

<b>1</b>	<b>ARTICLE 3</b>	<b>2</b>
1.1	Text of Article 3	2
1.2	General	2
1.3	"Except as provided in the Agreement on Agriculture"	3
1.4	Article 3.1(a)	3
1.4.1	General	3
1.4.2	"contingent in law ... upon export performance"	4
1.4.3	"contingent ... in fact ... upon export performance"	5
1.4.3.1	De facto contingency	5
1.4.3.2	Treatment of facts in the determination of <i>de facto</i> export contingency	12
1.4.3.2.1	Case-by-case approach	12
1.4.3.2.2	Which facts to consider	13
1.4.3.2.3	Relevance of the size of the domestic industry	14
1.4.4	"Export performance"	15
1.4.4.1	General	15
1.4.4.2	"produced within or outside the Member"	15
1.4.5	Relationship with other provisions of the SCM Agreement	16
1.4.5.1	Article 4.7	16
1.4.5.2	Article 27	17
1.4.5.3	Footnote 59	17
1.4.6	Annex VII(b)	18
1.4.7	Footnote 4	18
1.5	Article 3.1(b)	19
1.5.1	General	19
1.5.2	"subsidies contingent ... upon the use of domestic over imported goods"	20
1.5.2.1	"use"	20
1.5.2.2	"domestic over imported goods"	20
1.5.2.3	"goods"	20
1.5.2.4	Contingency	21
1.5.2.4.1	<i>De facto</i> and <i>de jure</i> contingency	21
1.5.2.4.2	Legal standard	22
1.5.3	Relationship with other provisions of the SCM Agreement	24
1.5.3.1	Chapeau of Article 3.1	24
1.5.3.2	Article 3.1(a)	24
1.5.3.3	Article 27	24
1.5.4	Relationship with other Agreements	24
1.5.4.1	Agreement on Agriculture	24
1.5.4.2	Article III of the GATT 1994	24
1.5.4.3	Article III:4 of the GATT 1994 and TRIMs Agreement	26
1.6	Article 3.2	26

1.6.1	"grant".....	26
1.6.2	Relationship with other provisions of the SCM Agreement.....	28
1.6.2.1	Article 3.1 .....	28
1.7	Relationship with other WTO Agreements .....	28
1.7.1.1	GATT 1994 .....	28
1.7.1.2	Agreement on Agriculture.....	28

## **1 ARTICLE 3**

### **1.1 Text of Article 3**

#### **Article 3**

##### *Prohibition*

3.1 Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:

- (a) subsidies contingent, in law or in fact<sup>4</sup>, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I<sup>5</sup>;

*(footnote original)*<sup>4</sup> This standard is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.

*(footnote original)*<sup>5</sup> Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement.

- (b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.

3.2 A Member shall neither grant nor maintain subsidies referred to in paragraph 1.

### **1.2 General**

1. In *US – Tax Incentives*, the Appellate Body elaborated on the role of Article 3 of the SCM Agreement. It clarified that the "granting of subsidies is not, in and of itself, prohibited under the SCM Agreement; nor does the granting of subsidies constitute, without more, an inconsistency with that Agreement".<sup>1</sup> It further added:

"Only subsidies contingent upon export performance within the meaning of Article 3.1(a) (commonly referred to as export subsidies), or contingent upon the use of domestic over imported goods within the meaning of Article 3.1(b) (commonly referred to as import substitution subsidies), are prohibited *per se* under Article 3 of the SCM Agreement. In any event, subsidies, if specific, are disciplined under Part III of the SCM Agreement, but a complaining Member must demonstrate the existence of adverse effects under Article 5 of that Agreement."<sup>2</sup>

2. In the same case, the Appellate Body noted that Article 3.1(b) of the SCM Agreement does not prohibit the subsidization of domestic production *per se* but rather the granting of subsidies

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<sup>1</sup> Appellate Body Report, *US – Tax Incentives*, para. 5.6 (referring to Appellate Body Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para. 47).

<sup>2</sup> Appellate Body Report, *US – Tax Incentives*, para. 5.6.

contingent upon the use of domestic over imported goods. The Appellate Body distinguished these two situations as follows:

"We recall that, by its terms, Article 3.1(b) does not prohibit the subsidization of domestic 'production' *per se* but rather the granting of subsidies contingent upon the 'use', by the subsidy recipient, of domestic over imported goods.<sup>3</sup> Subsidies that relate to domestic production are therefore not, for that reason alone, prohibited under Article 3 of the SCM Agreement.<sup>4</sup> We note in this respect that such subsidies can ordinarily be expected to increase the supply of the subsidized domestic goods in the relevant market, thereby increasing the use of these goods downstream and adversely affecting imports, without necessarily requiring the use of domestic over imported goods as a condition for granting the subsidy."<sup>5</sup>

### 1.3 "Except as provided in the Agreement on Agriculture"

3. In *US – Upland Cotton*, the Appellate Body noted that the introductory phrase "[e]xcept as provided in the Agreement on Agriculture" applies to both paragraphs (a) and (b) of paragraph 1 of Article 3, which deal with both export subsidies and import substitution subsidies, respectively. However, the Appellate Body found no provision in the Agreement on Agriculture that dealt specifically with import substitution subsidies:

"We are mindful that the introductory language of Article 3.1 of the *SCM Agreement* clarifies that this provision applies '[e]xcept as provided in the Agreement on Agriculture'. Furthermore, as the United States has pointed out, this introductory language applies to both the export subsidy prohibition in paragraph (a) and to the prohibition on import substitution subsidies in paragraph (b) of Article 3.1. As we explained previously, in our review of the provisions of the *Agreement on Agriculture* relied on by the United States, we did not find a provision that deals specifically with subsidies that have an import substitution component. By contrast, the prohibition on the provision of subsidies contingent upon the use of domestic over imported goods in Article 3.1(b) of the *SCM Agreement* is explicit and clear. Because Article 3.1(b) treats subsidies contingent on the use of domestic over imported products as prohibited subsidies, it would be expected that the drafters would have included an equally explicit and clear provision in the *Agreement on Agriculture* if they had indeed intended to authorize such prohibited subsidies provided in connection with agricultural goods. We find no provision in the *Agreement on Agriculture* dealing specifically with subsidies contingent upon the use of domestic over imported agricultural goods."<sup>6</sup>

### 1.4 Article 3.1(a)

#### 1.4.1 General

4. In *Canada – Aircraft Credits and Guarantees*, the Panel first recalled the text of Article 3.1(a) and found that to "prove the existence of an export subsidy within the meaning of

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<sup>3</sup> (*footnote original*) Pursuant to Article 2.1 of the SCM Agreement, a subsidy covered under that Agreement should be specific to certain enterprises "within the jurisdiction of the granting authority", or, in other words, domestic producers. Although, pursuant to Article 2.3, prohibited subsidies are "deemed to be specific", they are still subsidies granted to domestic producers. Other provisions of the SCM Agreement also refer to the "territory" of a Member, as well as to "domestic producers" or "domestic production". (See e.g. Article 1.1(a)(1); Article 8.2(b), now lapsed, pursuant to Article 31; Article 10; Article 25; and Article 28 of the SCM Agreement)

<sup>4</sup> (*footnote original*) In *Canada – Aircraft (Article 21.5 – Brazil)*, the Appellate Body found it "worth recalling that the granting of a subsidy is not, in and of itself, prohibited under the *SCM Agreement*. Nor does granting a 'subsidy', without more, constitute an inconsistency with that Agreement. The universe of subsidies is vast. Not all subsidies are inconsistent with the *SCM Agreement*. The only 'prohibited' subsidies are those identified in Article 3 of the *SCM Agreement*". (Appellate Body Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para. 47)

<sup>5</sup> Appellate Body Report, *US – Tax Incentives*, para. 5.15.

<sup>6</sup> Appellate Body Report, *US – Upland Cotton*, para. 547.

this provision, a Member must ... establish (i) the existence of a subsidy within the meaning of Article 1 of the SCM and (ii) contingency of that subsidy upon export performance".<sup>7</sup>

5. The Appellate Body in *US – FSC (Article 21.5 – EC)* noted that Article 3.1(a) provides that "subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance" are prohibited. The Appellate Body referred also to its statement in *Canada – Aircraft* that "contingent" means "conditional" or "dependent for its existence on something else" and said that the grant of the subsidy must be conditional or dependent upon export performance.<sup>8</sup> The Appellate Body stated:

"We start with the text of Article 3.1(a) of the *SCM Agreement*, which provides that 'subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance' are prohibited. We have considered this provision in several previous appeals.<sup>9</sup> In *Canada – Aircraft*, we said that the key word in Article 3.1(a) is 'contingent', which means 'conditional' or 'dependent for its existence on something else'.<sup>10</sup> The grant of the subsidy must be conditional or dependent upon export performance. Footnote 4 of the *SCM Agreement*, attached to Article 3.1(a), describes the relationship of contingency by stating that the grant of a subsidy must be 'tied to' export performance. Article 3.1(a) further provides that such export contingency may be the 'sole []' condition governing the grant of a prohibited subsidy or it may be 'one of several other conditions'.<sup>11</sup>

#### 1.4.2 "contingent in law ... upon export performance"

6. In *Canada – Autos*, the Appellate Body addressed the distinction between a *de jure* and a *de facto* export subsidy with reference to the wording of a particular measure:

"In our view, a subsidy is contingent 'in law' upon export performance when the existence of that condition can be demonstrated on the basis of the very words of the relevant legislation, regulation or other legal instrument constituting the measure. The simplest, and hence, perhaps, the uncommon, case is one in which the condition of exportation is set out expressly, in so many words, on the face of the law, regulation or other legal instrument. We believe, however, that a subsidy is also properly held to be *de jure* export contingent where the condition to export is clearly, though implicitly, in the instrument comprising the measure. Thus, for a subsidy to be *de jure* export contingent, the underlying legal instrument does not always have to provide *expressis verbis* that the subsidy is available only upon fulfillment of the condition of

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<sup>7</sup> Panel Report, *Canada – Aircraft Credits and Guarantees*, para. 7.16.

<sup>8</sup> Panel Report, *US – FSC (Article 21.5 – EC)*, paras. 8.54-8.55. On this issue, the Panel in *US – FSC (Article 21.5 – EC)* recalled that:

"[T]he meaning of 'contingent' in that provision is 'conditional' or 'dependent for its existence upon'. We further recall that the legal standard expressed by the word 'contingent' is the same for both *de jure* or *de facto* contingency. There is a difference, however, in what evidence may be employed to establish that a subsidy is export-contingent.

We recall the Appellate Body's [*Canada – Autos*] statement that '*de jure* export contingency' is demonstrated on the basis of the words of the relevant legislation, regulation or other legal instrument, as opposed to the 'total configuration of the facts constituting and surrounding the grant of the subsidy.' The Appellate Body [in *Canada – Autos*] has also recently stated,

'that a subsidy is also properly held to be *de jure* export contingent where the condition to export is clearly, though implicitly, in the instrument comprising the measure. Thus, for a subsidy to be *de jure* export contingent, the underlying legal instrument does not always have to provide *expressis verbis* that the subsidy is available only upon fulfilment of the condition of export performance. Such conditionality can also be derived by necessary implication from the words actually used in the measure.' " [See Appellate Body Report, *Canada – Autos*, para. 118].

<sup>9</sup> (footnote original) Appellate Body Report, *Canada – Measures Affecting the Export of Civilian Aircraft* ("*Canada – Aircraft*"), WT/DS70/AB/R, adopted 20 August 1999, paras. 162-180; Appellate Body Report, *US – FSC*, *supra*, footnote 3 paras. 96-121; Appellate Body Report, *Canada – Autos*, *supra*, footnote 56, paras. 95-117; Appellate Body Report, *Canada – Aircraft (Article 21.5 – Brazil)*, *supra*, footnote 62, paras. 25-52.

<sup>10</sup> (footnote original) Appellate Body Report, *supra*, footnote 86, para. 166.

<sup>11</sup> Appellate Body Report, *US – FSC (Article 21.5 – EC)*, para. 111.

export performance. Such conditionality can also be derived by necessary implication from the words actually used in the measure."<sup>12</sup>

7. The Appellate Body in *Canada – Autos* concluded that "as the import duty exemption is simply not available to a manufacturer unless it exports motor vehicles, the import duty exemption is clearly conditional, or dependent upon, exportation and, therefore, is contrary to Article 3.1(a) ... [.]"<sup>13</sup>

8. Before the Panel in *Canada – Aircraft*, Canada stated that the mandate of one of its agencies was "to offer a full range of risk management services and financing products 'for the purpose of supporting and developing, directly or indirectly, Canada's export trade'".<sup>14</sup> Basing itself on this statement by Canada, the Panel held that "export credits granted 'for the purpose of supporting and developing, directly or indirectly, Canada's export trade' are expressly contingent in law on export performance."<sup>15</sup>

9. In examining whether a subsidy is contingent "in law" upon export performance, the Appellate Body in *Canada – Autos* noted that "footnote 4 ... uses the words 'tied to' as a synonym for 'contingent' or 'conditional'. As the legal standard is the same for *de facto* and *de jure* export contingency, we believe that a 'tie', amounting to the relationship of contingency, between the granting of the subsidy and actual or anticipated exportation meets the legal standard of 'contingent' in Article 3.1(a) ... [.]"<sup>16</sup>

10. In *US – Upland Cotton*, the Appellate Body considered that a payment made on proof of exportation was export-contingent even though the payments under different conditions were also available, without exportation, on proof of sale to a domestic consumer:

"In sum, we agree with the Panel's view that Step 2 payments are export-contingent and, therefore, an export subsidy for purposes of Article 9 of the *Agreement on Agriculture* and Article 3.1(a) of the *SCM Agreement*. The statute and regulations pursuant to which Step 2 payments are granted, on their face, condition payments to exporters on exportation. In order to claim payment, an exporter must show proof of exportation. If an exporter does not provide proof of exportation, the exporter will not receive a payment. This is sufficient to establish that Step 2 payments to exporters of United States upland cotton are 'conditional upon export performance' or 'dependent for their existence on export performance'. That domestic users may also be eligible to receive payments under different conditions does not eliminate the fact that an exporter will receive payment only upon proof of exportation."<sup>17</sup>

### **1.4.3 "contingent ... in fact ... upon export performance"**

#### **1.4.3.1 De facto contingency**

11. Regarding the interpretation of the term "contingent ... in fact", the Panel in *Australia – Automotive Leather II* established a standard of "close connection" between the grant or maintenance of a subsidy and export performance. It added that a subsidy, in order to be export contingent in fact, must be "conditioned" upon export performance:

"An inquiry into the meaning of the term 'contingent ... in fact' in Article 3.1(a) of the SCM Agreement must, therefore, begin with an examination of the ordinary meaning of the word 'contingent'. The ordinary meaning of 'contingent' is 'dependent for its existence on something else', 'conditional; dependent on, upon'. The text of

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<sup>12</sup> Appellate Body Report, *Canada – Autos*, para. 100. See also Panel Report, *Canada – Aircraft Credits and Guarantees*, para. 7.365 and Panel Report, *US – FSC (Article 21.5 – EC)*, paras. 8.54-8.56.

<sup>13</sup> Appellate Body Report, *Canada – Autos*, para. 104. See also Appellate Body Report, *Canada – Autos*, para. 100.

<sup>14</sup> Panel Report, *Canada – Aircraft*, para. 6.52.

<sup>15</sup> Panel Report, *Canada – Aircraft*, para. 9.230.

<sup>16</sup> Appellate Body Report, *Canada – Autos*, para. 107. See also Panel Report, *Canada – Aircraft Credits and Guarantees*, paras. 7.365 and 7.367-7.368.

<sup>17</sup> Appellate Body Report, *US – Upland Cotton*, para. 582.

Article 3.1(a) also includes footnote 4, which states that the standard of 'in fact' contingency is met if the facts demonstrate that the subsidy is 'in fact tied to actual or anticipated exportation or export earnings'. The ordinary meaning of 'tied to' is 'restrain or constrain to or from an action; limit or restrict as to behaviour, location, conditions, etc.'. Both of the terms used – 'contingent ... in fact' and 'in fact tied to' – suggest an interpretation that requires a close connection between the grant or maintenance of a subsidy and export performance."<sup>18</sup>

12. In *Canada – Aircraft*, the Panel also considered the "tied to" language of footnote 4 to be equivalent to a relationship of "conditionality" between the grant of a subsidy and export performance.<sup>19</sup> The Appellate Body agreed with the term "conditioned" and linked it to the concept of contingency under Article 3.1(a):

"The ordinary meaning of 'tied to' confirms the linkage of 'contingency' with 'conditionality' in Article 3.1(a). Among the many meanings of the verb 'tie', we believe that, in this instance, because the word 'tie' is immediately followed by the word 'to' in footnote 4, the relevant ordinary meaning of 'tie' must be to 'limit or restrict as to ... conditions'. This element of the standard set forth in footnote 4, therefore, emphasizes that a relationship of conditionality or dependence must be demonstrated. The second substantive element is at the very heart of the legal standard in footnote 4 and cannot be overlooked. In any given case, the facts must 'demonstrate' that the granting of a subsidy is *tied to* or *contingent upon* actual or anticipated exports. It does *not* suffice to demonstrate solely that a government granting a subsidy *anticipated* that exports would result. The prohibition in Article 3.1(a) applies to subsidies that are *contingent* upon export performance."<sup>20</sup>

13. While the Appellate Body in *Canada – Aircraft* largely agreed with the findings of the Panel on the interpretation of the term "contingency", it nevertheless cautioned the use of the "but for" test established by the Panel on the basis of the term "tied to":

"We note that the Panel considered that the most effective means of demonstrating whether a subsidy is contingent in fact upon export performance is to examine whether the subsidy would have been granted *but for* the anticipated exportation or export earnings ... While we consider that the Panel did not err in its overall approach to *de facto* export contingency, we, and panels as well, must interpret and apply the language actually used in the treaty."<sup>21</sup>

14. The Appellate Body in *Canada – Aircraft* provided its own reasoning with respect to the ordinary meaning of the text "contingent ... in fact ... on export performance". In doing so, it first emphasized the term "contingent" as a "key word", held that the legal standard encapsulated by this term is the same for both *de jure* or *de facto* contingency and framed the distinction between these two types of contingency in terms of the evidence upon which such determination would rest:

"In our view, the key word in Article 3.1(a) is 'contingent'. As the Panel observed, the ordinary connotation of 'contingent' is 'conditional' or 'dependent for its existence on something else'. This common understanding of the word 'contingent' is borne out by the text of Article 3.1(a), which makes an explicit link between 'contingency' and 'conditionality' in stating that export contingency can be the sole or 'one of several other *conditions*'.

... In our view, the legal standard expressed by the word 'contingent' is the same for both *de jure* or *de facto* contingency. There is a difference, however, in what evidence may be employed to prove that a subsidy is export contingent. *De jure* export contingency is demonstrated on the basis of the words of the relevant legislation, regulation or other legal instrument. Proving *de facto* export contingency is a much more difficult task. There is no single legal document which will demonstrate, on its

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<sup>18</sup> Panel Report, *Australia – Automotive Leather II*, para. 9.55.

<sup>19</sup> Panel Report, *Canada – Aircraft*, para. 9.331.

<sup>20</sup> Appellate Body Report, *Canada – Aircraft*, para. 171.

<sup>21</sup> Appellate Body Report, *Canada – Aircraft*, para. 171, footnote 102.

face, that a subsidy is 'contingent ... in fact ... upon export performance'. Instead, the existence of the relationship of contingency, between the subsidy and export performance, must be *inferred* from the total configuration of the facts constituting and surrounding the granting of the subsidy, none of which on its own is likely to be decisive in any given case."<sup>22</sup>

15. The Appellate Body in *Canada – Aircraft* examined footnote 4 more closely as "a standard ... for determining when a subsidy is 'contingent ... in fact ... upon export performance'". It identified three elements, i.e. "granting of a subsidy", "tied to" and "anticipated":

"We note that satisfaction of the standard for determining *de facto* export contingency set out in footnote 4 requires proof of three different substantive elements: first, the '*granting* of a subsidy'; second, 'is ... *tied to* ...'; and, third, 'actual or anticipated exportation or export earnings'. (emphasis added) ...

The first element of the standard for determining *de facto* export contingency is the '*granting* of a subsidy'. In our view, the initial inquiry must be on whether the *granting authority* imposed a condition based on export performance in providing the subsidy. In the words of Article 3.2 and footnote 4, the prohibition is on the '*granting* of a subsidy', and not on receiving it. The treaty obligation is imposed on the *granting* Member, and not on the recipient. Consequently, we do not agree ... that an analysis of 'contingent ... in fact ... upon export performance' should focus on the reasonable knowledge of the recipient.<sup>23</sup>

The second substantive element in footnote 4 is 'tied to'. The ordinary meaning of 'tied to' confirms the linkage of 'contingency' with 'conditionality' in Article 3.1(a). Among the many meanings of the verb 'tie', we believe that, in this instance, because the word 'tie' is immediately followed by the word 'to' in footnote 4, the relevant ordinary meaning of 'tie' must be to 'limit or restrict as to ... conditions'. This element of the standard set forth in footnote 4, therefore, emphasizes that a relationship of conditionality or dependence must be demonstrated. The second substantive element is at the very heart of the legal standard in footnote 4 and cannot be overlooked. In any given case, the facts must 'demonstrate' that the granting of a subsidy is *tied to* or *contingent upon* actual or anticipated exports. It does *not* suffice to demonstrate solely that a government granting a subsidy *anticipated* that exports would result. The prohibition in Article 3.1(a) applies to subsidies that are *contingent* upon export performance.

We turn now to the third substantive element provided in footnote 4. The dictionary meaning of the word 'anticipated' is 'expected'. The use of this word, however, does *not* transform the standard for 'contingent ... in fact' into a standard merely for ascertaining 'expectations' of exports on the part of the granting authority. Whether exports were anticipated or 'expected' is to be gleaned from an examination of objective evidence. This examination is quite separate from, *and should not be confused with*, the examination of whether a subsidy is 'tied to' actual or anticipated exports. A subsidy may well be granted in the knowledge, or with the anticipation, that exports will result. Yet, that alone is not sufficient, because that alone is not proof that the granting of the subsidy is *tied to* the anticipation of exportation."<sup>24</sup>

16. The Panel in *Canada – Aircraft*, in a statement not specifically addressed by the Appellate Body, also noted that "the nature of the required conditionality [is] that 'one of the *conditions* for the grant of the subsidy is the *expectation* that exports will flow thereby'".<sup>25</sup> In the case at hand, the Panel came to the conclusion that "the facts available demonstrate that one of the conditions

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<sup>22</sup> Appellate Body Report, *Canada – Aircraft*, paras. 166-167.

<sup>23</sup> (*footnote original*) In finding that the knowledge of the recipient is not part of the legal standard of *de facto* export contingency, we do not suggest that relevant objective evidence relating to the recipient can never be considered by a panel.

<sup>24</sup> Appellate Body Report, *Canada – Aircraft*, paras. 169-172.

<sup>25</sup> Panel Report, *Canada – Aircraft*, para. 9.326.

of the grant of ... contributions to the ... industry is indeed such an expectation, in the form of projected export sales anticipated to 'flow' directly from these contributions."<sup>26</sup>

17. The Panel in *Canada – Aircraft Credits and Guarantees* considered that a Member's awareness that its domestic market is too small to absorb its domestic production of a subsidized product "may indicate" that the subsidy is granted upon export performance. However, after referring to statements by the Appellate Body in *Canada – Aircraft*<sup>27</sup>, the Panel clarified that even if a Member was to anticipate that exports would result from the grant of a subsidy, such anticipation "alone is not proof that the granting of the subsidy is *tied to* the anticipation of exportation" within the meaning of the footnote 4 to Article 3.1(a).<sup>28</sup>

18. In *EC and certain member States – Large Civil Aircraft*, the Appellate Body established the following "Export Inducement Test" for determining whether a subsidy is *de facto* contingent on export performance:

"The existence of *de facto* export contingency, as set out above, 'must be *inferred* from the total configuration of the facts constituting and surrounding the granting of the subsidy', which may include the following factors: (i) the design and structure of the measure granting the subsidy; (ii) the modalities of operation set out in such a measure; and (iii) the relevant factual circumstances surrounding the granting of the subsidy that provide the context for understanding the measure's design, structure, and modalities of operation."<sup>29</sup>

19. However, the Appellate Body in *EC and certain member States – Large Civil Aircraft* also suggested that, where relevant evidence exists, an assessment could be based on ratios:

"Moreover, where relevant evidence exists, the assessment could be based on a comparison between, on the one hand, the ratio of *anticipated* export and domestic sales of the subsidized product that would come about in consequence of the granting of the subsidy, and, on the other hand, the situation in the absence of the subsidy. The situation in the absence of the subsidy may be understood on the basis of historical sales of the same product by the recipient in the domestic and export markets before the subsidy was granted. In the event that there are no historical data untainted by the subsidy, or the subsidized product is a new product for which no historical data exists, the comparison could be made with the performance that a profit-maximizing firm would hypothetically be expected to achieve in the export and domestic markets in the absence of the subsidy. Where the evidence shows, all other things being equal, that the granting of the subsidy provides an incentive to skew anticipated sales towards exports, in comparison with the historical performance of the recipient or the hypothetical performance of a profit-maximizing firm in the absence of the subsidy, this would be an indication that the granting of the subsidy is in fact tied to anticipated exportation within the meaning of Article 3.1(a) and footnote 4 of the *SCM Agreement*."<sup>30</sup>

20. Referring to the above statement regarding a ratio-based assessment made by the Appellate Body in the original proceeding, the Panel in *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)* explained that the Appellate Body appeared to have "foreshadow[ed] the introduction of the Ratios Analysis". In a further reference to the Appellate Body's report, the Panel noted when and explained the context in which the "Ratios Test" would be applicable:

"The Appellate Body report then states that 'where relevant evidence exists, the assessment could be based on' a Ratios Analysis. In this context, we understand the words 'the assessment' to refer to the assessment of the Export Inducement Test. The phrase 'could be' suggests that the assessment need not be based on a Ratios Analysis, even when a Ratios Analysis can be performed. The phrase 'where relevant evidence exists' suggests that it may be possible to resolve the export-contingency

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<sup>26</sup> Panel Report, *Canada – Aircraft*, para. 9.346.

<sup>27</sup> Appellate Body Report, *Canada – Aircraft*, paras. 169-173.

<sup>28</sup> Panel Report, *Canada – Aircraft Credits and Guarantees*, paras. 7.370-7.376.

<sup>29</sup> Appellate Body Report, *EC and certain member States – Large Civil Aircraft*, para. 1046.

<sup>30</sup> Appellate Body Report, *EC and certain member States – Large Civil Aircraft*, para. 1047.



issue on the basis of other evidence, such as the design, structure and modalities of operation of the challenged measure, in cases where the evidence required to perform a Ratios Analysis does not exist."<sup>31</sup>

21. The Appellate Body emphasized that the test for determining whether a subsidy is *de facto* contingent on export performance is an objective one, and addressed the relevance of a government's reasons for granting a subsidy:

"The standard for determining whether the granting of a subsidy is 'in fact tied to ... anticipated exportation' is an objective standard, to be established on the basis of the total configuration of facts constituting and surrounding the granting of the subsidy, including the design, structure, and modalities of operation of the measure granting the subsidy. Indeed, the conditional relationship between the granting of the subsidy and export performance must be objectively observable on the basis of such evidence in order for the subsidy to be geared to induce the promotion of future export performance by the recipient. The standard for *de facto* export contingency is therefore not satisfied by the subjective motivation of the granting government to promote the future export performance of the recipient. In this respect, we note that the Appellate Body and panels have, on several occasions, cautioned against undue reliance on the intent of a government behind a measure to determine the WTO-consistency of that measure. The Appellate Body has found that 'the intent, stated or otherwise, of the legislators is *not conclusive*' as to whether a measure is consistent with the covered agreement. In our view, the same understanding applies in the context of a determination on export contingency, where the requisite conditionality between the subsidy and anticipated exportation under Article 3.1(a) and footnote 4 of the *SCM Agreement* must be established on the basis of objective evidence, rather than subjective intent. We note, however, that while the standard for *de facto* export contingency cannot be satisfied by the subjective motivation of the granting government, objectively reviewable expressions of a government's policy objectives for granting a subsidy may, however, constitute relevant evidence in an inquiry into whether a subsidy is geared to induce the promotion of future export performance by the recipient.

Similarly, the standard does not require a panel to ascertain a government's reason(s) for granting a subsidy. The government's reason for granting a subsidy only explains *why* the subsidy is granted. It does not necessarily answer the question as to *what* the government did, in terms of the design, structure, and modalities of operation of the subsidy, in order to induce the promotion of future export performance by the recipient. Indeed, whether the granting of a subsidy is conditional on future export performance must be determined by assessing *the subsidy itself*, in the light of the relevant factual circumstances, rather than by reference to the granting authority's reasons for the measure. This is not to say, however, that evidence regarding the policy reasons of a subsidy is necessarily excluded from the inquiry into whether a subsidy is geared to induce the promotion of future export performance by the recipient."<sup>32</sup>

22. The Panel in *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)* recalled the above considerations and applied the Appellate Body's test to determine whether the challenged LA/MSF measures for the A380 and A350XWB programs were *de facto* export subsidies.<sup>33</sup> The Panel explained its three-step approach:

"First, we discuss whether the United States has demonstrated the granting of relevant subsidies. Second, we consider whether the United States has established that such subsidies were granted in anticipation of exportation or export earnings.

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<sup>31</sup> Panel Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, para. 6.686.

<sup>32</sup> Appellate Body Report, *EC and certain member States – Large Civil Aircraft*, paras. 1051-1052.

<sup>33</sup> See Panel Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, paras. 6.674-6.677.

Third, we evaluate whether the United States has demonstrated that the granting of such subsidies was tied to, or contingent upon, such anticipation."<sup>34</sup>

23. The Panel in *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)* then undertook its analysis. First, the Panel recalled that, earlier in the Report, it had found each of the measures to be specific subsidies within meaning of Article 3.1(a) of the SCM Agreement.<sup>35</sup> Second, the Panel "detect[ed] no reason to on the record of this compliance proceeding" that called into the question the finding of the original panel, as affirmed by the Appellate Body, that the A380 LA/MSF contracts were granted in anticipation of exportation or export earnings<sup>36</sup>; and, relatedly, the Panel recalled that the original panel and Appellate Body both had found that the A380 LA/MSF measures were granted in anticipation of exportation based on similar evidence offered by the United States to demonstrate that the A350XWB LA/MSF contracts were granted in anticipation of exportation. The Panel accordingly found that the third element had been demonstrated. Third, as to whether the United States demonstrated that granting of the subsidies was tied to, or contingent upon, anticipation, the Panel recalled the applicable legal standards, namely the Export Inducement Test, the Ratios Analysis, and the relationship between the two, in determining a *de facto* export contingency.<sup>37</sup> Applying this guidance, the Panel ultimately concluded that the subsidies in question were not *de facto* contingent on export performance within the meaning of Article 3.1(a) and footnote 4 of the SCM Agreement.<sup>38</sup>

24. The Panel in *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)* recalled the Appellate Body's findings in *Canada – Aircraft* and noted that the Ratios Test is not a mandatory element of the Export Inducement Test, finding additional support in the Appellate Body's reasoning in the original proceeding:

"[T]he Appellate Body concluded that the measure at issue in *Canada – Aircraft* would have satisfied the Export Inducement Test, even in the absence of any Ratios Analysis, due to its design and structure, considered in context with the high export potential of the funded projects. This conclusion clarifies that performing a Ratios Analysis is not necessary in order to resolve the Export Inducement Test, and further confirms that the design, structure and modalities of operation of a subsidy are powerful considerations in resolving the Export Inducement Test.

...

The Appellate Body report [in *EC and certain member States – Large Civil Aircraft*] ... is consistent in its emphasis on examining the challenged measure's design, structure and modalities of operation when evaluating whether that measure is *de facto* contingent on export performance. In contrast, the Appellate Body report does not generally afford the Ratios Analysis equal stature. The Appellate Body report never states that a Ratios Analysis can independently resolve the Export Inducement Test or that the performance of a Ratios Analysis is a substitute for analysing either the total configuration of the facts or the relevant *subsidy itself* when attempting to detect whether that subsidy is contingent on export performance. This strongly suggests to us the primacy – indeed, necessity – of examining the *subsidy itself* when evaluating whether that subsidy is *de facto* contingent on export performance, and further suggests to us that, in the absence of such an examination, a Ratios Analysis should not independently resolve the Export Inducement Test.<sup>39</sup>

25. Having noted the Appellate Body's reasoning in the original proceedings, the Panel in *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)* explained the relationship between an analysis of the design and structure of a subsidy and a Ratios Analysis:

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<sup>34</sup> Panel Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, para. 6.678.

<sup>35</sup> Panel Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, para. 6.679.

<sup>36</sup> Panel Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, paras. 6.680 and 6.682.

<sup>37</sup> Panel Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, paras. 6.671-6.703.

<sup>38</sup> Panel Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, paras. 6.704 and 6.744.

<sup>39</sup> Panel Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, paras. 6.688 and 6.695.

"In light of this observation, we find it helpful to more specifically articulate the nature of the relationship between the performance of an analysis of the design and structure of a subsidy itself and a Ratios Analysis. The Appellate Body separately described the analysis of a subsidy's design and structure, on the one hand, and a Ratios Analysis, on the other hand, in the context of discussing what evidence is material in a panel's evaluation of export contingency. The two analyses, thus, must be distinct, at least to some appreciable degree. In other words, the latter cannot be simply a method of expressing the former analysis *per se*. We therefore recall that a Ratios Analysis is, in essence, a comparison of the expected sales behaviour of a firm in the absence and presence of a subsidy. We further recall that the firm's relevant sales behaviour in the presence of the subsidy for purposes of conducting a Ratios Analysis is 'the ratio of *anticipated* export and domestic sales of the subsidized product that would come about in consequence of the granting of the subsidy'. The Appellate Body did not specify from what source such expectations should arise.<sup>40</sup> In our view, however, such expectations must be formed in the presence of meaningful knowledge of a subsidy's terms including its design and structure (or perhaps demonstrated expectations of such aspects that ultimately prove accurate), or else it appears difficult to discern any meaningful manner in which a Ratios Analysis could assist in detecting whether that subsidy is export contingent. This reasoning further appears consistent with the Appellate Body's explanation that the Export Inducement Test – and, therefore, by extension, a Ratios Analysis – 'must be assessed on the basis of the information available to the granting authority at the time the subsidy is granted' because, of course, a grantor will always have meaningful knowledge regarding a subsidy that it grants. We therefore conclude that from whatever source expectations regarding a firm's sales behaviours arise in the context of calculating a relevant Anticipated Ratio, such expectations must be formed in the light of an understanding of the subsidy's design and structure. In our minds, these observations underscore that a Ratios Analysis is not a substitute for analysing a subsidy itself, yet it may be material insofar as it can be interpreted as examining sales behaviours that reflect relevant influences of a subsidy."<sup>41</sup>

26. The Panel in *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)* recalled the description of the Ratios Analysis as follows:

"We recall that a Ratios Analysis is a comparison of 'the ratio of *anticipated* export and domestic sales of the subsidized product that would come about in consequence of the granting of the subsidy' and 'the situation in the absence of the subsidy.' In other words, rather than examining a *subsidy itself*, a Ratios Analysis examines what effects a subsidy is anticipated to have on a recipient's sales behaviours. Hinging the outcome of the Export Inducement Test on such an effects-based inquiry appears in tension with the Appellate Body's explanation that the SCM Agreement's effects-based disciplines inhabit Part III, rather than Part II, of that agreement."<sup>42</sup>

27. The Panel in *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)* further clarified the relevance of a Ratios Analysis in determining a *de facto* export contingency:

"[W]e conclude that a Ratios Analysis is incapable of establishing that a given subsidy is *de facto* contingent on export performance in the absence of any meaningful analysis regarding how a subsidy's design and structure contributes to the presence of an incentive for a recipient to favour export sales over domestic sales. In cases in which a Ratios Analysis has been performed, however, it may form a material aspect of the analysis of whether a subsidy is contingent on export performance. We consider that this conclusion accords with the great weight of the Appellate Body's guidance on

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<sup>40</sup> (*footnote original*) Certain statements appear to suggest that such expectations should emanate from the granting authority. (See e.g. Appellate Body Report, *EC and certain member States – Large Civil Aircraft*, paras. 1043 ("Consistent with this understanding, it is the granting authority that 'anticipates' that exportation will occur after the granting of the subsidy, and that grants a subsidy *on the condition* of such anticipated exportation.") (emphasis original); and 1049 (explaining that the Export Inducement Test "must be assessed on the basis of the information available to the granting authority at the time the subsidy is granted.") (emphasis added))

<sup>41</sup> Panel Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, para. 6.696.

<sup>42</sup> Panel Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, para. 6.698.

this matter, and resonates with relevant considerations regarding the design and structure of the SCM Agreement and the inherent characteristics of a Ratios Analysis."<sup>43</sup>

28. Having concluded that a Ratios Analysis alone cannot determine a *de facto* export contingency, the Panel in *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)* proceeded to evaluate the evidence submitted by the United States. It concluded that the United States had not submitted sufficient evidence to make a *prima facie* case that the contested subsidy programs were contingent upon export performance.<sup>44</sup>

#### **1.4.3.2 Treatment of facts in the determination of *de facto* export contingency**

##### **1.4.3.2.1 Case-by-case approach**

29. The Panel in *Australia – Automotive Leather II* held that the language of footnote 4 of the SCM Agreement required it "to examine all the facts concerning the grant or maintenance of the challenged subsidy", emphasizing that the Panel was not precluded from considering any particular fact. The Panel also held that the specific facts to be considered will vary on a case-by-case basis:

"In our view, the concept of 'contingent ... in fact ... upon export performance', and the language of footnote 4 of the SCM Agreement, require us to examine all of the facts that actually surround the granting or maintenance of the subsidy in question, including the terms and structure of the subsidy, and the circumstances under which it was granted or maintained. A determination whether a subsidy is in fact contingent upon export performance cannot, in our view, be limited to an examination of the terms of the legal instruments or the administrative arrangements providing for the granting or maintenance of the subsidy in question. Such a determination would leave wide open the possibility of evasion of the prohibition of Article 3.1(a), and render meaningless the distinction between 'in fact' and 'in law' contingency. Moreover, while the second sentence of footnote 4 makes clear that the mere fact that a subsidy is granted to enterprises which export cannot be the sole basis for concluding that a subsidy is 'in fact' contingent upon export performance, it does not preclude the consideration of that fact in a panel's analysis. Nor does it preclude consideration of the level of a particular company's exports. This suggests to us that factors other than the specific legal or administrative arrangements governing the granting or maintenance of the subsidy in question must be considered in determining whether a subsidy is 'in fact' contingent upon export performance.

Based on the explicit language of Article 3.1(a) and footnote 4 of the SCM Agreement, in our view the determination of whether a subsidy is 'contingent ... in fact' upon export performance requires us to examine all the facts concerning the grant or maintenance of the challenged subsidy, including the nature of the subsidy, its structure and operation, and the circumstances in which it was provided. In this context, Article 11 of the DSU requires a panel to make an objective assessment of the facts of the case. Obviously, the facts to be considered will depend on the specific circumstances of the subsidy in question, and will vary from case to case. In our view, all facts surrounding the grant and/or maintenance of the subsidy in question may be taken into consideration in the analysis. However, taken together, the facts considered must demonstrate that the grant or maintenance of the subsidy is conditioned upon actual or anticipated exportation or export earnings. The outcome of this analysis will obviously turn on the specific facts relating to each subsidy examined."<sup>45</sup>

30. The Panel in *Australia – Automotive Leather II* drew a temporal limit to this broad standard of factual analysis. It opined that "the pertinent consideration is the facts at the time the conditions for the grant payments were established, and not possible subsequent developments."<sup>46</sup>

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<sup>43</sup> Panel Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, para. 6.702.

<sup>44</sup> Panel Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, paras. 6.704 and 6.744.

<sup>45</sup> Panel Report, *Australia – Automotive Leather II*, paras. 9.56-9.57.

<sup>46</sup> Panel Report, *Australia – Automotive Leather II*, para. 9.70.

31. The Panel in *Canada – Aircraft*, in a finding expressly endorsed by the Appellate Body<sup>47</sup>, confirmed this broad and case-by-case approach to the factual analysis of the Panel in *Australia – Automotive Leather II*. While it also emphasized that no factual considerations should automatically prevail over others, it pointed out that its finding that a broad range of facts should be considered as relevant did not mean that the *de facto* export contingency standard is easily met:

"In our view, no fact should automatically be rejected when considering whether the facts demonstrate that a subsidy would not have been granted but for anticipated exportation or export earnings. We note that footnote 4 provides that the 'facts' must demonstrate *de facto* export contingency. Footnote 4 therefore refers to 'facts' in general, without any suggestion that certain factual considerations should prevail over others. In our opinion, it is clear from the ordinary meaning of footnote 4 that any fact could be relevant, provided it 'demonstrates' (either individually or in conjunction with other facts) whether or not a subsidy would have been granted but for anticipated exportation or export earnings. We consider that this is true of the export-orientation of the recipient, or of the reason for the grant of the subsidy, just as it is true of a host of other facts potentially surrounding the grant of the subsidy in question. In any given case, the relative importance of each fact can only be determined in the context of that case, and not on the basis of generalities.

We would emphasise, however, that our finding that a broad range of facts could be relevant in this context does not mean that the *de facto* export contingency standard is easily met. On the contrary, footnote 4 of the SCM Agreement makes it clear that the facts must 'demonstrate' *de facto* export contingency. That is, *de facto* export contingency must be demonstrable on the basis of the factual evidence adduced."<sup>48</sup>

32. The Appellate Body in *Canada – Aircraft* agreed with the Panel that the fact that a subsidy is granted to enterprises which export may be considered in a determination whether or not a subsidy is *de facto* export contingent, but that this does not mean that export-orientation alone can necessarily be determinative:<sup>49</sup>

"There is a logical relationship between the second sentence of footnote 4 and the 'tied to' requirement set forth in the first sentence of that footnote. The second sentence of footnote 4 precludes a panel from making a finding of *de facto* export contingency for the sole reason that the subsidy is 'granted to enterprises which export'. In our view, merely knowing that a recipient's sales are export-oriented does not demonstrate, without more, that the granting of a subsidy is tied to actual or anticipated exports. The second sentence of footnote 4 is, therefore, a specific expression of the requirement in the first sentence to demonstrate the 'tied to' requirement. We agree with the Panel that, under the second sentence of footnote 4, the export orientation of a recipient may be taken into account as a relevant fact, provided that it is one of several facts which are considered and is not the only fact supporting a finding."<sup>50</sup>

#### **1.4.3.2.2 Which facts to consider**

33. The Panel in *Australia – Automotive Leather II* held that "the fact of expectation cannot be the sole determinative fact on the evaluation".<sup>51</sup> The Panel also considered the extent to which circumstances surrounding a loan contract can be facts on the basis of which the determination of an export contingent subsidy can be made:

"[T]he mere fact that one possible source of funds to pay off the loan is potential export earnings is insufficient to conclude that the loan was contingent in fact upon anticipated exportation or export earnings. ... We recognize that other facts are relevant to our consideration of the nature of the loan contract. Included among these

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<sup>47</sup> Appellate Body Report, *Canada – Aircraft*, para. 169.

<sup>48</sup> Panel Report, *Canada – Aircraft*, paras. 9.337-9.338.

<sup>49</sup> Panel Report, *Canada – Aircraft*, para. 9.336.

<sup>50</sup> Appellate Body Report, *Canada – Aircraft*, para. 173.

<sup>51</sup> Panel Report, *Australia – Automotive Leather II*, para. 9.66.

is the significance of exports in Howe's business, and the fact that loan was part of the overall 'assistance package' given to Howe, which Australia acknowledged would probably not have occurred if Howe had not been removed from eligibility under the ... programmes. ... Moreover, there is nothing in the terms of the loan contract itself which suggests a specific link to actual or anticipated exportation or export earnings ... These factors persuade us that there is not a sufficiently close tie between the loan and anticipated exportation or export earnings."<sup>52</sup>

34. While the Panel in *Canada – Aircraft* found that no one factual consideration should automatically prevail over others in the determination of *de facto* export contingency, it nevertheless held that "the closer a subsidy brings a product to sale on the export market, the greater the possibility that the facts may demonstrate that the subsidy would not have been granted but for anticipated exportation or export earnings." In this respect, the Panel noted that subsidies for "pure research" or "for general purposes such as improving efficiency or adopting new technology" would be less likely to give rise to *de facto* export contingency than "subsidies that directly assist companies in bringing specific products to the (export) market."<sup>53</sup> The Appellate Body did not object to the consideration of this factor by the Panel, but cautioned that "the mere presence ... of this factor" will not create "a presumption that a subsidy is *de facto* contingent upon export performance:

"We recall that the Panel added that 'the further removed a subsidy is from sales on the export market, *the less the possibility* that the facts may demonstrate that the subsidy' is 'contingent ... in fact ... upon export performance'. (emphasis added) By these statements, the Panel appears to us to apply what could be read to be a legal presumption. While we agree that this nearness-to-the-export-market factor *may*, in certain circumstances, be a relevant fact, we do not believe that it should be regarded as a legal presumption. It is, for instance, no '*less ... possible*' that the facts, taken together, may demonstrate that a pre-production subsidy for research and development is 'contingent ... in fact ... upon export performance'. If a panel takes this factor into account, it should treat it with considerable caution. In our opinion, the mere presence or absence of this factor in any given case does not give rise to a presumption that a subsidy is or is not *de facto* contingent upon export performance. The legal standard to be applied remains the same: it is necessary to establish each of the three substantive elements in footnote 4."<sup>54</sup>

#### **1.4.3.2.3 Relevance of the size of the domestic industry**

35. The Panel in *Canada – Aircraft Credits and Guarantees* referred to the findings of the Panel in *Australia – Automotive Leather II*<sup>55</sup> and noted that a Member's awareness that its domestic market is too small to absorb the domestic production of a subsidized product may "indicate", although not prove that the subsidy is granted on the condition that it be exported:

"In addressing Brazil's *de facto* export contingency claim, we shall be guided by note 4 to Article 3.1(a) of the SCM Agreement, whereby a subsidy is 'contingent ... in fact ... upon export performance' when

the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.

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<sup>52</sup> Panel Report, *Australia – Automotive Leather II*, para. 9.75.

<sup>53</sup> Panel Report, *Canada – Aircraft*, paras. 9.337-9.339.

<sup>54</sup> Appellate Body Report, *Canada – Aircraft*, para. 174.

<sup>55</sup> Panel Report, *Australia – Leather II*, para. 9.67.

... a Member's awareness that its domestic market is too small to absorb domestic production of a subsidised product may indicate that the subsidy is granted on the condition that it be exported."<sup>56</sup>

#### 1.4.4 "Export performance"

##### 1.4.4.1 General

36. The Panel in *Canada – Aircraft (Article 21.5 – Brazil)*, in a finding not specifically addressed by the Appellate Body, drew a distinction between "general technological or economic benefits" on the one hand and "export performance" on the other:

"Thus, whereas TPC assistance is conditional on a project having certain technological or net economic benefits ..., in our view this simply cannot be assumed to be synonymous with export performance, and therefore it does not mean *ipso facto* that such assistance is contingent on export performance. This remains true even though TPC administrators know that fulfilment of net economic benefits in certain cases may be likely to result in increased exports. The fact that they will have no concrete quantifiable information on exports in our view will act in practical terms to limit their discretion to select projects on the basis of export performance."<sup>57</sup>

37. The Panel in *Canada – Aircraft* rejected the argument that the subsidy programme at issue was not conditional on exports taking place on the grounds that "there are no penalties if export sales are not realised."<sup>58</sup> The Panel supported its rejection of this argument with the following statement:

"While this argument may be relevant in determining whether a subsidy would not have been granted but for actual exportation or export earnings, we find this argument insufficient to rebut a *prima facie* case that a subsidy would not have been granted but for anticipated exportation or export earnings."<sup>59</sup>

##### 1.4.4.2 "produced within or outside the Member"

38. The Appellate Body in *US – FSC (Article 21.5 – EC)*, upholding the findings of the Panel, observed that there are two different factual situations, one involving property produced *within* the Member and the other involving property produced *outside* it, which are subject to distinct conditions for receipt of the subsidy. The Appellate Body considered it appropriate to examine these two situations separately:

"In respect of property produced within the United States, the taxpayer can obtain the subsidy only by satisfying the conditions in the measure relating to this property and, for this property, the measure provides only one set of conditions governing the grant of subsidy. The conditions for the grant of subsidy with respect to property produced *outside* the United States are distinct from those governing the grant of subsidy in respect of property produced *within* the United States.

In our view, it is hence appropriate, indeed necessary, under Article 3.1(a) of the *SCM Agreement*, to examine separately the conditions pertaining to the grant of the subsidy in the two different situations addressed by the measure."<sup>60</sup>

39. Examining the measure with respect to property produced *within* the Member, the Appellate Body in *US – FSC (Article 21.5 – EC)* noted that in order to obtain the subsidy, the goods must be sold, leased or rented for direct use, consumption or disposition "outside the United States". Thus, to be eligible for the subsidy, "the property must be exported". In this way, the requirement of use outside the Member state makes the subsidy contingent upon export. Accordingly, the Appellate Body held that since property produced within the United States must

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<sup>56</sup> Panel Report, *Canada – Aircraft Credits and Guarantees*, paras. 7.370 and 7.372.

<sup>57</sup> Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para. 5.33.

<sup>58</sup> Panel Report, *Canada – Aircraft*, para. 9.343.

<sup>59</sup> Panel Report, *Canada – Aircraft*, para. 9.343.

<sup>60</sup> Appellate Body Report, *US – FSC (Article 21.5 – EC)*, paras. 114-115.



be exported to satisfy this condition, "then, the requirement of use outside the United States makes the grant of the tax benefit contingent upon export".<sup>61</sup>

40. The Appellate Body in *US – FSC (Article 21.5 – EC)* noted that its conclusion was not affected by the fact that the subsidy could also be obtained through production abroad, and that there was no export contingency in this second situation. The Appellate Body recalled:

"[T]he measure at issue in the original proceedings in *US – FSC* contained an almost identical condition relating to 'direct use ... outside the United States' for property produced in the United States. In that appeal, we upheld the panel's finding that the combination of the requirements to produce property in the United States and use it outside the United States gave rise to export contingency under Article 3.1(a) of the *SCM Agreement*. We see no reason, in this appeal, to reach a conclusion different from our conclusion in the original proceedings, namely that there is export contingency, under Article 3.1(a), where the grant of a subsidy is conditioned upon a requirement that property produced in the United States be used outside the United States.

We recall that the ETI measure grants a tax exemption in two different sets of circumstances: (a) where property is produced *within* the United States and held for use *outside* the United States; and (b) where property is produced *outside* the United States and held for use outside the United States. Our conclusion that the ETI measure grants subsidies that are export contingent in the first set of circumstances is not affected by the fact that the subsidy can also be obtained in the second set of circumstances. The fact that the subsidies granted in the second set of circumstances *might* not be export contingent does not dissolve the export contingency arising in the first set of circumstances. Conversely, the export contingency arising in these circumstances has no bearing on whether there is an export contingent subsidy in the second set of circumstances. Where a United States taxpayer is simultaneously producing property within and outside the United States, for direct use outside the United States, subsidies may be granted under the ETI measure in respect of both sets of property. The subsidy granted with respect to the property produced within the United States, and exported from there, is export contingent within the meaning of Article 3.1(a) of the *SCM Agreement*, irrespective of whether the subsidy given in respect of property produced outside the United States is also export contingent."<sup>62</sup>

#### **1.4.5 Relationship with other provisions of the SCM Agreement**

##### **1.4.5.1 Article 4.7**

41. In *Canada – Dairy (Article 21.5 – New Zealand and US)*, the Panel noted that a finding of violation with respect to Article 3.1 would affect the specificity of the recommendation to be made by the Panel, due to the more precise implementation requirements under Article 4.7 of the SCM Agreement, providing that an export subsidy be withdrawn without delay. However, the Panel observed that because of the context of the case, it would *not* be able to recommend that Canada "withdraw" measures constituting an export subsidy exclusively in respect of agricultural products. The Panel stated:

"Since the Panel, in case it would make an affirmative finding in respect of Article 3.1 of the *SCM Agreement*, would not be able to make the withdrawal recommendation provided for in the first sentence of Article 4.7 of the *SCM Agreement*, the Panel does not need to consider the first sentence of Article 4.7 to determine whether or not it should exercise judicial economy. Having found that it would not be able to make a recommendation to withdraw the subsidy, in accordance with the first sentence of Article 4.7, the Panel considers that, *a fortiori*, it would not be able to specify a *time-period for withdrawal*, in accordance with the second sentence of Article 4.7."<sup>63</sup>

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<sup>61</sup> Appellate Body Report, *US – FSC (Article 21.5 – EC)*, para. 117.

<sup>62</sup> Appellate Body Report, *US – FSC (Article 21.5 – EC)*, paras. 118-119.

<sup>63</sup> Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 6.100.



#### 1.4.5.2 Article 27

42. The Panel in *Brazil – Aircraft* addressed the relationship between Articles 3.1(a), 27.2(b) and 27.4. More specifically, the Panel was called upon to determine the allocation of burden of proof applicable to the special provision of Article 27.2, which establishes that the prohibition contained in Article 3.1(a) shall not apply to developing country Members, provided that the requirements of Article 27.4 are met. The Panel in a finding upheld by the Appellate Body considered that "until non-compliance with the conditions set out in Article 27.4 is demonstrated, there is also, on the part of a developing country Member within the meaning of Article 27.2(b), no inconsistency with Article 3.1(a)."<sup>64</sup>

43. The Appellate Body in *Brazil – Aircraft* emphasized that "the conditions set forth in paragraph 4 are positive obligations for developing country Members, not affirmative defenses. If a developing country Member complies with the obligations in Article 27.4, the prohibition on export subsidies in Article 3.1(a) simply does not apply".<sup>65</sup>

44. The Appellate Body in *Brazil – Aircraft* agreed with the Panel "that the burden [of proof] is on the complaining party (*in casu* Canada) to demonstrate that the developing country Member (*in casu* Brazil) is not in compliance with at least one of the elements set forth in Article 27.4. If such non-compliance is demonstrated, then, and only then, does the prohibition of Article 3.1(a) apply to that developing country Member."<sup>66</sup>

45. As regards the extension of the Article 27.4 transition period for developing and least-developed countries of the export subsidy prohibition, see the Section on Article 27 of the SCM Agreement. With regard to the graduation methodology from Annex VII(b), see the Section on Annex VII to the SCM Agreement.

#### 1.4.5.3 Footnote 59

46. In *US – FSC*, the Appellate Body addressed the United States' claim that footnote 59 exempts a measure from being an export subsidy within the meaning of Article 3.1(a) and that the 1981 Council Action serves as a confirmation for this exemption. In rejecting this argument, the Appellate Body proceeded to examine footnote 59 sentence by sentence:

"The first sentence of footnote 59 is specifically related to the statement in item (e) of the Illustrative List that the 'full or partial exemption remission, or deferral specifically related to exports, of direct taxes' is an export subsidy. The first sentence of footnote 59 qualifies this by stating that 'deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected.' Since the FSC measure does not involve the *deferral* of direct taxes, we do not believe that this sentence of footnote 59 bears upon the characterization of the FSC measure as constituting, or not, an 'export subsidy'.

The second sentence of footnote 59 'reaffirms' that, in allocating export sales revenues, for tax purposes, between exporting enterprises and controlled foreign buyers, the price for the goods shall be determined according to the 'arm's length' principle to which that sentence of the footnote refers. Like the Panel, we are willing to accept, for the sake of argument, the United States' position that it 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*

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<sup>64</sup> Panel Report, *Brazil – Aircraft*, para. 7.56.

<sup>65</sup> Appellate Body Report, *Brazil – Aircraft*, para. 140.

<sup>66</sup> Appellate Body Report, *Brazil – Aircraft*, para. 141.

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."<sup>67</sup>

47. The Appellate Body further found that the arm's-length principle contained in the second sentence of footnote 59 could not shed light on the issue before the Panel, namely whether the United States' tax measure was a prohibited export subsidy:

"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*.

The third and fourth sentences of footnote 59 set forth rules that relate to remedies. In our view, these rules have no bearing on the substantive obligations of Members under Articles 1.1 and 3.1 of the *SCM Agreement*."<sup>68</sup>

48. The Appellate Body in *US – FSC* then declined to examine the United States' claim under the fifth sentence of footnote 59, namely that the United States' measure was one taken to avoid double taxation of foreign-source income. The Appellate Body noted that the issue had not been properly litigated before the Panel and therefore declined to address the United States' claim.<sup>69</sup>

#### **1.4.6 Annex VII(b)**

49. With regard to the graduation methodology from Annex VII(b), see Section on Annex VII to the SCM Agreement.

#### **1.4.7 Footnote 4**

50. With respect to the relationship between "tied to" in footnote 4 and "contingent ... in law", see paragraphs 9-12 above.

51. With respect to the three substantive elements in footnote 4 as identified by the Appellate Body in *Canada – Aircraft*, see paragraph 15 above.

52. With respect to the requirement to examine all facts concerning the grant or maintenance of a subsidy, see paragraph 29 above. As regards the significance of the phrase "enterprises which export" within the *de facto* export contingency analysis, see paragraphs 29, 32 and 35 above.

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<sup>67</sup> Appellate Body Report, *US – FSC*, paras. 97-98.

<sup>68</sup> Appellate Body Report, *US – FSC*, paras. 99-100.

<sup>69</sup> Appellate Body Report, *US – FSC*, paras. 101 and 103.

## 1.5 Article 3.1(b)

### 1.5.1 General

53. In *Canada – Renewable Energy*, the Appellate Body noted that Article 3.1(b) of the SCM Agreement "regulates so-called import-substitution subsidies, which are one of only two kinds of subsidies prohibited under the SCM Agreement".<sup>70</sup>

54. In *US – Tax Incentives*, the Appellate Body noted that Article 3.1(b) of the SCM Agreement does not prohibit the subsidization of domestic production *per se* but rather the granting of subsidies contingent upon the use of domestic over imported goods. The Appellate Body distinguished these two situations as follows:

"We recall that, by its terms, Article 3.1(b) does not prohibit the subsidization of domestic 'production' *per se* but rather the granting of subsidies contingent upon the 'use', by the subsidy recipient, of domestic over imported goods.<sup>71</sup> Subsidies that relate to domestic production are therefore not, for that reason alone, prohibited under Article 3 of the SCM Agreement.<sup>72</sup> We note in this respect that such subsidies can ordinarily be expected to increase the supply of the subsidized domestic goods in the relevant market, thereby increasing the use of these goods downstream and adversely affecting imports, without necessarily requiring the use of domestic over imported goods as a condition for granting the subsidy."<sup>73</sup>

55. Based on the Appellate Body's prior findings, the Panel in *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)* articulated the legal test under Article 3.1(b):

"Like Article 3.1(a), Article 3.1(b) sets forth a single legal standard. That is, a subsidy must be 'contingent, whether solely or as one of several other considerations, upon the use of domestic over imported goods.' The Appellate Body has further explained that the word 'contingent' means 'conditional' or 'dependent for its existence on something else'. Unlike Article 3.1(a), however, Article 3.1(b) contains no reference to contingency 'in law or in fact'. Nevertheless, the Appellate Body has found that Article 3.1(b)'s scope covers both *de jure* and *de facto* contingency. The evidence used to demonstrate *de jure* and *de facto* contingency may differ. Contingency "in law" is demonstrated "on the basis of the words of the relevant legislation, regulation or other legal instrument."<sup>74</sup> The Appellate Body has also explained that 'such conditionality can be derived by necessary implication from the words actually used in the measure.' Consistent with the Appellate Body's guidance regarding evaluations of *de facto* contingency under Article 3.1(a), we feel it appears reasonable to conclude that an evaluation of *de facto* contingency under Article 3.1(b) should be objectively assessed with respect to the total configuration of facts constituting and surrounding the granting of the subsidy which include (i) the design and structure of the measure granting the subsidy; (ii) the modalities of operation set out in such a measure; and (iii) the relevant factual circumstances surrounding the granting of the subsidy that

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<sup>70</sup> Appellate Body Report, *Canada – Renewable Energy*, para. 5.6.

<sup>71</sup> (footnote original) Pursuant to Article 2.1 of the SCM Agreement, a subsidy covered under that Agreement should be specific to certain enterprises "within the jurisdiction of the granting authority", or, in other words, domestic producers. Although, pursuant to Article 2.3, prohibited subsidies are "deemed to be specific", they are still subsidies granted to domestic producers. Other provisions of the SCM Agreement also refer to the "territory" of a Member, as well as to "domestic producers" or "domestic production". (See e.g. Article 1.1(a)(1); Article 8.2(b), now lapsed, pursuant to Article 31; Article 10; Article 25; and Article 28 of the SCM Agreement)

<sup>72</sup> (footnote original) In *Canada – Aircraft (Article 21.5 – Brazil)*, the Appellate Body found it "worth recalling that the granting of a subsidy is not, in and of itself, prohibited under the *SCM Agreement*. Nor does granting a 'subsidy', without more, constitute an inconsistency with that Agreement. The universe of subsidies is vast. Not all subsidies are inconsistent with the *SCM Agreement*. The only 'prohibited' subsidies are those identified in Article 3 of the *SCM Agreement*". (Appellate Body Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para. 47)

<sup>73</sup> Appellate Body Report, *US – Tax Incentives*, para. 5.15.

<sup>74</sup> (footnote original) Appellate Body Report, *Canada – Autos*, para. 123 (quoting Appellate Body Report, *Canada – Aircraft*, para. 167). (emphasis original)

provide the context for understanding the measure's design, structure, and modalities of operation."<sup>75</sup>

### **1.5.2 "subsidies contingent ... upon the use of domestic over imported goods"**

#### **1.5.2.1 "use"**

56. In *US – Carbon Steel*, the Appellate Body interpreted the term "use" as the action of using or employing something.<sup>76</sup> The Appellate Body added, in *US – Tax Incentives*, that the meaning of this term would vary depending on the particular circumstances:

"Article 3.1(b) does not elaborate on what constitutes 'use of ... goods'; nor do other provisions of the SCM Agreement or other covered agreements define this term. In the absence of any further guidance, the term 'use' may, depending on the particular circumstances, refer to consuming a good in the process of manufacturing, but may also refer to, for instance, incorporating a component into a separate good, or serving as a tool in the production of a good."<sup>77</sup>

#### **1.5.2.2 "domestic over imported goods"**

57. In *US – Tax Incentives*, the Appellate Body noted that the terms "domestic" and "imported" are not qualified under Article 3.1(b). It interpreted these terms in light of Article III:4 of the GATT 1994, in the following manner:

"'[D]omestic' goods can be understood as goods originating within the relevant Member's territory and 'imported' goods as goods that cross the border into that Member's territory."<sup>78</sup>

58. The Appellate Body in *US – Tax Incentives* stated that the term "over" refers to "the use of domestic goods in preference to, or instead of, imported goods".<sup>79</sup>

#### **1.5.2.3 "goods"**

59. In *US – Tax Incentives*, the Appellate Body noted that the term "goods" can be read as a synonym for "products".<sup>80</sup> The Appellate Body pointed out that this term may refer to any type of good and is not confined to those goods that are traded:

"Neither the text nor the context of Article 3.1(b) provides any clarification of the type or nature of the goods that are the subject of this provision. Thus, this term may refer to any type of good that may be used by the subsidy recipient, including parts or components that are incorporated into another good, materials or substances that are consumed in the production process of another good, or tools or instruments that are used in the production process. In Article 3.1(b), the term 'goods' is qualified by the adjectives 'domestic' and 'imported', which implies that the goods concerned should be at least potentially tradable. However, the broad scope of the terms 'use' and 'goods' supports the view that the meaning of the term 'goods' is not confined to those goods that are actually traded."<sup>81</sup>

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<sup>75</sup> Panel Report, in *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, para. 6.778.

<sup>76</sup> Appellate Body Report, *US – Carbon Steel (India)*, para. 4.374.

<sup>77</sup> Appellate Body Report, *US – Tax Incentives*, para. 5.8.

<sup>78</sup> Appellate Body Report, *US – Tax Incentives*, para. 5.10.

<sup>79</sup> Appellate Body Report, *US – Tax Incentives*, para. 5.11.

<sup>80</sup> Appellate Body Report, *US – Tax Incentives*, para. 5.9.

<sup>81</sup> Appellate Body Report, *US – Tax Incentives*, para. 5.9.

#### 1.5.2.4 Contingency

60. In *US – Tax Incentives*, the Appellate Body stated that a subsidy would be "contingent" upon the use of domestic over imported goods "if the use of those goods were a condition, in the sense of a requirement, for receiving the subsidy"<sup>82</sup>.<sup>83</sup>

61. In the same case, the Appellate Body framed the question to be answered under Article 3.1(b) of the SCM Agreement as follows:

"[T]he relevant question in determining the existence of contingency under Article 3.1(b) is not whether the eligibility requirements under a subsidy may *result* in the use of more domestic and fewer imported goods. Rather, the question is whether *a condition requiring* the use of domestic over imported goods can be discerned from the terms of the measure itself, or inferred from its design, structure, modalities of operation, and the relevant factual circumstances constituting and surrounding the granting of the subsidy that provide context for understanding the operation of these factors."<sup>84</sup>

62. Referring to its findings in *Canada – Aircraft* where it had held that "the ordinary connotation of 'contingent' is 'conditional' or 'dependent for its existence on something else'"<sup>85</sup>, the Appellate Body in *Canada – Autos* opined that "this legal standard applies not only to 'contingency' under Article 3.1(a), but also to 'contingency' under Article 3.1(b)".<sup>86</sup>

##### 1.5.2.4.1 *De facto* and *de jure* contingency

63. In *Canada – Autos*, the Panel had found that "contingency" under Article 3.1(b) extended only to *de jure* contingency and not also to *de facto* contingency. In making this finding, the Panel relied on the fact that Article 3.1(a) referred explicitly to both subsidies contingent "in law or in fact", while Article 3.1(b) did not contain such an explicit reference.<sup>87</sup> The Appellate Body reversed this finding and held that "contingency" under Article 3.1(b) includes *both* contingency in law and contingency in fact. In its analysis, the Appellate Body first agreed with the Panel that an omission (of an express provision) must have some meaning, but emphasized that the significance of such omission can vary from one case to another:

"In examining this issue, the Panel appears to have taken the view that the terms of Article 3.1(b), on their own, do not answer the question, and, therefore, it turned to the context provided by Article 3.1(a). In this respect, the Panel relied on the fact that, in Article 3.1(a), there is explicit language applying to subsidies contingent 'in law or in fact' while in Article 3.1(b) there is not. In the view of the Panel, the absence of such an explicit reference in the adjacent and closely-related provision of Article 3.1(b) indicates that the drafters intended Article 3.1(b) to apply only to those subsidies which are contingent 'in law' upon the use of domestic over imported goods.

In our view, the Panel's analysis was incomplete. As we have said, and as the Panel recalled, 'omission must have some meaning.' Yet omissions in different contexts may have different meanings, and omission, in and of itself, is not necessarily dispositive. Moreover, while the Panel rightly looked to Article 3.1(a) as relevant context in interpreting Article 3.1(b), the Panel failed to examine other contextual

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<sup>82</sup> (*footnote original*) Appellate Body Report, *Canada – Autos*, para. 126. The link between "contingency" and "conditionality" is also borne out by the text of Article 3.1(b), which states that import substitution contingency can be the sole or "one of several other *conditions*". (Appellate Body Report, *Canada – Aircraft*, para. 166 (emphasis added by the Appellate Body)) As with Article 3.1(a), this "relationship of conditionality or dependence" lies at the "very heart" of the legal standard in Article 3.1(b) of the SCM Agreement. (Appellate Body Reports, *Canada – Aircraft*, para. 171; *Canada – Aircraft (Article 21.5 – Brazil)*, para. 47)

<sup>83</sup> Appellate Body Report, *US – Tax Incentives*, para. 5.7.

<sup>84</sup> Appellate Body Report, *US – Tax Incentives*, para. 5.18.

<sup>85</sup> Appellate Body Report, *Canada – Aircraft*, para. 166.

<sup>86</sup> Appellate Body Report, *Canada – Autos*, para. 123.

<sup>87</sup> Panel Report, *Canada – Autos*, paras. 10.220-10.222.

elements for Article 3.1(b) and to consider the object and purpose of the *SCM Agreement*.<sup>88</sup>

64. Having found that the omission of an explicit reference to *de facto* contingency in Article 3.1(b) was not dispositive of the question whether Article 3.1(b) actually extended to *de facto* contingency, the Appellate Body in *Canada – Autos* then considered the ordinary meaning and the context of this provision. While the Appellate Body agreed with the Panel that Article 3.1(a) was relevant context for Article 3.1(b), it held that "other contextual aspects should also be examined":

"We look first to the text of Article 3.1(b). In doing so, we observe that the ordinary meaning of the phrase 'contingent ... upon the use of domestic over imported goods' is not conclusive as to whether Article 3.1(b) covers both subsidies contingent 'in law' and subsidies contingent 'in fact' upon the use of domestic over imported goods. Just as there is nothing in the language of Article 3.1(b) that specifically *includes* subsidies contingent 'in fact', so, too, is there nothing in that language that specifically *excludes* subsidies contingent 'in fact' from the scope of coverage of this provision. As the text of the provision is not conclusive on this point, we must turn to additional means of interpretation. Accordingly, we look for guidance to the relevant context of the provision.

Although we agree with the Panel that Article 3.1(a) is relevant context, we believe that other contextual aspects should also be examined. First, we note that Article III:4 of the GATT 1994 also addresses measures that favour the use of domestic over imported goods, albeit with different legal terms and with a different scope. Nevertheless, both Article III:4 of the GATT 1994 and Article 3.1(b) of the *SCM Agreement* apply to measures that require the use of domestic goods over imports. Article III:4 of the GATT 1994 covers both *de jure* and *de facto* inconsistency. Thus, it would be most surprising if a similar provision in the *SCM Agreement* applied only to situations involving *de jure* inconsistency.

... The fact that Article 3.1(a) refers to 'in law or in fact', while those words are absent from Article 3.1(b), does not necessarily mean that Article 3.1(b) extends only to *de jure* contingency.

Finally, we believe that a finding that Article 3.1(b) extends only to contingency 'in law' upon the use of domestic over imported goods would be contrary to the object and purpose of the *SCM Agreement* because it would make circumvention of obligations by Members too easy.

...

For all these reasons, we believe that the Panel erred in finding that Article 3.1(b) does not extend to subsidies contingent 'in fact' upon the use of domestic over imported goods. We, therefore, reverse the Panel's broad conclusion that 'Article 3.1(b) extends only to contingency in law.'<sup>89</sup>

65. Thus, the Appellate Body in *Canada – Autos* interpreted Article 3.1(b) of the *SCM Agreement* to cover contingency both in law and in fact.<sup>90</sup> This interpretation was reiterated in *US – Tax Incentives*.<sup>91</sup>

#### **1.5.2.4.2 Legal standard**

66. With regard to *de jure* contingency, the Appellate Body in *US – Tax Incentives* indicated that a subsidy would be *de jure* contingent upon the use of domestic over imported products when:

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<sup>88</sup> Appellate Body Report, *Canada – Autos*, paras. 137-138.

<sup>89</sup> Appellate Body Report, *Canada – Autos*, paras. 139-143.

<sup>90</sup> Appellate Body Report, *Canada – Autos*, para. 143.

<sup>91</sup> Appellate Body Report, *US – Tax Incentives*, para. 5.12.



"[T]he existence of that condition can be demonstrated on the basis of the very words of the relevant legislation, regulation or other legal instrument constituting the measure', or can 'be derived by necessary implication from the words actually used in the measure'."<sup>92</sup>

67. With regard to *de facto* contingency, the Appellate Body in *US – Tax Incentives* noted that proving that a subsidy is *de facto* contingent upon the use of domestic over imported products is a "much more difficult task"<sup>93</sup> that requires a "holistic assessment"<sup>94</sup> of the factors that are used in addressing *de facto* contingency under Article 3.1(a) and the "factual circumstances that form part of the total configuration of the facts constituting and surrounding the granting of the subsidy".<sup>95</sup> Therefore, the analyses of *de jure* and *de facto* contingency are related:

"We understand the analysis of *de jure* and *de facto* contingency under Article 3.1(b) as a continuum, starting with the terms of the measure and their necessary implications, and continuing with factors including the measure's design and structure, its modalities of operation, and other relevant circumstances. A panel should conduct a holistic assessment of all relevant elements and evidence on the record, and need not compartmentalize *de jure* and *de facto* analyses, in order to reach an overall conclusion as to whether a subsidy is contingent upon the use of domestic over imported goods."<sup>96</sup>

68. The Appellate Body in *US – Tax Incentives* stated that the factors that are to be taken into account in determining the existence of *de facto* contingency under Article 3.1(a) are also relevant to determining *de facto* contingency under Article 3.1(b):

"In *EC and certain member States – Large Civil Aircraft*, the Appellate Body referred to a number of factors that may be relevant in this regard, including the design and structure of the measure granting the subsidy, the modalities of operation set out in such a measure, and the relevant factual circumstances surrounding the granting of the subsidy, that provide the context for understanding the measure's design, structure, and modalities of operation. While the Appellate Body has relied on these factors in addressing *de facto* contingency under Article 3.1(a), we consider that they are also relevant to a *de facto* contingency analysis under Article 3.1(b)."<sup>97</sup>

69. In the same case, the Appellate Body noted that Article 3.1(b) does not require demonstrating "any particular quantity or level of displacement of imported goods by domestic goods" in order to determine contingency upon the use of domestic over imported goods. In other words, the existence of contingency under Article 3.1(b) is not limited to cases where the measure requires the recipient of the subsidy to use domestic goods to the "complete exclusion" of imported goods.<sup>98</sup>

70. Reiterating the legal standard it had articulated in *US – Tax Incentives* for Article 3.1(b) analysis, the Appellate Body in *EC and certain member states- Large Civil Aircraft (Article 21.5 – US)* explained that "the relevant question in determining the existence of contingency under Article 3.1(b) is not whether the eligibility requirements under a subsidy may *result* in the use of more domestic and fewer imported goods. Rather, the question is whether *a condition requiring* the use of domestic over imported goods can be discerned from the terms of the measure itself, or inferred from its design, structure, modalities of operation, and the relevant factual circumstances constituting and surrounding the granting of the subsidy that provide context for understanding the operation of these factors."<sup>99</sup>

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<sup>92</sup> Appellate Body Report, *US – Tax Incentives*, para. 5.12 (referring to Appellate Body Report, *Canada – Autos*, paras. 100 and 123).

<sup>93</sup> Appellate Body Report, *Canada – Aircraft*, para. 167.

<sup>94</sup> Appellate Body Report, *US – Tax Incentives*, para. 5.12.

<sup>95</sup> Appellate Body Report, *US – Tax Incentives*, paras. 5.12-5.13 (referring to Appellate Body Report, *Canada – Autos*, para. 123).

<sup>96</sup> Appellate Body Report, *US – Tax Incentives*, para. 5.13.

<sup>97</sup> Appellate Body Report, *US – Tax Incentives*, para. 5.12.

<sup>98</sup> Appellate Body Report, *US – Tax Incentives*, para. 5.22.

<sup>99</sup> Appellate Body Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, para. 5.63.

71. The Appellate body in *Brazil – Taxation* reiterated the legal standard of contingency under Article 3.1(b), as analysed in *Canada – Autos* and *US – Tax Incentives*.<sup>100</sup> Even though the Panel did not expressly indicate whether it conducted a *de jure* or *de facto* analysis, the Appellate Body understood the Panel to have made a *de jure* finding of inconsistency, since the Panel had relied on the text of the relevant legal instruments, and had not examined the factual circumstances surrounding the granting of the subsidy.<sup>101</sup>

### **1.5.3 Relationship with other provisions of the SCM Agreement**

#### **1.5.3.1 Chapeau of Article 3.1**

72. As regards the relationship between Article 3.1(b) and the introductory phrase "[e]xcept as provided in the Agreement on Agriculture" in the chapeau of Article 3.1, see paragraph 3 above.

#### **1.5.3.2 Article 3.1(a)**

73. As regards the use of Article 3.1(a) as context for the interpretation of Article 3.1(b), see paragraphs 63-64 above.

#### **1.5.3.3 Article 27**

74. As regards the transition period exemptions for developing and least developed countries, see the Section covering Article 27.2 of the SCM Agreement.

### **1.5.4 Relationship with other Agreements**

#### **1.5.4.1 Agreement on Agriculture**

75. As regards the relationship of Article 3.1(b) of the SCM Agreement with the Agreement on Agriculture, in particular, Articles 6.3 and 21.1 and paragraph 7 of Annex 3, see the relevant Sections on the Agreement on Agriculture.

#### **1.5.4.2 Article III of the GATT 1994**

76. The Panel in *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)* noted the "well established" practice that provisions of the GATT 1994, specifically Article III:8(b), may be considered relevant context when interpreting the SCM Agreement. The Panel recalled that the Appellate Body in *Canada – Autos* "specifically indicated that because Article III of the GATT 1994 and Article 3.1(b) of the SCM Agreement both discipline subsidies that are contingent on the use of domestic over imported goods a degree of consistency is called for in their interpretation."<sup>102</sup>

77. In addition, the Panel in *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)* compared the disciplines on subsidies contained in Article III of the GATT 1994 with Article 3.1(b) of the SCM Agreement. The Panel explained that Article III:4 of the GATT 1994, like Article 3.1(b) of the SCM Agreement, prohibits subsidies that are contingent of the use of domestic over imported goods; however, Article III:8(b) of the GATT 1994 clarifies that "the act of granting subsidies to firms so long as they engage in domestic production activities, without more, should not be equated to making those subsidies contingent on the use of domestic over imported goods and hence prohibited."<sup>103</sup>

78. In *US – Tax Incentives*, the Appellate Body analysed the relationship between the exception found Article III:8(b) of the GATT 1994 and Article 3.1(b) of the SCM Agreement:

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<sup>100</sup> Appellate Body Report, *Brazil – Taxation*, paras. 5.241–5.248.

<sup>101</sup> Appellate Body Report, *Brazil – Taxation*, para. 5.258.

<sup>102</sup> Panel Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, para. 6.783 (referring to Appellate Body Report, *Canada – Autos*, para. 140).

<sup>103</sup> Panel Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, paras. 6.784–6.785.



"Article III:8(b) of the GATT 1994 exempts from the national treatment obligation in Article III 'the payment of subsidies exclusively to domestic producers'. Article III:8(b) makes clear that the provision of subsidies to domestic producers only, and not to foreign ones, does not in itself constitute a breach of Article III. To the extent that 'domestic producers' may generally be expected to manufacture a certain amount of 'domestic goods' in a Member's territory, Article III:8(b) comports with our reading of Article 3.1(b) under which something more than mere subsidization of domestic production is required for finding an import substitution subsidy. That said, even if the granting of a subsidy is exempt from the GATT national treatment obligation by virtue of it being paid exclusively to domestic producers within the meaning of Article III:8(b) of the GATT 1994, it may still be found to be contingent upon the use by those producers of domestic over imported goods under Article 3.1(b) of the SCM Agreement."<sup>104</sup>

79. The Appellate Body in *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)* noted that the payment of subsidies exclusively to domestic producers does not constitute a national treatment violation by virtue of the exemption contained in Article III:8(b).<sup>105</sup> It recalled its prior finding in *US – Tax Incentives* that a subsidy so exempted from national treatment obligation by virtue of Article III:8(b) may still be found to be contingent upon the use by those producers of domestic over imported goods under Article 3.1(b) of the SCM Agreement.<sup>106</sup>

80. Distinguishing import substitution subsidies from "subsidies that may relate to domestic production", the Appellate Body in *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)* noted that although subsidies that relate to domestic production may foster the use of subsidized domestic goods and result in displacement in respect of imported goods, such effects do not, in and of themselves, demonstrate the existence of a requirement to use domestic over imported goods. The Appellate Body noted that the legal standard under Article 3.1(b) is "not whether conditions for eligibility and access to subsidy may *result* in the use of more domestic and fewer imported goods, but whether the measure reflects a condition requiring the use of domestic over imported goods".<sup>107</sup> The Appellate Body agreed with the Panel's reasoning that "basing the legal standard under Article 3.1(b) on the market effects of a subsidy would result in significantly blurring – and with respect to at least certain subsidies, potentially erasing – the line between the disciplines of Part II of the SCM Agreement [prohibited subsidies] and the effects-based disciplines on actionable subsidies contained in Part III of the SCM Agreement".<sup>108</sup>

81. The Appellate Body in *Brazil – Taxation* assessed the relationship between Article 3.1(b) and Article III:4 of the GATT 1994:

"We note that the legal standard under Article 3.1(b) of the SCM Agreement is not the same as that under Article III:4 of the GATT 1994. In order to establish an inconsistency with Article 3.1(b) of the SCM Agreement, a measure must be 'contingent ... upon the use of the domestic over imported goods'. By contrast, to find an inconsistency with Article III:4 of the GATT, it is sufficient that the measure at issue alters the conditions of competition to the detriment of the imported products by providing an incentive to use domestic goods. Establishing the existence of a contingency requirement to use domestic over imported products under Article 3.1(b) of the SCM Agreement is thus a more demanding standard than demonstrating that an incentive to use domestic goods exists under Article III:4 of the GATT 1994. Accordingly, while establishing that a measure provides an incentive to producers to use domestic goods would be sufficient to find an inconsistency with Article III:4 of the GATT 1994, it would not suffice to also find that the same measure is contingent upon the use of domestic over imported goods under Article 3.1(b) of the SCM Agreement.

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<sup>104</sup> Appellate Body Report, *US – Tax Incentives*, para. 5.16.

<sup>105</sup> Appellate Body Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, para. 5.62 (referring to Appellate Body Report, *US – Tax Incentives*, para. 5.16).

<sup>106</sup> Appellate Body Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, para. 5.62 (referring to Appellate Body Report, *US – Tax Incentives*, para. 5.16).

<sup>107</sup> Appellate Body Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, para. 5.65.

<sup>108</sup> Appellate Body Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, para. 5.70 (referring to Panel Report, *EC and certain member States – Large Civil Aircraft (Article 21.5 – US)*, para. 6.787).

... [A]s long as the Panel made findings of inconsistency with Article III:4 due to the existence of a contingency requirement, as opposed to a mere incentive, to use domestic goods, it could rely on these findings as a basis for its findings of inconsistency with Article 3.1(b) of the SCM Agreement. However, if we were to find that the Panel relied in its analysis under Article 3.1(b) on findings it made under Article III:4 that merely establish the existence of an incentive to favour domestic over imported goods, such reliance would be incorrect."<sup>109</sup>

#### **1.5.4.3 Article III:4 of the GATT 1994 and TRIMs Agreement**

82. In *Canada – Renewable Energy*, the Appellate Body noted that the national treatment obligations found in Article III:4 of the GATT 1994, the TRIMs Agreement and the disciplines in Article 3.1(b) of the SCM Agreement, are "cumulative obligations" that address discriminatory conduct.<sup>110</sup> As to whether there should be a sequence of analysis among these provisions, the Appellate Body in *Canada – Renewable Energy* stated that there is "nothing in these provisions to indicate that there is an obligatory sequence of analysis to be followed when claims are made under Article III:4 of the GATT 1994 and the TRIMs Agreement, on the one hand, and Article 3.1(b) of the SCM Agreement, on the other hand".<sup>111</sup>

### **1.6 Article 3.2**

#### **1.6.1 "grant"**

83. As the *Canada – Aircraft* dispute illustrates, under the SCM Agreement a Member may challenge a subsidy programme of another Member "as such" or, alternatively, "as applied". In addressing Brazil's challenge of certain Canadian subsidies "as such", the Panel in *Canada – Aircraft* recalled the distinction between mandatory and discretionary legislation. In so doing, the Panel invoked what it considered consistent GATT/WTO practice and emphasized that it "must first determine whether the ... programme *per se* mandates the grant of prohibited export subsidies in a manner inconsistent with Articles 3.1(a) and 3.2 of the SCM Agreement."<sup>112</sup> The Panel continued as follows:

"In this regard, we recall the distinction that GATT/WTO panels have consistently drawn between discretionary legislation and mandatory legislation. For example, in *United States – Tobacco* the panel 'recalled that panels had consistently ruled that legislation which mandated action inconsistent with the General Agreement could be challenged as such, whereas legislation which merely gave the discretion to the executive authority ... to act inconsistently with the General Agreement could not be challenged as such; only the actual application of such legislation inconsistent with the General Agreement could be subject to challenge'. "<sup>113</sup>

84. In applying this standard to the facts of the case before it, the Panel in *Canada – Aircraft* concluded that "a mandate to support and develop Canada's export trade does not amount to a mandate to grant subsidies, since such support and development could be provided in a broad variety of ways."<sup>114</sup> As a consequence, the Panel in *Canada – Aircraft* held that it "may not make any findings on the EDC programme *per se*".<sup>115</sup>

85. The Panel in *Brazil – Aircraft* was called upon to decide whether Brazil had increased its level of export subsidies within the meaning of Article 27.4. Because footnote 55 to Article 27.4 refers to the "grant" of export subsidies, the Panel addressed the question concerning at which particular point in time Brazil had actually been "granting" the disputed subsidies. Under the part of the Brazilian PROEX programme relating to interest equalization payments, the Brazilian Government would first approve a particular export transaction (between the Brazilian manufacturer and a foreign buyer) and issue a "letter of commitment" to the manufacturer; this

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<sup>109</sup> Appellate Body Report, *Brazil – Taxation*, paras. 5.254–5.255.

<sup>110</sup> Appellate Body Report, *Canada – Renewable Energy*, para. 5.5.

<sup>111</sup> Appellate Body Report, *Canada – Renewable Energy*, para. 5.5.

<sup>112</sup> Panel Report, *Canada – Aircraft*, para. 9.124.

<sup>113</sup> Panel Report, *Canada – Aircraft*, para. 9.124.

<sup>114</sup> Panel Report, *Canada – Aircraft*, para. 9.127.

<sup>115</sup> Panel Report, *Canada – Aircraft*, para. 9.129.

letter would commit the Government to providing support, on the condition that the contract would indeed be concluded under the terms previously approved by the Government and entered into within a specific period of time. If these conditions were not fulfilled, the letter of commitment would expire. The actual interest equalization payments began after the aircraft had been exported and paid for under the relevant contract. The Brazilian Government, acting through the Brazilian National Treasury, would then issue bonds in the name of the bank financing the transaction; the bonds could be redeemed on a semi-annual basis for the duration of financing or sold for a discount in the securities market. In its analysis, the Panel began by comparing the term "grant" under Articles 3.2 and 27.4:

"We note that Article 3.2 and Article 27.4 are provisions of the same Agreement. Further, both provisions relate to the prohibition on export subsidies set out under that Agreement. We do not perceive any basis to attribute to the term 'grant' as used in Article 3.2 of the *SCM Agreement* a meaning different from that attributed to that term by this Panel and the Appellate Body as used in Article 27.4 of the *SCM Agreement*."<sup>116</sup>

86. The Panel in *Brazil – Aircraft*, in a finding subsequently upheld by the Appellate Body<sup>117</sup>, then found that the "granting" of the subsidy at issue occurred when the bonds were issued by the Brazilian National Treasury to the bank financing the export transaction:

"It is clear to us, however, that PROEX payments have not yet been 'granted' at the time a letter of commitment is issued. We note that the issuance of a letter of commitment, even if legally binding on the Government of Brazil in the event certain conditions are fulfilled, provides no assurance that PROEX payments will actually be made ... [T]he right to receive the PROEX payments only arises after the conditions relating to receipt of PROEX payments, and specifically the condition that the product in question actually be exported, has been fulfilled ...

The question remains whether PROEX payments are 'granted' when the bonds are issued or whether they are granted only when the bonds are redeemed on a semi-annual basis. In our view, PROEX payments should be considered to be 'granted' when bonds are issued and title to those bonds is transferred to the lender financial institution ... [W]e note that, while the bonds cannot be immediately redeemed, they are freely negotiable. The parties agree that lenders may exercise their right to sell these bonds – albeit at a discount as determined by the market -- to other entities rather than waiting until maturity to redeem the bonds themselves. Thus, at the point that title to the bonds is passed to the lenders, those lenders are the holders of a property right with a market value which is immediately realisable. Accordingly, we conclude that PROEX payments are 'granted' at that point, and we will calculate the Brazil's PROEX expenditures on that basis."<sup>118</sup>

87. In *Brazil – Aircraft*, while agreeing with the Panel on *when* the subsidy in question was granted, the Appellate Body criticized the Panel for making findings on *whether* a subsidy *existed*. More specifically, the Appellate Body held that in the case at hand, the Panel, in its findings on Article 27.4, did not have to make findings on the existence of a subsidy within the meaning of Article 1 of the SCM Agreement, because the export subsidies in that case were already deemed to "exist".<sup>119</sup>

88. The Panel in *Brazil – Aircraft (Article 21.5 – Canada II)* built on this distinction made by the Appellate Body in *Brazil – Aircraft* between the question of the *existence* of a subsidy and the question of the precise moment of the "granting" of such subsidy and held that this distinction, drawn by the Appellate Body in the context of Article 27.4, applied equally with respect to Article 3.2 of the SCM Agreement:

"We recognize that the distinction made by the Appellate Body was between the existence of a subsidy and when a subsidy is granted related to when a subsidy is

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<sup>116</sup> Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para. 6.11.

<sup>117</sup> Appellate Body Report, *Brazil – Aircraft*, para. 159.

<sup>118</sup> Panel Report, *Brazil – Aircraft*, paras. 7.71-7.72.

<sup>119</sup> Appellate Body Report, *Brazil – Aircraft*, paras. 156-157.

granted for the purposes of Article 27.4 of the *SCM Agreement*, and not when it was granted for the purposes of Article 3.2. As a matter of logic, however, we cannot perceive ... any basis for us to conclude that, while the existence of a subsidy is a legally distinct issue from when it is granted for the purposes of Article 27.4, it is *not* a legally distinct issue from when it is granted for the purposes of Article 3.2. In other words, if the issue of when a subsidy is 'granted' for the purposes of Article 27.4 is legally distinct from when it 'exists' for the purposes of Article 1, then it follows that the issue of when a subsidy is granted for the purposes of Article 3.2 is also legally distinct from the issue when it exists for the purposes of Article 1."<sup>120</sup>

## **1.6.2 Relationship with other provisions of the SCM Agreement**

### **1.6.2.1 Article 3.1**

89. In *US – FSC (Article 21.5 – EC)*, the Panel concluded that by maintaining prohibited export subsidies, the defendant also acted inconsistently with Article 3.2 of the *SCM Agreement*. The Panel stated:

"We therefore view this claim as wholly dependent upon our resolution of the claims under Article 3.1 of the *SCM Agreement*. Recalling our finding that the Act involves prohibited export subsidies in breach of Article 3.1(a) of the *SCM Agreement* by reason of the requirement of 'use outside the United States', we find that by maintaining the subsidies under the Act, the United States has acted inconsistently with its obligation under Article 3.2 of the *SCM Agreement* not to maintain subsidies referred to in paragraph 1 of Article 3 of the *SCM Agreement*."<sup>121</sup>

## **1.7 Relationship with other WTO Agreements**

### **1.7.1.1 GATT 1994**

90. In *Canada – Autos*, the Panel, after finding violations of Article III:4 of the GATT 1994 and Article XVII of the GATS, exercised judicial economy with respect to alternative claims under Article 3.1(a). The Appellate Body upheld this exercise of judicial economy:

"In our view, it was not necessary for the Panel to make a determination on the ... *alternative* claim relating to the CVA requirements under Article 3.1(a) ... in order 'to secure a positive solution' to this dispute. The Panel had already found that the CVA requirements violated both Article III:4 of the GATT 1994 and Article XVII of the GATS. Having made these findings, the Panel, in our view, exercising the discretion implicit in the principle of judicial economy, could properly decide not to examine the *alternative* claim ... that the CVA requirements are inconsistent with Article 3.1(a) of the *SCM Agreement*."<sup>122</sup>

### **1.7.1.2 Agreement on Agriculture**

91. In *Canada – Dairy (Article 21.5 – New Zealand and US)*, the Panel considered that Article 9.1 of the Agreement on Agriculture and Articles 1.1 and 3.1 of the *SCM Agreement* can be said to be "closely related" and "part of a logical continuum." Thus, the Panel considered that its reasoning regarding the claims made under Article 10.1 of the Agreement on Agriculture was equally relevant for the claims made under Articles 1.1 and 3.1 of the *SCM Agreement*. The Panel noted that:

"[T]he facts underlying the Article 9.1(c) and Article 10.1 claims are, in this case, fully co-extensive. The Panel believes that this conclusion also applies to the facts underlying the claims made under the *Agreement on Agriculture*, on the one hand, and those made under Articles 1.1 and 3.1 of the *SCM Agreement*, on the other. In addition, the Panel considers that Article 9.1 of the *Agreement on Agriculture* and

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<sup>120</sup> Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para. 6.14.

<sup>121</sup> Panel Report, *US – FSC (Article 21.5 – EC)*, para. 8.110.

<sup>122</sup> Appellate Body Report, *Canada – Autos*, para. 116.

Articles 1.1 and 3.1 of the *SCM Agreement* can be said to be 'closely related' and 'part of a logical continuum'. Thus, the Panel's reasoning set forth *supra* regarding the claims made under Article 10.1 of the *Agreement on Agriculture* is equally relevant for the claims made under Articles 1.1 and 3.1 of the *SCM Agreement*.<sup>123</sup>

92. The Appellate Body in *Canada – Dairy (Article 21.5 – New Zealand and US)*, noted that with regard to agricultural products, the WTO-consistency of an export subsidy has to be determined, in the first place, under the Agreement on Agriculture. In this case, the Appellate Body recalled that it was unable to determine whether the measures at issue "conform[] fully" to Articles 9.1(c) or 10.1 of the Agreement on Agriculture. Therefore, the Appellate Body "decline[d] to examine" the claim under Article 3.1(a) of the SCM Agreement.<sup>124</sup> The Appellate Body held:

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

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

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

93. In *Canada – Dairy (Article 21.5 – New Zealand and US)*, the Panel considered that when a Member exceeded its quantity commitment levels, the Panel could only recommend that the Member bring its measures into conformity with its obligations under the Agreement on Agriculture, and it could not require "withdrawal". Alternatively, assuming for the sake of argument that it could make a recommendation to the Member to "withdraw" the export subsidy, the Panel considered that, pursuant to Article 21.1 of the Agreement on Agriculture and Article 3.1 of the SCM Agreement, the Panel could only do so with respect to that portion of the subsidized exports that exceeded the Member's reduction commitment levels under the Agreement on Agriculture.<sup>126</sup>

94. In upholding the Panel's findings that Step 2 payments to domestic users of United States upland cotton pursuant to a specific provision of US legislation are subsidies contingent on the use of domestic over imported goods inconsistent with Articles 3.1(b) and 3.2 of the SCM Agreement, the Appellate Body in *US – Upland Cotton* rejected the United States' argument on appeal that Article 3.1(b) is inapplicable to Step 2 payments to domestic users because such payments are consistent with the United States' domestic support reduction commitments under the Agreement on Agriculture.<sup>127</sup>

95. In finding that Article 3.1(b) of the SCM Agreement is applicable to agricultural products, the Appellate Body examined the relevant provisions of the Agreement on Agriculture in order to determine whether it contains specific provisions that deal specifically with subsidies contingent upon the use of domestic over imported goods in light of the introductory language in Article 3 of the SCM Agreement, which provides "[e]xcept as provided in the *Agreement on Agriculture*, as

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<sup>123</sup> Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 6.92.

<sup>124</sup> See also Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 6.101, where the Panel exercised judicial economy on the claims made under Articles 1.1 and 3.1 of the SCM Agreement after having made an affirmative finding regarding the claim made under Article 9.1(c) of the Agreement on Agriculture.

<sup>125</sup> Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, paras. 123-125.

<sup>126</sup> Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para. 6.101.

<sup>127</sup> Appellate Body Report, *US – Upland Cotton*, para. 552.

well as Article 21 of *Agreement on Agriculture*, which provides that the covered agreements on goods apply subject to the provisions of the *Agriculture Agreement*".<sup>128</sup>

96. The Appellate Body in *US – Upland Cotton* found that both paragraph 7 of Annex 3 and Article 6.3 of the Agreement on Agriculture do not deal specifically with subsidies contingent upon the use of domestic over imported goods as set forth in Article 3.1(b) of the SCM Agreement:

"It may well be that a measure that is an import substitution subsidy could fall within the second sentence of paragraph 7 as '[m]easures directed at agricultural processors [that] shall be included [in the AMS calculation] to the extent that such measures benefit the producers of the basic agricultural products'. There is nothing, however, in the text of paragraph 7 that suggests that such measures, when they are import substitution subsidies, are exempt from the prohibition in Article 3.1(b) of the *SCM Agreement*. We agree with the Panel that there is a clear distinction between a provision that requires a Member to include a certain type of payment (or part thereof) in its AMS calculation and one that would authorize subsidies that are contingent on the use of domestic over imported goods.

... Like the Panel, we do not believe that the scope of paragraph 7 is limited to measures that have an import substitution component in them. There could be other measures covered by paragraph 7 of Annex 3 that do not necessarily have such a component. Indeed, Brazil submits that if the Step 2 payments were provided to United States processors of cotton, regardless of the origin of the cotton, these processors 'would still buy *at least* some U.S. upland cotton, so producers would continue to derive *some* benefit'. Thus, paragraph 7 of Annex 3 refers more broadly to measures directed at agricultural processors that benefit producers of a basic agricultural product and, contrary to the United States' assertion, it is not rendered inutile by the Panel's interpretation. WTO Members may still provide subsidies directed at agricultural processors that benefit producers of a basic agricultural commodity in accordance with the *Agreement on Agriculture*, as long as such subsidies do not include an import substitution component.

...

Like paragraph 7 of Annex 3, Article 6.3 does not explicitly refer to import substitution subsidies. Article 6.3 deals with domestic support. It establishes only a *quantitative* limitation on the amount of domestic support that a WTO Member can provide in a given year. The quantitative limitation in Article 6.3 applies generally to all domestic support measures that are included in a WTO Member's AMS. Article 3.1(b) of the *SCM Agreement* prohibits subsidies that are contingent—that is, 'conditional' – on the use of domestic over imported goods.

Article 6.3 does not authorize subsidies that are contingent on the use of domestic over imported goods. It only provides that a WTO Member shall be considered to be in compliance with its domestic support *reduction commitments* if its Current Total AMS does not exceed that Member's annual or final bound commitment level specified in its Schedule. It does not say that compliance with Article 6.3 of the *Agreement on Agriculture* insulates the subsidy from the prohibition in Article 3.1(b). We, therefore, agree with the Panel that:

Article 6.3 does *not* provide that compliance with such 'domestic support reduction commitments' shall necessarily be considered to be in compliance with other applicable WTO obligations. Nor does it contain an explicit textual indication that otherwise prohibited measures are necessarily justified by virtue of compliance with the domestic support reduction commitments."<sup>129</sup> <sup>130</sup>

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<sup>128</sup> Appellate Body Report, *US – Upland Cotton*, paras. 530-533.

<sup>129</sup> (*footnote original*) Panel Report, para. 7.1058. (original emphasis)

<sup>130</sup> Appellate Body Report, *US – Upland Cotton*, paras. 541, 542, 544 and 545.

97. The Appellate Body in *US – Upland Cotton* also found that since the introductory phrase "[e]xcept as provided in the *Agreement on Agriculture*" in Article 3.1 of the *SCM Agreement* applies to both the export subsidy prohibition in Article 3.1(a) and the import substitution subsidy prohibition in Article 3.1(b) it is reasonable to conclude that the drafters would have also included an explicit and clear provision in the *Agreement on Agriculture* if it was their intention to authorize these prohibited subsidies in respect of agricultural products.<sup>131</sup> Moreover, in looking at the introductory phrase, the Appellate Body agreed with the Panel that Article 3.1(b) of the *SCM Agreement* can be read together with provisions of the *Agreement on Agriculture* pertaining to domestic support coherently and consistently that gives effective meaning to the relevant terms of both agreements.<sup>132</sup>

Current as of: December 2020

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<sup>131</sup> Appellate Body Report, *US – Upland Cotton*, para. 547.

<sup>132</sup> Appellate Body Report, *US – Upland Cotton*, para. 549.