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1 ANNEX I

1.1 Text of Annex I

ANNEX I

ILLUSTRATIVE LIST OF EXPORT SUBSIDIES

(a) The provision by governments of direct subsidies to a firm or an industry contingent upon export performance.

(b) Currency retention schemes or any similar practices which involve a bonus on exports.

(c) Internal transport and freight charges on export shipments, provided or mandated by governments, on terms more favourable than for domestic shipments.

(d) The provision by governments or their agencies either directly or indirectly through government-mandated schemes, of imported or domestic products or services for use in the production of exported goods, on terms or conditions more favourable than for provision of like or directly competitive products or services for use in the production of goods for domestic consumption, if (in the case of products) such terms or conditions are more favourable than those commercially available on world markets to their exporters.

(footnote original) The term "commercially available" means that the choice between domestic and imported products is unrestricted and depends only on commercial considerations.

(e) The full or partial exemption remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises.

(footnote original) For the purpose of this Agreement:

The term "direct taxes" shall mean taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property;

The term "import charges" shall mean tariffs, duties, and other fiscal charges not elsewhere enumerated in this note that are levied on imports;

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The term "indirect taxes" shall mean sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges;
"Prior-stage" indirect taxes are those levied on goods or services used directly or indirectly in making the product;
"Cumulative" indirect taxes are multi-staged taxes levied where there is no mechanism for subsequent crediting of the tax if the goods or services subject to tax at one stage of production are used in a succeeding stage of production;
"Remission" of taxes includes the refund or rebate of taxes;
"Remission or drawback" includes the full or partial exemption or deferral of import charges.

The Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Any Member may draw the attention of another Member to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of Members under GATT 1994, including the right of consultation created in the preceding sentence. Paragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member.

(f) The allowance of special deductions directly related to exports or export performance, over and above those granted in respect to production for domestic consumption, in the calculation of the base on which direct taxes are charged.

(g) The exemption or remission, in respect of the production and distribution of exported products, of indirect taxes in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption.

(h) The exemption, remission or deferral of prior-stage cumulative indirect taxes on goods or services used in the production of exported products in excess of the exemption, remission or deferral of like prior-stage cumulative indirect taxes on goods or services used in the production of like products when sold for domestic consumption; provided, however, that prior-stage cumulative indirect taxes may be exempted, remitted or deferred on exported products even when not exempted, remitted or deferred on like products when sold for domestic consumption, if the prior-stage cumulative indirect taxes are levied on inputs that are consumed in the production of the exported product (making normal allowance for waste). This item shall be interpreted in accordance with the guidelines on consumption of inputs in the production process contained in Annex II.

(i) The remission or drawback of import charges in excess of those levied on imported inputs that are consumed in the production of the exported product (making normal allowance for waste); provided, however, that in particular cases a firm may use a quantity of home market inputs equal to, and having the same quality and characteristics as, the imported inputs as a substitute for them in order to benefit from this provision if the import and the corresponding export operations both occur within a reasonable time period, not to exceed two years. This item shall be interpreted in accordance with the guidelines on consumption of inputs in the production process contained in Annex II and the guidelines in the determination of substitution drawback systems as export subsidies contained in Annex III.

(j) The provision by governments (or special institutions controlled by governments) of export credit guarantee or insurance programmes, of insurance or guarantee programmes...
against increases in the cost of exported products or of exchange risk programmes, at premium rates which are inadequate to cover the long-term operating costs and losses of the programmes.

(k) The grant by governments (or special institutions controlled by and/or acting under the authority of governments) of export credits at rates below those which they actually have to pay for the funds so employed (or would have to pay if they borrowed on international capital markets in order to obtain funds of the same maturity and other credit terms and denominated in the same currency as the export credit), or the payment by them of all or part of the costs incurred by exporters or financial institutions in obtaining credits, in so far as they are used to secure a material advantage in the field of export credit terms.

Provided, however, that if a Member is a party to an international undertaking on official export credits to which at least twelve original Members to this Agreement are parties as of 1 January 1979 (or a successor undertaking which has been adopted by those original Members), or if in practice a Member applies the interest rates provisions of the relevant undertaking, an export credit practice which is in conformity with those provisions shall not be considered an export subsidy prohibited by this Agreement.

(l) Any other charge on the public account constituting an export subsidy in the sense of Article XVI of GATT 1994.

1.2 Items (c), (d), (j) and (k)

1.2.1 "provided or mandated by governments"

1. The Appellate Body in Canada – Dairy (Article 21.5 – New Zealand and US) after observing that Article 9.1(c) of the Agreement on Agriculture does not require that payments be financed by virtue of government "mandate," or other "direction," but rather government "action", noted that in comparison, items (c), (d), (j) and (k) of the Illustrative List seemed to imply the need to find some type of government mandate in the context of determining the existence of a subsidy. The Appellate Body stated:

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

1.3 Item (d)

2. The Panel in Brazil – Aircraft, in a finding not subsequently addressed by the Appellate Body, described the test whether a measure is a prohibited export subsidy under item (d) as "a comparison of the terms and conditions of the goods or services being provided by the government with the terms and conditions that would otherwise be available to the exporters receiving the alleged export subsidy". 2 As a consequence, the Panel rejected the argument that the relevant test depends upon "whether the measure merely offsets advantages bestowed on competing products from another Member". The Panel noted that "the fact that a foreign competitor had access to the same goods or services on better terms than those available to the exporters in question would not be a defense." 3

1.4 Items (e), (f), (g), (h) and (i)

3. Similarly to its finding with respect to item (d), the Panel in Brazil – Aircraft, in the context of items (e), (f), (g), (h) and (i), rejected the argument that whether a measure is a prohibited export subsidy should be decided based on whether the measure at issue merely serves to offset

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2 Panel Report, Brazil – Aircraft, para. 7.25.
3 Panel Report, Brazil – Aircraft, para. 7.25.
advantages bestowed on competing products from another Member.\(^4\) Regarding items (e) to (i), the Panel stated that "there is no hint that a tax advantage would not constitute an export subsidy simply because it reduced the exporter's tax burden to a level comparable to that of foreign competitors."\(^5\)

1.5 Footnote 59 of Item (e)

1.5.1 Fifth Sentence: "double taxation of foreign source-income"

1.5.1.1 Scope of application

4. In the context of footnote 59, the Appellate Body in US – FSC (Article 21.5 – EC), considered that the fifth sentence of footnote 59 applies to measures taken by a Member to avoid taxation of income earned by a taxpayer of that Member in a foreign state:

"'[D]ouble taxation' occurs when the same income, in the hands of the same taxpayer, is liable to tax in different States. The fifth sentence of footnote 59 applies to a measure taken by a Member to avoid such double taxation of 'foreign-source income'. In examining the phrase 'foreign-source income', we observe that, in ordinary usage, the word 'source' can refer to the place where a thing originates, and that the words 'source' and 'origin' can be synonyms. We consider, therefore, that the word 'source', in the context of the fifth sentence of footnote 59, has a meaning akin to 'origin' and refers to the place where the income is earned. This reading is supported by the combination of the words 'foreign' and 'source' as 'foreign' also refers to the place where the income is earned. Used in this way, the word 'foreign' indicates a source which is external to the Member adopting the measure at stake. Footnote 59, therefore, applies to measures taken by a Member to avoid the double taxation of income earned by a taxpayer of that Member in a 'foreign' State."\(^6\)

1.5.1.2 Scope of discretion to avoid double taxation

5. The Appellate Body in US – FSC considered that Members have a discretion to avoid double taxation:

"[I]t is 'implicit' in the requirement to use the arm's length principle that Members of the WTO are not obliged to tax foreign-source income, and also that Members may tax such income less than they tax domestic-source income. We would add that, even in the absence of footnote 59, Members of the WTO are not obliged, by WTO rules, to tax any categories of income, whether foreign- or domestic-source income. The United States argues that, since there is no requirement to tax export related foreign-source income, a government cannot be said to have 'foregone' revenue if it elects not to tax that income. It seems to us that, taken to its logical conclusion, this argument by the United States would mean that there could never be a foregoing of revenue 'otherwise due' because, in principle, under WTO law generally, no revenues are ever due and no revenue would, in this view, ever be 'foregone'. That cannot be the appropriate implication to draw from the requirement to use the arm's length principle."\(^7\)

6. The Appellate Body in US – FSC (Article 21.5 – EC), noted that Members have the authority to determine their rules of taxation, provided they comply with WTO obligations. The Appellate Body upheld the Panel's findings that footnote 59 does not require Members to adopt particular legal standards to define when income is foreign-source for the purposes of their double taxation-avoidance measures and noted that footnote 59 does not give Members an unlimited discretion to avoid double taxation of "foreign-source income" through the grant of export subsidies. Accordingly, for the Appellate Body, the term "foreign-source income", as used in footnote 59 cannot be interpreted solely by reference to the rules of the Member taking the measure to avoid double taxation of foreign-source income:

\(^4\) Panel Report, Brazil – Aircraft, para. 7.25.
\(^5\) Panel Report, Brazil – Aircraft, para. 7.25.
\(^7\) Appellate Body Report, US – FSC, para. 98.
"It is, however, no easy matter to determine in every situation when income is susceptible of being taxed in two different States and, thus, when a Member may properly regard income as 'foreign-source income'. We have emphasized in previous appeals that Members have the sovereign authority to determine their own rules of taxation, provided that they respect their WTO obligations. Thus, subject to this important proviso, each Member is free to determine the rules it will use to identify the source of income and the fiscal consequences — to tax or not to tax the income — flowing from the identification of source. We see nothing in footnote 59 to the SCM Agreement which is intended to alter this situation. We, therefore, agree with the Panel that footnote 59 does not oblige Members to adopt any particular legal standard to determine whether income is foreign-source for the purposes of their double taxation-avoidance measures.

At the same time, however, footnote 59 does not give Members an unfettered discretion to avoid double taxation of 'foreign-source income' through the grant of export subsidies. As the fifth sentence of footnote 59 to the SCM Agreement constitutes an exception to the prohibition on export subsidies, great care must be taken in defining its scope. If footnote 59 were interpreted to allow a Member to grant a fiscal preference for any income that a Member chooses to regard as foreign source, that reading would seriously undermine the prohibition on export subsidies in the SCM Agreement. That would allow Members, relying on whatever source rules they adopt, to grant fiscal export subsidies for income that may not actually be susceptible of being taxed in two jurisdictions. Accordingly, the term 'foreign-source income', as used in footnote 59 cannot be interpreted by reference solely to the rules of the Member taking the measure to avoid double taxation of foreign-source income.8

1.5.1.3 Design, structure and architecture of double taxation to target foreign source income

7. The Appellate Body in US – FSC (Article 21.5 – EC), also considered that measures falling under footnote 59 should not necessarily be "perfectly tailored" to the actual double tax burden, but that such measures must target "foreign-source income". Following the Panel's approach, the Appellate Body, also examined the "design, structure and architecture" of the measures under consideration to determine if they fell under footnote 59:

"The avoidance of double taxation is not an exact science. Indeed, the income exempted from taxation in the State of residence of the taxpayer might not be subject to a corresponding, or any, tax in a 'foreign' State. Yet, this does not necessarily mean that the measure is not taken to avoid double taxation of foreign-source income. Thus, we agree with the Panel, and the United States, that measures falling under footnote 59 are not required to be perfectly tailored to the actual double tax burden.

However, the fact that measures falling under footnote 59 to the SCM Agreement may grant a tax exemption even for income that is not taxed in another jurisdiction does not mean that such tax exemptions may be granted, under the fifth sentence of footnote 59, for any income. Footnote 59 prescribes that the income benefitting from a double taxation-avoidance measure must be 'foreign-source' and, as we have said, that means that the income must have links with a 'foreign' State such that it could properly be subjected to tax in that State, as well as in the Member taking the double taxation-avoidance measure.

We also recognize that Members are not obliged by the covered agreements to provide relief from double taxation. Footnote 59 to the SCM Agreement simply preserves the prerogative of Members to grant such relief, at their discretion, for 'foreign-source income'. Accordingly, we do not believe that measures falling under

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footnote 59 must grant relief from all double tax burdens. Rather, Members retain the sovereign authority to determine for themselves whether, and to what extent, they will grant such relief.10

1.5.2 "foreign source income"

8. The Appellate Body in US – FSC analysed footnote 59 and rejected the argument that since there is no requirement to tax export-related foreign-source income, a decision not to tax that income cannot be said to constitute revenue "foregone". The Appellate Body noted that if it was to follow this approach, there could never be "a foregoing of revenue 'otherwise due'" because WTO law does not require the collection of any particular category of revenue. The Appellate Body considered that the arm's-length requirement in footnote 59 does not provide a solution because this principle operates independently of the choice that a Member makes on what categories of foreign-sourced income it will not tax or will tax less. The Appellate Body held:

"Furthermore, we do not believe that the requirement to use the arm's length principle resolves the issue that arises here. That issue is not, as the United States suggests, whether a Member is or is not obliged to tax a particular category of foreign-source income. As we have said, a Member is not, in general, under any such obligation. Rather, the issue in dispute is whether, having decided to tax a particular category of foreign-source income, namely foreign-source income that is 'effectively connected with a trade or business within the United States', the United States is permitted to carve out an export contingent exemption from the category of foreign-source income that is taxed under its other rules of taxation. Unlike the United States, we do not believe that the second sentence of footnote 59 addresses this question. It plainly does not do so expressly; neither, as far as we can see, does it do so by necessary implication. As the United States indicates, the arm's length principle operates when a Member chooses not to tax, or to tax less, certain categories of foreign-source income. However, the operation of the arm's length principle is unaffected by the choice a Member makes as to which categories of foreign-source income, if any, it will not tax, or will tax less. Likewise, the operation of the arm's length principle is unaffected by the choice a Member might make to grant exemptions from the generally applicable rules of taxation of foreign-source income that it has selected for itself. In short, the requirement to use the arm's length principle does not address the issue that arises here, nor does it authorize the type of export contingent tax exemption that we have just described. Thus, this sentence of footnote 59 does not mean that the FSC subsidies are not export subsidies within the meaning of Article 3.1(a) of the SCM Agreement."11

9. For the Appellate Body in US – FSC (Article 21.5 – EC) the notion of "'foreign-source income', in footnote 59 to the SCM Agreement, refers to income generated by activities of a non-resident taxpayer in a 'foreign' State which have such links with that State so that the income could properly be subject to tax in that State."12 The Appellate Body considered that the existence of a "foreign element" in itself does not necessarily indicate that "all" income from transactions covered by the measures under consideration constitute "foreign-source income". The Appellate Body concluded that in this case the used methodology did not accurately allocate covered income as foreign or domestic, with the result that the measure at stake "improperly combines domestic-source income and foreign-source income" in the calculation, causing it to "systematically" misallocate this income.13 The Appellate Body held:

"[T]he fact that a transaction involves some foreign element, such as the 'foreign economic process', does not necessarily mean that all of the income generated by such a transaction will be "foreign-source income" within the meaning of footnote 59 to the SCM Agreement. ... In our view, under footnote 59 to the SCM Agreement, the 'foreign-source income' arising in such a transaction is only that portion of the total income which is generated by and properly attributable to activities that do occur in a 'foreign' State.

This reinforces our view that the approach embodied in the ETI measure can lead to very different allocations of income between domestic- and foreign-source in respect of precisely the same transaction. This implies to us that the different formulae for calculating QFTI result in a misallocation of income as between the domestic-and foreign-source and, through the election which the taxpayer can make between these formulae, allows the taxpayer to obtain the maximum benefit from the misallocation."14

1.5.2.1 (i) Recourse to international tax law

10. The Appellate Body in US – FSC (Article 21.5 – EC) acknowledged that in international tax law there is no agreed meaning for the term "foreign-source income" but that on the basis of its recourse to international legal principles and its review of a number of bilateral and multilateral tax agreements, that the term "foreign-source income" may be interpreted as follows:

"Although there is no universally agreed meaning for the term 'foreign-source income' in international tax law, we observe that many States have adopted bilateral or multilateral treaties to address double taxation. ...

Although these instruments do not define 'foreign-source income' uniformly, it appears to us that certain widely recognized principles of taxation emerge from them. In seeking to give meaning to the term 'foreign-source income' in footnote 59 to the SCM Agreement, which is a tax-related provision in an international trade treaty, we believe that it is appropriate for us to derive assistance from these widely recognized principles which many States generally apply in the field of taxation. In identifying these principles, we bear in mind that the measure at issue seeks to address foreign-source income of United States citizens and residents – that is, income earned by these taxpayers in 'foreign' States where the taxpayers are not resident.

We recognize, of course, that the detailed rules on taxation of non-residents differ considerably from State-to-State, with some States applying rules which may be more likely to tax the income of non-residents than the rules applied by other States. However, despite the differences, there seems to us to be a widely accepted common element to these rules. The common element is that a 'foreign' State will tax a non-resident on income which is generated by activities of the non-resident that have some link with that State. Thus, whether a 'foreign' State decides to tax non-residents on income generated by a permanent establishment or whether, absent such an establishment, it decides to tax a non-resident on income generated by the conduct of a trade or business on its territory, the 'foreign' State taxes a non-resident only on income generated by activities linked to the territory of that State. As a result of this link, the 'foreign' State treats the income in question as domestic-source, under its source rules, and taxes it. Conversely, where the income of a non-resident does not have any links with a 'foreign' State, it is widely accepted that the income will be subject to tax only in the taxpayer's State of residence, and that this income will not be subject to taxation by a 'foreign' State."15

1.5.2.2 Link between income of taxpayers and their activities in a foreign State

11. The Appellate Body in US – FSC (Article 21.5 – EC) noticed the need for a link between the taxpayer's income and their activities in a foreign State to establish whether there is a foreign source of income. The Appellate Body examined rules on foreign leasing and rental income and referred to additional aspects of the measures under consideration and considered that domestic-source income was improperly treated as exempt foreign-source income.16 The Appellate Body took the view that:

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"[I]n the absence of an established link between the income of such taxpayers and their activities in a 'foreign' State, we do not believe that there is 'foreign-source income' within the meaning of footnote 59 of the SCM Agreement.

... in our view, however, sales income cannot be regarded as 'foreign-source income', under footnote 59, for the sole reason that the property, subject-matter of the sale, is exported to another State, for use there. The mere fact that the buyer uses property outside the United States does not mean that the seller undertook activities in a 'foreign' State generating income there. Such an interpretation of footnote 59 would, in effect, allow Members to grant a tax exemption in favour of export-related income on the ground that the exportation by itself of the property renders the income 'foreign-source'. In our view, this reading would allow Members easily to evade the prohibition on export subsidies in Article 3.1(a) of the SCM Agreement and render this prohibition meaningless."  

12. The Appellate Body, in US – FSC (Article 21.5 – EC) considered that the flexibility under footnote 59 does not properly extend to allowing Members to adopt allocation rules that systematically result in a tax exemption for income that has no connection with a "foreign" country and that would not be regarded as foreign-source:

"We have said that avoiding double taxation is not an exact science and we recognize that Members must have a degree of flexibility in tackling double taxation. However, in our view, the flexibility under footnote 59 to the SCM Agreement does not properly extend to allowing Members to adopt allocation rules that systematically result in a tax exemption for income that has no link with a 'foreign' State and that would not be regarded as foreign-source under any of the widely accepted principles of taxation we have reviewed."  

1.5.3 Burden of proof

13. The Appellate Body in US – FSC (Article 21.5 – EC) addressed the issue of the burden of proof under the fifth sentence of footnote 59 and upheld the findings of the Panel in this regard. In reviewing the Panel's findings, the Appellate Body considered whether the footnote provides the "proper scope" of the Article 3.1(a) obligations, or whether it determines an "exception" for a measure that is otherwise an export contingent subsidy. The Appellate Body concluded that footnote 59 does not modify the scope of the definition of a "subsidy" in Article 1.1, the scope of item 1(e) of the Illustrative List, nor the meaning of export contingent subsidies under Article 3.1(a). The Appellate Body thus concluded that: (i) measures falling within the scope of footnote 59 may continue to be export subsidies under Article 1.1; and (ii) the fifth sentence of footnote 59 is an "exception" to the legal regime applicable to export subsidies under Article 3.1(a), by allowing Members to take or adopt measures to avoid the double-taxation of foreign-source income, while the latter may continue to be considered as export subsidies, within the meaning of Article 3.1(a). The Appellate Body also concluded that footnote 59 is an "affirmative defense" that may justify a prohibited export subsidy, and that the burden of proof is on the party invoking the exception:

"We recall that, in the original proceedings in this dispute, we said that the fifth sentence of footnote 59 'does not purport to establish an exception to the general definition of a 'subsidy' ...'. Thus, a measure taken to avoid the double taxation of foreign-source income, falling within footnote 59, may be a 'subsidy' under the SCM Agreement.

Article 3.1 of the SCM Agreement provides specific obligations with respect to two types of subsidy: subsidies contingent upon export performance and subsidies contingent upon the use of domestic over imported goods. Subsidies of these defined types are prohibited under Article 3 of the SCM Agreement. Item (e) of the Illustrative List identifies a particular measure which is deemed to be a prohibited export subsidy under Article 3.1(a).

The fifth sentence of footnote 59 provides that item (e) ‘is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member.’ In the same way that we do not see the fifth sentence of footnote 59 as altering the scope of the definition of a 'subsidy' in Article 1.1 of the SCM Agreement, we do not see it as altering either the scope of item (e) of the Illustrative List or the meaning to be given to the term 'subsidies contingent … upon export performance' in Article 3.1(a) of the SCM Agreement. Thus, measures falling within the scope of this sentence of footnote 59 may continue to be export subsidies, much as they may continue to be subsidies under Article 1.1 of the SCM Agreement.

The import of the fifth sentence of footnote 59 is that Members are entitled to 'take', or 'adopt' measures to avoid double taxation of foreign-source income, notwithstanding that they may be, in principle, export subsidies within the meaning of Article 3.1(a). The fifth sentence of footnote 59, therefore, constitutes an exception to the legal regime applicable to export subsidies under Article 3.1(a) by explicitly providing that when a measure is taken to avoid the double taxation of foreign-source income, a Member is entitled to adopt it.

Accordingly, as we indicated in US – FSC, the fifth sentence of footnote 59 constitutes an affirmative defence that justifies a prohibited export subsidy when the measure in question is taken 'to avoid the double taxation of foreign-source income'. In such a situation, the burden of proving that a measure is justified by falling within the scope of the fifth sentence of footnote 59 rests upon the responding party.”

1.6 Item (j)

1.6.1 General

14. In Canada – Aircraft Credits and Guarantees, the Panel concluded that in its view, "item (j) sets out the circumstances in which the grant of loan guarantees is per se deemed to be an export subsidy … Item (j) certainly does not provide … that all loan guarantees are per se prohibited by item (j)."22

15. In addressing the issue of whether premium rates under the United States export credit guarantee programmes are inadequate to cover long-term operating costs and losses to item (j), the Panel in US – Upland Cotton elucidated the test for assessing whether or not a particular export credit guarantee programme is consistent with item (j) in the following way:

"In general terms, the test for determining whether an export credit guarantee programme satisfies the terms of item (j) is the net cost to the government, as the service provider, of providing the service under the export credit guarantee programmes. To discern this overall cost to government, item (j) calls for an examination of whether the premium rates of the export credit guarantee programme at issue are adequate to cover the long-term operating costs and losses of the programmes. Beyond that, item (j) does not set forth, or require us to use, any one particular methodological approach nor accounting philosophy in conducting our examination. Nor are we required to quantify precisely the amount by which costs and losses exceeded premiums paid."23

16. In US – Upland Cotton (Article 21.5 – Brazil), the Appellate Body made the following general remarks regarding the type of analysis required under item (j):

"Thus, to the extent relevant data is available, an analysis under item (j) will primarily involve a quantitative evaluation of the financial performance of a programme. Such an analysis will focus on the difference, if any, between the revenues derived from the premiums charged under the programme and its long-term operating costs and

22 Panel Report, Canada – Aircraft Credits and Guarantees, para. 7.395.
losses. An analysis under item (j) may examine both retrospective data relating to a programme's historical performance and projections of its future performance. Evidence concerning a programme's structure, design, and operation may be relevant in situations where financial data is not available. It may also serve as a supplementary means for assessing the adequacy of premiums where relevant data are available.\textsuperscript{24}

1.6.2 The definition of the terms

1.6.2.1 "export credit guarantee ... programmes"

17. The Panel in \textit{US – Upland Cotton} declined to read caveats or conditions into the text of item (j), and rejected the position of the United States that the nature of US export credit guarantee programmes called for a cohort-specific examination by the Panel under item (j):

"We see no explicit reference to the term 'cohort' in the text of item (j). Nor do we read any caveat or condition in the text of item (j) which would require us to await the closure of any or all United States export credit guarantee cohorts before being able to conduct an objective assessment of the matter before us. Our task is not to calculate with precision any difference between premiums and operating costs and losses of certain cohorts on the basis of any specific accounting methodology. Rather, our task is to evaluate whether the premiums charged under the United States export credit guarantee programmes are inadequate to cover long-term operating costs and losses."\textsuperscript{25}

1.6.2.2 "premiums"

18. According to the Panel in \textit{US – Upland Cotton}, the ordinary meaning of "premium" is "an amount to be paid for a contract of insurance".\textsuperscript{26}

1.6.2.3 "are inadequate to cover"

19. The Panel in \textit{US – Upland Cotton} determined that the ordinary meaning of the phrase "are inadequate to cover" requires it to examine "whether or not the premiums are insufficient to meet the long-term operating costs and losses of the export credit guarantee programmes".\textsuperscript{27} According to the Panel, this assessment does not require it to quantify the precise amount of sufficiency or insufficiency of the premiums.\textsuperscript{28}

1.6.2.4 "long-term"

20. In light of the ordinary meaning of the term "long-term" as well as the arguments advanced and the evidence submitted by both Brazil and the United States, the Panel in \textit{US – Upland Cotton} understood the term "long-term" in item (j) as it relates to the challenged US export credit guarantee in the following manner:

"We understand the reference to 'long term' in item (j) to refer to a period of sufficient duration as to ensure an objective examination which allows a thorough appraisal of the programme and which avoids attributing undue significance to any unique or atypical experiences on a given day, month, trimester, half-year, year or other specific time period. The reference to 'long term' guides us to undertake an overall appraisal of the programme over a sufficiently long period of time in order to gain a full appreciation of the functioning of the programme and any relationship between premiums charged and operating costs and losses."\textsuperscript{29}

\textsuperscript{24} Appellate Body Report, \textit{US – Upland Cotton (Article 21.5 – Brazil)}, para. 278.
\textsuperscript{26} Panel Report, \textit{US – Upland Cotton}, para. 7.817.
\textsuperscript{29} Panel Report, \textit{US – Upland Cotton}, para. 7.832.
1.6.2.5 "operating costs and losses"

21. After recalling the ordinary meaning of the words in the phrase "operating costs and losses", the Panel in US – Upland Cotton was of the view that the immediate context of item (j) does not necessarily call for a single approach in evaluating the long-term "operating costs and losses" under item (j):

"The context of item (j) indicates that the 'operating costs and losses' relate to export credit guarantee programmes. We recognize that the terms "operating costs and losses" refer generally to an economic, financial or accounting concept. Operating costs and losses in that sense generally connote costs and losses in administering programmes. It is not at all clear to us that these terms in item (j) have obtained a rigid or universally agreed definition. Even if such a definition had arisen, we do not see any indication that it has been included in item (j), or more broadly in the SCM Agreement, or in any other covered agreement, as a common understanding among WTO Members. Therefore, in our examination of the United States export credit guarantee programmes at issue under item (j), we decline to adopt one particular rigid definition of the terms 'operating costs and losses', as those terms are used in item (j). Nor do we believe that the meaning of operating costs and losses, as referred to in item (j), are necessarily to be determined purely by reference to the domestic laws of the Member whose measures are subject to our examination, here, the United States."\(^{31}\)

(b) Application of item (j)

22. In its assessment of whether premium rates under the United States export credit guarantee programmes are inadequate to cover long-term operating costs and losses to item (j), and in particular whether there is a net loss to the US government in the administration of the three challenged export credit guarantee programmes, the Panel in US – Upland Cotton decided to first examine the past performance of the programmes and secondly, to look at the programmes' structure, operation and design.\(^{32}\) As regards the past performance of the programmes, the Panel found that the programmes are operated at a net cost to the US government.\(^{33}\) With respect to the structure, design and operation of the programmes, the Panel was of the view that the premiums are not geared toward ensuring adequacy to cover the long-term operating costs and losses for the purposes of item (j) in light of the following three elements of the programmes: (1) there is a statutory fee cap of 1 per cent of the amount of credit to be guaranteed under two of the three programmes\(^{34}\) (2) the premiums are not based on risk with respect to country risk or the creditworthiness of the borrower\(^{35}\) (3) additional evidence on record indicating that the premiums are not the source of the income covering the long-term costs and losses of the programmes.\(^{36}\)

23. In US – Upland Cotton, the Appellate Body upheld the Panel's findings that the US export credit guarantee programmes constitute a per se export subsidy within the meaning of item (j) of the Illustrative List of Export and that these programmes are export subsidies for the purposes of Article 3.1 (a) of the SCM Agreement, inconsistent with Articles 3.1 (a) and 3.2 of that agreement, on the basis that the Panel had conducted a thorough financial analysis of the United States' export credit guarantee programs using three approaches in determining that the premiums charged for such programmes are inadequate to cover long-term operating costs and losses:

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\(^{30}\) (footnote original) For example, the term "operating cost" may mean "a term for prime or variable costs" (see, for example, Dictionary of Economics (The Economist Books, 1999)). To the extent the term "operating" in item (j) also refers to the term "losses", the term "operating loss" can mean a loss, before tax and interest, usually on the principal trading activities of the business, excluding extraordinary items (see, for example, Dictionary of International Finance (The Economist Books, 1999)) or the accounting loss made by a business from its business activities in a given period (see, for example, Moles and Terry, The Handbook of International Financial Terms (Oxford University Press, 1999)).


"In the light of the above, it is clear that the Panel undertook a sufficiently detailed examination of the financial performance of the United States' export credit guarantee programs. Its analysis showed that none of the methods proposed by the parties indicated that the premiums charged under the United States' export credit guarantee programs are adequate to cover long-term costs and losses. In these circumstances, we agree with the Panel that, in this particular case, it was not necessary to choose a particular method nor determine the precise amount by which long-term operating costs and losses exceeded premiums. Although it did not provide a final figure for the long-term operating costs and losses of the United States' export credit guarantee programs, as the United States suggests it should have, the Panel found that the various methods put forward by the parties led to the same conclusion, namely, that the premiums for the United States' export credit guarantee programs are inadequate to cover the programs' long-term operating costs and losses. The Panel's decision not to choose between methods or make a finding on the precise difference between premiums and long-term costs and losses does not, in our view, invalidate the Panel's ultimate findings under Articles 3.1(a) and 3.2 of the SCM Agreement."37

24. The Panel in US – Upland Cotton (Article 21.5 – Brazil) similarly performed a quantitative analysis of the performance of the relevant US programme, combined with an examination of the structure, design and operation of that programme.38 In the context of the quantitative analysis, Brazil submitted evidence that the relevant premium rates were lower than the minimum premium rates ("MPRs") provided in the OECD Arrangement on Officially Supported Export Credits (hereinafter "the Arrangement"). The Panel found that the MPRs do not directly apply in the context of item (j) because, unlike the second paragraph of item (k), item (j) does not refer to the Arrangement.39 That being said, the Panel concluded that the MPRs may, from an evidentiary point of view, provide an indication of whether the relevant fees were sufficient to cover the long-term operating costs and losses of the programme.40

25. The Appellate Body accepted the general approach adopted by the Panel (including its treatment of the MPRs41), but found that the Panel's quantitative analysis "lacked evenhandedness".42 In particular, the Appellate Body criticized the Panel's treatment of evidence submitted by the United States regarding re-estimates (i.e., revised projections) of the performance of the programme. Whereas the Panel had relied more on the initial estimates than the re-estimates, the Appellate Body found that "[i]f anything, the re-estimates might be expected to be more reliable because they reflect the historical performance of the programme".43 In seeking to complete the Panel's analysis of the relevant evidence, the Appellate Body found that the quantitative evidence could support two plausible, but conflicting, conclusions regarding the performance of the programme. In such circumstances, the Appellate Body considered whether "one of the two plausible outcomes that emerge from the quantitative evidence [is] more likely than not".44 The Appellate Body concluded that inter alia the evidence regarding the structure, design and operation of the programme "provide[d] a sufficient evidentiary basis for the conclusion that it is more likely than not that the ... programme operates at a loss".45

1.7 Item (k)

1.7.1 First paragraph of item (k) – "material advantage" clause

1.7.1.1 General

26. In both Brazil – Aircraft and Brazil – Aircraft (Article 21.5 – Canada), Brazil asserted that the first paragraph of item (k) could be interpreted in an a contrario manner, so as to establish that subsidies constituting "payments", "of all or part of the costs incurred by exporters or financial institutions in obtaining credits", but which were not "used to secure a material advantage in the

field of export credit terms", would not be prohibited export subsidies within the meaning of Article 3.1(a). The Appellate Body in Brazil – Aircraft did not follow the Panels' findings to the extent that it did not make an explicit finding on whether or not it was permissible to use item (k) in an a contrario manner. Rather, the Appellate Body found that Brazil had not met its burden of proof of showing that the PROEX payments were not used to secure a material advantage in the field of export credit terms. In Brazil – Aircraft (Article 21.5 – Canada), the Appellate Body made the same finding about the revised PROEX programme. In this report, however, the Appellate Body made an additional statement:

"If Brazil had demonstrated that the payments made under the revised PROEX were not 'used to secure a material advantage in the field of export credit terms', and that such payments were 'payments' by Brazil of 'all or part of the costs incurred by exporters or financial institutions in obtaining credits', then we would have been prepared to find that the payments made under the revised PROEX are justified under item (k) of the Illustrative List. However, Brazil has not demonstrated that those conditions of item (k) are met in this case. In making this observation, we wish to emphasize that we are not interpreting footnote 5 of the SCM Agreement, and we do not opine on the scope of footnote 5, or on the meaning of any other items in the Illustrative List.

However, we do not believe it is necessary for us to rule on these general questions in order to resolve this dispute. We, therefore, hold that the Article 21.5 Panel's finding that 'the first paragraph of item (k) cannot be used to establish that a subsidy which is contingent upon export performance within the meaning of Article 3.1(a) is 'permitted' is moot, and, thus, is of no legal effect."

1.7.1.2 "payments of all or part of the costs incurred by exporters or financial institutions in obtaining credits"

27. In interpreting the phrase "payments of all or part of the costs incurred by exporters or financial institutions in obtaining credits", the Panel in Brazil – Aircraft (Article 21.5 – Canada) started with the ordinary meaning of the terms and opined that "the word 'credits' refers to 'export credits' as used earlier in the paragraph. Next, it also found that the costs involved must relate to obtaining export credits, not to providing them." Finally, the Panel rejected an argument by Brazil that cost incurred by a financial institution in raising capital could be equated with the cost of "obtaining" export credits. The Appellate Body in Brazil – Aircraft (Article 21.5 – Canada) did not believe that it was necessary to examine this issue (the Appellate Body had found that Brazil had not proven that the PROEX interest equalization payments were not used to secure a material advantage) and therefore did not address the Panel's findings. The Appellate Body stated that "$[t]hese findings of the Article 21.5 Panel are moot, and, thus, of no legal effect."

The Panel in Brazil – Aircraft (Article 21.5 – Canada II) reached the same conclusion as the Panel in Brazil – Aircraft (Article 21.5 – Canada) on this matter.

28. With respect to the term "export credit practice" under the second paragraph of item (k), see paragraph 43-46 below.

1.7.1.3 "used to secure a material advantage"

1.7.1.3.1 General

29. The Panel in Brazil – Aircraft opined that a payment is used to "secure a material advantage in the field of export credit terms" when it provides the recipient with export credits on terms which are more favourable than those available in the absence of such payments, i.e. on the "marketplace". The Panel considered it "evident that PROEX payments result in the availability of export credit for Brazilian regional aircraft on terms which are more favourable than the terms that

46 Appellate Body Report, Brazil – Aircraft (Article 21.5 – Canada), paras. 80-81.
47 Panel Report, Brazil – Aircraft (Article 21.5 – Canada), para. 6.71.
48 Panel Report, Brazil – Aircraft (Article 21.5 – Canada), para. 6.72.
49 Appellate Body Report, Brazil – Aircraft (Article 21.5 – Canada), para. 78.
50 Panel Report, Brazil – Aircraft (Article 21.5 – Canada II), paras. 5.274-5.275.
would otherwise be available with respect to the transaction in question."51 In this context, the Panel in Brazil – Aircraft also recalled a statement by Brazil to the effect that PROEX would presumably always be more favourable to the purchaser than the terms it could obtain on its own.52 However, the Appellate Body in Brazil – Aircraft rejected this interpretation by the Panel of the phrase "used to secure a material advantage".

1.7.1.3.2 "material"

30. More specifically, the Appellate Body in Brazil – Aircraft criticized the Panel for not adequately considering the term "material" and disagreed with equating the term "material advantage" under item (k) of the Illustrative List to the term "benefit" under Article 1.1(b):

"We agree with the Panel's statement that the ordinary meaning of the word 'advantage' is 'a more favorable or improved position' or a 'superior position'. However, we note that item (k) does not refer simply to 'advantage'. The word 'advantage' is qualified by the adjective 'material'. As mentioned before, in its ultimate interpretation of the phrase 'used to secure a material advantage' which the Panel finally adopted and applied to the export subsidies for regional aircraft under PROEX, the Panel read the word 'material' out of item (k). This, we consider to be an error.

... We note that the Panel adopted an interpretation of the 'material advantage' clause in item (k) of the Illustrative List that is, in effect, the same as the interpretation of the term 'benefit' in Article 1.1(b) ... If the 'material advantage' clause in item (k) is to have any meaning, it must mean something different from 'benefit' in Article 1.1(b). It will be recalled that for any payment to be a 'subsidy' within the meaning of Article 1.1, that payment must consist of both a 'financial contribution' and a 'benefit'. The first paragraph of item (k) describes a type of subsidy that is deemed to be a prohibited export subsidy. Obviously, when a payment by a government constitutes a 'financial contribution' and confers a 'benefit', it is, a 'subsidy' under Article 1.1. Thus, the phrase in item (k), 'in so far as they are used to secure a material advantage', would have no meaning if it were simply to be equated with the term 'benefit' in the definition of 'subsidy'. As a matter of treaty interpretation, this cannot be so. Therefore, we consider it an error to interpret the 'material advantage' clause in item (k) of the Illustrative List as meaning the same as the term 'benefit' in Article 1.1(b) of the SCM Agreement."53

1.7.1.3.3 Commercial Interest Reference Rate (CIRR) as market benchmark

31. Rather than considering the terms of export credits available to a purchaser in the absence of the PROEX interest equalization payments, the Appellate Body in Brazil – Aircraft held that the determination of whether a payment is "used to secure a material advantage" implies a comparison between the export credit terms available under the measure at issue and some other "market benchmark". The Appellate Body further viewed the second paragraph of item (k) as "useful context for interpreting the 'material advantage' clause in the text of the first paragraph". 54 In this respect, the Appellate Body stated that the Commercial Interest Reference Rate (the "CIRR"), defined in the Arrangement on Guidelines for Officially Supported Export Credits (the "OECD Arrangement"), could be "appropriately viewed as ... a market benchmark" for assessing whether a payment "is used to secure a material advantage". 55

32. The Appellate Body in Brazil – Aircraft (Article 21.5 – Canada) agreed with the Panel that a Member may under the first paragraph of item (k), as interpreted by the Appellate Body, establish that a payment is not used to secure a material advantage in the field of export credit terms, even

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51 Panel Report, Brazil – Aircraft, para. 7.34.
52 Panel Report, Brazil – Aircraft, para. 7.34.
53 Appellate Body Report, Brazil – Aircraft, paras. 177 and 179.
54 Appellate Body Report, Brazil – Aircraft, paras. 177 and 179.
55 Appellate Body Report, Brazil – Aircraft, para. 181.
if it resulted in a below-CIRR interest rate.\textsuperscript{56} The Appellate Body then set forth the manner in which Brazil could prove that the PROEX interest equalization payments did not secure a material advantage to Brazilian exporters:

"To establish that subsidies under the revised PROEX are not 'used to secure a material advantage in the field of export credit terms', Brazil must prove either: that the net interest rates under the revised PROEX are at or above the relevant CIRR, the specific 'market benchmark' we identified in the original dispute as an 'appropriate' basis for comparison; or, that an alternative 'market benchmark', other than the CIRR, is appropriate, and that the net interest rates under the revised PROEX are at or above this alternative 'market benchmark'.

... Brazil contends ... that the revised PROEX is not 'used to secure a material advantage in the field of export credit terms' within the meaning of the first paragraph of item (k) of the Illustrative List.

To prove this argument, Brazil must establish both of two elements: first, Brazil must prove that it has identified an appropriate 'market benchmark'; and, second, Brazil must prove that the net interest rates under the revised PROEX are at or above that benchmark."\textsuperscript{57}

33. The Panel in Brazil – Aircraft (Article 21.5 – Canada II), first interpreted the "material advantage" clause by referring to the Appellate Body report in Brazil – Aircraft (Article 21.5 – Canada) (see paragraph 32 above) The Panel concluded that if Brazil wanted to establish that the programme's payments were not used to secure a "material advantage," by reference to the CIRR, Brazil must show that export credits supported by PROEX III respect the CIRR and the applicable rules of the OECD Arrangement which relate to the application of the CIRR.\textsuperscript{58} The Panel further held:

"It could be argued that this interpretation of the 'material advantage' clause in effect re-creates in the first paragraph of item (k) the standard already provided for in the second paragraph of item (k), at least insofar as the interest rate benchmark used under the first paragraph of item (k) is the CIRR.\textsuperscript{59} However, this is an unavoidable implication of the Appellate Body's adoption of the CIRR as an appropriate benchmark for determining the existence of a material advantage. ... To the extent that the first paragraph of item (k) could be used a contrario to establish that a payment that is not used to secure a material advantage is not prohibited -- an issue addressed below -- we would, in other words, not only have re-created a safe haven in the first paragraph, but, in fact, would have deprived the second paragraph of all useful effect with respect to the export credit practices at issue in the first paragraph."\textsuperscript{60}

34. The Panel in Brazil – Aircraft (Article 21.5 – Canada II) found that given the nature of the CIRR as a constructed interest rate, a Member may also attempt to demonstrate that a rate below the CIRR would, at a particular point in time, constitute a more appropriate benchmark.\textsuperscript{61} In Brazil – Aircraft (Article 21.5 – Canada II), the Panel further indicated that "to establish that PROEX III is not used to secure a material advantage in the field of export credit terms, Brazil must either: (i) demonstrate conformity with the relevant CIRR as well as with all those rules of the 1998 OECD Arrangement which operate to support or reinforce the CIRR; or (ii) identify an appropriate 'market benchmark', other than the CIRR, and establish that net interest rates resulting from PROEX III support are at or above that alternative 'market benchmark'".\textsuperscript{62}

\textsuperscript{56} Appellate Body Report, Brazil – Aircraft (Article 21.5 – Canada), para. 63. See also Panel Report, on Brazil – Aircraft (Article 21.5 – Canada), paras. 6.84 and 6.92.
\textsuperscript{57} Appellate Body Report, Brazil – Aircraft (Article 21.5 – Canada), paras. 67-69.
\textsuperscript{58} Panel Report, Brazil – Aircraft (Article 21.5 – Canada II), paras. 5.234-5.252
\textsuperscript{59} See Article 21.5 Panel Report, Brazil – Aircraft, supra, para. 6.87. Of course, the second paragraph of item (k) is broader in scope than the first paragraph of item (k), which only refers to two types of export credit practices. To that extent, the second paragraph of item (k) retains independent meaning also on our interpretation of the "material advantage" clause.
\textsuperscript{60} Panel Report, Brazil – Aircraft (Article 21.5 – Canada II), para. 5.251.
\textsuperscript{61} Panel Report, Brazil – Aircraft (Article 21.5 – Canada II), para. 5.265.
\textsuperscript{62} Panel Report, Brazil – Aircraft (Article 21.5 – Canada II), para. 5.266.
1.7.2 First paragraph of item (k) as an affirmative defence

35. The Panel in Brazil – Aircraft (Article 21.5 – Canada II) incorporated by reference its reasoning in Brazil – Aircraft (Article 21.5 – Canada) into its analysis and remained of the view that the relationship between the Illustrative List and Article 3.1(a) is governed by footnote 5 to the SCM Agreement, and that the first paragraph of item (k) does not "refer to" any measures as "not constituting export subsidies" within the meaning of the footnote as an affirmative defence. On this basis, the Panel concluded that the first paragraph of item (k) cannot, as a legal matter, provide an affirmative defence to a violation of Article 3.1(a).63

1.7.3 Second paragraph of item (k) – "the safe haven"

1.7.3.1 General

36. The Panel in Canada – Aircraft (Article 21.5 – Brazil) set forth the propositions that a Member would need to prove in order to qualify, with respect to specific individual transactions, for the "safe haven" provided under the second paragraph of item (k):

"[F]irst, it would need to be determined that the transaction was in the form of either direct credits/financing, refinancing or interest rate support with repayment terms of at least two years, at fixed interest rates, and therefore was subject to the Arrangement generally and to the CIRRs (or a sector-specific minimum interest rate, if applicable) specifically. Second, it would need to be determined whether the interest rate was at or above the CIRR (or the applicable sector-specific rate). Third, it would need to be determined which of the other provisions of the Arrangement that operate to reinforce the minimum interest rate rule applied to that particular transaction (a determination that would need to be made on a case-by-case, transaction-specific basis). Fourth, the details of the transaction would need to be examined to determine whether or not it respected all such additional provisions, and did not involve any derogations or matching of derogations."64

1.7.4 "in the field of export credit terms"

37. With respect to the phrase "in the field of export credit terms", the Panel in Brazil – Aircraft held that in its ordinary meaning, that phrase would refer to "items directly related to export credits, such as interest rates, grace periods, transaction costs, maturities and the like."65 Furthermore, the Panel opined that that the term "field of export credit terms" did not encompass the price at which a product is sold.66 Although the Appellate Body in Brazil – Aircraft made no specific reference to this statement by the Panel, it rejected the Panel's interpretation of the phrase "used to secure a material advantage"67 which was made in the same context as the above statements on the term "in the field of export credit terms".68

1.7.5 "international undertaking on official export credits"

38. In Canada – Aircraft (Article 21.5 – Brazil), Canada claimed that as part of the revision of its subsidies programmes following the Appellate Body Report in Canada – Aircraft, it had implement a new policy guideline for its Canada Account financing under which "any financing which does not comply with the OECD Arrangement would not be in the national interest". Canada argued that compliance with the OECD Arrangement meant that such financing would not be a prohibited export subsidy, according to the second paragraph of item (k). Although the Panel ultimately found against Canada, it did agree that the OECD Arrangement was an "international undertaking on official export credits" within the meaning of item (k):

"[I]t is well accepted that the OECD Arrangement is an 'international undertaking on official export credits' in the sense of the second paragraph of item (k). Moreover, in

63 Panel Report, Brazil – Aircraft (Article 21.5 – Canada II), paras. 5.272-5.275.
64 Panel Report, Canada – Aircraft (Article 21.5 – Brazil), para. 5.153.
65 Panel Report, Brazil – Aircraft, para. 7.28.
66 Panel Report, Brazil – Aircraft, para. 7.28.
67 Appellate Body Report, Brazil – Aircraft, para. 186.
68 Appellate Body Report, Brazil – Aircraft, para. 286.
practice the *OECD Arrangement* is at present the only international undertaking that fits this description. Thus, we understand the essence of the second paragraph of item (k) at least at present to be that 'an export credit practice' which is in 'conformity' with 'the interest rates provisions' of the *OECD Arrangement* 'shall not be considered an export subsidy prohibited by' the SCM Agreement.\(^{69}\)

1.7.6 "a successor undertaking"

39. In *Brazil – Aircraft (Article 21.5 – Canada II)*, the Panel had to decide which was the "successor undertaking" to the 1979 OECD Arrangement, i.e. the 1992 or 1998 version. The Panel started by interpreting the terms of "has been adopted" and concluded that it referred to the present of the addressees of the SCM Agreement rather than to an act of adoption prior to the entry into force of the SCM Agreement:

"The parties differ, however, regarding whether the relevant 'successor undertaking' is the 1992 version of the *OECD Arrangement* or the 1998 version."

In interpreting the phrase 'a successor undertaking which has been adopted [...]', we focus first on the language 'has been adopted'. Brazil attaches great importance to the fact that that language is in the present perfect tense. The present perfect tense, Brazil maintains, refers to a time regarded as present. We agree. Brazil goes on to argue, however, that the relevant present is the time when the *SCM Agreement* entered into force. From this Brazil concludes that only those successor undertakings which had been adopted before the entry into force of the *SCM Agreement* are, textually, within the scope of the second paragraph of item (k). We are not persuaded by that view.

It should be noted, moreover, that, on our interpretation, the language 'has been adopted' retains meaning and effect. Thus, the use of the present perfect tense tells Members that any time they seek to determine the relevant successor undertaking, they should consider only those successor undertakings which, at that time, have been adopted by the relevant OECD Members. In other words, Members are not allowed to rely on, nor are they bound by the relevant provisions of a successor undertaking which has not yet been formally accepted by the relevant OECD Members. A successor undertaking which is merely being proposed for adoption or which exists only in draft form could not, therefore, constitute a successor undertaking which 'has been adopted'.

On the basis of the foregoing considerations, we find that the phrase 'has been adopted' is properly read as referring to the present of its addressees rather than as referring to an act of adoption prior to the entry into force of the *SCM Agreement*, i.e. prior to 1 January 1995."\(^{70}\)

40. In *Brazil – Aircraft (Article 21.5 – Canada II)*, the Panel continued its analysis by interpreting the terms "successor undertaking" and concluded that the relevant successor undertaking was the most recent one, provided that it had been adopted. The Panel then found that the most recent adopted successor undertaking was the 1998 OECD Arrangement:

"Turning next to the term 'successor undertaking', we note that, in its ordinary meaning, this term refers to an undertaking which 'succeeds [i.e. follows] another in [...] function'.\(^{71}\) There can be no question, in our view, that both the 1992 and the 1998 version of the *OECD Arrangement* constitute 'successor' undertakings to the *OECD Arrangement in effect in 1979*.\(^{72}\) It should be pointed out, in this regard, that the 1998 *OECD Arrangement* is the latest adopted version of the *OECD Arrangement*.

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69 Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para. 5.78.
70 Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*, paras. 5.73 and 5.75-5.79.
72 (footnote original) For the 1998 *OECD Arrangement*, see its Introduction, p. 7 ("Status").
We consider that the relevant successor undertaking is the most recent successor undertaking which has been adopted. It would not, in our view, have been rational for the drafters to consider, without specifying so, that, say, the fifth successor undertaking should be the relevant one. Indeed, the fact that the drafters used the simple and unqualified term 'a successor undertaking' strongly suggests to us that they intended to incorporate, and thus give effect to, the relevant provisions of all adopted successor undertakings. This, however, would not logically be possible, unless effect is given also to the changes introduced by the most recent successor undertaking. On that basis, we find that, in the absence of other textual directives, the most recent successor undertaking is the relevant benchmark undertaking for purposes of the second paragraph of item (k), subject to the one condition that it must have been adopted.

In view of the foregoing, we conclude that the 'successor undertaking' at issue in the second paragraph of item (k) is the most recent successor undertaking which has been adopted prior to the time that the second paragraph is considered. For purposes of these proceedings, we conclude that the most recent successor undertaking which has been adopted is the 1998 OECD Arrangement.\footnote{Panel Report, Brazil – Aircraft (Article 21.5 – Canada II), paras. 5.80–5.81 and 5.83.}

1.7.7 OECD Arrangement

41. Considering that "in practice eligibility for item (k)’s safe haven from the prohibition on export subsidies is defined entirely in terms of the OECD Arrangement, at least for the time being"\footnote{Panel Report, Canada – Aircraft (Article 21.5 – Brazil), para. 5.79.}, the Panel in Canada – Aircraft (Article 21.5 – Brazil) stated the following:

"We take note of the reference to ‘a successor undertaking’ in the second paragraph of item (k). In this regard, first, it is clear from this reference that to the extent that the [OECD] Arrangement today is the only undertaking of the kind referred to in the second paragraph of item (k), if in the future a ‘successor undertaking’ were to take effect, export credit practices conforming with the interest rate provisions of that undertaking also would be eligible for the safe haven in that paragraph. Thus, our detailed analysis of the Arrangement in its present form is not in any way intended to exclude this possibility. Second, for purposes of our analysis of the Arrangement, we assume that the Sector Understandings on Export Credits for Ships, for Nuclear Power Plant, and for Civil Aircraft, contained in Annexes I–III of the Arrangement, form an integral part of the Arrangement itself. Even if in the strict sense this were not the case (an issue that we do not here decide), in our view these Sector Understandings at a minimum would constitute ‘successor undertakings’ in the sense of the second paragraph of item (k), as the Arrangement as originally implemented in 1979 did not contain these Annexes. ... The Sector Understandings were negotiated and implemented later, and incorporate by reference provisions of the Arrangement. Thus, if they are not formally integral to the Arrangement, there is no doubt that these Understandings at a minimum constitute successor undertakings, and thus, conformity with the ‘interest rates provisions’ of the Understandings would

...\footnote{(footnote original) It is clear to us, however, that the drafters could not have left the addressees of the second paragraph free to choose among different successor undertakings. Were it otherwise, complainants could select the strictest successor undertaking with as much justification as respondents could select the most generous successor undertaking. The second paragraph would then fail to do what it is there to do, i.e. to inform Members regarding what their rights and obligations are.}
qualify an export credit practice for the safe haven in the second paragraph of item (k)."

42. As regards the discussion on whether the relevant successor undertaking to the 1979 OECD Arrangement was the 1992 or 1998 version, see paragraphs 39-40.

1.7.8 "export credit practice"

43. In the context of Canada's defence under the second paragraph of item (k), the Panel in Canada – Aircraft (Article 21.5 – Brazil) considered that the phrase "export credit practice", must, in its ordinary meaning, be a relatively broad term. The Panel continued:

"[T]his term on its own suggests any practices that might be associated in some way with export credits (i.e., export financing). This certainly would involve export credits as such, but presumably other sorts of practices as well. The first paragraph of item (k) provides useful context in this regard. In particular, we note that the first paragraph refers exclusively to 'export credits' and 'credits', in contrast to the second paragraph's reference to 'export credit practices'. This supports the conclusion that the second paragraph of item (k) concerns a broader range of 'practices' than export credits as such."

44. Following an analysis of the provisions of the OECD Arrangement, the Panel in Canada – Aircraft (Article 21.5 – Brazil) concluded that at the time of the dispute, only export credit practices in certain forms qualified for the "safe haven" under the second paragraph of item (k). Specifically, the Panel held that practices involving floating interest rates or support for export credits with shorter maturity were not eligible for this exception:

"[T]he safe haven in the second paragraph of item (k) at present is potentially available only to export credit practices in the form of direct credits/financing, refinancing, and interest rate support at fixed interest rates with repayment terms of two years or more. In other words, any such practices involving floating interest rates, as well as official support for export credits with shorter maturity or in the forms of guarantees and insurance, because none are subject to the Arrangement's 'interest rates provisions', most especially the CIRR but also the sector-specific minimum interest rates in the Sector Understandings, would not be eligible for the safe haven, as it simply would not be possible to judge their 'conformity' with the relevant interest rate provisions of the Arrangement, all of which pertain exclusively to fixed rates."

45. The Panel in Brazil – Aircraft (Article 21.5 – Canada II) held that based on "a reading which gives meaning to all of the terms used, the second paragraph suggests that export credit practices which are in conformity with the interest rates provisions of the relevant international undertaking are export subsidies -- and, as such, would normally be prohibited under the provisions of Article 3 of the SCM Agreement --, but that they are nevertheless not prohibited under the SCM Agreement."

46. The Panel in Brazil – Aircraft (Article 21.5 – Canada II), in a finding upheld by the Appellate Body, considered that if "the second paragraph of item (k) makes available an exception, it must be possible to invoke it as an affirmative defence to a claim of violation."

77 Panel Report, Canada – Aircraft (Article 21.5 – Brazil), para. 5.78, fn 69.
78 Panel Report, Canada – Aircraft (Article 21.5 – Brazil), para. 5.80.
79 Panel Report, Canada – Aircraft (Article 21.5 – Brazil), para. 5.80. See also Panel Report, Brazil – Aircraft (Article 21.5 – Canada II), paras. 5.65-5.66.
80 Panel Report, Canada – Aircraft (Article 21.5 – Brazil), para. 5.106.
81 Panel Report, Brazil – Aircraft (Article 21.5 – Canada II), para. 5.61.
83 Panel Report, Brazil – Aircraft (Article 21.5 – Canada II), para. 5.63.
1.7.9 "in conformity" with "interest rates provisions"

1.7.9.1 "interest rate provisions"

47. In Brazil – Aircraft (Article 21.5 – Canada II), the Panel recalled that the only export credit practices that are subject to the OECD Arrangement are those which take the form of "official financing support", i.e. "direct credits/financing, refinancing and interest rate support". Therefore, the Panel considered whether PROEX III payments are "official financing support". In this regard, the Panel noted that the OECD Arrangement does not define the term "interest rate support," but merely states that "interest rate support" is a form of official financing support. It concluded that official interest rate support will normally involve government payments to providers of export credits, and that for such payments to amount to "support," they need to be made with the "aim or effect of securing net borrowing rates for the recipients of export credits which are below those that they would have been without an official financing support:

"The Panel notes that the 1998 OECD Arrangement does not define the term 'interest rate support'. It merely states that 'interest rate support' is a form of official financing support. Since the 1998 OECD Arrangement does not give a special meaning to the term 'interest rate support', we must read it in accordance with its ordinary meaning in context.

We consider that, in its ordinary meaning, the term interest rate support relates broadly to official support for one particular export credit term, namely the interest rate to be paid in connection with export credits. Moreover, as a matter of relevant context, it is clear from the 1998 OECD Arrangement that interest rate support is distinct from direct credits/financing, refinancing, export credit insurance and guarantees. From this it may be deduced that official interest rate support will normally involve government payments to providers of export credits. For such payments to amount to "support," we think they need to be made with the aim or effect of securing net borrowing rates for the recipients of export credits which are lower than they would have been in the absence of official financing support."\(^\text{84}\)

48. The Panel in Brazil – Aircraft (Article 21.5 – Canada II), followed the interpretation of the Panel in Canada – Aircraft (Article 21.5 – Brazil) and concluded that certain provisions of the OECD Arrangement explicitly pertain to interest rates as such. The Panel observed that the programme under consideration provided, inter alia, support for interest rates ("financing costs"), involved payments by the Brazilian Government to commercial providers of export credits, and was framed to lower the net interest rates charged by commercial lenders so that they were compatible with the interest rates in the international market. The Panel concluded that the programme support constituted "interest rate support," and was therefore an export credit practice subject to the interest rates provisions of the OECD Arrangement.\(^\text{85}\)

1.7.9.2 "in conformity"

1.7.9.2.1 General

49. With respect to conformity with the interest rate provisions of export credit practices under the OECD Arrangement, the Panel in Canada – Aircraft (Article 21.5 – Brazil) concluded that "full conformity with the 'interest rates provisions' – in respect of 'export credit practices' subject to the CIRR – must be judged on the basis not only of full conformity with the CIRR but in addition full adherence to the other rules of the [OECD] Arrangement that operate to support or reinforce the minimum interest rate rule by limiting the generosity of the terms of official financing support."\(^\text{86,87}\)

\(^{84}\) Panel Report, Brazil – Aircraft (Article 21.5 – Canada II), paras. 5.131-132.
\(^{85}\) Brazil – Aircraft (Article 21.5 – Canada II), paras. 5.133-134.
\(^{86}\) Panel Report, Canada – Aircraft (Article 21.5 – Brazil), para. 5.114.
\(^{87}\) The Panel in Brazil – Aircraft (Article 21.5 – Canada II) followed the interpretation of the Panel in Canada – Aircraft (Article 21.5 – Brazil).
1.7.9.2.2 "Concept of conformity" under the OECD Arrangement

50. The Panel in Canada – Aircraft (Article 21.5 – Brazil) considered that the text of the OECD Arrangement provides the following guidance on how the term "conformity" should be understood:

"In the first place, the Arrangement text provides explicitly that derogations from provisions of the Arrangement, and the matching of such derogations, do not 'conform' with the provisions of the Arrangement. Thus, any transaction that involves derogations or matching of derogations by definition cannot be in conformity with the interest rate provisions of the Arrangement, as ... conformity with the interest rate provisions requires conformity not just with the minimum interest rate rule but also with the other provisions that support/reinforce that rule. As such, an otherwise eligible transaction involving derogations or matching of derogations could not qualify for the safe haven of the second paragraph of item (k). On the other hand, the Arrangement explicitly defines permitted exceptions and the matching of permitted exceptions, within the allowed limits, to be in compliance, i.e., in conformity with the relevant provisions of the Arrangement. Therefore, ... making use of permitted exceptions, within the specified limits, would not disqualify an eligible transaction from the safe haven, so long as the transaction conformed with the minimum interest rate and all of the other applicable disciplines."88

51. The Panel in Canada – Aircraft (Article 21.5 – Brazil) found that the Canadian Policy Guideline did not qualify for the "safe haven" under the second paragraph of item (k) of the Illustrative List. The Panel first held that it was "incumbent upon Canada to provide an explanation not only of what in its view constituted conformity with the interest rate provisions of the OECD Arrangement, but also how the Policy Guideline ensured such conformity."89 The Panel then turned to the Policy Guideline and found:

"[E]ven if the Policy Guideline contained all of the details that Canada has provided in its arguments concerning 'conformity' with the 'interest rates provisions' of the Arrangement, we would find on substantive grounds that it would not ensure that future Canada Account transactions would so conform. We note, however, that in fact the Policy Guideline contains no details at all, but simply indicates that transactions that 'do not comply' with 'the OECD Arrangement' will not be considered to be in the national interest. Thus, we find that the Policy Guideline is insufficient to accomplish what Canada says it will accomplish, namely to 'ensure that any future Canada Account financing transactions will be in conformity with the interest rate provisions of the [OECD] Arrangement and therefore the provisions referred to in the second paragraph of item (k)'.

In particular, the Policy Guideline is both generally worded and worded in the negative. In both of these aspects it seems to fall considerably short of what might reasonably be considered the minimum sufficient assurance which Canada wishes to provide. Concerning the generality of the wording, as just noted, the Policy Guideline simply refers to compliance with the OECD Arrangement. As has been discussed in detail, however, general conformity with whichever provisions of the Arrangement happen to apply to a given transaction would not appear to be sufficient to qualify for the relatively narrow safe haven in the second paragraph of item (k). Rather, only conformity with the Arrangement's interest rate provisions, which presupposes that those provisions apply (i.e., that the practice in question is in the form of official financing support at fixed interest rates), along with conformity with the Arrangement's other disciplines on financing terms, would qualify a practice for the safe haven."90

1.7.10 Burden of proof

52. The Appellate Body in Brazil – Aircraft (Article 21.5 – Canada) found that "Brazil's argument under item (k) constituted an alleged 'affirmative defence' for which Brazil bore the

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88 Panel Report, Canada – Aircraft (Article 21.5 – Brazil), para. 5.126.
89 Panel Report, Canada – Aircraft (Article 21.5 – Brazil), para. 5.142.
90 Panel Report, Canada – Aircraft (Article 21.5 – Brazil), paras. 5.143-5.144.
burden of proof." Referring to its report on US – Wool Shirts and Blouses, the Appellate Body confirmed that Brazil, as the party asserting a defence, bore the burden of proof of proving that the revised PROEX was justified under the first paragraph of item (k). (However, as noted in paragraph 26 above, the Appellate Body in Brazil – Aircraft (Article 21.5 – Canada) did not make a finding on whether the first paragraph of item (k) could in fact be used in an a contrario manner as an affirmative defence.) The Appellate Body then set forth in what manner Brazil could successfully prove that the revised subsidies scheme was not "used to secure a material advantage in the field of export credit terms":

"To establish that subsidies under the revised PROEX are not 'used to secure a material advantage in the field of export credit terms', Brazil must prove either: that the net interest rates under the revised PROEX are at or above the relevant CIRR, the specific 'market benchmark' we identified in the original dispute as an 'appropriate' basis for comparison; or, that an alternative 'market benchmark', other than the CIRR, is appropriate, and that the net interest rates under the revised PROEX are at or above this alternative 'market benchmark'." 92

53. The Panel in Canada – Aircraft (Article 21.5 – Brazil) did not state explicitly that Canada bore the burden of proving that its measure qualified for the "safe haven" clause under the second paragraph of item (k) of the Illustrative List. However, the Panel termed Canada's invocation of the second paragraph of item (k) a "defense to Brazil's claim". 93

54. The Panel in Brazil – Aircraft (Article 21.5 – Canada II) concluded that, while the programme as such allows the Member to make payments in such a way that they do not secure a material advantage in the field of export credit terms, payments under the programme are not the payment by the Member of "all or part of the costs incurred by exporters or financial institutions in obtaining credits". Therefore, the Panel considered that the Member failed to demonstrate the required elements for its defence under the first paragraph of item (k):

"[W]hile PROEX III, as such, allows Brazil to make PROEX III payments in such a way that they do not secure a material advantage in the field of export credit terms, PROEX III payments are not the payment by Brazil of 'all or part of the costs incurred by exporters or financial institutions in obtaining credits'. Brazil has, therefore, failed to demonstrate the required elements for its defence under the first paragraph of item (k). We have further concluded that, in any event, the first paragraph of item (k) cannot, as a legal matter, be invoked as an affirmative defence." 94

1.7.11 Second paragraph of item (k) as an affirmative defence

55. In Brazil – Aircraft (Article 21.5 – Canada II), the Panel noted that the second paragraph of item (k) provides for an "exception" from any prohibition on export subsidies, such that it may be invoked as an affirmative defence to a claim of violation:

"On a reading which gives meaning to all of the terms used, the second paragraph suggests that export credit practices which are in conformity with the interest rates provisions of the relevant international undertaking are export subsidies -- and, as such, would normally be prohibited under the provisions of Article 3 of the SCM Agreement --, but that they are nevertheless not prohibited under the SCM Agreement.

This interpretation leads us to the conclusion that the second paragraph of item (k) provides for an exception from any prohibition on export subsidies laid down elsewhere in the SCM Agreement. The fact that the second paragraph does not, itself, impose obligations supports that conclusion.

Consistently with our view that the second paragraph of item (k) makes available an exception, it must be possible to invoke it as an affirmative defence to a claim of

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91 Appellate Body Report, Brazil – Aircraft, para. 65.
92 Appellate Body Report, Brazil – Aircraft (Article 21.5 – Canada), paras. 66-67.
93 Panel Report, Canada – Aircraft (Article 21.5 – Brazil), para. 5.73.
94 Panel Report, Brazil – Aircraft (Article 21.5 – Canada II), para. 5.276.
violation. As is clear from relevant WTO jurisprudence, the burden of establishing an
affirmative defence rests with the party raising it.95

1.7.12 "Matching of a derogation"

1.7.12.1 General

56. The Panel in Canada – Aircraft (Article 21.5 – Brazil) considered that:

"Member's conformity with GATT/WTO rules [should not be] defined by the behaviour
of non-Members', the Panel considered that this concern would arise even if the
inclusion of the matching of a derogation in the item (k) safe haven would mean that
matching Members were acting in accordance with their WTO obligations. This is
because the inclusion of the matching of a derogation in the item (k) safe haven
would not establish any objective benchmark against which to determine whether or
not a Member is in accordance with its WTO obligations. In any given case, the
benchmark would be set by reference to the terms and conditions of the non-
conforming offer. To the extent that the non-conforming offer were made by a non-
WTO Member, the benchmark for determining whether or not a matching Member acts
in accordance with its WTO obligations would therefore be the non-conforming terms
and conditions offered by the non-Member. Thus, the fact that the matching of a
derogation is included in the second paragraph of item (k) would not remove the
potential for a 'Member's conformity with GATT/WTO rules [to be] defined by the
behaviour of non-Members".97

57. The Panel in Canada – Aircraft Credits and Guarantees concluded that, as a matter of law,
the matching of a derogation is not "in conformity with" the interest rates provisions of the OECD
Arrangement and therefore cannot fall within the scope of the item (k) safe haven.98 The Panel
held:

"Indeed, if one were to accept that the matching of a derogation could fall within the
item (k) safe haven, one would effectively be accepting that a Member could be 'in
conformity with' the 'interest rates provisions' of the OECD Arrangement even though
that Member failed to respect the CIRR (or a permitted exception). In our view, such
an interpretation would be unjustified."99

58. For the Panel in Canada – Aircraft Credits and Guarantees, the fact that the OECD
Arrangement allows matching of derogations, or the fact that participants' view matching of
derogations as a means of disciplining export credits, does not necessarily mean that the SCM
Agreement should allow matching of derogations. The Panel considered that unlike the
OECD Arrangement, the SCM Agreement is not an "informal" "gentleman's agreement". The
SCM Agreement therefore does not need to allow recourse to the matching of derogations in order
to instil discipline. The SCM Agreement is a binding instrument, and is therefore enforceable
through the WTO dispute settlement mechanism.100

59. The Panel in Brazil – Aircraft (Article 21.5 – Canada II) recalled that practices that follow
"permitted exceptions" under the OECD Arrangement are "in conformity with" the interest rates
provisions, whereas practices pursuant to "derogations" are not. The Panel in Brazil – Aircraft
(Article 21.5 – Canada II), stated that "to accept, for purposes of the SCM Agreement, that even
non-conforming departures from the provisions of the OECD Arrangement were covered by the
safe haven, would, in effect, remove any disciplines on official financing support for export
credits." For the Panel:

95 (footnote original) See the Appellate Body Report on United States – Measure Affecting Imports of
Woven Wool Shirts and Blouses from India, adopted 23 May 1997, WT/DS33/AB/R, p. 16; Article 21.5
Appellate Body Report on Brazil – Aircraft, supra, para. 66.
96 Panel Report, Brazil – Aircraft (Article 21.5 – Canada II), paras. 5.61-5.63.
97 Panel Report, Canada – Aircraft Credits and Guarantees, paras. 7.165.
98 Panel Report, Canada – Aircraft Credits and Guarantees, para. 7.177.
99 Panel Report, Canada – Aircraft Credits and Guarantees, para. 7.164.
100 Panel Report, Canada – Aircraft Credits and Guarantees, para. 7.165.
"[T]he fact that the OECD Arrangement allows matching of derogations does not logically imply that it should also be allowed under the SCM Agreement. Indeed, the OECD Arrangement and the SCM Agreement are very different ... In those circumstances, matching may serve an important deterrent and enforcement function and that rationale for matching does not apply to the SCM Agreement because the SCM Agreement is a binding instrument, and it is enforceable through the WTO dispute settlement mechanism." 101

1.7.12.2 Burden of proof in the framework of a derogation

60. The Panel in Canada – Aircraft Credits and Guarantees considered that the transaction under consideration could not be justified under the safe haven and that consequently such financing is a prohibited export subsidy, contrary to Article 3.1(a) of the SCM Agreement because Canada has failed to establish that the matching of a derogation could, as a matter of law, be "in conformity with" the "interest rates provisions" of the OECD Arrangement. 102 For the Panel, the burden is on the Member affirming that the matching of a derogation from the OECD Arrangement could, as a "matter of law", be "in conformity with" the "interest rates provisions" of the OECD Arrangement, pursuant to the safe haven. Only if the Member demonstrates this, would the Panel then examine whether it had, in fact, complied with the "matching" requirement of the OECD Arrangement:

"In order to avail itself of the item (k) safe haven, Canada must first establish that the matching of a derogation could, as a matter of law, be 'in conformity with' the "interest rates provisions" of the OECD Arrangement. Only if Canada establishes that this is possible as a matter of law, will we need to consider whether Canada has met its burden of establishing that the Canada Account financing to Air Wisconsin is matching according to the provisions of the OECD Arrangement. Similarly, only if Canada establishes that matching a derogation could, as a matter of law, fall within the item (k) safe haven, will we need to address Brazil's arguments regarding Canada's alleged failure to comply with the procedural requirements of Articles 47(a) and 53 of the OECD Arrangement." 103

1.7.13 Mandatory/discretionary distinction in the context of an affirmative defence under item (k) second paragraph

61. In Brazil – Aircraft (Article 21.5 – Canada II), the Panel recalled that the programme had been challenged "as such," and that the mandatory/discretionary distinction was therefore relevant. Accordingly, the Panel considered whether the Member was required to apply the programme under consideration "in a manner that gives rise to a prohibited export subsidy." In doing so, the Panel first dealt with the preliminary issue of whether the distinction between mandatory and discretionary legislation is applicable in the context of an affirmative defence under the second paragraph of item (k): 104

"[T]he distinction between mandatory and discretionary legislation is applicable in the context of the second paragraph of item (k). It is of course correct that, in the present context, we are concerned not with conformity with a WTO obligation, but with conformity with conditions attached to a WTO exception. This fact alone does not, however, render the GATT/WTO distinction between mandatory and discretionary legislation inapplicable or inappropriate.

In our understanding, the rationale underpinning the traditional GATT/WTO distinction between mandatory and discretionary legislation is that, when the executive branch of a Member is not required to act inconsistently with requirements of WTO law, it should be entitled to a presumption of good faith compliance with those requirements. We consider that that rationale is no less valid in the context of WTO exceptions than it is in the context of WTO obligations.

101 Panel Report, Brazil – Aircraft (Article 21.5 – Canada II), para. 5.115.
102 Panel Report, Canada – Aircraft Credits and Guarantees, paras. 7.180-7.181.
103 Panel Report, Canada Aircraft Credits and Guarantees, para. 7.161.
104 Panel Report, Brazil – Aircraft (Article 21.5 – Canada II), paras. 5.119-5.120.
We have stated above that the Member invoking an exception as an affirmative
defence has the burden of establishing it. In our view, the allocation of the burden of
proof is a procedural issue which is distinct from the substantive standard to be
applied in assessing the conformity of legislation with a particular provision of the
WTO Agreement.

Accordingly, the task before us is to examine whether, under PROEX III, Brazil is
required to act in a manner that is not in conformity with the interest rates provisions
of the 1998 OECD Arrangement or, expressed otherwise, whether PROEX III allows
compliance with the interest rates provisions. ¹⁰⁵

62. In Canada – Aircraft Credits and Guarantees, the Panel found that the fact that export
credit agencies provide export subsidies does not answer the question of mandatory
subsidization and that “the existence of item (k) does not eliminate the requirement for a complaining party to
prove the mandatory nature of the programme in order to prevail on an "as such" claim." ¹⁰⁶

1.7.14 Relationship with other provisions of the SCM Agreement

63. With respect to the relationship with Article 1.1(b), see the Section on Article 1.

¹⁰⁵ Panel Report, Brazil – Aircraft (Article 21.5 – Canada II), paras. 5.123-5.126.
¹⁰⁶ Panel Report, Canada – Aircraft Credits and Guarantees, para. 7.82.