conditions, continued varietal improvements, the eradication of the boll weevil, and precision crop management techniques. The increased production that resulted in MY 2002 to 2004 are "the effect" of these factors, not marketing loan and counter-cyclical payments.

[372] *See e.g.,* Brazil First Written Submission, paras. 93, 96, 124.




Source: USDA, PS&D,[373] USDA NASS

272. As shown above, planted acreage actually *fell* slightly from MY 2002 to 2003, but yields increased dramatically, resulting in much higher production than the year before. From MY 2003 to 2004, planted acreage increased only slightly, but favorable weather conditions reduced abandonment to well below the historical average, resulting in high harvested acreage. That, and

[373] U.S. Production Supply and Distribution (Exhibit US-27); Foreign Production Supply and Distribution (Exhibit US-27).

record high yields in MY 2004, resulted, again, in increasing *absolute* levels of production in that marketing year. In MY 2005, planted acreage increased slightly again and yields, while still at very high levels dropped somewhat from the record set in MY 2004. This resulted in a smaller increase in production in MY 2005 from 23.3 million bales to 23.9 million bales.

273. What the charts above show is that the *absolute* level production in the United States says little about the production *decisions* of U.S. producers (i.e., whether or not to plant upland cotton). Moreover, it does not explain whether these decisions were driven by market factors, as the empirical evidence indicates, or rather by marketing loan and counter-cyclical payments, as Brazil alleges. Indeed, Brazil recognized as much in the original proceeding, arguing that "ultimate production" was not an appropriate basis for assessing whether "the effect" of U.S. payments is to distort the production decisions made by U.S. producers.[374] Brazil noted that "producers do not decide on production, but on plantings. Ultimate production is affected by weather and other factors affecting yields."[375]

274. Now, however, Brazil argues that "ultimate production" *is* an appropriate consideration in assessing the effects of the U.S. marketing loan and counter-cyclical payments on the planting decision. According to Brazil, "in years with unusually high yields, th[e] subsidized planted acreage leads to even bigger increases in production due to the effects of the U.S. subsidies. In other words, it was the effect of the subsidies that led U.S. farmers to plant and finance the cost of growing upland cotton that was later harvested with high yields."[376] The United States disagrees.

275. The question under Article 6.3(c) of the *SCM Agreement* is whether "the *effect* of the *subsidy* is . . . significant price suppression . . . in the same market."[377] Brazil's theory, moreover, is that farmers' expectations of marketing loans and counter-cyclical payments have "led U.S. farmers to plant" when they other would not have done so and this results in

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[374] This is consistent with the evidence discussed above, which shows that U.S. share of world production and exports has been stable over the life of the FSRI Act. That evidence also suggests that the production and export decisions of U.S. producers and exporters were *not* distorted by the availability of marketing loan and counter-cyclical payments, but rather were similar to the decisions made by producers and exporters in the rest of the world.

[375] Brazil Appellee Brief, para. 706, n. 995. Brazil's assertions were made in support of its argument that U.S. *share* of production is not a relevant consideration. That argument is not sound. As discussed above, U.S. share of production provides valuable information regarding the decisions of U.S. producers relative to others. Where, over the course of a decade, U.S. production moves in the same way as production in the rest of the world, it cannot be dismissed as a remarkably long-standing coincidence of the various factors affecting production. Rather, it is important evidence that the production *decisions* made by U.S. producers – i.e., the planting decisions – are consistent with those made by producers in the rest of the world. However, while Brazil's assertions above are not correct with regard to the relevance of U.S. share of production, they do serve to explain precisely why it is not meaningful to consider *absolute* levels of production in assessing the alleged effect of U.S. marketing loan and counter-cyclical payments, as Brazil is now attempting to do.

[376] Brazil First Written Submission, para. 149.

[377] Emphasis added.

overproduction, export of excess production, and ultimately suppression of world market prices.[378] The key issue then is whether marketing loan and counter-cyclical payments have, in fact, "led U.S. farmers to plant." To examine this, one would presumably consider: (a) the expectations of farmers at planting regarding market returns on the one hand and government payments on the other, (b) the ultimate decision made regarding what to plant, and (c) the relationship between these factors. While *expected* yields may be relevant in understanding the farmers' ultimate planting decisions – and are, thus, an important consideration in examining whether it is market factors or government payments that have "led U.S. farmers to plant" – *actual* yields and the resulting volume of production are not.

276. In other words, where because of improved yields there happens to be an increased level of production, the latter is "the effect" of such factors as good weather, improved varieties, stronger pest controls, and good farming practices. Absolute increases in production as a result of improved yields can no more be attributed to the alleged *production-inducing* effect of marketing loan and counter-cyclical payments than absolute declines for such reasons as drought and pest damage can be attributed to any *production-restraining* effect of the payments.

### 4. Brazil Fails To Demonstrate a "Temporal Coincidence" Between Marketing Loan Payments and Counter-cyclical Payments and the Alleged Price Suppression

277. Brazil purports to point to evidence that will "reinforce the original panel's finding, at paragraph 7.1351 of its report, of a discernable temporal coincidence of suppressed world market prices and the price-contingent U.S. subsidies."[379] The Appellate Body has clarified, however, that "mere correlation between payment of subsidies and significantly suppressed prices would be insufficient, without more, to prove that the effect of the subsidies is significant price suppression."[380] Therefore, even if Brazil were able to adduce evidence of such "temporal coincidence," it would be insufficient. In any event, as discussed below, Brazil does not provide any such evidence.

278. The United States responds to Brazil's arguments in the course of addressing each of the factors considered by the panel in the original proceeding in its discussion of "temporal coincidence."[381]

- ***"United States production of upland cotton increased from MY 1998 to MY***

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[378] Brazil First Written Submission, para. 149.

[379] Brazil First Written Submission, para. 152. The United States notes that, while Brazil asserts in its first written submission that it will isolate the effects of the marketing loan and counter-cyclical payment programs, it does not do in its assessment of "temporal coincidence."

[380] *Upland Cotton (AB)*, para. 451.

[381] *Upland Cotton (Panel)*, para. 7.1351.

***2001 and, while production dropped in MY 2002, there was still an overall increase in MY 2002 compared to MY 1998."***[382]

279. The United States recalls Brazil's clarification in the Appellate Body proceeding that "ultimate production" is not an appropriate basis for assessing production *decisions* as "producers do not decide on production, but on plantings. Ultimate production is affected by weather and other factors affecting yields."[383] In fact, referring to this discussion of production and "temporal coincidence" in the panel report, Brazil explained that "[t]he Panel simply referred to "production" as shorthand for planting decisions by producers, which even in agricultural economics literature is not uncommon."[384]

280. The United States agrees with Brazil that it is important to consider plantings, rather than final production levels in this context. As shown below, U.S. planted acreage has been stable for the entire period that the FSRI Act has been in effect and, in fact, is substantially lower now than in the period examined in the original proceeding. Thus, since the FSRI Act came into effect, there has been no "overall increase" in plantings similar to that observed by the panel in the original proceeding.

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Planted (1,000 acres)** | 14395 | 13688 | 13064 | 14584 | 15347 | 15499 | 13714 | 13301 | 13409 | 13975 |
| **Harvested (1,000 acres)** | 12632 | 13157 | 10449 | 13138 | 12884 | 13560 | 12174 | 11826 | 12809 | 13534 |
| **Yields (lb/acre)** | 700 | 666 | 619 | 595 | 626 | 694 | 652 | 723 | 843 | 835 |
| **Production (lb)** | 18414 | 18245 | 13476 | 16294 | 16799 | 19602 | 16530 | 17823 | 22505 | 23260 |

Source: USDA, National Agricultural Statistics Service (NASS)

281. Brazil argues that "U.S. production of upland cotton increased from MY 2001, the previous record, to a new record in MY 2005. Production in MY 2005 was 19 percent higher than production in MY 2001, and 43 percent higher than production in MY 1999."[385] According to Brazil, this is evidence of a "strong causal link" between *the marketing loan and counter-cyclical payment programs* and U.S. production, exports, and effect on prices. However, as shown above, the "record" production in MY 2005 was due to record *yields*. In MY 2005, U.S. producers actually planted *fewer* acres than in either MY 2001 or MY 1999 (13.9 compared to 15.4 and 14.5 million acres, respectively).

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[382] *Upland Cotton (Panel)*, para. 7.1351.

[383] Brazil Appellee Submission, para. 706, n. 995.

[384] Brazil Appellee Submission, para. 686.

[385] Brazil First Written Submission, para. 152.

282. Had the yields in MY 2005 been what they were in the earlier years, U.S. production in MY 2005 would have been far lower. As noted above, Brazil suggests that it is appropriate to compare MY 2005 production to MY 1999 and 2001 production. However, if one were to applying MY 2001 yields to MY 2005 harvested acreage, U.S. production would have been almost 30 percent lower. And applying MY 1999 yields to MY 2005 harvested acreage, U.S. production would have been almost 40 percent lower. Thus, contrary to Brazil's assertions, the increased production in MY 2005 is not evidence of any "strong causal link" between the marketing loan and counter-cyclical payments and production. It is evidence of dramatic improvements in yields.

- ***"The United States' share of world upland cotton production increased to and remained at a level of approximately 20 per cent"***[386]

283. U.S. share of world production is shown in the chart in Section VI.C.2 above. As seen there, U.S. share of production has *not* increased over the period of the FSRI Act, as it appeared to do between MY 1998 and MY 2002, the period examined by the original panel. To the contrary, U.S. share of world production *declined* slightly from MY 2002 to 2003 (from 19.5 to 19.2 percent), and stayed at that level until MY 2005, when it shifted up slightly (to 20.9 percent), returning to a level only slightly higher than in MY 2001 (when in was at 20.6 percent). In other words, while there has been some slight up and down movement, U.S. share of production has remained stable throughout the period.

- ***"United States prices received by United States upland cotton producers decreased by 34 per cent between MY 1998 and MY 2001"***[387]

284. The U.S. prices received by U.S. upland cotton producers have not decreased since the FSRI Act came into effect. Rather, prices (the U.S. farm, mill, and spot prices and the A-Index) moved up in MY 2003, moved down in MY 2004, but moved up again in MY 2005. And they are projected to continue to increase.[388] The United States notes that Brazil does not even address this factor in its discussion of the alleged "temporal coincidence."

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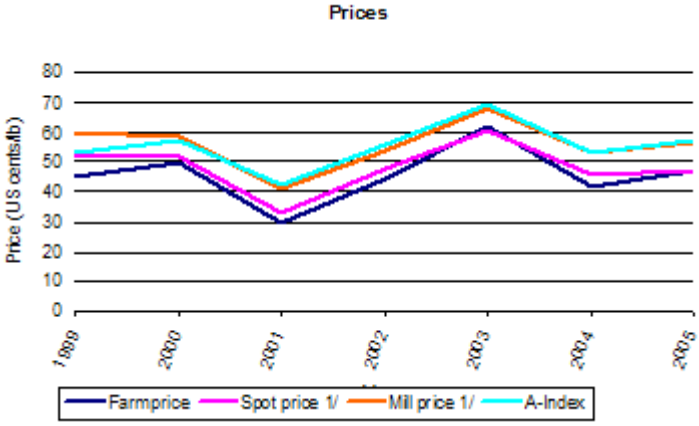
[386] *Upland Cotton (Panel)*, para. 7.1351.

[387] *Upland Cotton (Panel)*, para. 7.1351.

[388] Compiled Statistics – Prices & Futures (Exhibit US-25).




Source: USDA, Agriculture Marketing Service Reports[389]

- ***"the A-Index in MY 1999 – MY 2002 was, on average, 29.5 per cent below its 1980-1998 average"***[390]

285. Applying the panel's analysis to the period of the FSRI Act, we see that the A-Index in MY 2002 to MY 2005 was an average of 16% lower than the 1980-2001 average.[391] Thus, as before, per-pound prices for upland cotton *are* lower now than they were in that earlier period. However, that fact says nothing about whether or not *the marketing loan* and *counter-cyclical payment programs* are causing present significant price suppression.

286. For one, Brazil's claim in this proceeding is of significant price *suppression*, not price *depression*. Interpreting "suppression" in accordance with its ordinary meaning of "[p]revent or inhibit (an action or phenomenon)," the panel in the original proceeding defined "price suppression" as "the situation where 'prices' – in terms of the 'amount of money set for sale of upland cotton' or the 'value or worth' of upland cotton – either are prevented or inhibited from rising (i.e. they do not increase when they otherwise would have) or they do actually increase, but the increase is less than it otherwise would have been."[392] Thus a *decline* in prices does not demonstrate price *suppression*. The question is whether prices are being prevented from *rising* by something (in this case, the marketing loan and counter-cyclical payment programs). Brazil

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[389] Compiled Statistics – Prices (Exhibit US-25).

[390] *Upland Cotton (Panel)*, para. 7.1351.

[391] Brazil exaggerates this figure (citing prices 22 percent below the 1980-1998 average) by using MY 2001 as one of the end points. That year saw unusually low prices due to a substantial change in yields. The FSRI Act was not in effect in that year and, hence, the marketing loan and counter-cyclical payment programs under the FSRI act were not in operation. Therefore, MY 2001 is not the appropriate end-point in this analysis.

[392] *Upland Cotton (Panel)*, paras. 7.1276-7.1277. The Appellate Body agreed that this was an appropriate interpretation of "price suppression." *Upland Cotton (AB)*, para. 424.

provides no empirical evidence of such "suppression."

287. Moreover, the fact that the A-Index has trended downwards for more than 25 years now – well before the FSRI Act came into effect – and the fact that the A-Index has gone *up* from the levels that prevailed *before* the FSRI Act came into effect as of MY 2002 would tend to suggest that, to the extent there is any price *suppression*, it is not "the effect" of the marketing loan and counter-cyclical payment programs.


Source: USDA, Agriculture Marketing Service Reports[393]

- ***"United States exports increased by approximately 160 per cent from MY 1998 to MY 2001 and by an even greater percentage from MY 1998-MY 2002" and "United States share of world exports of upland cotton increased"***[394] and ***"United States imports of upland cotton remained at comparatively low levels."***[395]

288. The United States has addressed this issue in detail above in Section VI.C.2. As explained earlier, while the absolute volume of U.S. exports has gone up over the period of the FSRI Act, U.S. share of world exports has *not* increased. To the contrary, it *declined* in MY 2002.

289. The fact that U.S. exports have generally held a stable share of world exports over the life of the FSRI Act indicates that, to the extent U.S. exporters have exported larger *absolute* volumes of upland cotton, they have done so consistently with their foreign counterparts. Thus,

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[393] Compiled Statistics – Prices (Exhibit US-25).

[394] *Upland Cotton (Panel)*, para. 7.1351.

[395] *Upland Cotton (Panel)*, para. 7.1351.

there is no basis for Brazil's argument that the relative or absolute level of exports – or any of the other factors discussed above – evince "a strong causal relationship between U.S. subsidies, low U.S. prices, the suppression of world market prices, and the increase in U.S. exports." U.S. export behavior is shaped by market forces – the same market forces that shape the behavior of foreign producers and exporters – not "U.S. subsidies."

- ***United States imports of upland cotton remained at comparatively low levels***[396]

290. U.S. imports of upland cotton have been at low levels for many decades and, as the U.S. textile industry shrunk, the demand for cotton generally has declined (whether domestically produced or imported). The low level of imports, therefore, has little to do with the marketing loan and counter-cyclical payment programs.

291. For the reasons above, none of the factors considered by the panel in the original proceeding in reaching its conclusion of a "discernible temporal coincidence" between U.S. subsidies and significant price suppression support such a finding with respect to the marketing loan and counter-cyclical payment programs now. Moreover, contrary to its assertions, Brazil has *not* provided evidence that "reinforce[s] the original panel's finding . . . of a discernable temporal coincidence of suppressed world market prices and the price-contingent U.S. subsidies."[397]

### 5. Brazil Does Not Demonstrate That U.S. Producers Would "Switch to Alternative Crops" In the Absence of Payments Under the Marketing Loan and Counter-cyclical Payment Programs

292. Brazil suggests that payments under the marketing loan and counter-cyclical payment programs play "an essential role" in "covering U.S. upland cotton producers' *long-term total costs of production*."[398] Accordingly, in Brazil's view, "[*b*]*ut for* these subsidies, many upland cotton producers would have had to discontinue growing upland cotton and switch to alternative crops."[399] Brazil's argument is flawed both from an analytical and a factual standpoint.

#### (a) Total Costs and Returns of Growing Cotton Do Not Explain Short-term Planting Decision and Do Not Alone Explain Long-Term Farming Decisions

293. Brazil's argument is based on the incorrect assumption that decisions about whether to plant cotton or an alternative crop are made by reference to the "long-term total costs of

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[396] *Upland Cotton (Panel)*, para. 7.1351.

[397] Brazil First Written Submission, para. 153.

[398] Brazil First Written Submission, para.163 (emphasis added).

[399] Brazil First Written Submission, para. 163.

production" of upland cotton. That assumption is inconsistent with the accepted principle in the agricultural economics profession that the measure producers use when deciding what crops to grow is variable costs of production, not "long-term total costs of production."[400] Indeed, the Appellate Body acknowledged this in the original proceeding:

> We agree with the general proposition of the United States that *variable costs may play a role in farmers' decision-making as to whether to plant upland cotton or some alternative crop, and how much of each crop to plant*. From a short-term perspective, variable costs may be *particularly important*.[401]

294. To illustrate this principle in practice, consider a simplified example of a farmer deciding in January of a particular year whether to plant all soybeans, some soybeans and some cotton, all cotton, or to allow the land to sit idle. He will consider, *inter alia*, the expected price of cotton at harvest, the expected price of soybeans at harvest, as well as the anticipated costs of growing each crop. In so doing, he does not need to consider fixed asset and overhead costs. He has already incurred those costs; they will not differ based on whether the farmer plants soybeans, cotton, a mix, or nothing. Rather, the farmer will consider projected net revenues taking into account costs for such items as seed, fertilizer, chemicals, and other expenses that are directly related to planting, harvesting, and marketing each crop. The economically rational decision for him will be to plant the crop, or mix of crops, that *both* covers his variable costs *and* maximizes his net revenue. In other words, the farmer will choose the option that gives him the largest margin above variable costs. This will not only allow him to cover his variable expenses but will also give him the most revenue to pay down total costs.

295. Although it is variable costs that affect immediate production decisions, that does *not* mean that total costs of production are irrelevant to producers. To the contrary, in the long run, producers will have to cover asset and overhead costs, as well as variable costs. Thus, as the Appellate Body noted, "from a longer-term perspective, total costs *may* be relevant."[402] Total costs may be relevant, for example, to such long-term or big-picture decisions as whether to continue or exit cotton farming. However, those decisions are not be made on the basis of the segmented cotton-only analysis of costs and returns that Brazil presents in its first written submission. Rather, those types of whole-farm decisions will be made taking into consideration whole-farm costs and returns, including, for example, costs and revenue generated from other crops that have been (or may be) grown as well as off-farm revenues. The latter is an especially important consideration. In a study of changes in U.S. farm structure over the 20th century, Dmitry et. al. (2005) noted that:

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[400] The United States discussed the extensive literature in this regard in its submissions to the panel in the original proceeding. *See e.g.,* U.S. Further Rebuttal Submission, paras. 117-122 (18 November 2003).

[401] *Upland Cotton (AB)*, para. 453.

[402] *Upland Cotton (AB)*, para. 453 (emphasis added).

> [A]bout a third of farm operators worked off the farm for at least 100 days in 1930. . . . By 1970, more than half of farms had off-farm income, and by 2000, 93 percent of farms earned off-farm income. Off-farm work has played a key role in increased farm household income; while farm household income was once below the national average, in 2002 it exceeded the national average by nearly $8,000.[403]

296. Examining specifically the role of off-farm income in farm exits, Hoppe & Korb (2006) explained that:

> Off-farm work has become important to farm operators. About one-third of farmers have worked off the farm *at least 200 days per year*—essentially full-time—since 1978. Off-farm work could hypothetically affect exits in two ways. First, off-farm work may be the first step in an exit from farming, which would be reflected in higher exits for farms the operators of which work off-farm. Second, *off-farm work might lower the probability of exit by providing farm operator households with another source of income*.[404]

297. Brazil has provided no analyses of whole farm costs and revenues that would support its conclusion that, absent payments under the marketing loan and counter-cyclical payment programs, certain cotton producers in the United States would exit cotton farming altogether. Brazil, thus, has not demonstrated that without marketing loan and counter-cyclical payments U.S. cotton plantings would decline to any significant degree.

298. Brazil's analysis also ignores entirely the diversity of U.S. cotton producers. For example, as shown in Section VI.C.1 above, in MY 2005, almost 20 percent of upland cotton planted acres were planted on farms with no cotton base acres or in excess of a farm's base acres. This number has been growing, up from only about 16 percent in MY 2002. This means that there are a substantial number of producers who would not be affected by a reduction or elimination of payments. Brazil fails to account for these producers in its analysis. Nor does Brazil address the possibility that any exit of high-cost U.S. producers would be offset by the expansion of the production of more efficient lower-cost U.S. producers; leaving U.S. plantings and production at the same levels overall.[405]

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[403] Dimitri, Carolyn et. al., The 20th Century Transformation of U.S. Agriculture and Farm Policy. Economic Information Bulletin Number 3. June 2005, pg. 2-3 (Exhibit US-45).

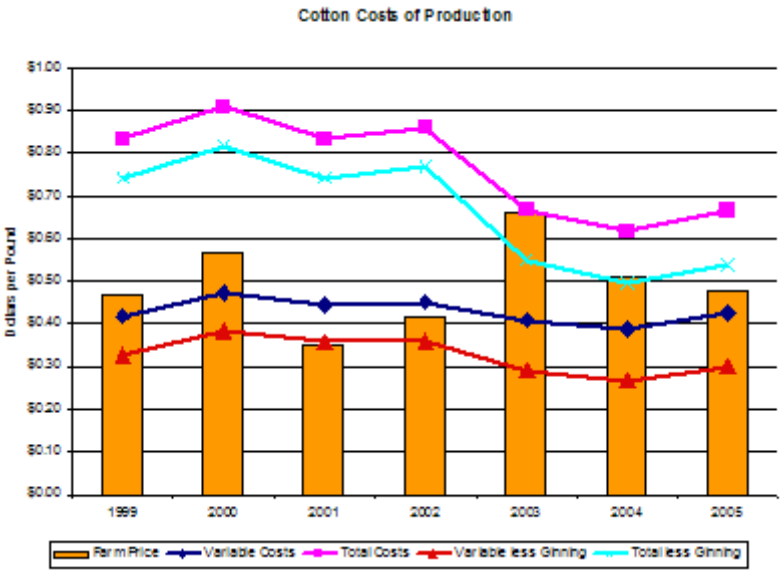
[404] Hoppe, Robert A. and Korb, Penni. Understanding U.S. Farm Exits. Economic Research Report 21. June 2006, p. 20 (Exhibit US-46).

[405] *See e.g.,* Hoppe, Robert A. and Korb, Penni. Understanding U.S. Farm Exits. Economic Research Report Number 21. June 2006, p. 18 (Exhibit US-46) ("One might, therefore, expect cash grain farms to have lower exit probabilities because one of the goals of farm programs is to support farm income (Effland, 2000), which would be expected to help farms survive. Government programs, however, might speed the exit of smaller grain farms by

299. In short, Brazil's assertion that there is a "gap" between *total* costs and revenues of growing cotton does not support the argument that cotton plantings and production would have been lower *but for* the marketing loan and counter-cyclical payment programs. The comparison of *total* costs and revenue is not relevant to short-term planting decisions. Accordingly, Brazil cannot show that plantings would be different in the short-term as a result of any alleged "gap" between total costs and revenues associated with growing cotton. Moreover, a comparison of cotton-specific total costs and revenue is not, alone, useful in explaining long-term farming decisions such as whether to continue or exit cotton farming.

### (b) U.S. Cotton Producers Have Not Only Covered Their Variable Costs But Also a Substantial Portion of Their Total Costs From Cotton Revenues in MY 2002-2005

300. As discussed above, the key consideration in assessing a farmer's decision to grow upland cotton or switch to alternative crops is whether the farmer has been covering his variable costs of production. As shown below, in the period MY 2002 to 2005, U.S. producers have not only covered variable costs but in almost all years have covered most if not all of their *total costs* of growing cotton as well.




Source: USDA, Economic Research Service[406]

providing funds for larger grain farms, which receive larger payments, to buy up smaller farms.").

[406] U.S. Upland Cotton Costs and Returns (Exhibit US-47).

301. The United States has presented costs of production in two ways. For both variable and total costs, the upper line is the cost for *both* cotton and cottonseed (i.e., for "raw" or seedcotton). The farm price shown above, however, is the price for cotton *lint*, which is the product at issue here. To calculate costs for cotton lint only that can properly be compared to the upland cotton farm price, the United States has subtracted ginning costs from variable costs of production. This is consistent with the practice in the United States of ginning costs being paid for out of the proceeds gained by the gin from sale of the cottonseed that is separated out in the ginning process. The bottom line for both variable and total costs shows costs net of ginning.

302. As shown above, costs per pound of cotton have been declining steadily over the period of the FSRI Act. With ginning costs removed, total costs – which have declined more than variable costs – have fallen from 82 cents/lb in MY 2000 to 50 cents/lb in MY 2005. Variable costs fell from 38 cents/lb in MY 2000 to 27 cents/lb in MY 2004, and rose again slightly in MY to 30 cents per pound in MY 2005. This general decline in costs is attributable in great part to the technological advances that the United States outlined during the original proceeding, the effects of which were not reflected in the 1997 USDA cost survey data available to the panel therein.[407] These included the boll weevil eradication programs and the introduction and widespread adoption of genetically modified varieties of cotton, which have had a tremendous impact on U.S. cotton production. These effects are being reflected in the more recent (2003) USDA cost survey data used to calculate the costs for MY 2003-2005 above.

### (c) The ICAC Study and Dr. Sumner's Assessment of the U.S. Producers' Cost of Production Are Flawed

303. Brazil attempts to bolster its argument that, in the absence of marketing loan and counter-cyclical payments, allegedly "high-cost" U.S. cotton producers would "discontinue" growing cotton with citations to an ICAC survey of the costs of production in various countries and the modeling findings of its own economist. The United States addresses Dr. Sumner's modeling – and his findings on the basis thereof – in Section VI.C.7. As explained there, Dr. Sumner's analysis is substantially flawed.

304. The ICAC survey, moreover, disqualifies itself as a reliable basis for comparison of costs across different countries. As ICAC explains about its survey data:

> Real comparisons among countries are difficult due to a *lack of complete data from all countries*. Difficulties also exist because of the method of estimating cost of production, the relative significance of different inputs in production systems and estimation of opportunity costs. *Data should be used carefully*, particularly

[407] *See e.g.,* U.S. Further Submission, paras. 46-54 (30 September 2002); U.S. Further Rebuttal Submission, para. 124 (18 November 2003).

when comparing net cost per kilogram of lint . . . .[408]

305. In a presentation of the results of this survey, ICAC was even more tentative, setting out the following detailed "caveats":

> The ICAC Secretariat is aware that cost of production data come from actual surveys of farming practices in some instances such as the USA and Australia. While some countries undertake sample surveys, cotton researchers complete survey forms in others. The source of data for individual input costs or operations *can vary greatly from country to country*. When and how the opportunity costs of inputs and operations are calculated is *also a source of variation* among countries. Therefore, it is quite possible that the ICAC cost of production data represent *potential* costs rather than the *actual* costs.
>
> Ideally, one could measure the cost of producing cotton using a uniform method of collecting data and measuring the cost of all inputs and operations through to the production of seedcotton and lint. At the same time, in order to calculate the net cost of lint or ownership cost of seedcotton production, one must have complete data on land rent, as well as the value of seed after ginning. However, *no uniform standard data are available other than for a very small number of countries*. No opportunity costs are available for some inputs/operations. Land is a basic requirement to grow cotton but in some countries there is no land rent system. Cotton companies in West African countries provide planting seed free to cotton growers. Production technology is free in most countries but not in a country like Australia where cotton consultants are hired by cotton growers.
>
> Family labor employed in field operations and government subsidies on inputs are other critical factors making comparisons difficult and sometimes invalid among countries.
>
> Cotton is produced in many parts of the world under a variety of production conditions, different climates and different systems of economic organization. Cotton produced in two countries at a same cost may not fetch the same price. Cotton produced in Egypt is not the same quality as in other countries and will be sold at a higher price.[409]

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[408] Survey of the Cost of Raw Cotton, International Cotton Advisory Council, at 5 (November 2004).

[409] *Cost of Production in the USA and Other Countries*, at 4 (Exhibit US-48).

306. In other words, the ICAC itself warns against the kind of superficial comparisons that Brazil attempts to make between costs in the United States, Brazil, and Cameroon.[410] Indeed, Brazil's assertion on the basis of the ICAC data that costs of production in the U.S. Prairie Gateway region were 98 cents/lb – compared to only 45 cents/lb in Brazil and 38 cents/lb in Cameroon – illustrates well why reliance on that data is problematic. According to official USDA data for MY 2004 – the same period that the ICAC survey purports to covers – the *total* costs of production of seedcotton in the Prairie Gateway were *60 cents/lb*. Taking the cost of ginning out to get a cost for cotton lint, the *total* per-lb cost is only *48 cents/lb*. Variable costs are even lower at *35 cents/lb* for seedcotton and *23 cents/lb* for cotton lint.

307. Brazil, therefore, overstates U.S. costs of production for what it alleges is "the most expensive region to produce cotton of all 30 countries/regions surveyed by the ICAC" by *more than 200 percent* (looking at total costs for cotton lint).[411] It is regrettable that Brazil presents these grossly inaccurate figures for the Prairie Gateway when it has before it the correct USDA data for the region (the figures are part of the same spreadsheet that Brazil used to construct its flawed "cumulative" assessment of costs).[412]

### 6. Brazil Attempts to Attribute the Price Effects of Other Factors to the Marketing Loan and Counter-cyclical Payment Programs

308. As discussed above, Brazil's claim that the U.S. marketing loan and counter-cyclical payment programs are "fueling" U.S. planting, production, and exports and thereby significantly suppressing world market prices does not find support in the empirical evidence. A key flaw in Brazil's claim is that its premise – that "[t]he U.S. market continues to be the most important market influencing cotton prices throughout the world"[413] and "the United States functions as a key 'driver' of the world market price"[414] – is overly simplistic and inconsistent with the realities of the world cotton market. By relying on this premise to make its arguments, Brazil ignores – and, in fact, attempts to attribute to the marketing loan and counter-cyclical payments – the effects of other factors. The United States considers below one of the most important of these other factors – China's trade in cotton.

#### (a) There Is a High Correlation Between China's Net Cotton Trade and the A-Index

309. While Brazil fails to provide evidence that the United States "drives" world market prices

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[410] Brazil First Written Submission, para. 162.

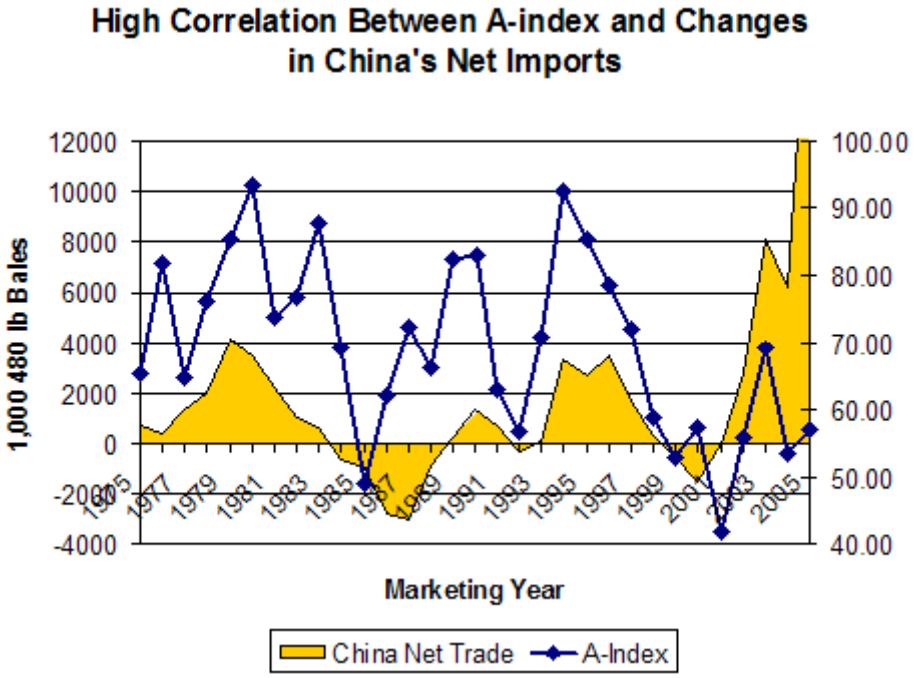
[411] Brazil First Written Submission, para. 162.

[412] Brazil First Written Submission, para. 160, n. 290 (citing Brazil's costs and returns worksheet in BRA-477 which states that the data used therein is from http://www.ers.usda.gov/data/costsandreturns/testpick.htm).

[413] Brazil First Written Submission, Annex II, para. 23.

[414] Brazil First Written Submission, Annex II, para. 24.

for upland cotton, there is substantial evidence of a close correlation between Chinese net trade in cotton and the A-Index. As shown in the chart below, this correlation undermines the assertion of Brazil's cotton market expert that "the influence of potential Chinese supply and demand on cotton prices is mitigated by the fact that market participants have only limited and not very reliable information about Chinese demand and production."[415]




Source: USDA, Agriculture Marketing Service Reports[416] USDA, PS&D[417]

310. The comparison above of movements in the A-Index to the changes in Chinese net trade in cotton over the last 30 years demonstrates that, when China has increased its imports of cotton, the A-Index has tended to move up. And, when China has decreased its imports of cotton, or even has started exporting cotton, the A-Index has trended down. Though they cannot alone explain price changes, China's policy decisions and changes in consumption factor largely into many of the movements seen above. Specifically:

- During the mid-1990's, China began accumulating surplus stocks as a result of setting internal procurement prices above world market-clearing levels. The

[415] Brazil First Written Submission, Annex II, para. 26.

[416] Compiled Statistics – Prices (Exhibit US-25).

[417] China Production, Supply, and Demand (Exhibit US-27).

government of China permitted some mills to continue importing cotton; thus, import levels rose along with stocks, supporting high world prices. China's imports averaged about 3.5 million bales per year in MY 1994 to 1996, triple the level of the early 1990's, and then fell to half that level in MY 1997. By the end of MY 1998, world ending stocks rose to 52.2 million bales – the highest stock level up to that time – and China held almost 27 million bales, over *half* the world total.

- China reversed its policy in September 1999, when it began allowing procurement prices to float. This change in policy necessitated the disposal of surplus cotton stocks. China became a significant net exporter in MY 1999 and was entirely self-sufficient in cotton until MY 2002. This was accomplished by auctioning 3.5 million bales of government-held stocks between October 1999 and July 2003. The result was a precipitous decline in world prices. China held 48 percent of world stocks in MY1998, but only 27 percent by the end of MY2001. This, plus record world yields and the effects of recession in the United States at the time of the September 11 terrorist attacks, drove the A-index to a 30-year low of just under 35 cents per pound in early November 2001.

- In MY 2002, world prices rebounded. World consumption rose 3.5 percent, as economic conditions improved and textile production increased to restock inventories that were depleted in 2001/02. With lower stocks in China, Chinese net imports surged to 2.4 million bales, the highest level in 6 years, signaling an end to the surplus disposal program. Ending stocks in the U.S., China, and the rest of the world returned to normal or near-normal levels and the A-index rose 35 percent to an average of 56 cents per pound.

- In MY 2003, with world stocks at extremely low levels, world prices rose to about 30 percent above the preceding five-year average, reaching 69 cents/pound (A-index NE). World production fell short of consumption for the second consecutive year, reducing world stocks. China's imports were sharply higher.

- Over MY 2004 and 2005, China led an increase in world consumption by an unprecedented 20 percent – more than five times the annual growth of the preceding 10 years. At the same time, however, world production also increased. Record production by the world's four largest producers – China, the U.S., India, and Pakistan – drove record world production in MY 2005, due largely to favorable weather as well structural (India) and technological changes (India and the United States).

- World cotton production for MY 2006 is projected to be about the same as in MY 2005 (approximately 116 million bales). U.S. production and exports are

> projected to decline. China's imports are projected to decline slightly from MY 2005 but China will still account for over 40 percent of world imports and consumption.

311. What the above review indicates is that, contrary to the assertions of Brazil's cotton market expert, the United States is *not* "the most important market influencing cotton prices throughout the world,"[418] nor "the 'driver' of the world market price."[419] Moreover, it does not seem to be true that "[t]he uncertainty regarding Chinese demand and the fact that domestic production continues to account for the majority of domestic consumption , limits the ability of the Chinese market to "drive" international prices. . . ."[420] Accordingly, Brazil's attempts to ascribe price-suppressive effects to the marketing loan and counter-cyclical payment programs on the basis of these representations – without properly addressing and distinguishing the effects of such other factors as the impact of China's net trade and trade policies – are simply untenable.

### (b) The A-Index Itself Has Changed to Reflect the Impact of China on the World Cotton Market

312. It is curious that, while Brazil's claim of price suppression *centers* on the "world price" for cotton as represented by the A-Index, Brazil gives short shrift to the fact that the "world price" itself has been changed to reflect the importance of China in the world cotton market. Specifically, as discussed above, the A-Index is now no longer calculated on the basis of prices of cotton delivered to Northern Europe, it is now calculated on the basis of cotton delivered to Far East ports.[421] The Cotlook website explains the reason for the transition as follows:

> Our change of emphasis to a Far Eastern geographical basis is a logical progression from the long established, European-based A Index in view of the increased tempo of the change in trade flows in cotton since China's accession to the WTO. . . . Cotlook regards the switch of emphasis to a Far Eastern basis as a transition that validly reflects today's current market. Our aim is to ensure that the A Index maintains its unrivalled position as the leading barometer of international cotton price movements.[422]

313. Although Brazil dismisses this change in the "world price" as a mere "technical change,"[423] it is clearly more significant. The fact that such a shift was necessary to allow

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[418] Brazil First Written Submission, Annex II, para. 23.

[419] Brazil First Written Submission, Annex II, para. 24.

[420] Brazil First Written Submission, Annex II, para. 26.

[421] *See* description of Cotlook indices at http://www.cotlook.com/information/cotlook_indices.php.

[422] *See* http://www.cotlook.com/information/cotlook_indices.php.

[423] Brazil First Written Submission, para. 85.

proper measurement of "international cotton price movements" and that this shift was driven primarily by the impact on the market of a single country – China – confirms what the market reports overwhelmingly recognize – that the price trends for upland cotton cannot be explained except by accounting for China's influence on the market. This is true regardless of whether the question is one of price *depression* or price *suppression*.

### (c) Market Reports Submitted By Brazil Indicate That Uncertainty About China's Trade Results In Downward Pressures On Price

314. Although Brazil's cotton market expert suggests that "[t]he uncertainty regarding Chinese demand and the fact that domestic production continues to account for the majority of domestic consumption, limits the ability of the Chinese market to 'drive' international prices. . . .,"[424] the market reports submitted by Brazil indicate just the opposite. According to these reports, downward pressure on prices may result from the uncertainty *itself*. In the case of China's market, there is uncertainty both about the reliability of China's supply and demand statistics as well as *ad hoc* changes in government policies, such as changes in procurement prices to farmers and changes in credit policies. Uncertainty leads to increased price volatility and risk to world market participants. These effects are reflected in prices.

315. The ICAC cotton review that Brazil submits explains, for example, that:

> It would seem that a few issues, mainly related to the rise of China (Mainland) as the dominant buyer in the world cotton market, have *prevented a significant price increase in 2005/2006*. Chinese cotton consumption is expected to increase by 18% in 2005/2006, about the same change as last season and much faster than in the rest of the world. . . .However, because there are uncertainties regarding statistics on cotton production, consumption, and stocks, it is difficult to estimate the gap between supply and use in China (Mainland), and therefore to predict the level of Chinese imports from one season to another. The timing and amount of import quotas released by China (Mainland) has thus become precious information to evaluate the need for cotton by Chinese mills. However, *the lack of information about the future releases of these import quotas may contribute to pushing prices downward*. In addition, the lack of detailed information about the amount of cotton located in consignment stocks in Asia, "floating stocks" that are already exported but not yet imported, contributes to increase doubts in the market. . . . .Another factor that could be preventing further price increases is the slow-down in growth of world mill use. World mill use is expected to increase by an estimated 6% in 2005/06, compared to 10% last season.[425]

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[424] Brazil First Written Submission, Annex II, para. 26.

[425] "Cotton: Review of the World Situation", International Cotton Advisory Committee at 7 (May-June 2006) (BRA-485).

316. Brazil's cotton market expert suggests that uncertainty about China's market can only lead to very short turn up- and down-ticks in price. In his view:

> Rumours that China is buying will lead to price increases and rumours about less than expected Chinese purchases will lead to price declines. But the long-term price trend will be determined by the hard facts of actual supply and demand. . . . . USDA's statistical information – and revisions thereof – on supply and demand for cotton in the U.S. and throughout the world is a key source of 'hard facts' and plays a key role in forming market participants perceptions of mid- to long-term trends[426]

317. Brazil does not take into account, however, that both USDA and the ICAC have had to significantly revise their estimates of Chinese cotton consumption and stocks in recent years because of lack of reliable initial information.[427] As explained in the May 2006 Cotlook report submitted by Brazil, the fact that "hard facts" do not really exist about the world's largest producer and consumer of cotton does not "mitigate" effects on price, as Brazil's expert suggest. Rather, it may contribute to such effects:

> A closer examination of the statistics re-emphasises the immense significance of China in the world cotton economy. . . .China . . . will witness a decline [in its stocks-to-use ratio in 2006/2007] to 16 percent (against a predicted 23 percent at the end of 2005/2006), even with imports during 2006/2007 of 4,000,000 tonnes and a domestic output above 6,000,000 tonnes. That is, of course, if the figures emanating from China as regards yarn production, and cotton's share of the fibre used, are to be believed. The fact that import buying of cotton from that quarter has proved less than anticipated (notwithstanding recent large monthly import figures) has led to renewed questioning of the statistics in some international trade circles. For the time being, *in consequence, the trade is struggling to dispose of current crop stocks that it would presumably have earmarked for China. In the circumstances, very little forward trading interest in 2006/2007 crops is discernible*.[428]

318. In short, Brazil sidesteps any meaningful analysis of world market prices and the factors that influence them. Rather, regardless of the evidence, Brazil simply attributes to the marketing loan and counter-cyclical payment programs any negative movement in world prices and any positive movement in U.S. plantings, production and exports. This is not consistent with Article 6.3(c) of the *SCM Agreement*, which requires a showing that "the effect *of the subsidy* is . . .

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[426] Brazil First Written Submission, para, Annex II, para. 32, 34.

[427] For example, see WASDE November 2004, May 2005, July 2005 (US-49).

[428] Cotton Outlook at 5, Volume 84, No. 18, May 5, 2006 (Exhibit BRA-444).

significant price suppression . . . in the same market."[429] Reviewing this provision, the Appellate Body has clarified that "it is necessary to ensure that the effects of other factors on prices are not improperly attributed to the challenged subsidies." Brazil does not carry its burden in this regard.

### 7. The Econometric Modeling Cited By Brazil Is Flawed and Greatly Exaggerates Any Effects of Removing the Programs

319. Finally, Brazil argues that econometric modeling by Dr. Sumner, Brazil's economist, demonstrates that "world market prices for upland cotton would have been 9 to 11 percent higher *but for* the effects of [the marketing loan and counter-cyclical payment programs in MY 2005]."[430] Brazil asserts that this modeling "confirm[s] the results of Brazil's extensive examination of market data and evidence"[431] and, further, that Dr. Sumner's analysis is consistent with a 2006 study conducted by certain World Bank economists.

320. For the reasons above, Brazil's "extensive examination of market data and evidence" does not withstand scrutiny. Absent any empirical evidence, Dr. Sumner's econometric model is the only remaining basis for Brazil's claim. However, even based on a preliminary review of Dr. Sumner's model, it is apparent that it relies on a series of flawed economic assumptions that grossly overstate any possible effect of removing the marketing loan and counter-cyclical payment programs. A preliminary review of the model and the results thereof are discussed in Annex I.

321. Brazil argues that Dr. Sumner's analysis "involves the use of an econometric model that employs many of the same parameters used in the model and analysis submitted to the original panel, as well as parameters commonly used by USDA and Food and Agricultural Policy Research Institute ("FAPRI") economists."[432] As explained in Annex I, this is untrue. Indeed, not only are the parameters *not* those commonly used by USDA and FAPRI but they are even more exaggerated than parameters that Dr. Sumner used in what he termed was his "FAPRI-like" model in the original proceeding.[433]

322. In fact, Dr. Sumner estimated using his earlier model that the removal of *six* different U.S. programs – the production flexibility contract/direct payments, market loss assistance/counter-cyclical payments, crop insurance payments, marketing loan payments, Step 2 payments, and some alleged subsidy component of the GSM-102 export credit guarantee program – would have resulted in a total 12.6 percent impact on world price in MY 1999 to MY

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[429] Emphasis added.

[430] Brazil First Written Submission, para. 167.

[431] Brazil First Written Submission, para. 180.

[432] Brazil First Written Submission, para. 168.

[433] Brazil Further Submission, para. 158.

2002 and a 10.8 percent impact in MY 2003 to 2007[434] (and Brazil portrayed *each* of these programs as having dramatic negative impacts on price both individually and collectively in the original proceeding).

323. Now, however, Dr. Sumner manages to ascribe almost the *same* price impact (9.3 to 10.7 percent) to just *two* of these programs – the marketing loan and counter-cyclical payment program.[435] Brazil does not allege that the programs have changed; to the contrary Brazil emphasizes that its "claims of serious prejudice involve the *same* subsidy programs under the FSRI Act of 2002 that were at issue before the original panel."[436] What has changed, however, are the assumptions that Dr. Sumner makes to produce the more egregious effects.

324. The United States recalls Brazil's explanation in the original proceeding that:

> The key elasticities of supply and demand relating to the U.S. upland cotton market used in Professor Sumner's [earlier] model are the same as those used in the FAPRI model. *This is significant as these elasticities drive the results of the model in terms of production, demand and price effects.* Brazil notes that USDA uses very similar elasticities in its model.[437]

325. The United States demonstrates in Annex I that, when these "key elasticities" and some other basic assumptions are re-calibrated to *actually* reflect FAPRI and other well-established parameters, the effects predicted by Dr. Sumner's model decline sharply. Removal of the marketing loan and counter-cyclical payment programs results in world prices increasing by only 1.41 percent over baseline levels over the period MY 2002-2005 and 0.96 percent over the period MY 2006-2008. Even using long-run values for supply and demand elasticities taken from the UNCTAD-FAO ATPSM model shows removal of marketing loans and counter-cyclical programs resulting in an increase in world prices of 2.26 percent over the period MY 2002-2005 and 1.52 percent over the period MY2006-2008. *These dramatically lower price impacts result from only some very basic, preliminary adjustments to Dr. Sumner's model*. More detailed analysis and re-calibration would presumably reduce the price effects even more. The United States is continuing to review Dr. Sumner's model and will provide further views in its rebuttal submission.

326. Brazil also asserts that Dr. Sumner results are consistent with those in a recent World Bank study.[438] Brazil does not clarify, however, that the World Bank study concludes that elimination of *all* subsidies and tariffs across *all* countries amounts to a 12.9 percent impact on

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[434] Brazil Further Submission, Annex I, at 1, paras. 70-75.

[435] Brazil First Written Submission, Annex I, para. 9.

[436] Brazil First Written Submission, para. 50 (emphasis in original).

[437] Brazil Further Submission, para. 216 (emphasis added).

[438] Brazil First Submission, paras. 181-185.

the world price. The study is *not* limited to the United States, it is not even limited to domestic support programs, let alone the U.S. marketing loan and counter-cyclical payments programs. The report implies that United States accounts for a small portion, less than half, of this – for *full* elimination of *all* supports and tariffs.

327. Moreover, for the United States, the study includes the marketing loan program, production flexibility/direct payments, market loss assistance/counter-cyclical payment program, the crop insurance program and the Step 2 program. These programs are accounted for in a manner entirely inconsistent with the panel's findings in the original proceeding. For example, the model used does not appear to ascribe any different acreage impact to $1 of direct payments – which are entirely decoupled from price and production and were found to have no significant price effects in the original proceeding – than to $1 of marketing loan payment, which is paid upon harvest and depends upon prevailing prices. The same approach is taken with respect to crop insurance benefits, which also were found not to have any price-suppressive effects in the original proceeding. In short, that study, too, greatly exaggerates any possible impact. Yet, even with that, the World Bank report implies a substantially smaller impact on world prices from removal of the marketing loan and counter-cyclical payment programs than Dr. Sumner's model (a *fraction* of 12.9 percent).

328. In summary, the Sumner and World Bank studies are consistent only insomuch as they both overstate any possible impact of removing U.S. programs. In this regard, they are inconsistent with a number of other recent studies that show only minimal impacts from removing the U.S. programs.[439]

### 8. Brazil Has Not Demonstrated That "the Effect" of the Marketing Loan and Counter-cyclical Payment Program Is "Significant" Price Suppression

329. For the reasons above, Brazil has not demonstrated either through empirical evidence, or through its modeling exercise, that the marketing loan and counter-cyclical payment programs have had any appreciable impacts on price in MY 2005, let alone caused any "significant" price suppression within the meaning of Article 6.3(c) of the *SCM Agreement*.

330. The *SCM Agreement* does not define "significant" price suppression. The ordinary meaning of significant, however, is "important, notable; consequential,"[440] which suggests that

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[439] To take one example, Pan et. al. estimated that the removal of U.S. direct, counter-cyclical, step-2 and marketing loan payments would result in approximately a 2 percent increase in the world price in the initial period, but this effect would diminish over time as other producers increased their production. The authors estimated an average increase of only 1.58 percent for the MY03-MY07 period. *See* Pan, Suwen, Samarendu Mohanty, Don Ehridge, and Mohamadou Fadiga. "Economics and Marketing The Impact of U.S. Cotton Programs on the World Market: An Analysis of Brazilian WTO Peition." The Journal of Cotton Science 10 (2006) (Exhibit US-50).

[440] *The New Shorter Oxford English Dictionary*, vol. 2, at 2860 (1993 ed.) (second definition) (Exhibit US-51).

any price suppression must reach a level at which it is important, notable, and consequential in order to be inconsistent with Article 6.3(c). The panel agreed with this interpretation in the original proceeding.[441] Further, drawing contextual guidance from Article 15.2 of the *SCM Agreement*, which relates to analysis of the price effects of subsidized imports for purposes of countervailing duty investigations, the panel clarified that "it is the degree of price suppression or depression itself that must be 'significant' (i.e. important, notable or consequential) under Article 6.3(c) of the SCM Agreement."[442]

331. Brazil does little more than cite back to the same arguments it makes in its discussion of causation to attempt to demonstrate that the price suppression it alleges is "significant." In so doing, Brazil effectively writes "significant" out of Article 6.3(c) altogether. Brazil does not explain how any of the arguments it makes in its causation discussion demonstrate that the *degree* of the alleged price suppression is "important, notable; consequential." In any event, the United States has addressed Brazil's causation arguments above and shown them to be without merit. In particular, the United States has demonstrated that:

- Recent empirical research confirms that any effects of the counter-cyclical payment program on acreage decisions are minimal.

- Any analysis of the planting-time expected price conditions, and other market considerations, confirm that the marketing loan program did not have any significant effect on planting decisions in the current marketing (which is the year relevant to Brazil's "present" serious prejudice claim).

- Brazil has provided no basis for its argument that the marketing loan and counter-cyclical payment programs "insulated" U.S. producers from market signals; to the contrary, U.S. production and exports have moved in much the same way as foreign production and exports over the entire life of the FSRI Act.

- Brazil's comparisons of U.S. plantings, production, and exports to prices are flawed and fail to demonstrate any "market insulation."

- Contrary to Brazil's claims, Brazil has failed to demonstrate that there is any "temporal coincidence" based on the factors considered by the panel in the original proceeding (which would be insufficient, in any event, for a finding of serious price suppression).

- U.S. producers covered their variable costs of production and, indeed, in most

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[441] *Upland Cotton (Panel)*, para. 7.1325. *See also Upland Cotton (AB)*, para. 426.

[442] *Upland Cotton (Panel)*, para. 7.1328.

years all or substantially all of their *total* costs of production in the years since the FSRI Act came into effect.

- Brazil has *not* provided evidence that "reinforce[s] the original panel's finding . . . of a discernable temporal coincidence of suppressed world market prices and the price-contingent U.S. subsidies." To the contrary, none of the factors considered by the panel in the original proceeding in reaching its conclusion of a "discernible temporal coincidence" support such a finding with respect to the marketing loan and counter-cyclical payment programs now.

- Brazil's effectively attributes to the marketing loan and counter-cyclical payment programs, the effects of other factors including, importantly, the effects of China's trade in cotton on world market prices.

- The econometric studies that Brazil cites are flawed and greatly exaggerate any possible price impacts of removing the marketing loan and counter-cyclical payment programs.

For all of these reasons, Brazil has failed to make a *prima facie* case that "the effect" of the marketing loan and counter-cyclical payment programs is "significant price suppression" of the world market price for upland cotton.

## D. Brazil Fails To Make A *Prima Facie* Case Of WTO-Inconsistency Under Articles 5(c) and 6.3(d) of the *SCM Agreement*

332. Brazil claims that the United States is causing "serious prejudice" to Brazil's interests within the meaning of Articles 5(c) of the *SCM Agreement* because "the effect" of U.S. marketing loan and counter-cyclical payment programs under the FSRI Act is an increase in the U.S. world market share that is inconsistent with Article 6.3(d) of the *SCM Agreement*. There is neither a legal nor a factual basis for Brazil's claim.

333. First, Brazil challenges the marketing loan and counter-cyclical payment *programs* under the FSRI Act of 2002.[443] Not only are those claims not within the scope of this proceeding, but, as discussed above, Brazil fails to demonstrate that the programs *mandate* a breach of Articles 5(c) and 6.3(d) of the *SCM Agreement*. Brazil has, thus, provided no legal basis for a finding against the marketing loan and counter-cyclical payment programs.

334. Second, even leaving aside the lack of legal basis, Brazil does not demonstrate that all of the elements of Article 5(c) and 6.3(d) are satisfied. Article 5(c) of the *SCM Agreement* provides that "[n]o Member should cause, through the use of any subsidy referred to in paragraphs 1 and 2 of Article 1, adverse effects to the interests of other Members, i.e. . . . serious prejudice to the

[443] Brazil First Written Submission, para.217.

interests of another Member." Article 6.3(d) of the *SCM Agreement* explains that "serious prejudice in the sense of paragraph (c) of Article 5 may arise" where "the effect of the subsidy is an increase in the world market share of the subsidizing Member in a particular subsidized primary product or commodity as compared to the average share it had during the previous period of three years and this increase follows a consistent trend over a period when subsidies have been granted."

335. In the original proceeding, the panel interpreted"world market share" under Article 6.3(d) to mean "share of the world market supplied by the subsidizing Member of the product concerned."[444] Brazil has proposed two different measures of "supply" – either production in a marketing year or production plus beginning stocks in a marketing year. It is not necessary, however, for the panel to decide, for purposes of this proceeding, which is the more appropriate measure. This is because Brazil's claim fails under either proposed measure of "supply."

336. The factual basis for Brazil's claim is that in MY 2005, U.S. share of world production plus beginning stocks increased by 0.46 percent over the average for MY 2002-2004 and U.S. share of world production increased by 1.53 percent over the average for MY 2002-2004.[445] Although the Step 2 program was still in effect in MY 2005, Brazil fails to segregate from the adverse effects it alleges any effects of that program. The United States recalls Brazil's arguments in the original proceeding that "the effect of the Step 2 program is to increase upland cotton producers' expected market returns, thereby increasing the production of upland cotton,"[446] and that "the Step 2 program has strong production, trade and price-distorting effects regardless of the level of world market prices."[447] Brazil has not shown that the 0.46 percent or 1.53 percent increase was *not* caused by the "strong production . . . effects" of the Step 2 program.

337. Even leaving that aside, however, Brazil fails to demonstrate that the slight increase in share of world production or production plus beginning stocks over the average share in MY 2002-2004 "follows a consistent trend over a period when subsidies have been granted." Indeed, Brazil attempts to show such a trend by selecting as the starting point MY 1998, a disastrous year for U.S. production, in which, as a result of severe drought U.S. abandonment rates skyrocketed and harvested area fell *more than 2,000,000 acres* compared to the previous year. At the same time, growers in the rest of the world, unaffected by the drought, increased harvested area about 100,000 acres. U.S. production that marketing year was the lowest in almost a decade, by more than 1,500,000 bales, and lower than any marketing year *since* by

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[444] *Upland Cotton (Panel)*, para. 7.1446.

[445] Brazil First Written Submission, paras. 222 and 224. Brazil also references increases in the *absolute* volume of U.S. upland cotton production. *See e.g.,* Brazil First Written Submission, para. 229. Absolute production levels are, however, entirely irrelevant to the inquiry under Article 6.3(d) of the *SCM Agreement*.

[446] Brazil Appellee Submission, para. 741 (16 November 2004).

[447] Brazil Further Written Submission, para. 351 (9 September 2003).

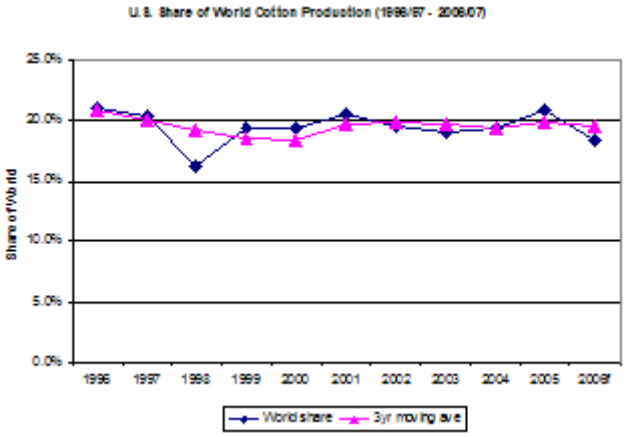
more than 3,000,000 bales. It is only by selecting this year as the starting point of its "representative period,"[448] that Brazil attempts to show any "consistent trend over a period when subsidies have been granted."

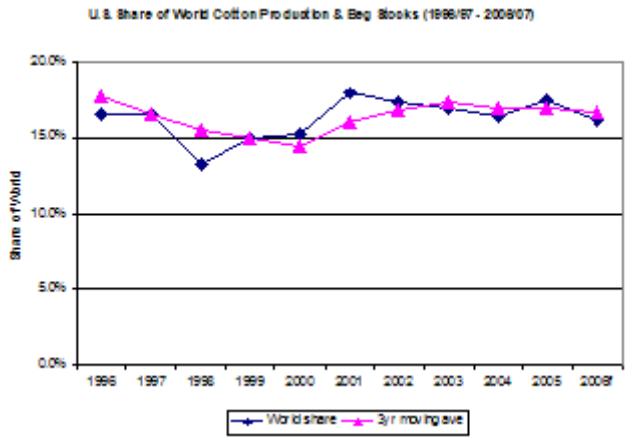
338. 1998 is hardly "representative," of U.S. production. Moreover, any "increase" in U.S. share of world production (or production plus stocks) since MY 1998 is a result of, *inter alia*, the recovery of U.S. production and the re-balancing of world market shares over time. In 1999, weather in the United States was more normal and the harvested acres increased by almost exactly the acres lost to drought in the previous year. Brazil's assertion of a "consistent trend" based on changes since MY 1998 is, therefore, not meaningful. Moreover, Brazil fails to account for the production projections for MY 2006, which show U.S. share of world production (and production plus beginning stocks) declining slightly to a level *lower* than those that have prevailed in every marketing year *since 1998*. In other words, the slight increase in MY 2005 is clearly a part of the ordinary fluctuations in U.S. share of world production.

339. As the FSRI Act has only been in effect since 2002, there is no long-term period over which the effect of the specific measures challenged by Brazil can be evaluated. Nonetheless, even comparing developments in that period to historical periods demonstrates that U.S. share of world production (and production plus beginning stocks) has been entirely stable for more than 40 years. Such a historical assessment seems particularly apt here given Brazil's assertion that "[t]here is no 'starting' or 'ending' point for the purposes of evaluating the existence of a consistent trend . . . [because the] U.S. Government has supported the production of upland cotton massively for decades."

340. U.S. share of world production and production plus beginning stocks is stable if one looks back to MY 1996, when the FAIR Act came into effect.

[448] Brazil First Written Submission, para. 227.

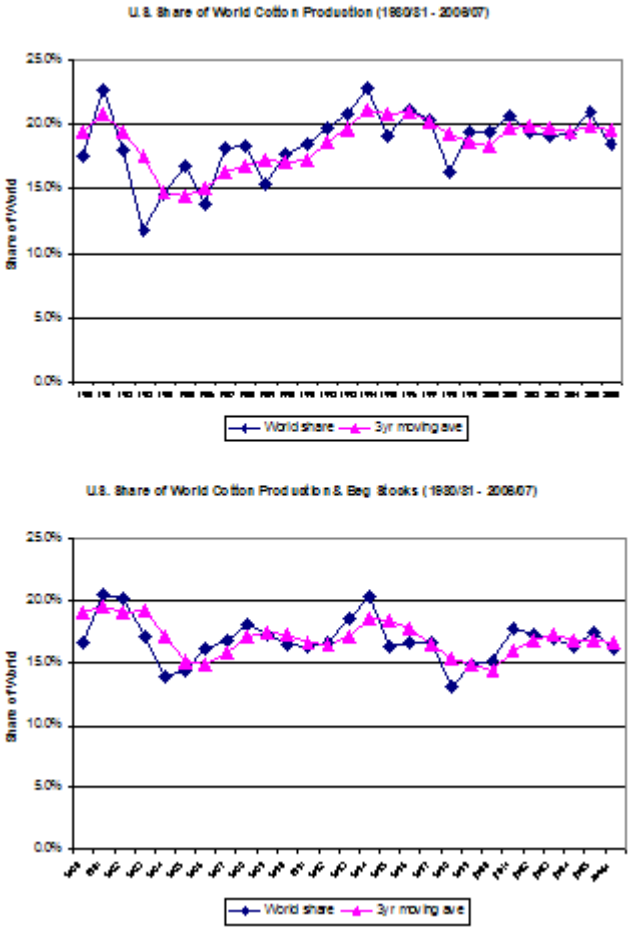



Source: USDA, PS&D[449]

341. U.S. share of world production and production plus beginning stocks is stable if one looks back to MY 1980.

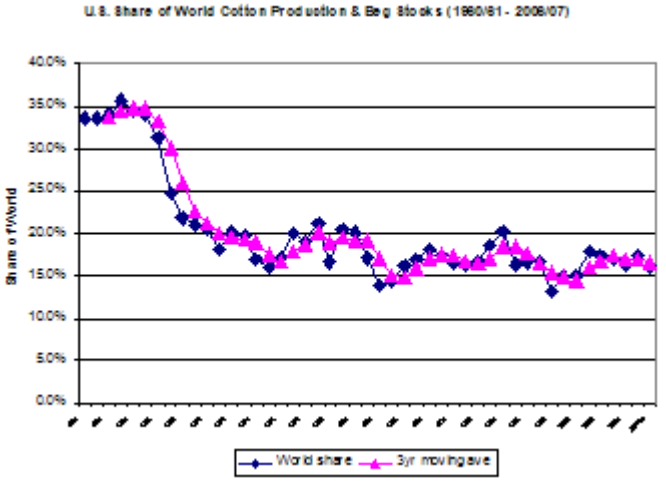
[449] U.S. Production Supply and Distribution (Exhibit US-27); World Production Supply and Distribution (Exhibit US-27).

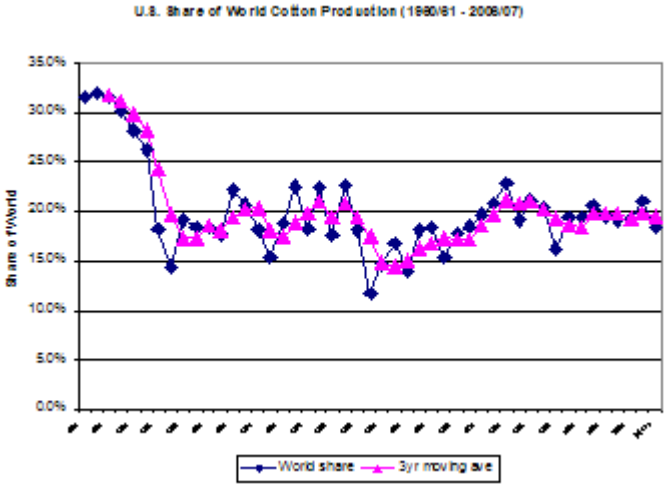



Source: USDA, PS&D[450]

342. And U.S. share of world production and production plus beginning stocks has actually *declined* significantly if one looks back to MY 1960.

[450] U.S. Production Supply and Distribution (Exhibit US-27); World Production Supply and Distribution (Exhibit US-27).




Source: USDA, PS&D[451]

343. No matter which period one looks to, however, there is no evidence that the effect of the U.S. marketing loan and counter-cyclical payment programs "is an increase in the world market share" of the United States "as compared to the average share it had during the previous period of three years and this increase follows a consistent trend over a period when subsidies have been granted." There is, therefore, no basis for Brazil's claim under Articles 5(c) and 6.3(d) of the *SCM Agreement*.

[451] U.S. Production Supply and Distribution (Exhibit US-27); World Production Supply and Distribution (Exhibit US-27).

## VII. CONCLUSION

344. For the reasons set forth above, the United States requests that the Panel reject Brazil's claims in their entirety, and find that the United States has complied with the DSB's recommendations and rulings and, further, that the U.S. measures taken to comply are not inconsistent with the *SCM Agreement* or the *Agreement on Agriculture*.