

ANNEX 1-1

FIRST SUBMISSION OF CANADA

(23 December 1999)

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I. INTRODUCTION

1. In this proceeding under Article 21.5 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (DSU), Canada contends that the measures taken by Brazil in respect of the *Programa de Financiamento às Exportações* (PROEX) and export subsidies on sales of Brazilian regional aircraft, neither withdraw the export subsidies nor otherwise comply with the *Agreement on Subsidies and Countervailing Measures* (SCM Agreement) and the findings and the recommendations of the Panel, as modified by the Appellate Body, in *Brazil – Export Financing Programme for Aircraft* (PROEX).¹

2. The Panel found that interest equalization payments made under PROEX for the benefit of purchasers of exported Brazilian regional aircraft were subsidies contingent upon export performance. The Panel further found that these subsidies were not covered by any exceptions or affirmative defences under the SCM Agreement and were therefore prohibited in accordance with Article 3 of that Agreement. The Panel recommended that Brazil withdraw these prohibited export subsidies within ninety days of the adoption of its report by the DSB, that is, by 18 November 1999. Brazil has not done so.

3. Brazil has failed to meet its obligation to modify the PROEX export subsidy programme in two senses, each of which constitutes a failure to withdraw its export subsidies under Article 4.² and thereby to bring its measures into conformity with the SCM Agreement. First, in respect of regional aircraft that have been or will be delivered after 18 November 1999 Brazil has not ceased granting export subsidies pursuant to conditional commitments made before that date. Contrary to Article 4.7 and Article 3.2, Brazil is thus continuing to grant export subsidies by issuing NTN-I bonds to buy down purchasers' financing costs under conditions that the DSB found to constitute illegal export subsidies.

4. Second, Brazil has not modified the PROEX export subsidy programme for new financing commitments by the Government of Brazil respecting future sales or leases of regional aircraft in a way that withdraws the illegal export subsidies or otherwise brings the programme into conformity with the SCM Agreement. Brazil has announced certain measures that it claims would bring the PROEX export subsidy programme into compliance with the recommendations and rulings of the DSB and with its obligations under the SCM Agreement. Those measures call for PROEX interest rate buy-down subsidies to aim to achieve an effective interest rate for a transaction equivalent to US 10-year Treasury Bonds plus 20 basis points. Canada submits that such payments would continue to be subsidies contingent upon export performance that do not benefit from any exceptions or affirmative defences under the SCM Agreement.

5. Accordingly, Canada requests that the Panel find that:

in respect of PROEX export subsidies committed on exports of regional aircraft but not yet granted as of 18 November 1999: Brazil continues to pay subsidies found to have been illegal and is therefore not in compliance with the recommendations and rulings of the DSB and Articles 4.7 and 3.2 of the SCM Agreement; and

in respect of post-November 18 conditional commitments to pay PROEX subsidies on the export of Brazilian regional aircraft: Brazil has failed to implement measures

¹ WT/DS46/R and WT/DS46/AB/R, Reports of the Panel and the Appellate Body adopted on 20 August 1999.

² Unless otherwise indicated, all references to Article numbers are references to Articles of the SCM Agreement.

that would bring the PROEX export subsidy programme into compliance with the recommendations and rulings of the DSB and Articles 4.7 and 3.2 of the SCM Agreement.

II. MEASURES TAKEN BY BRAZIL TO COMPLY WITH THE PANEL AND APPELLATE BODY REPORTS

A. FACTUAL FINDINGS OF THE PANEL AND THE APPELLATE BODY IN RESPECT OF THE OPERATION OF THE PROEX EXPORT SUBSIDY PROGRAMME

6. At paragraphs 2.2 to 2.6 of its Report, the Panel made the following findings of fact in respect of the operation of the PROEX export subsidy programme that are relevant to an assessment of Brazil's implementation measures (footnotes omitted from quotations):

"2.2 ...With interest equalization, underlying legal instruments provide that the National Treasury grant[s] to the financing party an equalization payment to cover, at most, the difference between the interest charges contracted with the buyer and the cost to the financing party of raising the required funds."

"2.3 The financing terms for which interest rate equalization payments are made are set by Ministerial Decrees. The terms, determined by the product to be exported, vary normally from one year to ten years. In the case of regional aircraft, however, this term has been extended to 15 years. The length of the financing term, in turn, determines the spread to be equalized: the payment ranges from 2 percentage points per annum, up to 3.8 percentage points per annum for a term of nine years or more. The spread is fixed and does not vary depending on the lender's actual cost of funds.

"2.4 PROEX is administered by the Comitê de Crédito as Exportações ("Committee"), a 13-agency group, with the Ministry of Finance serving as its executive. Day-to-day operations of PROEX are conducted by the Banco do Brasil. For applications for financing transactions not exceeding US\$5 million, whose terms otherwise fall within PROEX guidelines, Banco do Brasil has pre-approved authority to provide PROEX support without requesting the approval of the Committee. All other applications are referred to the Committee, which has the authority to waive some of the published PROEX guidelines. In the case of regional jet aircraft, the most frequent waiver has been to extend the length of the financing term from ten to fifteen years.

"2.5 PROEX involvement in aircraft financing transactions begins when the manufacturer requests a letter of approval from the Committee prior to conclusion of a formal agreement with the buyer. This request sets forth the terms and conditions of the proposed transaction. If the Committee approves, it issues a letter of commitment to the manufacturer. This letter commits PROEX to providing support as specified for the transaction provided that the contract is entered into according to the terms and conditions contained in the request for approval, and provided that it is entered into within a specified period of time, usually 90 days. If a contract is not entered into within the specified time, the commitment contained in the letter of approval expires.

"2.6 PROEX interest equalization payments, pursuant to the commitment, begin after the aircraft is exported and paid for by the purchaser. PROEX payments are made to the lending financial institution in the form of non-interest bearing National Treasury Bonds (Notas do Tesouro Nacional – Série I) referred to as NTN-I bonds. These are denominated in Brazilian Reais indexed to the United States dollar. The

bonds are issued by the Brazilian National Treasury to its agent bank, Banco do Brasil, which then passes them on to the lending banks financing the transaction. The bonds are issued in the name of the lending bank which can decide to redeem them on a semi-annual basis for the duration of the financing or discount them for a lump sum in the market. PROEX resembles a series of zero coupon bonds which mature at six months intervals over the course of the financing period. The bonds can only be redeemed in Brazil and only in Brazilian currency at the exchange rate prevailing at the time of payment. If the lending bank is outside of Brazil, it may appoint a Brazilian bank as its agent to receive the semi-annual payments on its behalf."

7. The Appellate Body made the following relevant finding of fact:

"4. For sales of regional aircraft, PROEX interest rate equalization subsidies amount to 3.8 percentage points of the actual interest rate on any particular transaction. The lending bank charges its normal interest rate for the transaction, and receives a payment from two sources: the purchaser, and the Government of Brazil. Of the total interest payments, the Government of Brazil pays 3.8 percentage points, and the purchaser pays the rest. In this way, PROEX reduces the financing costs of the purchaser and, thus, reduces the overall cost to the purchaser of purchasing an Embraer aircraft.³

B. SUBSTANTIVE FINDINGS OF THE PANEL AND THE APPELLATE BODY IN RESPECT OF BRAZIL'S OBLIGATIONS

8. Canada's challenge to the PROEX export subsidy programme was concerned with both the application in practice of the programme to specific exports of regional aircraft and, more broadly, the nature and operation of the interest equalization scheme.⁴

9. The Panel found that "PROEX payments on exports of Brazilian regional aircraft are subsidies within the meaning of Article 1 of the SCM Agreement and are contingent upon exportation within the meaning of Article 3.1(a) of that Agreement."⁵

10. According to the Panel, this followed from the very design of PROEX and the manner in which PROEX export subsidy scheme operated:

³ Report of the Appellate Body, *op. cit.*, at para. 4.

⁴ At para. 7.2 of its Report, *op. cit.*, the Panel observed:

"We do not understand Canada to be alleging that the interest rate equalization component of the PROEX programme *per se* is the prohibited measure, because Canada does not seek a finding or recommendation with respect to the programme itself. In fact, it limits itself to challenging PROEX payments relating to the particular sector of regional aircraft. On the other hand, neither is Canada restricting its challenge to a particular specified payment or payments already made pursuant to the interest rate equalization component of PROEX. To the contrary, although Canada identifies specific transactions with respect to which it considers that PROEX payments have been or will be made, Canada is arguing that all PROEX payments, to the extent they relate to exported Brazilian regional aircraft, *including payments to be made in the future pursuant to the PROEX interest rate equalization scheme*, are prohibited subsidies. Thus, we understand Canada to be challenging not only specific payments, but more generally the practice involving PROEX payments relating to exported Brazilian regional aircraft (which we will hereafter refer to as 'PROEX payments'). In order to analyse this contention, we are required to go beyond an examination of individual PROEX payments that have been identified and look more generally at the nature and operation of the PROEX interest rate equalization scheme which governs the payment of the alleged export subsidies." (footnotes omitted; underline added).

⁵ *Ibid.*, at paras. 7.13 and 7.14.

"As characterized by Brazil, the purpose of the payments is to improve the terms of export credit financing that would otherwise be available to purchasers of Brazilian regional aircraft and other Brazilian products by offsetting "Brazil risk". Thus, under the PROEX interest rate equalization scheme, Embraer and its export customers are free to negotiate the best credit terms they may obtain in the market, irrespective of whether the lender is a Brazilian or a foreign financial institution The [PROEX] payments may be used to improve the export credit terms in one of several ways. For example, the availability of the payments may be used to negotiate lower interest rates for the export credits in question than would otherwise be available for the transaction. In the alternative, the lending bank may agree to discount the bonds and to pass the sum along to the purchaser/borrower as a cash discount. In any event, we consider that, as a matter of logic, the payments will as a natural consequence allow Embraer and the purchaser to negotiate more favourable export credit terms than they could otherwise achieve in the marketplace.⁶

11. The Panel noted Brazil's admission that purchasers of its regional aircraft would not be interested in PROEX payments if the payments did not offer them an advantage relative to what they could obtain in the market:

"PROEX presumably would always be more favourable to the purchaser than the terms it could obtain on its own; otherwise, the purchaser would have no interest in PROEX. If the PROEX-supported export credit term is compared merely to the credit terms a particular buyer could obtain on its own, PROEX could never provide assistance and always would be at a disadvantage vis-à-vis competitors supported by an export credit agency, whether that agency's programmes were or were not consistent with WTO obligations.⁷

12. Accordingly, the Panel found that Brazil had failed to demonstrate that the PROEX payments did not secure a "material advantage" in the field of export credit terms within the meaning of Item (k) of the Illustrative List of Export Subsidies (Annex I to the SCM Agreement). The Appellate Body considered the relevant Commercial Interest Reference Rate (CIRR) an appropriate point of comparison in determining whether a material advantage was secured and to that extent modified the Panel's findings. The Appellate Body nevertheless upheld the findings of the Panel, because Brazil had failed also to demonstrate a relationship between actual interest rates in financing transactions involving exported Brazilian regional aircraft that benefited from PROEX subsidies and the relevant CIRR.

13. The Panel and the Appellate Body then made a number of additional findings with respect to Brazil's rights and obligations under Article 27 of the SCM Agreement. In particular, they found that:

- (a) PROEX export subsidies are granted, for the purposes of Article 27.4, at the time when NTN-I bonds are issued upon the exportation of regional aircraft⁸;
- (b) Brazil had increased its level of export subsidies⁹; and
- (c) Brazil had failed to phase-out its export subsidies, as conditional commitments it had made lasted well past the end of the transitional period provided for in Article 27.¹⁰

⁶ *Ibid.*

⁷ *Ibid.*, at para. 7.35.

⁸ *Ibid.*, at para. 7.72; Report of the Appellate Body, *op. cit.*, at para. 159.

⁹ Report of the Panel, *ibid.*, at para. 7.76; Report of the Appellate Body, *ibid.*, at para. 164.

¹⁰ Report of the Panel, *ibid.*, at para. 7.84.

14. Having found that Brazil had failed to meet the conditions of Article 27, the Panel further found that "payments on exports of regional aircraft under the PROEX interest rate equalization scheme are export subsidies inconsistent with Article 3 of the SCM Agreement".¹¹

15. The Panel recommended that Brazil withdraw its subsidies within 90 days of the adoption of the reports by the DSB.¹² The Appellate Body confirmed the Panel's recommendation.¹³ The DSB adopted the reports of the Panel and the Appellate Body on 20 August 1999.

C. MEASURES TAKEN BY BRAZIL

1. Export subsidies on regional aircraft exported after 18 November 1999 pursuant to commitments made before that date

16. With respect to the export of regional aircraft after 18 November 1999 under commitments made before that date, Brazil has taken no action to terminate the PROEX export subsidies found to be inconsistent with Brazil's obligations under Article 3 of the SCM Agreement. Not only has Brazil presented no evidence of any cessation of such illegal export subsidies, but the Brazilian Government also orally informed Canada that it did not have any intention of withdrawing PROEX export subsidies with respect to such exports. Indeed, ten days after the end of the implementation period, Mr. Valdemar Carneiro Leao, Director-General of the Economic Department of Brazil's Ministry of Foreign Affairs, noted that to resolve this dispute the parties should let "bygones be bygones" and affirmed that:

"From the very beginning of the dispute Brazil has consistently declared it will honour its commitments. A commitment is a commitment and it would make no sense for the country or for the company not to meet them. It would mean a breach of contract, which can incur hefty penalties."¹⁴

17. Apparently to allay fears by Embraer's customers that they might no longer benefit from export subsidies found to have been prohibited by this Panel, Mauricio Botelho, the President of Embraer, has consistently and publicly stated that such subsidies will continue to be paid on aircraft to be delivered after 18 November 1999.¹⁵ Publicly available information such as the US Security and Exchange Commission filings by purchasers of Embraer aircraft does not even suggest that any changes to prior PROEX commitments have occurred. One such company, Skywest, in materials filed on 3 November 1999, simply noted that it had no reason to believe subsidies it receives from Brazil would be discontinued.¹⁶ Had changes, such as those required by the recommendations of the DSB occurred, they should have been notified as material changes of circumstances under the rules of

¹¹ *Ibid.*, at para. 8.2.

¹² *Ibid.*, at para. 8.4.

¹³ Report of the Appellate Body, *op. cit.*, at para. 194.

¹⁴ Mara Lemos, "Brazil, Canada Trapped in Past Aircraft Row", Dow Jones International News, 11/29/99. Documentary Annex 1.

¹⁵ *Folha de Sao Paulo*, 25 November 1999 (3 December 1999). Documentary Annex 2. This public affirmation has, at no point, been contradicted by officials of the Government of Brazil.

¹⁶ See, e.g., Form 10-Q filing of Skywest Airlines before the US Securities and Exchange Commission for the quarter ending on September 30, 1999, online: Securities and Exchange Commission (SEC), <http://www.sec.gov/Archives/edgar/data/793733/0000950149-99-001424.txt> (date accessed 19 December 1999). The Skywest 10-Q filing states that:

"While the Company has no reason to believe, based on information currently available, that the Company will not continue to receive these subsidy payments from the Federative Republic of Brazil in the future, there can be no assurance that such a default will not occur."

This statement was made after the date of the adoption by the DSB of the rulings in this case. Documentary Annex 3.

the SEC.¹⁷ Brazil thus continues to grant PROEX prohibited export subsidies, contrary to its obligation to withdraw such subsidies in respect of commitments made before 18 November 1999.

2. Revisions to PROEX in respect of new commitments

18. The PROEX programme continues to exist by virtue of provisional measures issued on a monthly basis by the Government of Brazil.¹⁸ Brazil has notified the DSB that it has adopted the following measures to comply with the recommendations and rulings of the DSB:

- (a) Resolution No. 2.667 (19 December 1999) of the National Monetary Board (Resolution) (amending Resolution No. 2.576 of 17 December 1998).¹⁹ The Resolution establishes requirements for interest rate equalization transactions under PROEX; and
- (b) Newsletter No. 2.881 (Newsletter), in which the Central Bank of Brazil indicated the maximum percentages that may be applied under the PROEX interest rate equalization scheme.²⁰

(a) The Resolution

19. The Resolution amended Articles 1, 8 and 9 of Resolution 2.576. The key changes are found in the amendments to Article 1 of Resolution 2.576. Translated, the amendments read as follows:

"Article 1: In export financing operations covering goods and services including computer software programmes as set out in Law No. 9.609 of 19 February 1998, the National Treasury may grant to the financing or refinancing agency, as the case may be, sufficient equalization credits to ensure that the relevant financial charges are consistent with standard practices on the international market.

"Paragraph 1: In the financing of aircraft exports for regional aviation markets, equalization rates shall be established on a case by case basis and at levels which may be differential, preferably based on the United States Treasury Bond 10-year rate, plus an additional spread of 0.2 per cent per annum, to be reviewed periodically in accordance with market practices.

"Paragraph 2: The equalization rate shall be limited to the percentages established by the Banco Central do Brasil, and shall remain fixed throughout the period in question." (emphasis added)

(b) The Newsletter

20. The Newsletter sets out new maximum interest rate reductions for the PROEX export subsidy payments. The maximum reduction available is 2.5 percentage points for financing equalization

¹⁷ SEC rules (Rule 12b-20) require that 10-Q filings describe any "further material information" needed to ensure that the information that is specifically required by the SEC to be included in the 10-Q is not misleading. Skywest has viewed the Brazilian subsidies as "material" and included these in its 10-Q filings; a development that increased the risk that Skywest would not continue to receive those subsidies would also be considered as "material."

¹⁸ The PROEX programme is currently being maintained by Provisional Measure No. 1892-33 of 23 November 1999. Documentary Annex 4.

¹⁹ Documentary Annex 5.

²⁰ Documentary Annex 6.

periods of over 9 years and up to 10 years. The Newsletter does not specify a maximum interest rate reduction percentage for financing terms in excess of ten years.

D. BRAZIL'S MEASURES DO NOT CHANGE OTHER ELEMENTS OF PROEX

21. The Resolution and the Newsletter apply only to future commitments. They do not apply to or in any way modify PROEX export subsidies in respect of regional aircraft that have been or will be exported after 18 November 1999 pursuant to commitments made before that date. For commitments made after 18 November 1999, except for a reduction of the interest rate buy-down subsidy from 3.8 to 2.5 percentage points (for certain transactions), and the concept that the payments would "preferably" result in a net interest rate 20 basis points above the noted US Treasury Bond rate, the basic elements of the PROEX programme found by the Panel remain the same:

- (a) PROEX interest equalization payments are grants from the Brazilian National Treasury to buy down commercial interest rates freely negotiated by the borrower, as found by the Panel and the Appellate Body;
- (b) the programme is still administered by the Committee and the Committee retains the authority to waive the published PROEX guidelines including the term of the payments; and
- (c) the interest rate equalization payments made under the programme are still being provided at the time of export of the aircraft in the form of non-interest-bearing bonds.

22. The PROEX programme, as modified, continues to be an export subsidy scheme prohibited under Article 3 of the SCM Agreement.

III. APPLICABLE LAW

A. JURISDICTION OF THE PANEL UNDER ARTICLE 21.5

23. Under Article 21.5 of the DSU²¹ the Panel must determine whether a measure taken to comply with the recommendations and rulings of the DSB is consistent with a covered agreement.

24. In the context of this dispute, the Panel must determine whether Brazil's implementation measures are consistent with its obligations under Article 4.7 of the SCM Agreement to withdraw the prohibited export subsidies and under Article 3.2 of the Agreement to neither grant nor maintain such subsidies. As demonstrated below, Brazil's implementing measures do not comply with these obligations.

B. THE REQUIREMENT TO WITHDRAW PROHIBITED SUBSIDIES UNDER ARTICLE 4.7

25. Article 4.7 provides that:

"4.7 If the measure in question is found to be a prohibited subsidy, the panel shall recommend that the subsidizing Member withdraw the subsidy without delay. In this

²¹ Article 21.5 states, in relevant part:

"Where there is disagreement as to the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings such dispute shall be decided through recourse to these dispute settlement proceedings, including, wherever possible, resort to the original panel...".

regard, the panel shall specify in its recommendation the time period within which the measure must be withdrawn.²²

26. The Concise Oxford Dictionary defines "withdraw" to mean "discontinue, cancel, retract (*withdrew my support; the promise was later withdrawn*).²³ Thus the plain meaning of withdraw conveys as a minimum the notion of cessation (discontinuance) of the illegal subsidy.

27. This plain meaning of withdraw should be interpreted in the light of the context and object and purpose of the relevant provisions of the WTO Agreements. Article 19.1 of the DSU provides that "[w]here a panel or the Appellate Body concludes that a measure is inconsistent with a covered agreement, it shall recommend that the Member concerned bring the measure into conformity with that agreement." Withdrawal of the illegal subsidies, under Article 4.7 implies certainly no lesser obligation than to "bring into conformity" under Article 19.1 of the DSU.

28. A related contextual point is Article 3.2, which provides that: "A Member shall neither grant nor maintain subsidies referred to in paragraph 1." Withdrawal of a subsidy must therefore entail, at a minimum, ceasing to grant or maintain subsidies found to have been prohibited in accordance with the Article 3.1.

29. Accordingly, in the case at hand, Brazil's withdrawal of prohibited PROEX export subsidies must include, at a minimum, two actions:

first, it must cease to grant subsidies found to have been prohibited, in respect of commitments made before the date of compliance for regional aircraft exported after that date; and

second, Brazil must make the necessary modifications to the programme to eliminate export subsidies in respect of *future* commitments.

30. The obligation to withdraw without delay illegal export subsidies would be largely nullified if the rule did not apply to all exports after the date for compliance, including aircraft that had been contracted for under pre-existing government commitments. Such an outcome would result in possible prohibited export subsidies being granted in respect of some 700 Embraer regional aircraft²⁴ (undelivered firm orders and options) covered by commitments made by the Brazilian government prior to 18 November 1999.

31. The two actions referred to in paragraph 29 above constitute the only means by which Brazil could be found to have discontinued the granting of PROEX prohibited export subsidies and, accordingly, found to have withdrawn such subsidies in accordance with its obligation to implement the recommendations and rulings of the DSB.

IV. BRAZIL HAS NOT WITHDRAWN THE PROEX EXPORT SUBSIDY

32. In claiming to have implemented the DSB recommendations in this dispute, Brazil has cited as evidence three document.²⁵

(a) Provisional Measure 1892-32 of 22 October 1999;

²² Article 4.7 is a special or additional rule and procedure under Appendix 2 of the DSU.

²³ *The Concise Oxford Dictionary*, Ninth Edition, Della Thompson, ed. (Oxford: Clarendon Press, 1995), at 1609.

²⁴ Mara Lemos, "Brazil, Canada Trapped in Past Aircraft row", *op. cit.*

²⁵ Letter to the Chairman of the Dispute Settlement Body announcing Brazil's implementation. Sent by the Permanent Representation of Brazil to the United Nation, dated 19 November 1999. Documentary Annex 7.

- (b) Resolution 2.667 of 19 December 1999, which amends Resolution 2.576 of December 1998; and
- (c) Newsletter 2.881 of 19 November 1999 (the Newsletter).

The Provisional Measure of 22 October 1999 is the continuation of the chain of such measures that have maintained PROEX since July 1998. These measures do not bring the PROEX export subsidy programme into conformity with the SCM Agreement.

A. COMMITMENTS MADE BEFORE 18 NOVEMBER 1999

33. None of these documents appears on its face to apply to exports of undelivered regional aircraft pursuant to commitments made prior to 18 November 1999. Brazil has not claimed that it will not continue to grant the subsidies that were found illegal by issuing NTN-I bonds. Indeed, as stated above, Brazil has informed Canada that it has no intention of withdrawing PROEX export subsidies committed but not yet granted. It has not, therefore, withdrawn such subsidies found by the Panel to be prohibited under Article 3.1 of the SCM Agreement.

B. MEASURES TAKEN TO COMPLY IN RESPECT OF FUTURE COMMITMENTS

34. With respect to future commitments of the Government of Brazil, the Resolution and the Newsletter make two apparent modifications to the measures previously in effect. First, the Newsletter establishes a 2.5 percentage point interest rate buy-down for ten-year financing as opposed to an interest rate buy-down of 3.8 percentage points for financing periods that, in practice, were as long as fifteen years under the previous programme. Almost all regional aircraft financing is for terms of fifteen years or more. Accordingly the limit of 2.5 percentage points for ten-year terms does not appear, in practice, to be relevant for transactions involving regional aircraft. As under the previous programme, the Brazilian implementation measures enable the Committee to waive any of the conditions of the programme with respect to both the interest rate and the financing term. The sole effect of the Newsletter is to replace the former applied ceiling of 3.8 percentage point interest reduction subsidy with an apparent ceiling of 2.5 percentage points.²⁶ The Newsletter does nothing else.

35. Second, Resolution 2.667 modifies Resolution 2.576 to provide that, for exports of regional aircraft, "equalization rates shall be established on a case by case basis and at levels which may be differential, preferably based on the United States Treasury Bond 10-year rate, plus an additional spread of 0.2 per cent per annum." The Resolution calls for equalization rates to be set at a level aimed at achieving (but apparently not required to achieve) a net interest rate of 0.2 per cent (20 basis points) over the US Treasury Bond rate. This preferred rate is consistent neither with CIRR nor with the market.

²⁶ In its question 13 to the Parties the Panel asked: "Please explain the basis on which Brazil decided that the level of interest rate equalization pursuant to PROEX should be 3.8 percentage points." In its Reply, dated 4 December 1998, Brazil noted that the level had been established in 1995 "in response to representations of financial institutions concerning the level of Brazil risk." It noted that although a number of meetings had been held to determine whether the subsidy should be reduced, following the world financing crisis of 1997, "there was no need to alter the level of PROEX assistance from its current level of 3.8 percentage points." Brazil clearly identified the 3.8 percentage point buy-down as the level of assistance applicable to regional aircraft.

The Panel found in paragraph 2.3 of its Report: "The spread is fixed and does not vary depending on the lender's actual cost of funds."

36. The Provisional Measure and the new Resolution also refer to rates "compatible with ... the international market" or "in accordance with market practices". These references do not represent a change. Essentially the same concepts have been part of the governing rules and regulations of the previous PROEX programme.²⁷ Even the possibility that different subsidies will be granted for different transactions does not represent a change given that the Committee maintains its discretionary authority to waive the published conditions.

37. Thus, Brazil's modifications to the PROEX programme with respect to future commitments and aircraft deliveries that would benefit from subsidies granted under those commitments do not bring the programme into compliance with the SCM Agreement. Payments by the Brazilian National Treasury for the purpose of reducing the interest paid by a purchaser by 2.5 percentage points are financial contributions that confer a benefit and are, accordingly, subsidies within the meaning of Article 1 of the SCM Agreement.²⁸ As they are paid only upon the exportation of regional aircraft, these subsidies are contingent upon export performance and therefore continue to be prohibited under Article 3.1 of the SCM Agreement.

38. PROEX payments under the revised PROEX programme continue to be prohibited under Article 3.1 of the SCM Agreement and must be withdrawn in accordance with the recommendations of the DSB. Any granting of such subsidies by Brazil is a violation of Article 3.2 of the SCM Agreement and, therefore, would be inconsistent with Brazil's obligation under Article 4.7 of the Agreement.

V. TRANSPARENCY

39. To facilitate a definitive resolution of this dispute, Canada proposes the establishment of transparency provisions in respect of measures taken by Brazil to immediately bring its subsidies into compliance with the SCM Agreement in accordance with the original recommendations and rulings of the DSB. In this respect, Canada recalls Articles 3.3, 3.4 and 19 of the DSU.

²⁷ The Panel examined Provisional Measure 1700/15 of 30 June 1998 (Report of the Panel, *op. cit.*, at para. 2.1 and footnote 6). It states at Article 1 that:

"In financing operations using funds from the Special Public Credit Operations programme for the export of domestic goods and services, the National Treasury may establish financing charges that are the *consistent with practices on the international market. ...*"

It further states, at Article 2, that:

"In operations to finance the export of domestic goods and services not covered by the preceding article and in financing for the production of goods for export, the National Treasury may grant the financing entity *equalization funding sufficient to make the financing charges consistent with practices on the international market.*" (emphasis added)

²⁸ A grant by the National Treasury, by definition, is a financial contribution that, also by definition, is not available in the marketplace and therefore confers a benefit. See in particular *Canada – Measures Affecting the Export of Civilian Aircraft*, WT/DS70/AB/R, Report of the Appellate Body adopted on 20 August 1999, at para. 157:

"We also believe that the word 'benefit', as used in Article 1.1(b), implies some kind of comparison. This must be so, for there can be no benefit to the recipient unless the 'financial contribution' makes the recipient 'better off' than it would otherwise have been, absent that contribution. In our view, the marketplace provides an appropriate basis for comparison in determining whether a 'benefit' has been 'conferred', because the trade-distorting potential of a 'financial contribution' can be identified by determining whether the recipient has received a 'financial contribution' on terms more favourable than those available to the recipient in the market."

Since grants are not available in the marketplace, by definition they confer a benefit and constitute a subsidy when made by governments.

40. According to Article 3:

"3. The prompt settlement of situations in which a Member considers that any benefits accruing to it directly or indirectly under the covered agreements are being impaired by measures taken by another Member is essential to the effective functioning of the WTO and the maintenance of a proper balance between the rights and obligations of Members.

"4. Recommendations or rulings made by the DSB shall be aimed at achieving a satisfactory settlement of the matter in accordance with the rights and obligations under this Understanding and under the covered agreement."

41. Article 19.1 further provides that the Panel may suggest ways in which the Member concerned could implement the Panel's recommendations to bring its measures into conformity with the covered agreements.

42. In its submissions before the Panel in this case, Brazil claimed that the application of PROEX in the regional aerospace sector was designed to and did offset the alleged higher cost of financing Brazilian aircraft exports by bringing these costs into line with financing costs for regional aircraft in international financial markets. The Panel did not find this claim persuasive.

43. Resolution No. 2.667 of 19 December 1999, which Brazil claims to effect compliance with the Panel's recommendation to withdraw the subsidy, states that the National Treasury "may grant ...sufficient equalization credits to ensure that the relevant financial charges are consistent with standard practices on the international market." The same resolution then directs, however, that in the regional aerospace sector such "equalization rates" shall preferably be based on a rate – 10-year US Treasury Bonds plus 20 basis points – that is demonstrably not consistent with international market rates.

44. In the light of Brazil's previous and current characterization of PROEX's purpose and effect, a finding by this panel that Brazil is not in compliance and that it must withdraw its prohibited export subsidies immediately will be meaningful only if procedures are established that enable the verification of Brazil's withdrawal of the prohibited subsidies.

45. Canada also notes that Brazil has a reciprocal interest in verifying Canada's compliance in the parallel dispute, *Canada - Measures Affecting the Export of Civilian Aircraft*. For this reason, in consultations with Brazil on 16 and 19 November concerning implementation of the Panels' recommendations and rulings in the two cases, Canada proposed that the Parties establish transparency procedures that would enable each government to verify the compliance of the other with respect to specific transactions under the pertinent measures as revised in order to bring that Party into consistency with the SCM Agreement.

46. Canada remains ready to develop and implement such verification procedures on a reciprocal basis. Canada believes that it would be useful if the Panel were to suggest that the Parties develop such procedures, consistent with its authority under Article 19.1 of the DSU.

VI. RELIEF REQUESTED

47. In the light of the above considerations, Canada requests that the Panel find that Brazil has failed to withdraw its export subsidies with effect from 18 November 1999, with respect to all regional aircraft exported after that date whether PROEX interest equalization subsidies were committed on, after or before that date.

48. Canada further notes that a process for verification of compliance will be useful in order to avoid recurrent recourse to the DSU, including under Article 21.5. Accordingly Canada requests that the Panel suggest, in accordance with Article 19.1, that the Parties develop verification procedures so as to permit verification that future Brazilian financing of exported regional aircraft conforms with the SCM Agreement without the need for further recourse to the DSU.

LIST OF ANNEXES

Documentary Annex 1	Mara Lemos, "Brazil, Canada Trapped in Past Aircraft Row", Dow Jones International News, 11/29/99.
Documentary Annex 2	<i>Folha de Sao Paulo</i> , 25 November 1999 (3 December 1999).
Documentary Annex 3	Form 10-Q filing of Skywest Airlines before the US Securities and Exchange Commission for the quarter ending on 30 September 1999.
Documentary Annex 4	Provisional Measure No. 1892-33 of 23 November 1999.
Documentary Annex 5	Resolution No. 2.667 (19 December 1999)
Documentary Annex 6	Newsletter No. 2.881 (Newsletter)
Documentary Annex 7	Letter to the Chairman of the Dispute Settlement Body announcing Brazil's implementation. Sent by the Permanent Representation of Brazil to the United Nation, dated 19 November 1999.

ANNEX 1-2

REBUTTAL SUBMISSION OF CANADA

(17 January 2000)

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I. INTRODUCTION

1. In its First Article 21.5 Written Submission, Canada establishes that Brazil has failed to "withdraw" PROEX export subsidies by 18 November 1999, as required by the Reports of the Panel and the Appellate Body¹ in two ways. First, Brazil has not exhibited any intention, and indeed has confirmed that it has no intention, of ceasing to grant export subsidies pursuant to commitments made before 18 November 1999 in respect of regional aircraft delivered after that date. Second, it has not reformed the PROEX export subsidy programme in a manner that complies with the *Agreement on Subsidies and Countervailing Measures* (SCM Agreement). The PROEX programme, as applied to exports of Brazilian regional aircraft, continues to provide subsidies that are contingent upon export performance. The measures taken by Brazil do not bring PROEX into conformity with the SCM Agreement, and they do not amount to a "withdrawal" of the subsidies that the Panel and the Appellate Body determined were prohibited.

2. Brazil's submission addresses only some of Canada's arguments and refutes none of the evidence adduced by Canada. Most tellingly, Brazil says nothing at all with respect to subsidies on future deliveries of regional aircraft pursuant to commitments issued before 18 November 1999. Nor does Brazil deny that PROEX, as reformulated, continues to grant subsidies that are contingent upon export performance.

3. Instead of refuting Canada's submissions, Brazil implicitly admits them by resurrecting its defence of PROEX export subsidies on the basis of a purported *a contrario* exception in the first paragraph of Item (k) of Annex I of the SCM Agreement. It argues, but does not establish, that "PROEX as modified is not used to secure a material advantage in the field of export credit terms". On this basis, Brazil concludes that it has implemented the rulings and recommendations of the DSB in this case and brought the PROEX export subsidy programme, as applied to exports of Brazilian regional aircraft, into conformity with the SCM Agreement. Brazil makes this assertion without any attempt to establish the other two elements that must be demonstrated under the first paragraph of Item (k), as found by the Panel and confirmed by the Appellate Body. As the party advancing an affirmative defence, Brazil also bears the burden of demonstrating that the first paragraph of Item (k) gives rise to an *a contrario* exception, and that PROEX export subsidies are "payments" of the kind mentioned in that paragraph.

4. Brazil's submission is also silent on Canada's request for the establishment of transparency procedures to facilitate verification and implementation.

5. In the light of Brazil's failure to withdraw PROEX export subsidies, its adoption of measures that amount to less than full and good faith implementation of the rulings and recommendations of the DSB, and its failure to ensure that the matter is finally resolved, Canada requests that the Panel find that Brazil's measures are not in compliance with the recommendations and rulings of the DSB in that:

- **first**, Brazil continues to pay export subsidies committed on exports of regional aircraft but not yet granted as of 18 November 1999 ; and
- **second**, Brazil has failed to implement measures that would bring the PROEX export subsidy programme into conformity with the SCM Agreement because:
 - (a) PROEX payments continue to constitute prohibited export subsidies,

¹ The Dispute Settlement Body (DSB) adopted these Reports on 20 August 1999.

- (b) the first paragraph of Item (k) does not give rise to an *a contrario* exception, and
- (c) even if Item (k) were considered to give rise to an *a contrario* exception:
 - (i) PROEX export subsidies are not "payments" of the kind referred to in the first paragraph of Item (k); and
 - (ii) PROEX export subsidies under the revised programme will continue to "secure a material advantage" in the field of export credit terms.

6. Canada further requests that the Panel suggest that the Parties develop verification procedures so as to permit verification that future Brazilian financing of exported regional aircraft conforms with the SCM Agreement without the need for further recourse to the DSU.

II. BRAZIL MIS-STATES THE FINDINGS OF THE APPELLATE BODY

7. In its submission Brazil makes a number of assertions and draws certain conclusions about the findings of the Appellate Body that are either incorrect or misleading.

8. Brazil states, for example, that the Appellate Body noted that "Members are *permitted* to obtain an 'advantage' in the field of export credit terms, provided that advantage is not 'material'.² [emphasis added] It asserts that the "Appellate Body made clear that the 'marketplace' should provide the benchmark for determining whether PROEX is used to secure a material advantage.³ Brazil also argues that, according to the Appellate Body, "the appropriate reference for determining whether a material advantage is secured is the 'marketplace' and not a specific transaction.⁴ None of these statements is accurate.

9. First, the Appellate Body noted that:

"... we do not rule on whether the export subsidies for regional aircraft under PROEX are 'the payment by [governments] of all or part of the costs incurred by exporters or financial institutions in obtaining credits'. Nor do we opine on whether a 'payment' within the meaning of item (k) which is not 'used to secure a material advantage within the field of export credit terms' is, *a contrario*, 'permitted' by the *SCM Agreement*, even though it is a subsidy which is contingent upon export performance within the meaning of Article 3.1(a) of that Agreement."

10. The Appellate Body did not, therefore, in any way suggest what would be permitted by the first paragraph of Item (k). It merely determined what would be prohibited. And it made no finding about whether PROEX export subsidies even qualify as "payments" within the meaning of the first paragraph such that they could benefit from an exception if one existed.

11. Second, Brazil's description of the Appellate Body's benchmark for "material advantage"⁵ confuses the Panel's findings with that of the Appellate Body. The Appellate Body did not make "clear that the appropriate reference for determining whether a material advantage is secured is the 'marketplace'

² Brazil's Article 21.5 First Submission (Brazil's Submission), at para 4.

³ *Ibid.*, at para 25.

⁴ *Ibid.*, at para 4.

⁵ *Ibid.*

and not a specific transaction." Rather, in the paragraph cited by Brazil (para. 178) the Appellate Body was referring to the *Panel's* findings and not its own.

12. In contrast to what Brazil asserts, the Appellate Body determined that the "market" test of "benefit" in Article 1, and "material advantage in the field of export credit terms" in Item (k) should be given different meanings. To do so, the Appellate Body turned to the second paragraph of Item (k):

"... we see the second paragraph of item (k) as useful context for interpreting the 'material advantage' clause in the text of the first paragraph. The *OECD Arrangement* establishes minimum interest rate guidelines for export credits supported by its participants ('officially-supported export credits'). Article 15 of the Arrangement defines the minimum interest rates applicable to officially-supported export credits as the Commercial Interest Reference Rates ('CIRRs'). ... We believe that the *OECD Arrangement* can be appropriately viewed as one example of an international undertaking providing a specific market benchmark by which to assess whether payments by governments, coming within the provisions of item (k), are 'used to secure a material advantage in the field of export credit terms'. Therefore, in our view, the appropriate comparison to be made in determining whether a payment is 'used to secure a material advantage', within the meaning of item (k), is between the actual interest rate applicable in a particular export sales transaction after deduction of the government payment (the '*net* interest rate') and the relevant CIRR.

"It should be noted that the commercial interest rate with respect to a loan in any given currency varies according to the length of maturity as well as the creditworthiness of the borrower. Thus, a potential borrower is not faced with a single commercial interest rate, but rather with a range of rates. Under the *OECD Arrangement*, a CIRR is the *minimum* commercial rate available in that range for a particular currency. In any given case, whether or not a government payment is used to secure a '*material* advantage', as opposed to an 'advantage' that is not 'material', may well depend on where the *net* interest rate applicable to the particular transaction at issue in that case stands in relation to the range of commercial rates available. The fact that a particular *net* interest rate is below the relevant CIRR is a positive indication that the government payment in that case has been 'used to secure a material advantage in the field of export credit terms'.⁶

13. The Appellate Body did not, therefore, establish the "marketplace" as a legal benchmark against which it may be determined whether a particular payment or financing transaction "secures a material advantage". The Appellate Body recognized that "[i]n any given case, whether or not a government payment is used to secure a '*material* advantage', as opposed to an 'advantage' that is not 'material', may well depend on where the *net* interest rate applicable to the particular transaction at issue in that case stands in relation to the range of commercial rates available."⁷ It found that as a matter of evidence, a net interest rate below the applicable CIRR is a positive indication that material advantage has been secured.

14. Canada will demonstrate below that the evidence produced by Brazil fails to establish that PROEX export subsidies do not secure such a material advantage.

⁶ *Brazil – Export Financing Programme for Aircraft (Brazil – Aircraft)*, WT/DS46/AB/R, Report of the Appellate Body adopted on 20 August 1999, at para. 181-2.

⁷ *Ibid.*, at para. 182.

III. BRAZIL HAS NOT WITHDRAWN ITS EXPORT SUBSIDIES

A. BRAZIL MUST WITHDRAW PROEX EXPORT SUBSIDIES

15. Canada argued in its First Article 21.5 Written Submission that Brazil's withdrawal of prohibited PROEX export subsidies must include, at a minimum, two actions:

first, Brazil must cease to grant subsidies found to have been prohibited, in respect of commitments made before 18 November 1999 for regional aircraft exported after that date; and

second, Brazil must make the necessary modifications to the PROEX programme to eliminate export subsidies in respect of commitments made after 18 November 1999.

16. Canada further observed that the obligation to "withdraw without delay" illegal export subsidies would be largely nullified if the rule did not apply to all exports after 18 November 1999, including aircraft that had been contracted for under pre-existing government commitments. Accordingly, the two actions referred to above constitute the only means by which Brazil could be found to have discontinued the granting of PROEX prohibited export subsidies and found to have withdrawn such subsidies in accordance with its obligation to implement the recommendations and rulings of the DSB and thereby bring itself into compliance with the SCM Agreement.

17. Brazil has not challenged Canada's interpretation of what constitutes "withdrawal" of an illegal export subsidy.

B. BRAZIL'S CONDITIONAL COMMITMENTS GIVEN PRIOR TO 18 NOVEMBER 1999

18. In its First Article 21.5 Written Submission, Canada demonstrates that Brazil has not "withdrawn" PROEX export subsidies found to have been illegal by the Panel. Brazil has chosen not to respond to Canada's arguments in this regard. Brazil does not deny that it has no intention of withdrawing PROEX subsidies with respect to the exports of regional aircraft that have been or will be delivered after 18 November 1999 pursuant to commitments made before that date. It does not rebut Canada's evidence that deliveries under existing commitments continue to take place and that PROEX subsidies continue to be granted. And Brazil does not attempt to explain how it can continue to pay such export subsidies and be in compliance with the rulings and recommendations of the DSB.

19. As Canada pointed out⁸ the conditional commitments made by Brazil prior to 18 November 1999 cover a significant number of Embraer regional aircraft that would continue to benefit from illegal PROEX export subsidies in the absence of a clear finding on this issue.⁹

C. PROEX PAYMENTS UNDER THE MODIFIED PROGRAMME CONTINUE TO BE EXPORT SUBSIDIES

20. Nothing that Brazil has done changes the basic elements of PROEX. Except for a reduction of the interest rate buy-down subsidy from 3.8 to 2.5 percentage points (for certain transactions), and the concept

⁸ Canada's First Article 21.5 Written Submission, at para. 30.

⁹ Based on information reported in a newspaper article, Canada stated in its first Article 21.5 submission that the commitments prior to 18 November 1999 cover some 700 aircraft that have been or will be delivered after 18 November 1999. However, data from Back Information Services/Lundkvist Aviation Research indicate that, in fact, such commitments cover 969 aircraft. This data is set out in Exhibit CDN-8.

that payments would "preferably" result in a net interest rate 20 basis points above the 10-year US Treasury Bond rate, the elements remain the same. The payments are still grants to buy down commercial interest rates freely negotiated by the borrower. The programme is still administered by the Committee, which retains authority to waive all guidelines. PROEX payments are still being provided in the form of NTN-I bonds. The payments are made to reduce the interest paid by a purchaser. Such payments continue to be financial contributions that confer a benefit. As these subsidies are available only for exported products, they are export subsidies prohibited by Article 3.

D. BRAZIL'S "MODIFICATION" OF PROEX DOES NOT BRING IT WITHIN AN EXCEPTION

1. Burden of proof

21. As a party advancing an affirmative defence Brazil has the burden of establishing its case. This is uncontroversial. Brazil accepted that it had this burden in the course of the original proceedings. Without conceding that the first paragraph of Item (k) is capable of giving rise to an affirmative defence, Canada underlines that Brazil continues to bear the burden of establishing such a defence. In this respect, Canada recalls the findings of the Panel in paragraph 7.17 of the Report:

"In reviewing Brazil's item (k) defense, we note that in order for this Panel to rule in favour of Brazil we must find for Brazil on all of the following points. First, we must find that PROEX payments are the 'payment by [governments] of all or part of the costs incurred by exporters or financial institutions in obtaining credits' within the meaning of item (k). Second, we must find that PROEX payments are not 'used to secure a material advantage in the field of export credit terms' within the meaning of item (k). Finally, we must find that a 'payment' within the meaning of item (k) which is not 'used to secure a material advantage in the field of export credit terms' is 'permitted' by the SCM Agreement even though it is a subsidy within the meaning of Article 1 of the SCM Agreement which is contingent upon export performance within the meaning of Article 3.1(a) of that Agreement. If we were to find against Brazil on any of these points, Brazil's item (k) defense would fail. Finally, we note Brazil's explicit acknowledgement that 'its view of the "material advantage" clause is that it constitutes an affirmative defense and, therefore, the burden of establishing entitlement to it is on the challenged party.'"

22. These findings establish that Brazil has the burden of establishing its Item (k) defence. This defence has three elements, all of which must be established in favour of Brazil. Brazil did not appeal these findings, and the Appellate Body did not rule on them. The Appellate Body agreed that Brazil had the burden (as Brazil had conceded) of proving that PROEX export subsidies are not used to secure a material advantage and that it had not met its burden. Nothing in these proceedings relieves Brazil of this burden where, as in this case, Canada has put forward a *prima facie* case of non-compliance with the covered agreements.

2. PROEX payments do not benefit from an exception under the first paragraph of Item (k)

(a) The first paragraph of Item (k) does not give rise to an a contrario exception

23. Brazil makes assertions and draws certain conclusions about the findings of the Appellate Body that are either incorrect or misleading. It states that the Appellate Body noted that "Members are

permitted to obtain an 'advantage' in the field of export credit terms, provided that advantage is not 'material'.¹⁰ [emphasis added]

24. This statement is incorrect. In fact, the Appellate Body stated that:

"... we do not rule on whether the export subsidies for regional aircraft under PROEX are 'the payment by [governments] of all or part of the costs incurred by exporters or financial institutions in obtaining credits'. Nor do we opine on whether a 'payment' within the meaning of item (k) which is not 'used to secure a material advantage within the field of export credit terms' is, *a contrario*, 'permitted' by the *SCM Agreement*, even though it is a subsidy which is contingent upon export performance within the meaning of Article 3.1(a) of that Agreement."

25. Contrary to Brazil's assertion, the Appellate Body did not in any way suggest what would be permitted by the first paragraph of Item (k). It merely determined what would be prohibited. And it made no finding one way or another about whether PROEX export subsidies are indeed "payments" within the meaning of the first paragraph, even if such an exception existed therein. Both of these issues have yet to be determined by the Panel.

26. Canada has consistently argued that there is no *a contrario* exception in the first paragraph of Item (k). Item (k) is part of an "illustrative" list of export subsidies. Each specific item sets out a particular practice that, by its very nature, is considered an export subsidy and therefore prohibited by Article 3. Footnote 5 to Article 3 creates a limited exception for certain practices identified in the Annex as not constituting export subsidies. Neither the wording of footnote 5, nor the position of the Illustrative List suggests, let alone establishes, that an Item can give rise to an *a contrario* exception. Where a practice does not fit squarely within a specific Item, it simply means that a complainant must go through the process of establishing that Articles 1 and 3 apply. It does not mean that the practice in question is, by virtue of an *a contrario* implication, *permitted*. Canada also refers the Panel to its arguments on this issue that were presented in the original proceedings, which arguments continue to be relevant in all material respects.¹¹ Brazil has the burden of establishing its claim to an exception. It has not done so.

(b) PROEX export subsidies are not "payments" of the kind referred to in the first paragraph of Item (k)

27. Even if the Panel finds that Item (k) does give rise to an *a contrario* exception, Brazil must establish two other elements under the first paragraph. One of these is whether PROEX export subsidies fit within the terms of that paragraph. Canada has consistently argued that PROEX export subsidies do not constitute "payments" within the meaning of Item (k). PROEX export subsidies are available to purchasers, even when they finance their purchases outside Brazil and through non-Brazilian banks. In such instances, any "payments" by Brazil are not the coverage of the costs incurred by a financing institution or an exporter in "obtaining credits". Canada established in the original case that even where financing is offered by Brazilian financial institutions, PROEX payments are made to reduce interest rates below market rates, rather than to reimburse an exporter or a financing institution for costs incurred in "obtaining credits". Canada also refers the Panel to its arguments on this issue that were presented in the

¹⁰ Brazil's Submission, at para 4.

¹¹ Canada's Second Written Submission, *Brazil – Aircraft*, at paras. 38-60.

original proceedings, which arguments continue to be relevant in all material respects.¹² Brazil has the burden of establishing its claim to an exception. It has not done so.

(c) The PROEX programme secures a material advantage

28. Even if Brazil demonstrates that the first paragraph of Item (k) can give rise to an *a contrario* exception and that PROEX export subsidies are "payments" within the meaning of the first paragraph of Item (k), it must still establish that such payments do not secure a material advantage in the field of export credit terms. It has not done so.

29. **First**, nothing on the face of Brazil's measures would enable the revised PROEX programme to qualify for an exception, where the programme as challenged by Canada was found not to qualify. The Newsletter of 19 November 1999 establishes a 2.5 percentage point buy-down for ten-year financing as opposed to a previous interest rate buy-down of 3.8 percentage points for financing periods that, in practice, were as long as fifteen years. Even assuming that the 2.5 percentage point buy-down for ten-year transactions would be applicable to longer term financing transactions, a 2.5 percentage point interest rate buy-down that is contingent upon exportation is, at best, a smaller export subsidy than one of 3.8 percentage points. Such an export subsidy would still secure a material advantage in the field of export credit terms.

30. **Second**, Brazil's establishment of a preference for a net interest rate of 0.2 per cent [20 basis points] above the US 10-year Treasury Bond rate (which, even at that rate, is *preferable* only¹³ on its face demonstrates that PROEX export subsidies secure a material advantage in the field of export credit terms.

31. The Appellate Body found that, in any given case, whether or not a government payment is used to secure a "material advantage"¹⁴ may well depend on where the net interest rate applicable to a particular transaction at issue stands in relation to the range of commercial interest rates available.¹⁵ So as to avoid conflating "benefit" in Article 1 and "material advantage", the Appellate Body interpreted the phrase "field of export credit terms" in the first paragraph of Item (k) in the light of the provisions of the second paragraph. It recognized that the *OECD Arrangement* can be viewed as one example of an international undertaking of the type mentioned in the second paragraph of Item (k). The Appellate Body pointed out that the OECD's Commercial Interest Reference Rate (CIRR¹⁶ is, under the *OECD Arrangement*, the minimum commercial rate available in a range of available rates for a particular currency.¹⁷ Accordingly, the Appellate Body used the CIRR as a reference benchmark by which to assess whether payments by governments are used to secure a material advantage. The Appellate Body concluded that, as an evidentiary matter, a net interest rate below the relevant CIRR "is a positive indication that the government payment ... [at issue] has been 'used to secure a material advantage in the field of export credit terms'".¹⁸

¹² *Ibid.*, at para. 31 and Appendix III, and Canada's First Oral Submission, at paras. 75-77.

¹³ Resolution No. 2.667 (19 December 1999) of the National Monetary Board.

¹⁴ As opposed to an "advantage" that is not material.

¹⁵ *Brazil – Aircraft*, Report of the Appellate Body, at para. 182.

¹⁶ *Ibid.*, at paras. 181-2.

¹⁷ *Ibid.*

¹⁸ *Ibid.*, at para. 182.

32. Under the new PROEX programme, the Resolution establishes that PROEX export subsidies should result in financing "*preferably*" at a rate considerably below the applicable CIRR.¹⁹ It does not set a floor, contrary to Brazil's assertion "that *no* application for PROEX interest equalization support for regional aircraft *will be favourably considered unless* it reflects a net interest rate to the borrower equal to or more than the 10-year United States Treasury Bond ("*T-Bill*") plus 0.2 per cent per annum.²⁰ [emphasis added] Rather, it simply calls for a payment aimed at achieving – but not at all required to achieve – a net interest rate of 10-year US Treasury Bonds + 20 basis points.

33. A net interest rate of 20 basis points above the US 10-year Treasury Bond rate is well below CIRR.²¹ By establishing a preference for a rate below the applicable CIRR, Brazil has demonstrated a preference for securing advantage in the field of export credit terms. Indeed, the "preference" is not a floor as such for the desired interest rate and is therefore in no sense a limit on the amount of the export subsidy that may be granted under PROEX.

34. Thus, even if the first paragraph of Item (k) were considered to constitute an *a contrario* exception and even if PROEX export subsidies are considered "payments" within the meaning of that paragraph – points with which Canada does not agree – Brazil has not demonstrated that its revised system would meet the terms of that exception. In establishing a *preference* for financing resulting in a rate considerably below the CIRR, Brazil is flagrantly providing for continued use of export subsidies to secure a "material advantage" by any standard.

E. BRAZIL'S ARGUMENTS ABOUT LOAN GUARANTEES AND "MARKET WINDOW" ARE IRRELEVANT AND WITHOUT ANY MERIT

35. In its submission, Brazil presents two grounds to defend the PROEX subsidies. First, it compares the subsidies to loan guarantees offered by the United States Export Import (Ex-Im) Bank to China. Second, it makes a vague reference to "market window" operations of agencies such as Canada's Export Development Corporation (EDC). Neither ground has merit.

1. Loan guarantees

36. The transaction cited by Brazil is a simple US Ex-Im Bank loan guarantee under which the Government of the United States extends its own Sovereign credit risk to cover a percentage of the amount financed. In such circumstances, the lending bank establishes financing terms in the light of the risk of the US Government, not the borrower. Loan guarantees such as that transaction are fundamentally different from the direct export subsidies paid in the form of interest rate buy-downs under the PROEX programme.

¹⁹ US\$ CIRR for regional aircraft transactions would be the 7-year US Treasury Bond +100 bps. See "Commercial Interest Reference Rates" and "About CIRR Rates", <http://www.exim.gov/country/cntcirrc.html>, accessed 16 January 2000, Exhibit CDN-9. Brazil uses the 10-year Treasury Bond as its reference benchmark. While there is no simple formula to allow for the concordance of 7-year and 10-year Treasury Bond Rates, historically (at least since 1970), 10-year Treasury Bond rates have been between 3 bps to 30 bps above 7-year Treasury Bond rates. Thus, a preference for 10-year Treasury Bond+20 bps indicates a preference for a rate (7-year Treasury Bond+23-50 bps) that would be between 77 and 50 bps below the prevailing CIRR. See in particular *Federal Reserve Statistical Release H15 – Historical Data*, <http://www.federalreserve.gov/Releases/H15/data.htm>, accessed 16 January 2000, Exhibit CDN-10.

²⁰ Brazil's Submission, at para. 6.

²¹ Commercial Interest Reference Rates (CIRRs) which, for most Consensus Participants are set at a fixed margin of *100 basis points* above their respective base rates. See in particular *supra*, note 19.

37. **First**, Canada recalls the Panel's finding that "in its ordinary meaning, the field of export credit terms would refer to items directly related to export credits, such as interest rates, grace periods, transaction costs, maturities and the like."²² Although the Appellate Body modified the Panel's use of the market as the appropriate reference benchmark, the Appellate Body did not disagree with the Panel's definition of the term.

38. **Second**, Canada notes that Item (j) of Annex I sets out an example of a loan guarantee that would *ipso facto* be considered an export subsidy.²³ Although loan guarantees generally can be considered a form of export credit, for the specific purposes of the SCM Agreement, and in particular first paragraph of Item (k) and Item (j), loan guarantees are to be treated separately from direct financing. Indeed, the term "export credit" in the first phrase of the first paragraph of Item (k) *must* refer only to direct financing, given that loan guarantees are already covered in the previous Item. It would be incongruous if "export credit" in the first phrase of the first paragraph referred only to direct financing, but "export credit terms" in the same paragraph included loan guarantees.

39. Brazil's use of loan guarantees by US Ex-Im Bank indicates that the essence of its defence has changed little from the original proceedings. There, Brazil argued that PROEX export subsidies should be compared to domestic and other export subsidies allegedly offered by Canada. Now it argues that PROEX export subsidies to reduce interest rates for direct financing should be compared with a loan guarantee by the US Ex-Im Bank to China. The Panel rejected the first comparison as without any basis in logic or law. Canada submits that the Panel should reject this latest claim as well, for want of logic or of foundation in law.

40. **Third**, Brazil's comparison, even if it made sense in principle, is fundamentally flawed factually. Brazil's calculations and conversions are incorrect. A proper methodology would, for example, take into account, *inter alia*, the fact that LIBOR is a floating rate benchmark, while US Treasury Bonds are fixed rate reference benchmarks (to each of which, then, must be added a proper risk premium and transaction costs). Such a methodology would also take into account the fact that the 3 basis point spread above LIBOR in this instant is taken from a large aircraft transaction. In such transactions, spreads of less than 10 basis points are common, while spreads of less than 20-30 bps for regional aircraft would be unlikely. Indeed, proper calculation indicates that the preferred PROEX rate (10-year US Treasury Bonds+20 bps) would be well below the rate obtained *after* US Government guarantees are taken into account.²⁴ An

²² *Brazil – Aircraft*, Report of the Panel (WT/DS46/R, adopted on 20 August 1999), at para. 7.28.

²³ Canada, needless to say, does not in any way agree with Brazil's assertion that it *permits* loan guarantees that do not meet its terms. Indeed, if that were so, Item (j), which operates on cost to government basis, and Article 14, which sets out a market-based benchmark for determining whether there is a benefit in a loan guarantee, would be manifestly at odds with one another.

²⁴ Without complete details on the transaction in question, it is not possible for Canada to provide a definitive analysis of the transaction cited by Brazil. However, it is clear that Brazil's position that the net interest rate for the PROEX transaction is above the Ex-Im transaction (Brazil's Submission, at para. 7) is unsustainable.

First, Brazil converts the Ex-Im guarantee fee of 3.54 per cent into 30 basis points. The proper conversion yields is in the range of 75 basis points.

Second, the LIBOR rate of interest is a floating rate of interest. To compare this to a US Treasury Bond, which has a fixed interest rate, a "swap spread" currently in the range of 75-80 basis points must be added. (See attached Bloomberg Financial chart, dated 12 January 2000, Exhibit CDN-11.) Brazil did not account for this necessary conversion in its calculation.

Using these figures, the Table presented at paragraph 17 of Brazil's Submission would show a total interest rate for the Ex-Im transaction of 7.71 per cent compared to the PROEX transaction at 6.59. Moreover, if the low 3 basis point spread for large aircraft transactions is replaced with a proper 20-30 basis point spread for regional

export subsidy that brings down the interest paid by any purchaser to one below that would be paid by the Government of the United States in a specific transaction would "secure" a material advantage in the field of export credit terms.

41. Brazil's "loan guarantee" defence must, therefore, fail.

2. The Market Window

42. Brazil's second ground for justifying PROEX export subsidies under the alleged exception in the first paragraph of Item (k) is a vague reference to the "market window" operations of export credit agencies.

(a) Market window and the OECD Arrangement

43. "Market window" generally refers to circumstances where an export credit agency offers a recipient direct financing at terms comparable to those that the recipient would be able to obtain in the market. An export credit agency that steps through this "window" is operating similar to a private commercial bank, rather than as an *official* export credit agency.

44. Market window transactions are undertaken at prevailing market levels in the sense both of interest rate and of terms and conditions offered to the recipient. In this light, Brazil's reference to market window solely in the context of the cost of funds is misleading. As well, Brazil's implied reference to market window as indicating a range of possible rates against which PROEX export subsidized rates could be measured is incorrect. For the purposes of market window transactions, the appropriate reference is to terms available to a recipient in the market with respect to a particular transaction.

45. To the extent relevant, Brazil's letter from the Director General of the OECD establishes no more than the simple fact that market window operations are not inconsistent with the *OECD Arrangement*.

(b) Brazil confuses Canada's position on market window transactions

46. Brazil confuses several aspects of Canada's position before the panel in *Canada – Measures Affecting the Export of Civilian Aircraft*. In that case, Canada argued that in providing direct financing under its Corporate Account, the EDC "operates on the basis of commercial principles, and does not provide an advantage above and beyond the market."²⁵ The panel so found. That finding was upheld on appeal.

47. The EDC does not lend at below its cost of funds. The EDC does not make the payments referred to in the first paragraph of Item (k) of the SCM Agreement. The first paragraph of Item (k) is therefore not relevant to the market window operations of the EDC. For this reason, even if Canada had thought this paragraph provided an *a contrario* exception, it would not have, in the *Canada – Aircraft* case, sought the protection of such an exception.

aircraft, the total interest rate for the Ex-Im transaction would be 7.88-7.98 per cent. In other words, the PROEX transaction is well *below* the Ex-Im rate.

²⁵ Canada's First Written Submission, *Canada – Measures Affecting the Export of Civilian Aircraft*, at para. 163.

48. The EDC does not provide a subsidy under its Corporate Account, in the sense that in entering into financing transactions, it does not confer a benefit in accordance with the terms of Article 1 of the SCM Agreement.

(c) Brazil's arguments with respect to "market window" transactions are irrelevant and incorrect

49. Canada recalls the Panel's finding in paragraph 7.26 of its Report:

"Brazil's approach to 'material advantage' boils down to an argument that an admitted export subsidy should not be deemed to be prohibited if it can be demonstrated merely to offset some advantage or advantages available to the competing product of another Member. ... The Brazilian approach to item (k), however, would effectively allow a Member to raise the provision of export subsidies --or indeed of any subsidy -- by the complaining Member as a defense justifying its own provision of export subsidies."

50. In this instance, Brazil seeks to raise not the provision of subsidies, but the simple operation of the market (direct financing at market rates by export credit agencies, through the market window) as a justification for the granting of an admitted export subsidy. This argument is not tenable.

51. Canada notes that a rate of 10-year Treasury Bonds+20 bps is, under no circumstance, available to the purchasers of regional aircraft in direct financing offered at market rates.²⁶ It is telling that although Brazil relies on this ostensible benchmark, and although it has the burden of establishing its claim, it adduces no data in support of its position.

3. Brazil's examples are without merit and do not establish its affirmative defence

52. Where a Member lends at below its cost of funds, at rates below the CIRR, there is positive indication that a "material advantage" is being secured. Where a Member makes payments of the kind referred to in the first paragraph of Item (k) that would, in turn, bring down interest rates below the CIRR, there is positive indication that "material advantage" is being secured. Canada reiterates its view that PROEX export subsidies are not, in fact, "payments" of the kind referred to in the first paragraph of Item (k). The preferred interest rates of the PROEX export subsidy programme are well below CIRR. If, therefore, PROEX export subsidies were "payments" of the kind referred to in the first paragraph of Item (k), there is positive indication that such payments secure a material advantage in the field of export credit terms.

53. Brazil has not demonstrated the relevance of either of its two examples in the light of the findings of the Appellate Body. It has not shown that any interest rates derived from those examples would be appropriate benchmarks for the purposes of comparison with PROEX export subsidies. Brazil's data and calculations are incorrect in respect of one example and non-existent with respect to the other. Brazil,

²⁶ For example, British Airways, which is the best rated non-Sovereign airline, obtains rates of LIBOR + 30 to 40 bps for large aircraft deals (an additional 20-30 bps should be added for regional aircraft, even for clients with British Airways' credit rating). This translates (see *supra* note 24) to T+105-120 (+125-150 for regional aircraft). See Chart obtained from Captial DATA Loanware, Exhibit CDN-12. Indeed, AAA-rated industrials (and there are no airlines with this rating) cannot obtain credit at T + 20; AAA's tend to pay a spread of approximately 70 bps. See Bloomberg Professional industrial sector chart, accessed 14 and 16 December 1999, Exhibit CDN-13.

It would appear that the only borrower that could obtain rates at or below the PROEX preferred rate is the US Government, which pays, naturally, simply the Treasury rate.

which has the burden of establishing its entitlement to an affirmative defence, has failed to demonstrate that PROEX export subsidies do not secure a material advantage in the field of export credit terms.

IV. REQUESTED FINDINGS AND RECOMMENDATIONS

54. In the light of Brazil's failure to withdraw PROEX export subsidies and its adoption of measures that amount to less than full and good faith implementation of the rulings and recommendations of the DSB, Canada requests that the Panel find that Brazil's measures are not in compliance with the recommendations and rulings of the DSB in that:

- **first**, Brazil continues to pay export subsidies committed on exports of regional aircraft not yet granted as of November 18, 1999 ; and;
- **second**, Brazil has failed to implement measures that would bring the PROEX export subsidy programme into conformity with the SCM Agreement because:
 - (a) PROEX payments continue to constitute prohibited export subsidies,
 - (b) the first paragraph of Item (k) does not give rise to an *a contrario* exception,
 - (c) even if Item (k) were considered to give rise to an *a contrario* exception:
 - (i) PROEX export subsidies are not "payments" of the kind referred to in the first paragraph of Item (k); and
 - (ii) PROEX export subsidies under the revised programme will continue to "secure a material advantage" in the field of export credit terms.

55. Canada also requests that, so as to ensure that the matter is finally resolved, the Panel make a finding in respect of each of the elements of Brazil's purported Item (k) defence.

56. Canada further requests that the Panel suggest that the Parties develop verification procedures so as to permit verification that future Brazilian financing of exported regional aircraft conforms with the SCM Agreement without the need for further recourse to the DSU.

LIST OF ANNEXES

- Exhibit CDN-8 Back Information Services/Lundkvist Aviation Research
- Exhibit CDN-9 "Commercial Interest Reference Rates" and "About CIRR Rates"
- Exhibit CDN-10 <http://www.exim.gov/country/cntcirrc.html>, accessed 16 January 2000
Federal Reserve Statistical Release H15 – Historical Data
- <http://www.federalreserve.gov/Releases/H15/data.htm>, accessed
16 January 2000
- Exhibit CDN-11 Bloomberg Financial chart, dated 12 January 2000
- Exhibit CDN-12 British Airways borrowing rate, chart obtained from Captial DATA
Loanware
- Exhibit CDN-13 Bloomberg Professional industrial sector chart, accessed 14 and
16 December 1999.

ANNEX 1-3

ORAL STATEMENT OF CANADA

(3 February 2000)

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I. INTRODUCTION

[Mr. Hankey]

1. Mr. Chairman, distinguished Members of the Panel, distinguished members of the delegation of Brazil, it is an honour to appear before you in this proceeding under Article 21.5 of the DSU. On behalf of Canada, I want to express our appreciation for the time and attention that you continue to devote to the resolution of this dispute.

2. At issue in this proceeding is whether Brazil has complied with Articles 3.2 and 4.7 of the SCM Agreement and the recommendations of the DSB to withdraw its illegal PROEX export subsidies by 18 November 1999.

3. Canada respectfully submits that Brazil has not done so. It is continuing to grant interest equalization payments under PROEX in respect of regional aircraft that have been or will be delivered after 18 November 1999, pursuant to commitments made before that date. It has also failed to modify the PROEX programme in a way that withdraws the illegal subsidies promised after 18 November 1999. In fact, Brazil has indicated that it will continue to grant illegal PROEX export subsidies whenever Embraer regional aircraft are exported.

4. Because Brazil appears intent on rearguing issues that were decided by this Panel and the Appellate Body in the original proceedings, I want to underscore at the outset what this proceeding is *not* about. The Panel will recall its findings that PROEX interest equalization payments are subsidies within the meaning of Article 1 of the SCM Agreement that are contingent upon export performance within the meaning of Article 3.1(a). The Panel further found that the subsidies were not covered by any exceptions or affirmative defences under the SCM Agreement and that they were accordingly prohibited in accordance with Article 3. The Appellate Body upheld the appealed findings of the Panel.

5. The issue in this proceeding, therefore, is not whether PROEX interest equalization payments are subsidies under Article 1 and export subsidies under Article 3. The only issue is whether Brazil has complied with the recommendations and rulings of the DSB by withdrawing its illegal export subsidies.

6. Before turning to the specific legal issues and Brazil's contentions, I want to stress how crucial this proceeding under Article 21.5 of the DSU is, not only to the resolution of this dispute, but also to the operation of the WTO dispute settlement system more broadly. Canada believes that the dispute settlement system will live up to its promise only if it leads Members to bring their programmes and practices into conformity with their obligations without endless recourse to litigation before panels and the Appellate Body. We believe that the legal interpretations of the SCM Agreement provisions in the prior proceedings in this dispute have already substantially clarified the kinds of steps Brazil might take that would constitute withdrawal of its illegal subsidies. Canada now hopes that this Article 21.5 proceeding will lead to a definitive determination that Brazil has not complied with its obligations.

7. Finally, we note that to that same end of avoiding continuing resort to dispute settlement, Canada has proposed reciprocal transparency provisions to enable each Party – in this case and in the counter case brought by Brazil against Canada – to verify compliance of the other with regard to the specific applications of its measures. Canada is fully cognisant that panels and the Appellate Body may not add to or diminish rights and obligations provided in the WTO agreements. Hence in proposing these verification procedures, Canada does not in any way seek a continuing role or responsibility for the Panel; nor, certainly, does it seek to have the Panel impose transparency requirements. Rather, in purely practical terms, Canada sees reciprocal transparency as a means of bilateral compliance oversight that

might obviate continued recourse to the DSU. In that context, Canada continues to hope that the Panel will endorse its transparency proposal as a potentially helpful incentive for adherence to WTO obligations.

8. Mr. Chairman, I will now turn to Brazil's failure to withdraw its illegal PROEX subsidies in respect of the export of regional aircraft exported after 18 November 1999 pursuant to letters of commitment issued before that date, and to Brazil's arguments in that regard. My colleague, Mr. Rambod Behboodi, will then address the failure of Brazil's revised measures to bring the PROEX programme into conformity with the SCM Agreement and the recommendations of the DSB.

II. BRAZIL MUST CEASE GRANTING PROEX EXPORT SUBSIDIES CONDITIONALLY COMMITTED PRIOR TO 18 NOVEMBER 1999

9. Mr. Chairman, distinguished Members of the Panel, Canada respectfully submits that Brazil has failed to "withdraw" PROEX under commitments issued before 18 November 1999 because it continues to grant NTN-I bonds on newly delivered aircraft in accordance with the terms of those commitments. My argument in support of this position can be summarized in the following five points:

first, Brazil must cease granting illegal PROEX export subsidies;

second, the issue of whether a subsidy is deemed to "exist" under Article 1 of the SCM Agreement is legally distinct from the issue of when a subsidy is "granted" under Article 3.2;

third, illegal PROEX export subsidies are "granted" when the NTN-I bonds are issued;

fourth, Brazil proposes to continue granting illegal PROEX export subsidies under letters of commitment issued before November 18, 1999; and

fifth, the requirement to cease granting PROEX does not amount to a retroactive remedy.

A. BRAZIL MUST CEASE GRANTING ILLEGAL PROEX EXPORT SUBSIDIES

10. Mr. Chairman, my first point is simply that Brazil must cease granting illegal PROEX export subsidies in order to comply with the recommendations and rulings of the DSB. The Panel and the Appellate Body have already determined that PROEX constitutes a subsidy within the meaning of Article 1 of the SCM Agreement. The Panel and the Appellate Body have also determined that PROEX is a prohibited subsidy within the meaning of Article 3.1(a). The DSB recommended and ruled, in accordance with Article 4.7, that Brazil must withdraw the illegal PROEX export subsidies by 18 November 1999.

11. At a minimum, to comply with the recommendation to "withdraw" the illegal PROEX export subsidies in accordance with Article 4.7 of the SCM Agreement, Brazil must abide by the prohibition set out in Article 3.2. The purpose of Article 4.7 is to ensure that the subsidizing member brings itself into compliance with the prohibition in Article 3.2.

12. Article 3.2 prohibits the granting or maintaining of export contingent subsidies in language that is quite clear: "[a] Member shall neither grant nor maintain subsidies referred to in paragraph 1." To comply with the prohibition in Article 3.2, Brazil must cease granting the illegal PROEX export subsidies.

13. The language of Articles 4.7 and 3.2 of the SCM Agreement does not leave any room for debate. The DSB recommended that Brazil withdraw the illegal PROEX export subsidies by November 18, 1999. To comply with the DSB's recommendation, Brazil must cease granting the illegal PROEX export subsidies after that date.

B. THE ISSUE OF WHETHER A SUBSIDY "EXISTS" IS LEGALLY DISTINCT FROM THE ISSUE OF WHEN A SUBSIDY IS "GRANTED"

14. Mr. Chairman, my second point addresses the relationship between Articles 1 and 3.2 of the SCM Agreement. Brazil appears to take the position that it has already complied with the DSB's recommendation in respect of the illegal PROEX export subsidies because there is nothing left to "withdraw". The illegal PROEX export subsidies already "exist" and, therefore, cannot be "withdrawn" on a prospective basis. In support of its position, Brazil provided an exhaustive analysis of Article 1 in its second written submission to this Panel.

15. Article 1 is important. It sets forth the test to determine whether a subsidy is deemed to "exist", and, thereby, sets the stage for a determination whether the subsidy is prohibited under Article 3.1(a). However, the Article 1 analysis is not relevant to these proceedings.

16. As I stated earlier, the issue before this Panel is not whether PROEX is deemed to be a subsidy in accordance with Article 1, or whether PROEX is export contingent under Article 3.1(a). Illegal PROEX export subsidies "exist" within the meaning of Article 1 of the Agreement. They are prohibited because they are contingent upon export within the meaning of Article 3.1(a) of the SCM Agreement.

17. The only issue is whether Brazil has withdrawn its illegal PROEX export subsidies by ceasing to "grant" such subsidies pursuant to its obligation under Article 3.2. In its review of this Panel's finding that the illegal PROEX export subsidies were granted at the moment the NTN-I bonds were issued, the Appellate Body stressed that the issue of the "existence" of a subsidy, and the issue of the time at which the subsidy is "granted" are two legally distinct issues. The Appellate Body certainly agreed with the Panel that, for the purpose of Article 27.4, PROEX is granted when the NTN-I bonds are issued. However, it also stressed that the Article 1 issues of "financial contribution" and "benefit" are to be taken together to determine whether a subsidy "exists", not when a subsidy is granted.²⁷

18. In its second written submission in these proceedings, Brazil correctly observed that the Appellate Body had found that PROEX is granted when "all legal conditions have been fulfilled that entitled the beneficiary to receive the subsidies." Not surprisingly, Brazil failed to note that the Appellate Body also shared "the Panel's view that such unconditional legal right exists when the NTN-I bonds are issued", not before.²⁸ Brazil skirts this finding because it has chosen to reargue the position it advanced before the Appellate Body on the issue of when the illegal PROEX export subsidies are granted. Brazil's arguments that the illegal PROEX export subsidies are granted when the letters of commitment are issued failed before the Appellate Body. Brazil's arguments about the moment when the illegal PROEX export subsidies are granted should also fail in these proceedings.

C. PROEX IS GRANTED AT THE MOMENT THE NTN-I BONDS ARE ISSUED

19. This brings me to my third point, Mr. Chairman, which is that PROEX is granted for the purposes of Article 3.2 when the NTN-I bonds are issued. The Panel and the Appellate Body have already

²⁷ Report of the Appellate Body at para. 157.

²⁸ *Ibid.*, at para. 158.

determined that, for the purpose of Article 27.4, PROEX is granted when the NTN-I bonds are issued. Brazil has suggested no logical, legal or factual basis for the assertion that this issue should be analysed differently for the purposes of Articles 3.2 and 27.4. Indeed, there is no basis for Brazil's assertion. The finding of the Appellate Body should be applied to the analysis of when a subsidy is granted for the purposes of Article 3.2.

20. Articles 3.2 and 27.4 both deal with the prohibition of export subsidies. Both establish a time frame for the withdrawal of prohibited export subsidies. Article 3.2 requires a Member to cease granting prohibited export subsidies immediately. In recognition of the important role that subsidies play in the economic development programmes of developing country Members, Article 27.4 provides that a developing country Member must phase-out the grant of prohibited export subsidies and cease granting such subsidies by the end of the phase-out period. If those conditions are met, the prohibition in Article 3.2 does not apply.

21. Brazil ceased to benefit from the special treatment afforded by Article 27.4 because it was determined that it had increased the level of the export subsidies that it had granted during the phase-out period. In order to make that determination, the Panel and the Appellate Body first had to determine when illegal PROEX export subsidies are granted.

22. Both Articles 3.2 and 27.4 of the SCM invite a determination of when a prohibited export subsidy is granted. The word "grant" is not used in Article 27.4, but two derivatives thereof, "granting" and "granted", are used in footnote 55 to Article 27.4. Footnote 55 reads as follows: "For a developing country Member not granting export subsidies as of the date of entry into force of the WTO Agreement, this paragraph shall apply on the basis of the level of export subsidies granted in 1986." Article 3.2 provides that a Member shall not "grant" prohibited export subsidies. The only way to determine whether a Member is in compliance with its obligations under Article 27.4 or Article 3 is to first determine when the prohibited export subsidy is granted.

23. The term "grant" should be interpreted in the same manner for both Article 27.4 and 3.2. There is nothing in the analysis of the Appellate Body that would indicate that the time when a subsidy is granted for the purposes of Article 27.4 should be different for the purpose of Article 3.2. There is nothing in the spirit or context of the SCM Agreement that would indicate that the term "grant" should be interpreted differently for the two Articles. On the contrary, the term "grant" is used in the same manner in similar types of provisions in the same agreement. It should, therefore, be interpreted and applied to the same set of facts in the same way.

24. Since PROEX is granted when the NTN-I bonds are issued, in order to comply with the prohibition in Article 3.2 of the SCM Agreement, Brazil must cease issuing NTN-I bonds on the export of regional aircraft pursuant to letters of commitment issued before 18 November 1999.

D. BRAZIL PROPOSES TO CONTINUE GRANTING ILLEGAL PROEX EXPORT SUBSIDIES UNDER LETTERS OF COMMITMENT ISSUED BEFORE 18 NOVEMBER 1999

25. Mr. Chairman, Brazil has not done so. Brazil has taken no measures to withdraw illegal PROEX export subsidies committed before 18 November 1999 on exports of regional aircraft scheduled for delivery after that date. On the contrary, Brazil has indicated that it intends to continue granting illegal PROEX export subsidies on each regional aircraft this is exported so long as the letter of commitment was issued before 18 November 1999.

26. Far from complying with the recommendations and rulings of the DSB, Brazil consistently declares that it will honour its obligations under the letters of commitment issued before 18 November 1999, and continue issuing NTN-I bonds after that date.

27. Canada first requested consultations in accordance with Article 4.1 of the SCM Agreement on 18 June 1996. During the consultations and negotiations that took place in the following two years – that is, before this Panel was established – Brazil issued letters of commitment to provide illegal PROEX export subsidies in respect of approximately 298 orders for Embraer aircraft that have yet to be delivered or exported.

28. This Panel was established to determine whether PROEX interest rate equalization was prohibited under Article 3 on 23 July 1998. During the proceedings before this Panel and up to the date that the Panel issued its report, Brazil issued letters of commitment to provide illegal PROEX export subsidies in respect of approximately 259 additional orders for Embraer aircraft that have yet to be delivered or exported.

29. This Panel found that PROEX interest rate equalization was prohibited under Article 3 of the SCM Agreement in its report circulated on 14 April 1999. Since that date -- and before the deadline by which the DSB recommended that Brazil withdraw the illegal PROEX export subsidies -- Brazil has issued letters of commitment to provide illegal PROEX export subsidies in respect of approximately 312 more orders for Embraer aircraft that have yet to be delivered or exported.

30. Our numbers are estimates. But the actual numbers of Embraer aircraft that are yet to be exported under letters of commitment issued prior to 18 November 1999 is irrelevant to the determination that Brazil is not in compliance with its obligations under Article 3.2 of the SCM Agreement. Whether a single Embraer aircraft or 869 Embraer aircraft are exported, Brazil is prohibited under Article 3.2 from granting NTN-I bonds after November 18, 1999 pursuant to letters of commitment issued prior to that date.

E. THE OBLIGATION TO CEASE GRANTING NTN-I BONDS PURSUANT TO LETTERS OF COMMITMENT ISSUED BEFORE 18 NOVEMBER 1999 DOES NOT RESULT IN THE IMPOSITION OF A RETROACTIVE REMEDY

31. Mr. Chairman, I now turn to Brazil's arguments concerning retroactivity. Whether retroactive remedies are prohibited under the SCM Agreement is not before this Panel because the finding requested by Canada does not result in the imposition of a retroactive remedy. Brazil's assertions about a retroactive remedy are based entirely on its confusion about the issues of whether a subsidy "exists" and when a subsidy is "granted". Canada is not requesting that Brazil terminate its obligations in respect of any of the NTN-I bonds issued prior to 18 November 1999. Canada is requesting only that Brazil cease issuing NTN-I bonds on a prospective basis, that is, after 18 November 1999.

32. Brazil argues that it must be allowed to meet its commitments to issue the NTN-I bonds pursuant to letters of commitment issued on or before 18 November 1999. As emotionally engaging as Brazil's arguments about its liability for damages may be, Brazil cannot be allowed to contract out of its international obligations. No one can have legitimate expectations regarding subsidies that are prohibited by the SCM Agreement. In its third-party written submission to this Panel, the United States correctly points out that it is the rare case when the economic position of private parties is *not* disrupted by the recommendations and rulings of the DSB that a prohibited export subsidy be withdrawn. As recognized by Appellate Body Member Beeby in *Indonesia -- Certain Measures Affecting the Automobile Industry*, "[i]n virtually every case in which a measure has been found to be inconsistent with a Member's

obligations under the GATT 1994 or any other covered agreement, and therefore, must be brought into conformity with that agreement, some degree of adjustment by the domestic industry of the Member concerned will be necessary.²⁹

33. If the position put forward by Brazil were accepted, it would eviscerate the WTO dispute settlement system as a vehicle for sanctioning prohibited export subsidies. A subsidizing Member could simply grant contingent legal rights to receive prohibited export subsidies, as Brazil has done. In the event of a challenge, the subsidizing Member could then argue that the prohibited export subsidies had already been granted: i.e., the prohibited export subsidies were "granted" at the moment the subsidizing Member conditionally obligated itself to grant the prohibited export subsidies, not when the prohibited export subsidies were actually granted.

34. Canada respectfully submits, therefore, that the Panel reject Brazil's argument that it be allowed to continue to issue NTN-I bonds in respect of letters of commitment issued before 18 November 1999. Mr. Chairman, members of the Panel, WTO Members cannot be allowed to contract out of their WTO obligations. To rule otherwise would render the prohibition on export subsidies in Part II of the SCM Agreement a nullity.

35. That completes my statement this morning. With your submission, Sirs, I will ask Mr. Behboodi to continue this presentation on behalf of Canada.

III. BRAZIL HAS NOT BROUGHT PROEX INTO CONFORMITY WITH THE SCM AGREEMENT

[Mr. Behboodi]

36. Mr. Chairman, Members of the Panel, it is indeed an honour to appear before you again.

37. The second issue before you today is whether Brazil has complied with the rulings and recommendations of the DSB in respect of letters of commitment to be issued after 18 November 1999.

38. But before I discuss the legal questions involved in this aspect of the dispute, we wish to underline the enormous economic impact that Brazil's continued illegal subsidization has on the regional aircraft market. We note, in particular, a report issued only last Friday about Embraer's fourth largest sale of regional aircraft, potentially worth about US\$1.7 billion, to Mesa Airline.³⁰

39. Mesa Airline, you will recall, was a major beneficiary of PROEX export subsidies under the old regime.³¹ It is our understanding that all sales by Embraer, including this one to Mesa Airline, continue to benefit from PROEX subsidies. The Panel may wish to inform itself further about the particulars of this deal.

40. Mr. Chairman, while Canada is here again challenging PROEX, Embraer is busy making subsidized sales to its old subsidized customers. We are here to ask you to put a stop to this patent flouting of the international law of trade, to ensure that lawlessness will not win the day.

41. I now turn to the legal issues.

²⁹ WT/DS54/15, Award of the Arbitrator under Article 21.3(c) issued 7 December 1998, para. 25.

³⁰ *Folha de São Paulo*, 28 January 2000.

³¹ Canada's First Written Submission, at para. 56.

42. Brazil claims to have met its obligation to "withdraw" PROEX export subsidies. It argues that certain administrative steps will cause PROEX payments under future commitments to fall within the terms of what Brazil assumes to be an *a contrario* exception in the first paragraph of Item (k) of the Illustrative List of Export Subsidies.

43. Brazil does not deny that PROEX payments under the reformulated programme will continue to constitute subsidies within the meaning of Article 1 of the SCM Agreement. It does not deny that these subsidies will continue to be contingent upon export performance within the meaning of Article 3 of the SCM Agreement.

44. Brazil argues, however, that PROEX payments now "preferably" will result in a net interest rate equal to 10-year US Treasury Bonds plus 20 basis points for a purchaser of Brazilian aircraft. It asserts that because of this "preferred" rate, PROEX export subsidies do not "secure a material advantage in the field of export credit terms." Brazil rests its claim on the example of a loan guarantee to China by the US Export-Import Bank, and also on the "market window" export credit practices of participants in the *OECD Arrangement*.

45. Brazil then asserts that PROEX export subsidies with this resulting net interest are "permitted" under the first paragraph of Item (k) of the Illustrative List of Export Subsidies.

46. Brazil's defence, Mr. Chairman, has no merit. The measures Brazil has taken – that is, the Resolution 2667 and Newsletter 2881 – do not bring the PROEX export subsidy programme into compliance with the SCM Agreement.

47. Brazil seeks refuge in an exception that does not exist and whose terms Brazil would not have met if it did exist. As this Panel noted when Brazil claimed in the original proceeding an *a contrario* exception under the first paragraph of item K, Brazil would have to demonstrate each of three elements in order to succeed with such as defence:

first, Brazil must show that the first paragraph of Item (k) of the Illustrative List creates an *a contrario* exception, notwithstanding that this is an illustrative list;

second, even if there were an exception by *a contrario* implication, Brazil must show that PROEX export subsidies are "export credits" or "payments" of the kind referred to in the first paragraph; and

third, even if Brazil were able to show each of the first two elements, Brazil would bear the burden of demonstrating that the payments do not secure a material advantage in the field of export credit terms.

48. Brazil bears the burden of proving each of these elements of a claimed affirmative defence. Brazil has not even attempted to demonstrate the first two elements. And the steps it has taken with respect to the third are manifestly insufficient according to the findings of the Panel, as modified by the Appellate Body.

A. BRAZIL'S A CONTRARIO DEFENCE HAS NO MERIT

49. You will recall that in the original proceedings, Canada extensively argued the first two points; we do not propose to retread this familiar ground here. Instead we refer the Panel to arguments set out in

Canada's Second Written Submission and the Panel's own comments in footnotes 197 and 198 of its Report.

50. I should, however, like to make three observations in this respect.

51. The first is to bring to your attention to Brazil's erroneous statement about the findings of the Appellate Body in respect of the first paragraph of Item (k), and Brazil's generally incorrect conclusions about Annex I. In paragraph 4 of its First Article 21.5 Written Submission, Brazil states, "The Appellate Body, noted, however that Members are permitted to obtain an 'advantage' in the field of export credit terms, provided that advantage is not 'material'."

52. The Appellate Body did not note, or even suggest, any such thing. The Appellate Body simply stated that "item (k) does not *refer* simply to 'advantage'. The word 'advantage' is qualified by the adjective 'material'."³² These are the words of the Appellate Body. They noted a *reference* in Item (k), not a *permission*.

53. In fact, contrary to what Brazil alleges, in paragraph 187 of its Report the Appellate Body unambiguously declined to rule on this issue.³³ Brazil is thus wrong to assert that the Appellate Body found Item (k) to permit the securing of an advantage that is not material.

54. This leads me to the second observation: Brazil has ignored your findings that each of three elements must be established before an *a contrario* defence under Item (k) first paragraph prevails. Your determination was manifestly correct and Brazil did not appeal it.³⁴

55. Nevertheless, Brazil ignores that it has the burden of establishing its claim to this defence. It has the burden of proving that PROEX export subsidies are "payments" of the kind referred to in Item (k) first paragraph. It must convince you that Item (k) first paragraph gives rise to an *a contrario* exception.

56. Mr. Chairman, Members of the Panel, you have already indicated your scepticism about both points. You determined, nevertheless, that it was not necessary to decide whether Brazil could meet either of the first two elements required for its defence.

57. The Panel could again find that it does not need to rule on the first two elements because Brazil does not meet the third element (material advantage). But, in the interests of resolving this issue, Canada respectfully asks you to make a finding in respect of all of these issues. Otherwise, instead of reforming PROEX to bring it within the disciplines of the SCM Agreement, Brazil will continue to grant illegal export subsidies with small adjustments based on the claim that there is an *a contrario* exception to be found somewhere in the first paragraph of Item (k).

58. My third observation has to do with the scope of any "exception" the Panel might find *a contrario* in Item (k) first paragraph. For, it is not any and all export subsidies that would benefit from any such

³² Report of the Appellate Body, at para 177.

³³ As the Appellate Body stated:

"Nor do we opine on whether a 'payment' within the meaning of item (k) which is not 'used to secure a material advantage within the field of export credit terms' is, *a contrario*, 'permitted' by the *SCM Agreement*, even though it is a subsidy which is contingent upon export performance within the meaning of Article 3.1(a) of that Agreement."

³⁴ *Ibid.*, at para. 187.

exception. The first paragraph of Item (k) specifically relates to only two types of practices to which the so-called "material advantage" clause would apply:

first, export credits provided by governments below their own cost of funds;

second, payments made to cover "the costs incurred by exporters or financial institutions in obtaining credits".

59. Thus, if there is an exception under the first paragraph of Item (k), it does not apply to interest rate buy-down export subsidies. It does not apply to subsidies that cover the cost of loan guarantees, residual value guarantees, "opportunity costs" related to money placed in escrow, or other such costs. And, self-evidently, PROEX export subsidies do not pay the costs of financial institutions or exporters in obtaining credits.

60. The reason, Mr. Chairman, can be found in the very structure of the Item (k) in which Brazil seeks to find an *a contrario* exception. Canada submits that the "payments" referred to in the second part of the first paragraph must be viewed in the light of the first part. That is, both cases relate to granting export credits at below the lender's cost of funds. The first part describes the situation in which a government incurs a cost by granting export credits at rates below its own borrowing cost; the second, where the government covers the same costs incurred by a financial institution or an exporter.

61. If, therefore, the Panel considers that Item (k) first paragraph gives rise to an *a contrario* exception, the Panel should also recognize that any such exception is narrow. Only those subsidies that fit within the specific circumstances described in the first two parts of the first paragraph could benefit from such an exception, if they did not secure a material advantage. And PROEX export subsidies do not fit within this exception. We ask that the Panel also find that PROEX payments are not "payments" of the type that would fit within the first paragraph of Item (k), even if they did not secure a material advantage.

62. Before turning to material advantage we note that Brazil's failure to establish – even argue – the other elements of its claim to an exception ought to be conclusive in Canada's favour. Indeed, a Panel finding that Brazil is not entitled to an exception under the first paragraph of Item (k) would considerably clarify Brazil's rights and obligations under the SCM Agreement and, in Canada's submission, be an important step towards finally settling this dispute.

63. Mr. Chairman, in concluding this section of our presentation, I should like to assure you that the Panel's scepticism about the validity of Brazil's reliance on Item (k) was and continues to be well-justified.

64. Last summer, in the midst of the appellate process, Brazil offered PROEX subsidies on the sale of Embraer regional aircraft to Crossair, a subsidiary of Swiss Air, Alitalia, and KLM Excell, a subsidiary of Royal Dutch Airlines. It strains credulity to argue that some of the most profitable airlines in the world, operating out of some of the richest countries in the world and major centres of international financing, needed half-a billion dollars to "equalize" their borrowing rates.

65. No amount of linguistic agility would fit such a subsidy into an *a contrario* exception in the first paragraph of Item (k).

B. PROEX EXPORT SUBSIDIES DO INDEED SECURE A MATERIAL ADVANTAGE IN THE FIELD OF EXPORT CREDIT TERMS

66. Even if Brazil did not fail the required elements of a defence that Brazil simply and wrongly assumes in these proceedings, Brazil's defence would still fail because PROEX subsidies are designed systematically to secure a material advantage in the field of export credit terms. Although it is not required to do so as it does not bear the burden of proof, Canada will establish that PROEX export subsidies do in fact secure a material advantage in the field of export credit terms within the meaning of the first paragraph of Item (k). Thus, Brazil's affirmative defence would still fail even if Brazil had established that it met the first two requirements of Item (k).

1. The findings of the Panel and the Appellate Body

67. I propose first to briefly discuss the findings of the Appellate Body and the Panel in the original proceedings. The most salient features of the PROEX export subsidy programme as challenged by Canada were the following.

first, for sales of regional aircraft, PROEX interest rate equalization subsidies amounted to 3.8 percentage points of the actual interest rate on any particular transaction;

second, the lending bank charged its normal interest rate for the transaction, and received a payment from two sources: the purchaser, and the Government of Brazil;

third, of the total interest payments, the Government of Brazil paid 3.8 percentage points, and the purchaser paid the rest;

fourth, in this way, PROEX subsidies reduced the financing costs of the purchaser and, thus, reduced the overall cost to the purchaser of purchasing an Embraer aircraft; and

fifth, the subsidies were available to purchasers that obtained their financing at prevailing international commercial rates, even where the lender was a non-Brazilian financial institution, even where the financing was guaranteed by large non-Brazilian manufacturers.

68. The Panel determined that such payments constituted subsidies contingent upon export performance. The Appellate Body confirmed this finding. The Panel and the Appellate Body also found, although on different grounds, that these export subsidies secured a material advantage in the field of export credit terms. The Panel considered that the benchmark was the marketplace: whether the purchaser benefited relative to what it could otherwise have obtained on the market in respect of the specific transaction. PROEX export subsidies did not meet that test. The Appellate Body modified that finding and considered that:

"the fact that a particular *net* interest rate is below the relevant CIRR is a positive indication that the government payment in that case has been 'used to secure a material advantage in the field of export credit terms'.³⁵

³⁵ Para. 182.

2. What are Brazil's "measures to comply"

69. I now turn to the measures that Brazil claims constitute "compliance" on the theory that they do not obtain a "material advantage in the field of export credit terms." Under Resolution 2667,

"no application for PROEX interest equalization support for regional aircraft will be favorably considered unless it reflects a net interest rate to the borrower equal to or more than the 10-year United States Treasury Bond ('T-bill') plus 0.2 percent per annum. ... While the use of the T-bill as the benchmark is preferred, the authorities retain the authority to utilize LIBOR as an alternative reference point in appropriate market circumstances".

70. Canada has pointed out and Brazil has not contested that the impact of PROEX may well be to drive the net interest rate below the "preferred" rate. In **Chart 1**, we have taken the "preferred rate" and compared it with the prevailing CIRR over the last ten year. You will notice that the "preferred rate" would have been consistently below the prevailing CIRR. Based on this historical information, we could project that the "preferred rate" will, in the future, be below the prevailing CIRR.

3. The claim of an item(k) first paragraph exception

71. Brazil does not claim that PROEX is not an export subsidy. Rather, it claims the benefit of an exception to the prohibition in Article 3. It argues that PROEX export subsidies amounting to an interest buy-down of 2.5 percentage points for the benefit of the purchaser do not secure a material advantage in the field of export credit terms.

72. Even if it had disposed of its other burdens as noted above, Brazil has the burden of establishing this defence. That is, it must establish that the impact of PROEX export subsidies is not to reduce the *net* interest paid by a recipient in a financing transaction below an applicable benchmark. This much is not controversial.

(a) Brazil's erroneous claims and assertions

73. While acknowledging that there must a benchmark, Brazil misstates or simply ignored the Appellate Body's findings and determinations in respect of the applicable benchmark.

74. **First**, Brazil asserts that the Appellate Body "also made clear that the appropriate reference for determining whether a material advantage is secured is the 'marketplace' and not a specific transaction." Brazil refers in its footnotes to paragraph 178 of the Report of the Appellate Body. Brazil is wrong. In paragraph 178 the Appellate Body was referring to what the Panel had found, a finding that the Appellate Body expressly modified.

75. **Second**, Brazil asserts that the Appellate Body found that the CIRR provides only "one example" of an appropriate benchmark.³⁶ Brazil does not cite where in the Report the Appellate Body might have made such an observation. This is not surprising, for this is not at all what the Appellate Body said.

³⁶ At para. 9, it states:

"The Appellate Body noted that the Commercial Interest Reference Rate ('CIRR') of the *Arrangement on Guidelines for Officially Supported Export Credits* ('OECD Arrangement' or 'Arrangement') of the Organization for Economic Cooperation and Development ('OECD') provided one example of an appropriate benchmark"

Rather, the Appellate Body found that the *Arrangement* was one example of an agreement referred to in the second paragraph of Item (k).³⁷ In fact, as a practical matter, the *OECD Arrangement* is and has been the *only* example of an agreement that meets the criteria of the second paragraph of Item (k).

76. The Appellate Body, in an analysis that Brazil completely ignored, used the second paragraph, and therefore the *Arrangement*, as useful context for arriving at the appropriate benchmark to be used in the *first paragraph*. The Appellate Body found that the CIRR constituted the *minimum* commercial rate for the purposes of the *Arrangement*. It determined, accordingly, that a net interest rate below the relevant CIRR was a positive indication that material advantage was being secured. There was no suggestion at all by the Appellate Body that any other, lower, benchmark could appropriately be used instead of CIRR.³⁸

77. **Third**, Brazil purports to recall a statement made by Canada in footnote 17 to its First Written Submission that: "In aircraft financing transactions (which are mostly US dollar-denominated) the benchmark used is US Treasury."³⁹ Brazil does not, however, quote the passage to which the footnote refers. There Canada noted:

"For example, the credit quality of the airline is an important variable in determining the 'spread' that would be demanded by the financier over the market benchmarks of LIBOR (for floating-rate transactions) and US Treasuries (for fixed rate transactions in US dollars)."⁴⁰

78. This does not mean, as Brazil incorrectly suggests in its Rebuttal Submission, that by simply using LIBOR or US Treasury Bond rates as a *base* an interest rate would be consistent with the market. Canada at no point argued or even implied that the US 10-year Treasury Bond rate, without any spread or with an inadequate spread, is the appropriate benchmark for an Item (k) determination.

79. In fact, before the Appellate Body made its finding that CIRR is the appropriate minimum benchmark, Canada had repeatedly and emphatically pointed out that the benchmark for determining material advantage in the regional aircraft sector was US Treasury Bonds *plus a credit risk premium* for fixed rate transactions. This is so because in financing transactions, the credit risk premium is as important a constituent element of the final interest rate paid by a purchaser as the base to which the premium would be added.

³⁷ At para. 181, the Appellate Body found that:

"We believe that the *OECD Arrangement* can be appropriately viewed as one example of an international undertaking providing a specific market benchmark by which to assess whether payments by governments, coming within the provisions of item (k), are 'used to secure a material advantage in the field of export credit terms'."

³⁸ At *ibid.*, the Appellate Body went on to find that,

"Therefore, in our view, the appropriate comparison to be made in determining whether a payment is 'used to secure a material advantage', within the meaning of item (k), is between the actual interest rate applicable in a particular export sales transaction after deduction of the government payment (the '*net* interest rate') and the relevant CIRR."

³⁹ At para. 7.

⁴⁰ At para. 24.

80. **Fourth**, in its Rebuttal Submission, Brazil states that:

"Canada asserts, without any elaboration, that the preferred benchmark rate of T-bill plus 20 bps is 'consistent neither with CIRR nor with the market.' By this statement, Canada acknowledges implicitly that Brazil must be deemed to have brought PROEX into conformity to the extent that the benchmark rate of T-bill plus 20 bps is found to be 'consistent' with 'CIRR []or with the market'."⁴¹

81. Mr. Chairman, Canada did not say and does not agree that PROEX could be brought into conformity with the SCM Agreement if the net interest rate, after PROEX subsidies are applied, were at or above either the relevant CIRR or "the market". Canada does not consider Item (k) first paragraph to give rise to an *a contrario* exception. And even if it did, PROEX subsidies would not fit within its express terms. Further, Canada was not establishing or endorsing an alternative benchmark, but merely pointing out that Brazil could not even meet the alternative it had contrived for itself. Finally, as Chart 1 demonstrates, the "preferred" rate of US Treasury Bond+20 bps is on its face below the relevant CIRR.

(b) Brazil has not established its claim to the benefit of an *a contrario* exception

82. I should now like to address Brazil's claimed exception. After misquoting and misinterpreting the Report of the Appellate Body to conjure up a "market" benchmark, Brazil makes two further errors. First, Brazil relies on erroneous calculations of the impact of loan guarantees on net interest rates to claim that the rate of T-Bonds+20 bps is somehow consistent with its market standard. Second, to justify such a rate notwithstanding that it is below CIRR, Brazil relies on the unremarkable observation that in some instances in the regional aircraft market, rates and terms offered to purchasers may be different from those provided for in the *OECD Arrangement*. This point, we note, was already on the record considered by the Panel and the Appellate Body.

83. In respect of the loan guarantee example, Canada established, in its Rebuttal Submission that:

first, the example was irrelevant to an Item (k) first paragraph determination;

second, Brazil simply reargued its case in the original proceedings by trying to include disparate elements in the phrase "export credit", even though its defence had already been rejected; and

third, Brazil's calculations were simply wrong.

84. In the interest of time, I do not propose to go through the numbers. But, we will of course be more than happy to provide you with additional clarification if needed.

85. In respect of the market window question, Brazil argues that "the 'market' for aircraft supported rates that may be lower than the CIRR rate (which was just 'one example' of an appropriate benchmark)." Brazil goes on to claim that "T-bill plus 20 bps benchmark rate was fully 'consistent' with the market and provided no advantage, material or otherwise, to borrowers in PROEX-backed transactions."⁴²

86. It is an unremarkable observation that market rates could, on rare occasions, be below the prevailing CIRR in certain circumstances, or that market terms could be longer than those provided for in the *OECD Arrangement*. But Brazil has not furnished a scintilla of evidence in support of its contention

⁴¹ At 32.

⁴² Rebuttal at 35.

that the T-bill rate+20 bps is remotely consistent with the market. On this basis alone, its claim to the defence would fail, even if it could meet all other elements.

(c) PROEX export subsidies do, in fact, secure a material advantage

87. In the ordinary course of dispute settlement, Canada should prevail because Brazil has failed to support its claim to the benefit of an exception.

88. But, we want to ensure that the Panel is seized of all the facts and arguments necessary for making a complete determination. For this reason, Canada provided evidence and argument in respect of both the CIRR and the market in its Rebuttal Submission. I will not go through these submissions in detail. Rather, in the remaining minutes I propose to focus on three salient points.

89. **First**, the Appellate Body found that a net interest rate below the prevailing CIRR is a *positive* indication that material advantage has been secured. The PROEX programme provides for a preferred rate that is manifestly below the prevailing CIRR. This positive indication that the PROEX programme secures a material advantage.

90. The finding of the Appellate Body does not, however, exclude that a net interest rate *above* the prevailing CIRR could also be found to secure a material advantage.

91. Brazil proposes, however, that there are other benchmarks *below* the CIRR against which a net interest may be compared. In the light of the findings of the Appellate Body, this argument is not tenable. Such an argument would effectively eviscerate the finding of the Appellate Body that a net interest rate below the prevailing CIRR is a *positive* indication of material advantage. In Canada's view, it is not appropriate for Brazil to ask you, Mr. Chairman, Members of the Panel, to modify what the Appellate Body has found. We therefore request that the Panel dismiss arguments by Brazil inviting the Panel to question or modify the findings of the Appellate Body on this issue.

92. In respect, we note that in paragraph of its Second Submission, Brazil argues that using the CIRR as a benchmark would place developing countries "at a permanent structural disadvantage in the field of export credit terms." The Panel should reject Brazil's renewed attempt to turn the discussion of Item (k) first paragraph into a developing versus developed country question. The Appellate Body had ample evidence and argument before it concerning the impact of various interpretative approaches on the interests of developing and developed countries. The Appellate Body could not be said to have ignored developing country interests. Indeed, weakening the export subsidy rules to accommodate Brazilian practices does no favour to developing countries that are more often the victims of subsidized competition from wealthier competitors.

93. **Second**, as Canada demonstrated in its Rebuttal Submission, and as the Chart clearly shows, the preferred rate established under Brazil's Resolution is indeed below the prevailing CIRR.⁴³

94. The CIRR, of course, is not a raw interest rate. The CIRR for each currency is a rate based strictly on the terms set out in the *OECD Arrangement*. In the regional aircraft sector, the prevailing US\$ CIRR is based on seven-year US Treasury Bond rates for terms not exceeding ten years and is applicable to fixed-rate transactions. Thus, applying a ten-year CIRR for terms of over ten years or for floating rate

⁴³ Canada acknowledges that the comparison is not exact, because in the regional aircraft field, the prevailing CIRR is based on the seven-year US Treasury Bond rate, while the preferred PROEX rate is based on a ten-year Bond.

transactions would amount to effectively going below the reference level and "securing a material advantage." In this respect, Canada refers the Panel to Exhibit 15 and **Chart 2**. Canada notes that extending the term results in an increase in the applicable credit risk premium.

95. **Third**, the preferred PROEX rate is also considerably below what the market would provide. For fixed rate transactions, the benchmark is US Treasury Rates, to which also a risk premium must be added.

96. The "market" is important for the purposes of the first paragraph of Item (k), but not for the reasons Brazil asserts.

97. Simply put, for the purposes of Item (k) first paragraph, if a net interest rate is below the relevant CIRR, the "payment" in question must be considered to have secured a material advantage. If, however, a net interest rate is above the CIRR, a party that claims the benefit of an *a contrario* exception, if such an exception existed, would have the burden of establishing that it does not secure a material advantage as compared with prevailing market rate.

98. This is because an interest rate buy down of 2.5 percentage points may well not bring the net interest rate in a transaction below the relevant CIRR. But, it would be untenable to argue that such a massive subsidization would not, at the same time, secure a material advantage. To illustrate this point better, we have prepared two charts for your examination.

99. In **Chart 3** we compare the PROEX preferred rate to actual interest rates offered in the market. You will notice that the preferred rate is significantly below the rates offered in the market even to the best credit risk in the airline business.

100. In **Chart 4**, we set out the impact of reducing interest rates by a few basis points. While a 5 basis point interest reduction translates to less than one half of one percent of the cost of an aircraft, the impact of higher rates of subsidization does amount to an advantage substantial enough to persuade a purchaser to choose one product over another. Such an advantage, Canada submits, should be considered material for the purposes of the first paragraph of Item (k).

101. For these reasons, Mr. Chairman, Members of the Panel, PROEX export subsidies do not benefit from an exception in the first paragraph of Item (k), were one to be found by *a contrario* implication.

IV. RELIEF REQUESTED

102. Canada respectfully requests that the Panel find that Brazil has failed to withdraw its export subsidies with effect from 18 November 1999, with respect to all regional aircraft exported after that date whether PROEX interest equalization subsidies were committed on, after or before that date.

103. I thank you Mr. Chairman and Members of the panel for your patience. This concludes Canada's presentation this morning. We will make a concluding statement at the close of these statement.

ANNEX 1-4

RESPONSES BY CANADA TO QUESTIONS OF THE PANEL

(3 February 2000)

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For Canada

Question 1

Please state your views about whether, under the "material advantage" clause as interpreted by the Appellate Body, the CIRR is the exclusive benchmark for determining whether a material advantage has been secured, or whether, as argued by Brazil, a different benchmark might prevail if it could be demonstrated that interest rates in the marketplace were lower than the CIRR.

Reply

The Appellate Body found that the CIRR was the appropriate benchmark against which a net interest rate had to be compared to determine whether "material advantage" had been secured. The Appellate Body derived this benchmark after rejecting the benchmarks suggested by the Panel on grounds that it made the concept of material advantage redundant of the measure for benefit, and after considering the useful context of the second paragraph of item (k).

We see no basis in the rulings of the Appellate Body for Brazil's claim to a benchmark below CIRR even if Brazil could demonstrate that interest rates in the marketplace were below CIRR at some given moment. Brazil is already asking the Panel to agree that item (k) creates an *a contrario* exception, which would enable Brazil to make cash buy-down payments or to lend below Brazil's cost of funds so long as no "material advantage" is secured. In suggesting now a "market" benchmark for measuring material advantage, Brazil is asking the Panel to loosen the standards for this exception and disregard the Appellate Body rulings.

As the Appellate Body noted, the second paragraph of item (k) provides context for interpreting the first paragraph of item (k). The second paragraph provides an exception to the application of Article 3

for export credit practices that apply the "interest rates provisions" of the *OECD Arrangement*. Those provisions include provisions relating to CIRR and to the repayment term of the support being extended. Thus, if a Member applies the "interest rates provisions" of the Arrangement, an export credit practice that is in conformity with these provisions will not be considered an export subsidy prohibited under Article 3.

If the first paragraph of item (k) were interpreted to provide an *a contrario* exception, as paragraph two provides by its terms, the standards that must be met for claiming each exception should not be so dissimilar as to reward those who do not adhere to *OECD Arrangement* standards and claim an exception under paragraph one. A discrepancy that permitted governments claiming the benefit of paragraph one to lend (or pay others' credit costs) at interest rates lower than the "minimum commercial rate available" under the *OECD Arrangement* would give an advantage to those governments claiming the paragraph one exception and penalize those providing officially supported export credits under the terms of the Arrangement. Those adhering to the Arrangement would then have no choice but to exercise their right to match, as provided for under the Arrangement and paragraph two, the more favourable terms being offered by others.

Question 2

Brazil argues that PROEX interest rate equalization which results in a net interest rate equal to or higher than the 10-year US Treasury rate plus 20 basis points is not used to secure a "material advantage" because developed country Members can provide export credits for regional aircraft below the CIRR rate through "market window" operations. In the view of Canada, could support provided through the "market window" result in export credits being extended at interest rates that are below the CIRR rate? Please explain your answer.

"Market window" financing may result in the provision of export credits at net interest rates that are below the prevailing CIRR. However, whether "market window" financing results in net interest rates that are below CIRR does not depend on the identity of the lender or the lender's cost of funds.

The term "market window" is used to describe the provision of financing on terms that are consistent with those that are available in the market place to a particular borrower in a particular transaction. When an export credit agency provides "market window" financing, it is providing financing on terms and conditions consistent with those available from commercial banks and lenders. In that sense, the borrower obtains a net interest rate that is consistent with the market. Since the borrower could go out on the market and obtain a competitive rate in respect of the transaction from a commercial bank or lender, no benefit is conferred within the meaning of Article 1 of the SCM Agreement and, therefore, no subsidy exists.

Unlike "market window" financing, PROEX interest rate equalization provides financing on terms that are better than those available to a particular borrower in a particular transaction. PROEX interest rate equalization payments "buy-down" the rate negotiated in the market by a particular borrower in a particular transaction. As such, PROEX always results in a net interest rate that is better than the rate otherwise available to the borrower. A "buy-down" from the interest rate secured by a particular borrower in the market always results in a net interest rate that is below market.

Question 3

Please state whether, in the view of Canada, Participants to the Arrangement are required to respect the CIRR (a) in respect of "pure cover" and (b) in respect of floating interest rate transactions.

The CIRR as constructed in accordance with Article 16 is a fixed interest rate. Therefore, it is not applicable for the purpose of floating rate transactions or pure cover transactions involving a floating rate undertaken under the *OECD Arrangement*.

However, it is Canada's view that pure cover and floating rate transactions should respect the relevant principles for minimum interest rates of Article 15, and should not, therefore, be undertaken at rates below internationally recognized market standards, such as LIBOR. The transactions would also have to respect all the other relevant interest rate provisions of the Arrangement including, in particular, the requirement for a risk-based premium and the limitations on maximum repayment terms (i.e., ten years for regional aircraft).

Question 4(a)

Has any Canadian government agency (including the Export Development Corporation), since 1 January 1998, in respect of regional aircraft, (a) provided fixed interest-rate export credits at interest rates below CIRR?

Yes. Due to the time delay in the construction of CIRR (as discussed below), there were instances where certain of EDC's financing transactions were at a rate less than the CIRR applicable on the date the transaction closed. However, the interest rates charged by EDC for such transactions were market-based and commensurate with the risk associated with the particular borrower, and said transactions included customary collateral security protection. There was also one instance of matching in respect of a Canada Account financing transaction that was implemented in full compliance with the *OECD Arrangement*, and this transaction also benefited from collateral security.

A meaningful comparison of market transactions to CIRR is difficult due to the fact that the CIRR is a constructed rate, while commercial aircraft transactions are priced at commercial rates available at the time of the specific transaction. To recall, the CIRR is determined by taking the average of the 7-year Treasury rate (in the case of deals with repayment terms up to 10 years) for the previous month and adding 100 bps. For example, the CIRR for the period 15 September-15 October would be constructed using the average of the 7-year Treasury for the month of August, plus 100 bps. Carrying on with the example, the result of this calculation is that the CIRR applicable to transactions closing during the period from 15 September through 15 October would close using a rate that was calculated using the average of the applicable Treasury rate during August, i.e. up to two months earlier. To an entity that operates on the basis of commercial principles, the calculation of the CIRR is such that it would not be considered a reliable reflection of current market conditions.

We have attached hereto as Exhibit CDN-16 a chart that compares the 7-year Treasury rate and the 10-year Treasury rate to the applicable CIRR during the period January 1998 through December 1999. (Please note that the seven and 10-year Treasury rates provide a base to which the risk premiums appropriate for a particular borrower must be added.) The attached Exhibit CDN-16 demonstrates clearly the lagging aspect of the CIRR due to the method of its calculation. One good example of this is the period September - October 1998, when the market rates decreased considerably while the CIRR lagged

behind. At certain times during this period, the CIRR was more than 200 bps above the then applicable 7-year Treasury rate.

As a result, during this September-October 1998 period, a commercial lender could have made a loan at a rate of interest equal to the 7-year Treasury plus 200 bps, and the rate of interest still would have been below the applicable CIRR. As the graph in Exhibit CDN-16 demonstrates, during the period September - October 1998, the 7-year Treasury and the 10-year Treasury were trading at about the same level, which suggests that a 10-year Treasury rate + 200 bps would also have been below the applicable CIRR.

The same issue of the appropriateness of the CIRR applies when interest rates are increasing. If one looks again at Exhibit CDN-16, during the period May-June 1999, it is again apparent that the CIRR lags behind the market. As a result, during this period, there are times when commercial interest rates in the range of the 7-year Treasury rate + 15 to 20 bps and the 10-year Treasury + 25 to 30 bps (which Canada has previously indicated would not be reflective of commercial market pricing) would have been above the applicable CIRR.

While the examples provided above are only relevant for the time periods covered therein, they nonetheless illustrate the shortcomings of comparing a constructed rate such as a CIRR to commercial market pricing.

With the exception of the one Canada Account transaction referenced above, we can confirm that the interest rate charged in respect of regional aircraft has been market-based, that it has been commensurate with the risk associated with the particular borrower and that in every case it has been well above Brazil's preferred PROEX rate of 10-year Treasury plus 20 bps.

Question 4(b)

Has any Canadian government agency (including the Export Development Corporation), since 1 January 1998, in respect of regional aircraft, (b) provided guarantees in respect of fixed interest-rate export credits extended at interest rates below CIRR?

Reply

No,

Question 5(a)

Canada states (second submission, footnote 24) that, in order to compare a floating interest rate expressed in LIBOR to a US Treasury Bond, a "swap spread" must be added. Has any Canadian government agency (including the Export Development Corporation), since 1 January 1998, in respect of regional aircraft (a) provided floating interest-rate export credits the initial interest rate of which was below the CIRR applicable as of the date of the transaction, less the relevant swap spread prevailing as of that date?

Reply

No.

Question 5(b)

Canada states (second submission, footnote 24) that, in order to compare a floating interest rate expressed in LIBOR to a US Treasury Bond, a "swap spread" must be added. Has any Canadian government agency (including the Export Development Corporation), since 1 January 1998, in respect of regional aircraft (b) provided guarantees in respect of floating interest-rate export credits the initial interest rate of which was below the CIRR as of the date of the transaction, less the relevant swap spread prevailing as of that date?

Reply

No.

Question 6

Canadian Exhibit CDN-11 appears to establish a "swap spread" between the floating interest rates and 7-year fixed interest rates. Canada, however, uses this swap spread to compare a floating interest rate to a 10-year US Treasury Bond rate. Please explain.

Reply

In the normal course, when swapping a fixed interest rate to a floating interest rate, the swap spread relating to the average life of the loan in question is used. In the case of a loan requiring equal, semi-annual payments of principal and interest, the average life of the loan is determined by reference to the time in the life of the loan when 50 percent of the principal amount of the loan has been repaid.

In the transaction submitted by Brazil, which was based on a twelve-year loan, the average life of a twelve-year loan with equal semi-annual payments (i.e., six years) would be closer to seven years than it would be to ten. We therefore took the conservative route and selected the seven-year swap rate. Had we selected the ten-year swap rate for the same period, it would in fact have been marginally higher, i.e., 80 to 85 basis points.

Question 7

The Appellate Body has stated that "the appropriate comparison to be made in determining whether a payment is 'used to secure a material advantage', within the meaning of item (k), is between the actual interest rate applicable in a particular export transaction after deduction of the government payment (the 'net interest rate') and the relevant CIRR." (WT/DS46/AB/R, para. 54). It could be argued that whether PROEX interest rate equalization results in a net interest rate below CIRR will depend upon the initial, pre-equalization interest rate, and PROEX interest rate equalization does not necessarily result in a below-CIRR net interest rate in any given transaction. Please comment.

Reply

Yes, it could be argued that whether PROEX results in a net interest rate below CIRR depends upon the initial pre-equalization interest rate in a given transaction. However, the situation in which PROEX interest rate equalization produces a net interest that is higher than CIRR arises only where the credit standing of the borrower is particularly poor. In such a case, the interest rate spread payable by the

borrower may be in excess of 350 basis points; and, in that case, PROEX interest rate equalization effectively puts the borrower in a position that is similar to that of a borrower with a much better credit rating.

In the unlikely event that PROEX results in a net interest rate that is above CIRR, such a rate still secures a "material advantage". Canada has provided evidence that, in the regional aircraft market, an interest rate advantage on the order of as little as 25 basis points is substantial enough to persuade a purchaser to choose one product over another.

By its design, PROEX secures a material advantage. Brazil has provided no evidence to the contrary.

Question 8

To what extent do you consider the OECD Arrangement is legally binding on Canada?

Reply

As a matter of WTO law, the interest rate provisions of the *OECD Arrangement* are binding in the sense that compliance with those provisions is a condition of benefiting from the exception in paragraph two of item (k).

In addition to the legal status of the *OECD Arrangement* in the context of the WTO, Canada considers that, as a participant in the Arrangement, Canada is bound to follow its terms in the same way as all other participants. Notwithstanding the somewhat ambiguous and certainly archaic use of the term "gentlemen's agreement" in OECD documents and the lack of apparent dispute settlement terms within the Arrangement, participants have treated the Arrangement as a serious multilateral commitment, and recognized that discipline on export credit competition through adherence to the Arrangement is in their individual and mutual self-interest.

Question 9

Canada states (second submission, para. 24) that the 3.54 per cent guarantee fee in respect of the US Export-Import Bank transaction cited by Brazil is equivalent to 75 bps, rather than the 30 bps cited by Brazil. Please explain the basis for your statement.

Reply

Brazil uses a methodology in determining the amount one would need to add to the annual interest rate spread of a loan to achieve a return equivalent to the up-front Ex-Im Bank fee that simply divides the fee by the number of years the loan is outstanding. This is not the appropriate formulation to determine this figure. In calculating our estimate of this amount we utilised EDC's standard "yield model" which determines the yield of such an up-front fee essentially by determining the cash-flow required over the term of the loan to produce the equivalent of the up-front fee. The assumptions made in terms of a range of elements of a particular loan, including interest rate, disbursement schedule and repayment profile, will have a bearing on this calculation. The yield is determined as the transaction's internal rate of return (IRR). The IRR is the discount rate at which the net present value (NPV) of all cash outflows (i.e. loan disbursements) equals the NPV of all cash inflows (i.e. principal repayment, interest and all fees). The NPV is taken as of the date of the first disbursement.

We have included two attachments that demonstrate this calculation as Exhibit CDN-17 and Exhibit CDN-18. The first of these attachments highlights the calculation of the IRR using a set of assumptions, including a guarantee fee of 3.54 per cent as included in Brazil's example. Our determination of the 75 bps is included at the bottom of Exhibit CDN-17. Exhibit CDN-18 simply demonstrates that increasing the interest rate margin by 75 bps results in the same IRR.

Brazil has noted that Canada and the EU came up with different figures for the appropriate number (the EU suggested 60 basis points, Canada suggested in the range of 75 basis points). The differences in these two calculations could result from differences in a range of assumptions regarding the characteristics of the loan that, as referred to above, can have a bearing on the calculation of this figure. The important point is that Canada and the EU agree that the Brazilian methodology is incorrect, and that the appropriate number is well above the 30 basis points put forward by Brazil.

Question 10

Canada states (second submission, para. 51) that "a rate of 10-year Treasury Bonds + 20 bps is, under no circumstance, available to purchasers of regional aircraft in direct financing at market rates." Is such a rate available to the purchasers of regional aircraft through modalities other than direct financing, e.g., through loan guarantees? Please support your answer.

Reply

Canada's assertion that a "rate of 10 year Treasury Bonds + 20 bps is, under no circumstance, available to the purchasers of regional aircraft in direct financing at market rates" is equally true for loan guarantees and direct financing.

Canada knows of no transaction in the regional aircraft sector, or in any other sector, where a loan guarantee – or any other financing modality – has led to rates of 10-year Treasury bonds + 20 bps. Brazil has not adduced any evidence to the contrary. In Exhibit CDN-15, the rates for a range of credit ratings were provided, and these demonstrate that even for the highest rated borrowers (AAA), interest rate spreads of 20 bps are not attainable. In fact, as shown in the same exhibit for a 10-year transaction, the borrowers with the highest credit ratings were borrowing on an unsecured basis at interest rates of 10-year Treasury plus 82-97 bps. While the interest rates paid by borrowers fluctuates over time as market conditions vary, our research indicates that the average yield spread for AAA credits for the last nine years has been approximately the 10-year Treasury Bond + 43 bps.

Question 11

Please provide further information regarding the interest rates you identify in respect of transactions regarding AMR, NW and US Air, sufficient to establish the basis on which they were calculated and the comparability of the transactions including, *inter alia*, the nature of the aircraft financed.

Reply

Canada is pleased to provide further information in respect of the transactions regarding American Airlines, Northwest Airlines and US Air, referred to in Chart 2, which was produced during Canada's oral statement.

First, with respect to the method of calculation, Canada notes that, in all three cases, a weighted average of the series of *tranches* and their accompanying interest rates was calculated. In the American Airlines and US Air deals, structuring fees were excluded, though we estimate they would constitute an additional five to ten basis points. We have attached hereto as Exhibit CDN-19 the specific information regarding *tranches* and corresponding spreads relating to the US Air and AMR cases provided by Morgan Stanley Dean Witter. With respect to the Northwest transaction, the weighted average was calculated on the basis of the spreads provided below:

<u>Class</u>	<u>Coupon</u>	<u>Amt</u>	<u>LTV</u>	<u>Term</u>	<u>Avg Life</u>	<u>Rating</u>	<u>Offer Spread</u>	<u>Current Pricing</u>
G*	7.93%	\$150	44%	4/19	12	Aaa/AAA	170	160
B	9.48%	\$58	61%	4/15	9	Baa2/BBB	325	310
C	9.15%	\$32	69%	4/10	5	Baa3/BBB-	300	285

*It is important to note that the G *tranche* of the above-noted transaction is "credit wrapped" by a financial guarantee provided by MBIA, a world-wide financial insurance company. The "credit wrap" obligates MBIA (a AAA-rated company) to ensure timely payment of interest and ultimate payment of principal by the legal final maturity date. MBIA is paid a one-time up-front premium by the airline which represents an additional estimated 30 bps to the guaranteed *tranche*, i.e., raising the guaranteed *tranche* from 170 bps to 200 bps. The wrap enhances the rating of the *tranche*, thus lowering the yield required by investors, as demonstrated in Exhibit CDN-20, attached hereto.

Second, with respect to the issue of comparability, Canada notes that these are all North American transactions, and that all are secured by the aircraft. They are fully comparable. The fact that they are North American transactions is noteworthy for the following reason: for US major airlines, S&P makes a two-notch upwards rating adjustment (e.g., BB+ to BBB flat, skipping over BBB) from the airline's senior unsecured rating for being secured with "good" aircraft (a viable product with significant market demand) at a non-aggressive loan-to-value ratio and with Section 1110 legal protection. The Section 1110 protection obligates the defaulting airline, within 60 days of default, to either continue the financing (or lease) and make all payments current, or give the aircraft to the lender / lessor in a repossession.

As for the type of aircraft purchased, the Northwest Airlines transaction involved the purchase of regional aircraft: 14 Avro RJ85 aircraft from British Aerospace.

The American Airline and US Air examples involved the purchase of large aircraft.

Specifically, in the case of US Air, the acquisition was for thirteen Airbus 319-100s, five Airbus A320-200s and two Airbus A330-300s, as shown in Exhibit CDN-21.

In the American Airlines' transaction, the financing was for two Boeing 777-200s, three 767-300s and ten 737-800s.

The above establishes without doubt that 20 bps above US Treasury Bills is well below rates which prevail in the marketplace.

The most recent evidence of this was made available after Canada submitted its oral arguments earlier this month. Just last week, Bloomberg announced that Brazil's BNDES sold \$190 million in asset-backed bonds that were backed by the receivables from the sale of 42 Embraer ERJs to AMR. Bloomberg states, "BNDES provided the export financing to support the sale of the Embraer jets. The bonds were sold to yield 7.79 percent, representing a difference of 115 to 135 basis points above equivalent US Treasury bonds." The relevant Offering Memorandum states at page 1 that, "[f]rom February 27, 1998 to November 16, 1999, FINAME, the Brazilian state owned export-import agency, provided debt financing to American Eagle for the purchase by American Eagle of 42 new Embraer EMB-145LR regional jet aircraft." Canada has attached the Bloomberg newswire and relevant Salomon Smith Barney Summary Offering Memorandum hereto as Exhibit CDN-22.

This most recent information provides evidence of two other unassailable facts:

- (i) Contrary to Brazil's claims in its oral submission that, due to the prohibitive cost, Brazil "has been forced to reject [direct financing]," Brazil can provide, and, indeed, has provided, direct financing.
- (ii) Embraer aircraft can easily be financed on the private market.

This last fact was proven long ago with the purchase of 9 ERJ-145s by Continental Airlines in 1997. Canada refers here to the prospectus supplement by Morgan Stanley Dean Witter that is attached hereto as Exhibit CDN-23. The Continental pass-through had a weighted average cost of some 93 bps. The Continental weighted average spread was unusually low because conditions were extremely tight at that date.

Canada submits that all of the above demonstrates that, by definition, PROEX interest rate equalization results in a below-market rate that yields a material advantage. PROEX interest rate equalization always "buys-down" the prevailing market rates by up to 250 bps, and, thereby, provides a rate that, except in rare circumstances, falls in the range of 100 to 350 bps above US Treasury rates.

Question 12

The Appellate Body refers to the CIRR as a minimum commercial rate, and it could be argued that it was for that reason that it chose the CIRR as reference point for evaluating material advantage. Canada has stated that commercial rates below CIRR are possible. Does this not

suggest that, to the extent that a commercial rate below CIRR exists, that commercial rate should represent the reference point for evaluating material advantage?

Reply

No. The Appellate Body correctly observed that CIRR is "the minimum commercial rate available under the *OECD Arrangement*". The Arrangement applies to officially supported export credits. Paragraph 1 of item (k) concerns the provision by governments of export credits provided at rates below the government's cost of funds, or government payments to cover similar costs incurred by exporters or financial institutions. The relevant benchmark against which a net interest rate must be compared to determine whether a material advantage has been secured under paragraph 1 is CIRR. Commercial market rates that are below CIRR would occur only in the context of market window transactions that do not require either paragraph of item (k). Such a reference point, therefore, would not be relevant to any item (k) analysis.

For Both Parties

Question 1

The Appellate Body has referred to the CIRR as "a minimum commercial interest rate". The US dollar CIRR is however constructed on the basis of US Treasury bond yields. Further, Canada has stated (second submission, para. 40) that US Treasury Bonds are fixed rate reference benchmarks, while LIBOR is a floating rate benchmark. That being the case, to what extent can CIRR rates be considered relevant to establishing a "minimum commercial interest rate" in respect of floating rate transactions?

Reply

The CIRR is a constructed rate that is calculated monthly on the basis of the applicable US Treasury rate plus 100 basis points. The swap market provides a current indication of the cost at any given time of taking a stream of floating interest rate cash-flows and converting them to fixed interest rate cash-flows. The US Treasury rates and the swap spreads are dynamic and subject to constant fluctuation and adjustment due to current economic, financial and market conditions. While we have demonstrated that it is possible to convert a floating rate of interest to a fixed rate of interest, we do not believe that the CIRR would be relevant in establishing a minimum floating rate of interest because the CIRR is a constructed rate that is adjusted only on a monthly basis.

Question 2

Resolution 2667 states, inter alia, that "equalization rates shall be established on a case by case basis and at levels that may be differential." What relevance, if any, does this language have to the issues now before the Panel?

Reply

The language in Resolution 2667 to which the Panel's question refers is not germane to the issue whether Brazil has withdrawn its illegal PROEX export subsidies.

By design, PROEX always results in a net interest rate that is below CIRR or that is materially below the market, as we have explained in our response to question 7 to Canada, above.

The language identified in this question must be understood in the context of the revised PROEX programme. The market-based interest rates secured by a borrower prior to the application of a PROEX interest rate buy-down to that interest rate will vary depending on several factors, such as the creditworthiness of the borrower and the structure and terms of the transaction. Because the market-based interest rates will always vary from borrower to borrower and transaction to transaction, the "gap" or "spread" between that interest rate and the Preferred PROEX rate (which could, theoretically, go below T + 20 bps as a result of the discretionary authority of the Committee) will also vary.

Accordingly, PROEX interest rate equalization will have to be "established on a case by case basis", and the levels of equalization to different borrowers "may be differential". However, the net interest rate will invariably secure a "material advantage", whether it is below or above CIRR because it is still an interest rate buy-down of up to 250 bps that will influence the outcome of the transaction.

II. CANADA'S RESPONSES TO PANEL'S FURTHER QUESTION POSED ON 7 FEBRUARY 2000

Question 1

Canada stated at the meeting with the Panel on 4 February 2000 that, if the Export Development Corporation provides financing at rates equal to or higher than its borrowing costs, but below the CIRR, that practice may still not constitute a subsidy because no benefit is conferred. That would mean that there may exist a market benchmark lower than the CIRR. Does Canada agree that if Brazil, for instance, used that same benchmark, which is lower than the CIRR, no subsidy would exist as per the Canadian argument because no benefit is conferred.

Reply

No. Canada does not agree. As discussed in response to questions 1 and 12, above, Brazil, having claimed an *a contrario* exception under paragraph one of item (k), must comply with the CIRR benchmark for material advantage. If it gains a material advantage through its payments, by buying down rates to levels below

CIRR, then it is by definition, under item (k), granting an illegal export subsidy. Item (k) does not apply to EDC when it engages in market transactions; in such cases, EDC is free to lend at market rates and would not require recourse to item (k) for an exception.

III. CANADA'S RESPONSES TO BRAZIL'S QUESTIONS POSED ON 7 FEBRUARY 2000

Question 1(a)

At the meeting of the Panel, Canada stated that the concept of "market window" was applied whenever financing was provided at a commercial rate.

- a. Please explain how Canada determines for each transaction whether or not it needs to resort to the concept of "market window".**

Reply

Canada did not make the statement referred to by Brazil. Canada indicated that the "market window" is used to provide financing on terms and conditions consistent with those available from commercial banks or lenders to a particular borrower. When the terms and conditions available from commercial banks or lenders for a specific transaction are outside the terms and conditions under the *OECD Arrangement*, the "market window" is used.

Question 1(b)

- b. How does Canada determine whether the interest rate for any such transaction is consistent with the marketplace?**

Reply

Canada has already answered this question, as well as questions 2(a), 2(b) and 2(c), in the context of the original proceeding in *Canada – Measures Affecting the Export of Civilian Aircraft*. At paragraphs 57 and 58 of its second written submission to the Panel in that proceeding, Canada explained as follows in respect of EDC's Corporate Account:

"The EDC operates on commercial principles. This means that in providing financing in sales transactions, the terms it offers to prospective purchasers are "priced" commercially. The EDC provides financing at market rates by setting its interest margins to reflect credit risk in accordance with market principles. The EDC's interest rates reflect commercial benchmarks and interest rate margins that are in accordance with commercial credit ratings provided by rating agencies such as Moody's or Standard & Poor. Where commercial credit ratings are not available from rating agencies, the EDC uses internal credit ratings determined in accordance with prudent commercial practices. Like several other international financial institutions, the EDC's internal credit ratings are based upon the result of analyses using a sophisticated computer program, *LA Encore*. This program is employed for the same purpose by other major financial institutions, such as Lloyd's Bank and Barclays Bank in the United Kingdom.

In terms of the pricing process, the EDC's transportation group has a committee that reviews and approves the pricing on all transactions in the civil aircraft sector. In setting this pricing, EDC compares what the relevant borrower has recently paid in the market for *similar terms* and with *similar security*. The EDC then prices according to that benchmark. In the absence of this benchmark, the EDC compares the relevant borrower to borrowers of comparable credit standing in the civil aviation sector for whom a similar credit history exists; the EDC then prices according to this alternative benchmark."

Question 2(a)

At the meeting of the Panel, Canada stated that the "market window" concept permits financing transactions at rates below the CIRR. Canada also stated that in such cases no benefit is conferred within the meaning of Article 1 of the SCM Agreement because financing is provided on commercial terms.

- a. How does Canada determine in such cases that financing is provided on commercial terms otherwise available in the marketplace?**

Reply

See response to Question 1(b), above.

Question 2(b)

- b. What criteria or benchmarks are used other than financing provided by Canada itself?**

Reply

See response to Question 1(b), above.

Question 2(c)

- c. What are the sources of information Canada uses to determine what the commercial rates available in the marketplace are?**

Reply

See response to Question 1(b), above.

Question 2(d)

- d. What are the public sources of information that Brazil or other governments could use to determine what are the commercial rates available in the marketplace?**

Reply

The various public sources of information include published information memoranda and prospectuses from completed transactions, deal and market summaries published by many financial institutions as well as a number of on-line services (i.e. Reuters, Bloomberg) which publish both deal specific and general information as well as market trends and the current trading levels of many airline transactions.

Question 3

At the meeting of the Panel, Canada stated that when it "steps through the market window," it operates on commercial terms and, therefore, the issue of its cost of funds is irrelevant. Does this mean that Canada would be justified in lending below its cost of funds under the "market window" concept?

Reply

Canada put forward during the Panel meeting that determining the appropriate terms and conditions for a specific transaction was done on the basis of what would be available to the specific borrower from commercial banks or lenders for the type of transaction in question. The issue is therefore not whether a lender would be justified in lending below its cost of funds, but whether any lender that operates on the basis of commercial principles would consider a transaction where meeting the terms

available in the market would require it to lend at below its cost of funds, and we believe the answer to this question is no.

Question 4

Does Canada comply with the "matching" provisions of the OECD Arrangement (Article 29) when it applies or resorts to the concept of the "market window" under the OECD Arrangement?

Reply

"Market window" transactions are different from "official support" transactions. Although the OECD Participants continue to discuss "market window", both with the objective of ensuring transparency on all of the participating governments' export credit practices (whether involving official support or not) and more formally defining the appropriate borderline between "official support" and "market window", the disciplines of the *OECD Arrangement* are simply not applicable to "market window" transactions. In international trade law, "market window" transactions are legitimate because they do not involve the granting of a subsidy; they do not need the protection of the "safe haven" of the second paragraph of item (k).

In the *OECD Arrangement* context, "matching" refers only to the matching of "official support" offered by another government on non-compliant terms and conditions through the provision of "official support" by the matching Participant. This has nothing to do with the operation of a "market window".

Question 5

Canada stated at the meeting of the Panel that it has not applied the "matching provisions" of Article 29 of the OECD Arrangement. Please confirm.

See our response to Question 4 above. Canada did not make the statement referred to by Brazil. Rather, Canada indicated that it does not apply the matching provisions of the *OECD Arrangement* in the case of "market window" because they are simply not applicable. "Market window" is not "official support", and the "matching" and other provisions of the *OECD Arrangement* are pertinent only to "official support".

Question 6

At the meeting of the Panel, Canada seemed to say that when it resorts to the "market window" concept it "matches" the commercial rate available in the marketplace, while the "matching" provisions of Article 29 permit Canada to provide the financing below the market rate if another government does so. Please confirm and explain.

Reply

See our responses to Questions 4 and 5, above.

Canada did not make the statement suggested by Brazil. Rather, it indicated that "market window" transactions are entered into on terms and conditions that are consistent with those that are otherwise available to a borrower in the marketplace.

Question 7

In its First Submission dated January 10, 2000 (paras. 12-18 and Ex. Bra-2), Brazil provided information regarding an Ex-Im Bank loan guarantee for the financing of two Boeing aircraft sold to China. In Canada's view, do the terms and conditions of this transaction represent the commercial rates available in the marketplace for financing of large jet aircraft?

Reply

No. The Ex-Im Bank transaction is exceptional and would simply not occur "in the marketplace". There is no commercial bank that could provide such rates without the benefit of an Ex-Im Bank guarantee. This transaction is influenced by and clearly reflects particular US-China policy issues; therefore, it does not "represent the commercial rates available in the marketplace for financing of large jet aircraft".

In other words, the financing terms in this transaction are an isolated example that cannot be used as a comparison to a financing transaction in the commercial market.

Question 8

Please assume that the transaction described above was for an actual sale of regional jet aircraft rather than of large jet aircraft. In such circumstances, would Canada consider the terms of this transaction to represent the "market" for regional jet aircraft?

Reply

No. For the reasons cited in Canada's response to Question 7, the transaction does not represent the "market" for large jet financing; nor could it represent the "market" for regional jet financing. The Ex-Im Bank transaction is made within the applicable conditions of the *OECD Arrangement* applicable to large aircraft financing. It was for a term of 12 years . And it is completely irrelevant to the market conditions applicable to the commercial market financing of regional aircraft, which has terms that are recognized as being for 15 to 18 years .

Question 9

Repeating the hypothetical situation described in the previous question, would the provision of financing under these terms constitute a violation of either the OECD Arrangement or the SCM Agreement?

Reply

No. Canada understands that the Ex-Im Bank loan guarantee is fully compliant with the Arrangement. Therefore, the transaction enjoys the protection of the "safe haven" of item (k), which also makes it compliant with the SCM Agreement.

Question 10

Again repeating the hypothetical situation described in the previous two questions, in such circumstances, would Canada be entitled to "step through the market window" and provide the same terms and conditions to finance or guarantee the sale of Canadian regional jet aircraft?

Reply

Brazil's question combines two separate and distinct concepts, "pure cover guarantees" and "market window". They cannot be combined.

Recognising that the Ex-Im Bank transaction referred to by Brazil was a pure cover *OECD Arrangement* transaction, if Canada were to deliver a similar transaction, it would also do so in accordance with the *OECD Arrangement*.

ANNEX 1-5

CANADA'S COMMENTS ON BRAZIL'S RESPONSES TO
QUESTIONS OF THE PANEL

(17 February 2000)

FOR BRAZIL

Question 1

1. Brazil correctly responds that a net interest rate equal to the 10-year US Treasury Bond rate plus 20 basis points is below CIRR. Brazil is wrong in asserting, first, that such a rate is "consistent with the market for regional aircraft transactions" and, second, that Canada agrees.
2. Canada does not agree that a 10-year US Treasury Bond rate plus 20 basis points is consistent with the market for regional aircraft. Canada stated, at paragraph 51 of its Rebuttal Submission (17 January 2000), that a 10-year US Treasury Bond rate plus 20 basis points is under no circumstance available to purchasers of regional aircraft in direct financing offered at market rates. Canada's Exhibit 15 and the Charts adduced as evidence in the course of Canada's Oral Statement demonstrate that the preferred PROEX net interest rate is significantly below the current rates offered in the market to a number of major US airlines. Canada addressed this point again in its response to Question 10 to Canada, posed by the Panel on 3 February 2000. The evidence adduced by Canada has never been questioned or contradicted by Brazil.
3. Canada has also argued that the first paragraph of item (k) does not provide an *a contrario* exception to the prohibition on export contingent subsidies in Article 3 of the SCM Agreement. But, even if it did, Brazil has admitted, and this Panel and the Appellate Body have already found, that Brazil has the burden of establishing that PROEX export subsidies do not "secure a material advantage in the field of export credit terms." Apart from misstating Canada's views with respect to the net interest rates available in the regional aircraft sector, Brazil has adduced no evidence that would allow this Panel to find that the preferred PROEX net interest rate would satisfy the requirements of paragraph one of item (k). PROEX secures a material advantage. It results in a net interest rate that is below the market rates available in the regional aircraft sector, and, most importantly, below CIRR.

Question 3

4. Brazil attempts to support its interpretation of "maintain" in Article 3.2 by relying on alleged Canadian "subsidy" programmes as notified to the WTO under Article 25. Canada recalls that under Article 25.7, notification of a programme to the WTO does not prejudice whether those practices are subsidies. *A fortiori*, such notification has little relevance in the interpretation and application of an obligation solely related to subsidies prohibited under Article 3, and required by the DSB to be withdrawn. The Panel in *Canada – Aircraft* rejected Brazil's reliance on Canada's notification for the establishment of a *prima facie* case against the Canadian programmes (at 9.256).
5. At issue are Brazilian export subsidies found to have been prohibited by the DSB and whether Brazil continues to "grant" such subsidies under Article 3.2. Canadian programmes that, according to

Brazil itself, no longer exist and that may or may not constitute subsidies, let alone subsidies contingent upon export performance, have no relevance to this case.

6. Finally, Canada notes Brazil's statement that,

"a financial contribution is made and a benefit is conferred within the meaning of Article 1 of the SCM Agreement, *and a subsidy is thereby granted within the meaning of Article 3.2 of the SCM Agreement*, when contracts are signed pursuant to the letters of commitment." (emphasis added)

7. Brazil provides no rationale for interpreting "grant" differently in the case of Articles 3 and 27 of the SCM Agreement. It does not in any way explain what the word "grant" might mean in Article 3. Instead, it challenges an argument not made by Canada in respect of Article 1 of the SCM Agreement that is not pertinent to the question before the Panel in this instance, based impermissibly on notifications in respect of programmes that no longer exist. Having done so, it baldly conflates the point at which a subsidy comes into "existence" under Article 1 and when it might be "granted" for the purposes of the prohibition in Article 3, without any analysis, logic or explanation.

8. Brazil must withdraw subsidies found by the DSB to have been prohibited and granted at the time of the issuance of NTN-I bonds. Brazil must, accordingly, cease granting such subsidies in accordance with Article 3, by no longer issuing NTN-I bonds upon the delivery of aircraft after 18 November 1999.

Question 6

9. Brazil's response confirms that Brazil will provide PROEX payments for terms longer than 10 years, and apparently up to 18 years, on the same basis as for 10-year financing. Canada notes that PROEX payments are provided to reduce the borrower's costs after the borrower has already obtained what are presumably the best possible combination of interest rates and terms available on the market for that borrower. Brazil's response in effect means that the PROEX subsidies that Canada has already shown to be inconsistent with the SCM Agreement will indeed be applied in the case of regional aircraft for an even longer tenure than that provided "normally" under the PROEX programme.

Question 9

10. In its response to Question 9 to Brazil, Brazil asserts that, "PROEX's spread of 20 bps above the 10-year T-bill falls within the range for regional jet aircraft transactions suggested by Canada." On this point, Canada refers to its comments under Question 1, above. A 10-year US Treasury Bond rate plus 20 basis points is under no circumstance available to purchasers of regional aircraft in direct financing offered at market rates. For the last nine years, the average yield spread for AAA credits has been approximately the 10-year Treasury Bond rate plus 43 basis points; and *no* airline enjoys such a rating.

11. Canada has already demonstrated that in December 1999, a representative sample of airline companies operating in the US market obtained financing at T+110 to 250 basis points (based on a weighted average of the different *tranches* of the financing transaction). It has also noted that the net interest rate payable by a borrower with a particularly poor credit rating may be in excess of T+350 basis points. Of course, neither of these examples establishes a hard limit for the international aircraft financing market. Prevailing market conditions, different payment profiles, or terms, or other conditions negotiated between a lender and a borrower could affect the final interest rate, resulting in higher or lower rates than those set out in Chart 1. However, a rate of T+20 bps is under no circumstance available in the

international financing market to even the highest-rated airline, regardless of the other terms and conditions of the transaction.

Question 11

12. A commercial lender operating in the market does not "distort" that market. An export credit agency, acting as a commercial lender and on the basis of commercial principles does not "distort" the market, or the field of export credit terms. Brazil's allegation that commercial lending by export credit agencies acting in the so-called market window somehow distorts the market is simply wrong.

13. The term market window merely describes the provision of financing on terms that are consistent with those that a commercial bank or lender would provide to a particular borrower in a particular transaction. An export credit agency lending through the market window is simply acting as a commercial lender would. In such circumstances, there is no "benefit" to the recipient because the recipient does not receive terms and conditions that are more favourable than those that it could obtain from a commercial lender. Accordingly, there is no more "distortion" in the market from the market window operations of an export credit agency than from the involvement of any other commercial lender in the market.

14. Finally, Brazil again asserts that the "T-bill plus 20 bps rate does not provide a material advantage vis-à-vis [EDC's 'market window' operations]". Canada refers to its comments to Questions 1 and 9, above, and repeats, a 10-year US Treasury Bond rate plus 20 basis points is not available to purchasers of regional aircraft in direct financing offered at market rates.

15. PROEX export subsidies buy down interest rates negotiated freely in the market between a purchaser and financial institutions, many of which are non-Brazilian financing institutions. Such interest rate buy-down subsidies by definition result in a net interest rate that is better than the rate otherwise available to the borrower. Where the resulting net interest rate is below the prevailing CIRR, PROEX export subsidies *ipso facto* secure a material advantage. Even where the resulting interest rate is above the prevailing CIRR, by providing a buy-down of 250 basis points, as Canada has demonstrated, PROEX export subsidies secure a material advantage.

Question 12(a)

16. With respect to Brazil's statement that "the letter of commitment temporarily creates a binding legal obligation, which becomes final when the contracts are signed before the letter of commitments expires", Canada notes that the Panel found that:

"...at the time the letter of commitment is issued, no PROEX payments have been made, nor has the beneficiary earned the unconditional right to receive PROEX payments. Rather, the issuance of the letter of commitment means only that, if an export transaction is closed within a certain period of time, and if the product in question actually is exported, a right to receive PROEX payments will arise" (para. 7.71).

17. The Appellate Body has not modified this finding. Clearly, Brazil is not legally obligated to provide PROEX equalization payments at the time a letter of commitment is issued. As the Panel found

and the Appellate Body confirmed, that obligation arises only when the aircraft are actually exported, i.e., when Brazil issues NTN-I bonds.

Question 12(b)

18. Without questioning Brazil's statement of Brazilian law, Canada considers it important to make three brief points in this regard. First, as provided in Article 27 of the *Vienna Convention on the Law of Treaties*, "[a] party may not invoke the provisions of its internal law as justification for its failure to perform a treaty." Thus, the fact that the Government of Brazil might be liable for damages if it ceased to issue NTN-I bonds on regional aircraft exported after 18 November 1999 pursuant to letters of commitment issued prior to that date cannot excuse its failure to act in conformity with Articles 3.2 and 4.7 of the SCM Agreement and the recommendations and rulings of the DSB. See also Canada's Oral Statement to the Panel at paragraphs 32 and 33.

19. Second, Canada notes that – even if Brazil's plea for relief from its WTO obligations were legitimate, and it is not – whether or the extent to which the Government of Brazil might in fact face damages claims is entirely speculative. Brazil has not provided copies of the letters or contracts as evidence to permit a factual assessment of their contents (including, for example, whether they contain, or have been renegotiated to incorporate, clauses protecting the Government of Brazil against liability in these circumstances, or provide it defences against damages claims), or even to permit a factual conclusion regarding whether the contracts – many of which involved non-Brazilian financial institutions – are subject to Brazilian or foreign law. (Brazil provided only two sample letters of commitment, in the original proceeding, and the legal opinion submitted by Brazil was based only on those samples.)

20. As Canada noted in its oral statement to the Panel, Brazil has been on notice since at least June 1996 that Canada considered PROEX interest equalization payments to be prohibited export subsidies. It has known since April 1999 that this Panel agreed. During the consultations and Panel proceedings, Brazil issued letters of commitment to provide illegal PROEX export subsidies in respect of orders for some 557 Embraer aircraft not yet exported and on which, therefore, the subsidies have yet to be granted. After the Panel Report, that number grew to approximately 869 aircraft. The notion that a government would have taken no steps to avoid future legal liabilities in these circumstances strains credulity.

21. Third, from the perspective of the integrity of the WTO Agreements (which, as Brazil explains, are incorporated in Brazilian law), the only appropriate solution is for Brazil to cease granting illegal PROEX export subsidies under pre-18 November 1999 commitments and defend in court as necessary claims for damages if indeed it is subject to them and any materialize. (Canada notes, but does not address here, that the payment of damages in lieu of illegal subsidies may itself constitute a continuing failure to conform to WTO obligations.) If Brazil does not follow that course, it will simply pay twice – once in illegal subsidies, and again in compensation or retaliation pursuant to the DSU.

ANNEX 2-1

FIRST SUBMISSION OF BRAZIL

(10 January 2000)

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I. INTRODUCTION

1. On 18 November 1999, Brazil informed the Dispute Settlement Body of the action it had taken to withdraw the prohibited export subsidy in the Programa de Financiamento às Exportações ("PROEX") in conformity with the Report of the Panel in *Brazil – Export Financing Programme for Aircraft*, adopted as modified by the Appellate Body on 20 August 1999. Canada disagrees with Brazil's conclusion that the action Brazil has taken complies with the recommendations and rulings of the Panel and the Appellate Body. In this submission, Brazil will demonstrate that the steps it has taken are fully consistent with its obligations under the Agreement on Subsidies and Countervailing Measures ("SCM Agreement" or "Agreement"), as elaborated upon in the adopted reports.

II. PROEX AS MODIFIED IS NOT USED TO SECURE A MATERIAL ADVANTAGE IN THE FIELD OF EXPORT CREDIT TERMS.

A. PROEX BEFORE THE PANEL.

2. Brazil argued before the Panel that, even though PROEX was a subsidy conditioned on export, it was not prohibited because it did not confer a "material advantage" within the meaning of item (k) of Annex I of the SCM Agreement. Canada, however, argued that the fundamental flaw with PROEX was the absence of a floor below which the interest rate to a borrower could not go. Canada argued that PROEX either did or potentially could bring the interest rate to the borrower well below recognized and accepted international benchmarks and thereby confer a material advantage. For example, in its Second Written Submission, Canada made reference to financing that carried a margin of 10 to 15 basis points (0.10 to 0.15 per cent) above LIBOR, the London Inter Bank Offer Rate. This "lending rate," Canada said, "is consonant with normal business practices in the regional aircraft market and does not exhibit the influence of any 'Brazil cost.'¹ In its Second Oral Submission, Canada told the Panel that if "PROEX simply reduced the interest rate offered to an airline to one that is above LIBOR or OECD rates, Canada would not have brought this case."² In its response to Question 36 from the Panel, Canada said:

It is Canada's position that material advantage should be assessed with respect to the international financing market. The international financing market is defined by the benchmarks that have been discussed by Canada (LIBOR or US Treasuries plus a spread that reflects the credit risk of [the] transaction – see footnotes 15 to 17 of Canada's First Written Submission).

3. The footnotes in its First Written Submission referred to by Canada in its response to the Panel's Question 36 are lengthy, but are very much on point and merit full quotation:

15. London Inter Bank Offer Rate: this is the rate of interest at which banks offer to lend money to one another in the "wholesale" money markets in the City of London. Although LIBOR figures are available for the major currencies, the US dollar tends to be the currency of choice in international financing activities related to aircraft. They tend to quote interest rates they would charge as "basis points (or bps) above LIBOR". These "basis points above LIBOR" are what is known as the "spread" charged by a lender – the additional charge that reflects the credit risk of the transaction. This credit risk is based on the credit quality of the borrower and incorporates other criteria determined by the lender to be relevant to the transaction, such as the value of any asset being financed, any security interests in the assets of

¹ Brazil – Export Financing Programme for Aircraft, Second Written Submission of Canada, Appendix IV, note 6 (4 December 1998).

² Brazil – Export Financing Programme for Aircraft, Canada's Second Oral Submission, paragraph 109.

the borrower, or any third-party guarantees. If three-month LIBOR were (for example) six per cent, a bank may choose to lend to a purchaser at (for example) seven and a quarter per cent, or 125 basis points (bps) above three-month LIBOR. (Citation omitted).

16. In a floating rate transaction the lender sets an interest rate that will be moved up or down in relation to general movements in interest rates in the wider economy. In floating-rate aircraft transactions, the benchmark used (to reflect the "general movements of interest rates") is the three-month or the six-month LIBOR.

17. In fixed-rate transactions, the borrower's interest payments are set at the outset of the transaction and are not subject to variation in the underlying interest rate. In aircraft financing transactions (which are mostly US dollar-denominated) the benchmark used is US Treasury. (Emphasis added).

B. THE LEGAL STANDARD ESTABLISHED BY THE APPELLATE BODY

4. The Appellate Body agreed with Canada that PROEX was flawed because it lacked a benchmark based in the marketplace.³ The Appellate Body, noted, however that Members are permitted to obtain an "advantage" in the field of export credit terms, provided that advantage is not "material."⁴ It also made clear that the appropriate reference for determining whether a material advantage is secured is the "marketplace" and not a specific transaction.⁵

C. THE ACTION TAKEN BY BRAZIL

5. On 22 November 1999, the Central Bank of Brazil published in the Diário Oficial Resolution No. 2667 of 19 November 1999, which amended Resolution No. 2576 of 17 December 1998.⁶ These Resolutions define the criteria applicable to the operations related to the equalization programme of interest rates under the PROEX. Article 1, paragraph 1 of Resolution No. 2576 of 17 December 1998, was amended by Resolution No. 2667 of 19 November 1999, to read in relevant part:

In financing of aircraft exports for regional aviation, the equalization will be established on an operation-by-operation basis, at levels that may be differentiated, preferably having as a reference the United States 10-year "Treasury Bonds," plus a "spread" of 0.2 per cent per annum, to be reviewed periodically depending on market practices.

6. What this means, effectively, is that no application for PROEX interest equalization support for regional aircraft will be favorably considered unless it reflects a net interest rate to the borrower equal to or more than the 10-year United States Treasury Bond ("T-bill") plus 0.2 per cent per annum. The 0.2 per cent per annum spread also may be referred to as "20 basis points" or "20 bps." While the use of the T-bill as the benchmark is preferred, the authorities retain the authority to utilize LIBOR as an alternative reference point in appropriate market circumstances.

7. Brazil recalls the statement made by Canada in footnote 17 to its First Written Submission, quoted in full above, that, "In aircraft financing transactions (which are mostly US dollar-

³ Brazil – Export Financing Programme for Aircraft, AB-1999-1, WT/DS46/AB/R para. 178 ("AB Report").

⁴ *Id.* para. 177.

⁵ *Id.* para. 178.

⁶ Exhibit Bra-1 contains the original Portuguese and English translated versions of the Resolution, together with the original and translated versions of Circular Letter No. 00281 referred to in paragraph 8 below.

denominated) the benchmark used is US Treasury." This is precisely what Brazil has used, with an additional 20 bps spread.

8. In an additional action that does not directly affect the question before this Panel, Brazil also reduced the maximum PROEX interest equalization payment available from 3.8 per cent to 2.5 per cent per annum.⁷ No payment may be greater. The practical effect of this will be to reduce the overall amount of interest equalization available and, in all likelihood, an increase in the number of instances in which the Brazilian exporter will not be able to offer competitive financing even with PROEX support.

D. BRAZIL'S ACTION MEETS THE APPELLATE BODY'S TEST

9. The Appellate Body held, as Brazil has noted above, that the appropriate reference for determining whether a material advantage is secured by PROEX interest equalization payments for aircraft is the "marketplace" for export financing. The Appellate Body noted that the Commercial Interest Reference Rate ("CIRR") of the *Arrangement on Guidelines for Officially Supported Export Credits* ("OECD Arrangement" or "Arrangement") of the Organization for Economic Cooperation and Development ("OECD") provided one example of an appropriate benchmark, and explained the potential operations of that example at some length. However, as the Appellate Body noted, the OECD CIRR rate is only "one example."

10. Brazil chose a point of reference other than CIRR for PROEX based on evidence that, in the case of aircraft, the marketplace in fact supports lower interest rates. These lower rates are the result of at least two factors: loan guarantees and the operations of "market windows."

1. Loan Guarantees

11. With a loan guarantee, a government effectively can make its credit rating available to borrowers that otherwise would face higher financing costs. Export credit guarantee programmes are permitted by item (j) of Annex I to the SCM Agreement, provided they are at premium rates that are adequate to cover the long-term operating costs and losses of the programme.

12. Attached as Exhibit Bra-2, is a "Term Sheet," which is an example of a loan guarantee provided by the Export-Import Bank of the United States ("Ex-Im Bank") for the financing of two Boeing aircraft, together with two spare engines and spare parts.⁸ While the country of the loan recipient is not identified on the first page of the Term Sheet, the first paragraph of the "Special Conditions" refers to a "Chinese Guarantor" which suggests, quite strongly in Brazil's view, that the ultimate user of the aircraft is a Chinese airline.

13. The interest rate listed on the Term Sheet is "LIBOR plus 3 bps."

14. While a guarantee adds to the borrower's net cost, this additional increment is comparatively small. Ex-Im's charge is based upon its calculation of "transaction risk." Exhibit Bra-3 is an Ex-Im Bank "exposure fee calculation" for China taken from Ex-Im's web site.⁹ In the case of China, the

⁷ Exhibit Bra-1 contains an original and translated versions of Circular Letter No. 002881 of the Central Bank of Brazil effecting this change.

⁸ Term Sheet Ex-Im Bank Guaranteed Loan, Ex-Im Bank Final Commitment No. APO73516. The identity of the end-user of the aircraft, the type of aircraft, and the amounts were deleted before the document was made available to Brazil.

⁹ Visited 31 December 1999

nominal amount runs from 2.63 per cent to 4.46 per cent.¹⁰ However, Ex-Im's web site notes that the amounts shown are non-binding approximations and that actual fees are determined upon approval by the Bank of a completed application. Thus, they would be higher or lower than the displayed amounts.

15. Assuming a transaction risk assessment of two, the Ex-Im calculator indicates a one-time guarantee fee of 3.54 per cent. For a 12-year loan, this would add about 30 bps to the loan's cost ($3.54 \div 12$). For a 15-year loan, the added amount would be 23.6 bps. China, however, is not necessarily the best credit risk according to the criteria of international markets and the US Ex-Im Bank. In the same transaction for Taiwan, a transaction risk assessment of two would indicate a one-time guarantee fee of 1.75 per cent. For a 12-year loan, this would add less than 15 bps ($1.75 \div 12$). For a 15-year loan, the amount would be less than 12 bps.¹¹

16. Even more to the point is a comparison involving Switzerland, the headquarters of Embraer's largest European customer, Crossair. Again, assuming a transaction risk assessment of two, the Ex-Im calculator indicates a one-time guarantee fee of 1.00 per cent.¹² For a 12-year loan, this would add about 8.3 bps to the loan's cost ($1.00 \div 12$). For a 15-year loan, the added amount would be a mere 6.6 bps ($1.00 \div 15$).

17. As Canada noted, both the T-bill and LIBOR are used as reference points in the financing of aircraft. The rates are comparable. On 28 December 1999, the reported T-bill yield was 6.39 per cent while six month LIBOR was quoted at $6 \frac{5}{32}$ or 6.16 per cent.¹³ A comparison of the PROEX reference of T-bill plus 20 bps to these rates makes clear that, even for a transaction involving China, PROEX does not provide a material advantage, as that term was interpreted by the Appellate Body:

<u>PROEX</u>		<u>Ex-Im Transaction</u>	
T-bill:	6.39	LIBOR	6.16
Spread	.20	Spread	.03
		Guarantee Fee	.30
<u>Total</u>	<u>6.59</u>	<u>Total</u>	<u>6.49</u>

18. Thus, in comparison with the Ex-Im guaranteed 12-year loan involving an airline in China, PROEX with a reference benchmark of T-bill plus 20 bps provides no advantage whatsoever, material or otherwise. In the case of Taiwan, the difference between T-bill plus 20 bps and an Ex-Im guaranteed transaction is even greater: 6.59 *versus* 6.34 ($6.16 \text{ plus } .03 \text{ plus } .15$). In the case of Switzerland, the difference is 6.59 *versus* 6.27 ($6.16 \text{ plus } .03 \text{ plus } .08$). PROEX offers no advantage here, material or otherwise.

¹⁰ The 5th example shown on the Ex-Im web site would not print. The amount on the web site, as indicated in the text, was 4.46 per cent. While the web page indicates page 1 of 2, no text appears on page 2 which is, therefore, omitted.

¹¹ Exhibit Bra-4. Again, the 5th example shown on the Ex-Im web site would not print. The amount on the web site, as indicated in the text, was 2.20 per cent. While the web page indicates page 1 of 2, no text appears on page 2 which is, therefore, omitted.

¹² Exhibit Bra-5. Again, the 5th example shown on the Ex-Im web site would not print. The amount on the web site, as indicated in the text, was 1.26 per cent. While the web page indicates page 1 of 2, no text appears on page 2 which is, therefore, omitted.

¹³ *Financial Times*, 28 December 1999, pp. 14, 15.

2. The "Market Window"

19. The OECD Arrangement applies to "official support" for exports.¹⁴ The term "official support" is not defined in the Arrangement. Some Participants in the Arrangement take the position that "official support" consists only of the provision of support at rates below the government's cost of funds. Support at rates equal to or above the government's cost of funds, in the view of these Participants, is so-called "market window" support. In the view of these Participants, so long as support is provided above the government's cost of funds – through the "market window" – it may be provided at rates below CIRR rates and remain consistent with the requirements of the Arrangement. Among those Participants who take this position is Canada, which Canada described its market window operation to the Panel in *Canada -- Measures Affecting the Export of Civilian Aircraft*. Its Export Development Corporation, or EDC, according to Canada, always lends above its cost of funds, and does not incur a net cost on its financing activities. It operates on the basis of commercial principles, and does not provide an advantage above and beyond the market. Canada told the Panel that EDC financing, therefore, is not a subsidy.¹⁵ Canada did not tell the Panel, however, that EDC's loans were at CIRR rates.

20. The operation of "market windows" and the definition of "official support" have been ongoing issues in the OECD for several years. Article 86 of the Arrangement provides:

The Participants undertake to investigate further both the issue of transparency and the definition of market window operations in order to prevent distortion of competition.

21. Article 88 of the Arrangement provides:

It has not proved possible to reach total agreement on the definition of official support in the light of differences between long-established national export credit systems. It is understood that efforts will be made to resolve differences of interpretation as a matter of urgency. Until agreement is reached, the current wording in the Arrangement does not prejudice present interpretations.

22. In an effort to clarify the requirements of the Arrangement, the Foreign Minister of Brazil, on 6 May 1999, wrote to the Director General of the OECD asking for information. The Director General of the OECD responded on 4 June 1999.¹⁶

23. The reply of the OECD Director General established, *inter alia*, that the Participants in the Arrangement had not reached a conclusion regarding the issue of market windows or of the definition of official support. The Director General referred to a meeting of the Participants scheduled for October 1999 where the matters would be considered further. Brazil has been informed, however, that the October meeting did not result in a resolution of either question.

24. Market windows, accordingly, are not inconsistent with obligations under the OECD Arrangement in the view of the OECD. This means that developed countries that are able to borrow US dollars at a rate below the CIRR rate are able to lend at that below-CIRR rate in conformity with the Arrangement as presently interpreted. The actions of OECD Arrangement Participants in their

¹⁴ Art. 2: "The Arrangement shall apply to all official support for exports of goods and/or services, or to financial leases, which have repayment terms (as defined in Article 8) of two years or more. This is regardless of whether the official support for export credits is given by means of direct credits/financing, refinancing, interest rate support, guarantee or insurance. The Arrangement shall also apply to official support in the form of tied aid."

¹⁵ WT/DS70/R (14 April 1999) para. 9.145.

¹⁶ This correspondence is attached as Exhibit Bra-6.

"market window" operations are an objective part of the marketplace, providing a benchmark below CIRR against which "material advantage" must be measured.

III. CONCLUSION

25. The Appellate Body made clear that the "marketplace" should provide the benchmark for determining whether PROEX is used to secure a material advantage. Appropriate market benchmarks may include the CIRR rate, as the Appellate Body noted, and also include rates on loans that are guaranteed by government export credit agencies, and rates on loans that are made pursuant to "market window" operations. Because aircraft are financed primarily in dollars, the most appropriate benchmark is a dollar-based rate. The floor established by Brazil, the 10-year United States Treasury Bond plus a spread of 20 basis points, is clearly consistent with an established benchmark in the marketplace. This floor does not secure a material advantage in the field of export credit terms in comparison to either guaranteed loans or loans made through the "market window." Accordingly, Brazil has withdrawn the prohibited subsidy found to exist by the Panel and the Appellate Body, and is in full conformity with all of its obligations under the SCM Agreement.

LIST OF EXHIBITS

- Exhibit Bra-1: Official and Translated Versions of Central Bank of Brazil Resolution No. 2667 and Circular Letter No. 002881.
- Exhibit Bra-2: Term Sheet for Ex-Im Bank Guaranteed Loan.
- Exhibit Bra-3: Ex-Im Bank "Exposure Fee" Calculation (China).
- Exhibit Bra-4: Ex-Im Bank "Exposure Fee" Calculation (Taiwan).
- Exhibit Bra-5: Ex-Im Bank "Exposure Fee" Calculation (Switzerland).
- Exhibit Bra-6: Correspondence Regarding "Market Windows."

ANNEX 2-2

REBUTTAL SUBMISSION OF BRAZIL

(17 January 2000)

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I. INTRODUCTION

1. In its submission of 23 December 1999, Canada argues that the measures taken by Brazil to withdraw the prohibited export subsidy in the Programa de Financiamento às Exportações ("PROEX") in conformity with the Report of the Panel in *Brazil – Export Financing Programme for Aircraft*, adopted as modified by the Appellate Body on 20 August 1999, were inadequate for two reasons. First, Canada argues that Brazil must cease to make PROEX payments with respect to letters of commitment previously entered into for regional aircraft that may be delivered after 18 November 1999. Second, Canada argues that Brazil has not modified the PROEX programme sufficiently to bring it into conformity with the findings of the Appellate Body with respect to future commitments.

2. Brazil disagrees with Canada that Brazil is required to amend its conduct with respect to legally binding letters of commitment issued before the date of implementation of the findings and recommendations in the adopted report. Moreover, the actions taken to amend PROEX have brought that programme fully into compliance with the requirements of the SCM Agreement as interpreted by the Panel and the Appellate Body.

II. BRAZIL MAY CONTINUE TO PROVIDE PROEX SUPPORT TO AIRCRAFT SUBJECT TO PRIOR COMMITMENTS

3. Canada's first claim is that Brazil is required to cease providing PROEX support with regard to aircraft delivered after 18 November 1999 pursuant to commitments made prior to that date. In Canada's view, by continuing to honour its prior commitments to provide PROEX support, Brazil is continuing to subsidize aircraft exports contrary to the requirements of the SCM Agreement. Canada is incorrect; its position is tantamount to a retroactive remedy, calling upon Brazil to dishonour its commitments. In simply fulfilling its legal obligations under those prior commitments, Brazil is not creating new subsidies and is not acting in a manner inconsistent with its obligations.

4. Canada's argument confuses a determination the Appellate Body made with regard to Article 27 with a determination it explicitly did not make with regard to Article 1. Canada's argument fails to address the sound reasons why the Appellate Body made a distinction between when a subsidy comes into existence for purposes of Article 1 of the Agreement, and when it is granted for purposes of Article 27.

A. THE APPELLATE BODY'S DECISION

5. The only issue before the Panel with regard to the "timing" of the subsidy, the Appellate Body held, was the issue of when it is granted for purposes of Article 27.4: "[G]iven that export subsidies in this case were already deemed to 'exist,'" the Appellate Body asked, "when were they 'granted'?"¹ The Appellate Body affirmed the finding of the Panel that, for purposes of Article 27.4, PROEX is granted when "all the legal conditions have been fulfilled that entitle the beneficiary to receive the subsidies."²

6. But this conclusion did not, as Canada argues it did, mean that PROEX comes into existence for purposes of Article 1 only when aircraft are exported. To the contrary, "We wish to underscore especially," the Appellate Body wrote, "that we find that it is not relevant, for purposes of calculating the level of Brazil's export subsidies under Article 27.4, for the Panel to decide whether the 'financial

¹ *Brazil -- Export Financing Programme for Aircraft*, WT/DS46/AB/R (2 August 1999) (Adopted 20 August 1999) para. 156.

² *Id.* para. 158.

contribution' for PROEX subsidies involved a 'direct transfer of funds' or a 'potential direct transfer of funds' under Article 1.1 of the *SCM Agreement*.³

7. There were sound reasons why the Appellate Body should have made the distinction it made between the question of when a subsidy is granted for Article 27.4 purposes, and when it comes into existence for purposes of Article 1. These reasons include the language of Article 1; the principles of treaty interpretation; the consequences of not treating the legally-binding commitment of the Government of Brazil to provide PROEX support as the subsidizing event; and the fact that PROEX commitments are legally binding on Brazil.

B. THE LANGUAGE OF ARTICLE 1

8. Article 1 provides that "a subsidy shall be deemed to exist" when "there is a financial contribution by a government" and "a benefit is thereby conferred."⁴ The Appellate Body made clear that "financial contribution" and "benefit" are "two separate legal elements in Article 1.1 of the *SCM Agreement*, which *together* determine whether a subsidy *exists*, and not whether it is *granted* for the purpose of calculating the level of a developing country Member's export subsidies under Article 27.4 of that Agreement."⁵

9. Basic logic and the wording of Article 1 make clear that the financial contribution must either precede or coincide with the benefit. The benefit conferred by a financial contribution cannot, in logic, precede the contribution itself. The benefit is the effect; the financial contribution is the cause. As Article 1.1(a)(1) states, a subsidy exists when "there is a financial contribution" and, moving to Article 1.1(b), "a benefit is thereby conferred."⁶

10. The economic beneficiary of PROEX interest equalization payments for aircraft is the Brazilian producer, Embraer -- not the financial institution that receives the payments, not the airline whose cost of financing is reduced. The entire purpose of PROEX interest equalization payments for aircraft is to permit Embraer to offer customers financing that is competitive with the financing offered by other, non-Brazilian, suppliers. Embraer receives this benefit when Brazil makes a legally-binding commitment to provide PROEX support. It is this action by Brazil that assists Embraer in its sales effort and that confers the benefit on Embraer.

11. This benefit must be preceded by or coincide with a financial contribution, as that term is defined in Article 1 of the Agreement. The financial contribution is not, at this point, "a direct transfer of funds," within the meaning of Article 1.1(a)(1)(i). It is, rather, a "potential direct transfer of funds" within the meaning of that provision. To say that it is not is to say that there is no benefit to Embraer by the commitment, and to say this is to say that Part III of the Agreement is a nullity, contrary to the customary rules of interpretation of public international law.

C. THE RULES OF INTERPRETATION OF PUBLIC INTERNATIONAL LAW

12. The Appellate Body held, in its very first decision, that, "interpretation must give meaning and effect to all the terms of a treaty. An interpreter," it said, "is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility."⁷ A reading of Article 1 that would result in the conclusion that PROEX comes into existence when aircraft are exported rather than when the letter of commitment is issued would reduce whole clauses

³ *Id.* para. 159.

⁴ SCM Agreement Article 1.1(a)(1) and (b).

⁵ Para. 157 (emphasis in the original).

⁶ Emphasis added.

⁷ United States -- Standards for Reformulated and Conventional Gasoline , WT/DS2/AB/R (29 April 1996) (Adopted 20 May 1996) pg. 23.

and paragraphs of Part III of the SCM Agreement to inutility. It would effectively read them out of the Agreement altogether.

D. THE CONSEQUENCES OF FINDING THAT PROEX EXISTS ONLY WHEN AIRCRAFT ARE EXPORTED

13. Article 1 defines the term "subsidy" not only for purposes of Part II of the Agreement, dealing with prohibited subsidies, but also for purposes of Part III, dealing with actionable subsidies. Article 5 of the Agreement, the first article in Part III, begins: "No Member should cause, through the use of any subsidy referred to in paragraphs 1 and 2 of Article 1, adverse effects to the interests of other Members ..."

14. Canada has pointed out that Brazil is required to "make the necessary modifications to the programme to eliminate export subsidies in respect of future commitments."⁸ One of Brazil's options is to modify PROEX by removing the export requirement for interest equalization payments for aircraft. This simple action would turn PROEX from a prohibited export subsidy to an actionable subsidy. A Member challenging such a modified PROEX would be required to show not only the existence of a subsidy, but also adverse effects to its interests caused by that subsidy.

15. One of three means by which a Member may demonstrate adverse effects is by showing injury to its domestic industry within the meaning of Part V of the Agreement, dealing with countervailing measures.⁹ The requirements for a determination of injury under Part V are set forth in Article 15. Paragraph 5 of Article 15 specifies that, for an affirmative determination of injury, "[i]t must be demonstrated that the subsidized imports are, through the effects of the subsidies, causing injury within the meaning of this Agreement."¹⁰

16. If the subsidy does not come into existence until an aircraft is exported, then "the effects of the subsidies" could not be felt until that time, since the effect can only follow the cause. Thus, no determination of injury could be made prior to export. This result defies the economic realities of the aircraft industry, and would reduce the injury provision of Article 5 to inutility.

17. This consequence can be made clear from a consideration of how aircraft normally are bought and sold. An airline decides that it wishes to acquire aircraft and makes that fact known to potential suppliers. The suppliers offer not only their aircraft, but also a financing arrangement. This financing package would include whatever government support is available. In the case of Brazil, this is when PROEX is offered.

18. If Embraer, benefiting from PROEX, is successful in obtaining the order, the impact, if any, on the domestic industry of another Member would be immediate. It is possible that workers would lose their jobs, that factories would shut down, that a company's ability to raise capital could be jeopardized. All of these adverse effects could result from the loss of a significant order.

19. Yet, if in these circumstances a Member were to initiate dispute settlement proceedings under Canada's proposed standard, claiming adverse effects based on injury to its domestic industry "through the effects of subsidies," it would be met with the question: What subsidies? At the time the contract was awarded, no aeroplanes would have been exported. Export would occur only months, perhaps even years, in the future. An order for a large number of aircraft is likely to call for delivery of only one or two aircraft per month over a period of years, with the first delivery not occurring for several months or even a year or more after the contract is awarded.

⁸ Brazil -- Export Financing Programme for Aircraft, First Submission of Canada (23 December 1999) para. 29 ("Canada Submission").

⁹ SCM Agreement Art. 5(a).

¹⁰ A footnote referring to the economic factors to be examined is omitted.

20. Moreover, even an injury proceeding brought after the first aircraft were exported would be limited. The causal connection between exports of a few aircraft and injury would be far less than the causal connection between the entire number of aircraft ordered and the alleged injury.

21. In this regard, it is instructive to note that, in applying its own antidumping and countervailing duty laws, Canada rejects the timing standard it proposes here. Section 2 of Canada's Special Import Measures Act ("SIMA") defines the term "sale" to include leasing and renting, an agreement to sell, lease or rent, and an irrevocable tender. The SIMA Handbook explains:

The definition is significant because it establishes the category of transactions considered as a sale. For example, the definition covers an irrevocable offer to sell, e.g. bids accompanied by a bond. This is particularly relevant where large capital equipment is involved. In such cases, the purchaser's decision to buy is usually made on the basis of irrevocable tenders. *The market for large capital equipment is characterized by long time gaps between the irrevocable tender and the actual delivery of goods. In such cases, the injury occurs not only at the time of acceptance of the tender but as early as when the bid is offered.*¹¹

22. It is clear that, were Canada to initiate countervailing duty proceedings, under Part V of the Agreement, against imports of aircraft from Brazil based on PROEX, it would consider the question of injury "as early as when the bid is offered." If PROEX has been committed for a transaction, the bid from Embraer reflects that fact. In considering the question of injury, Canada would deem the letter of commitment to be the subsidy. If it did not, it could not impose countervailing duties because, as noted above, those duties require a demonstration that the subsidized imports are, "through the effects of the subsidies, causing injury."¹² The definition of "subsidy" used by a Member for purposes of countervailing duty proceedings under Part V of the Agreement is the same definition that applies to Parts II and III. It is the definition in Article 1, which begins, "For purposes of this Agreement, a subsidy shall be deemed to exist if ..."

23. Finally, it should be noted that a "threat of injury" determination would not support a complainant in these circumstances. By definition, in this example, the injury has occurred at the time of the order. It is present, not anticipated or threatened injury, when workers are already unemployed. To be sure, there may be a real "threat" of a subsidy in the future, but threat of *subsidy* will not support an affirmative determination under Article 15; only a "threat of injury" from an already existing subsidy will do that.

E. PROEX COMMITMENTS ARE LEGALLY BINDING ON BRAZIL

24. In honouring binding commitments it made prior to the date of implementation of the adopted report, Brazil is not bringing new subsidies into existence. The subsidies on which these payments are based came into existence with the letters of commitment, prior to Brazil's obligation, pursuant to the Report, to cease creating new subsidies. Brazil is legally obligated to honour those commitments. It cannot take them back; it cannot, with impunity, inform the institutions and parties that have acted in reliance on those commitments that Brazil will not honour them. If Brazil does not provide the PROEX payments to which it has already committed, Brazil will be required to provide payments for damage resulting from breach of contract.

25. No useful purpose would be served by a determination that Brazil must dishonour its financial commitments in order to comply with WTO requirements. Payment must be made, if not as PROEX, then, as noted above, as damages for breach of contract. If this should occur, Brazil's reputation for reliability will be unfairly damaged in the international financial community. Perhaps even more

¹¹ Canada SIMA Handbook Inserts (emphasis added) (Exhibit Bra-7).

¹² SCM Agreement Art. 15.5.

important, the wisdom, if not the sanity, of a WTO dispute settlement system that requires such a result, would be questioned seriously.

26. Such a result, which amounts to a retroactive remedy, not only is not necessary, it is not permitted. PROEX comes into existence, for the reasons given above, when Brazil issues a letter of commitment. The Panel should so conclude.

III. BRAZIL'S ACTIONS TO AMEND PROEX FULLY IMPLEMENT THE APPELLATE BODY'S DECISION

27. In its First Submission of 10 January 2000, Brazil explained that it had amended PROEX to ensure that no application for PROEX interest equalization support would be considered favorably unless the transaction was based on a net interest rate to the borrower equal to or greater than an appropriate benchmark rate used in the commercial marketplace. Under the amended PROEX regulation, the preferred benchmark rate is the 10-year United States Treasury Bond (the "T-bill") plus a spread of 0.20 per cent ("20 basis points" or "20 bps") per annum. Brazil also explained that the adoption of this benchmark rate fulfilled Brazil's obligation to withdraw the aspect of the PROEX programme found to be a prohibited subsidy by the Appellate Body.

28. In its First Submission of 23 December 1999, Canada argued that these amendments do not bring the programme into compliance with the SCM Agreement. Canada quotes the dictionary definition of the word "withdraw" and argues that withdrawal requires cessation of a subsidy found to have been prohibited.¹³ As Canada notes, however, the word "withdraw" must be interpreted in the light of the context and object and purpose of the relevant WTO Agreements and their provisions¹⁴ In the end Canada concludes, and Brazil agrees, that, in this proceeding, this means that Brazil is required to make the modifications necessary in PROEX to eliminate export subsidies with respect to future commitments. Brazil has done exactly that.

29. Canada's arguments that Brazil has failed to withdraw the prohibited aspects of PROEX are unavailing.¹⁵ First, Canada argues that the action of the Central Bank of Brazil to amend the maximum amount of PROEX assistance payable on a given transaction, taken under Circular Letter No. 002881, does not constitute withdrawal of the prohibited subsidy. Brazil has never claimed that it does.

30. Circular Letter No. 002881 simply amends the PROEX programme to reduce the maximum interest equalization payment available from 3.8 per cent to 2.5 per cent. Contrary to Canada's arguments, as explained in Brazil's First Submission, the imposition of this new ceiling on PROEX payments is not directly relevant to the question before the Panel. This is because reducing the maximum payment under PROEX did not directly address the primary flaw in PROEX identified by the Appellate Body – the absence of a floor net interest rate based on a cognisable benchmark rate in the commercial marketplace. Nevertheless, the reduction of the amount of funds available for PROEX transactions will necessarily mean that in practice, Brazil will be able to equalize net interest rates on regional aircraft transactions to commercial marketplace rates in many fewer transactions, since a payment of 2.5 per cent will reduce an interest rate less than a payment of 3.8 per cent.

31. Second, Canada claims that the new requirement of Resolution 2667 requiring that net interest rates be compatible with international market rates "do[es] not represent a change" in PROEX.

¹³ Canada Submission para. 26.

¹⁴ *Id.* para. 27.

¹⁵ Brazil described the measures it had taken to bring PROEX into conformity in its communication to the Dispute Settlement Body on 18 November 1999, and in paragraphs 5-8 of its 10 January 2000 submission to this Panel. The documents amending PROEX were attached as Exhibit Bra-1 to the 10 January 2000 submission.

Canada states that essentially the same concepts have been part of previous PROEX programmes. Canada is mistaken. The absence of any such benchmark was precisely the flaw found in PROEX by the Appellate Body. In fact, Canada acknowledges that Resolution 2667 " calls for equalization rates to be set at a level aimed at achieving . . . a net interest rate of 0.2 per cent . . . over the US Treasury Bond rate." Thus, contrary to Canada's protestations, Brazil's actions to implement have rectified the defect found in PROEX by imposing the discipline of a commercial marketplace benchmark below which the net interest rate may not fall.

32. Canada asserts, without any elaboration, that the preferred benchmark rate of T-bill plus 20 bps is "consistent neither with CIRR nor with the market."¹⁶ By this statement, Canada acknowledges implicitly that Brazil must be deemed to have brought PROEX into conformity to the extent that the benchmark rate of T-bill plus 20 bps is found to be "consistent" with "CIRR []or with the market."

33. In these circumstances, Canada's failure to explain why it believes that this benchmark is not "consistent " with CIRR or the "market" is somewhat surprising. As explained in Brazil's First Submission, Canada has previously stated to the Panel that "In aircraft financing transactions (which are mostly US dollar-denominated) the benchmark used is US Treasury."¹⁷ The Panel has already noted Canada's position:

Canada submits in that connection that the relevant rates to be considered in the international market are the London Inter Bank Offer Rate (LIBOR) or the United States (US) Treasuries rate plus a spread that reflects the credit risk of the transaction.¹⁸

34. By Canada's own admission, therefore, the new benchmark rate used in PROEX is totally "consistent" with the market, and, therefore, meets the standard announced by the Appellate Body.

35. Brazil provided in its First Submission a detailed explanation of why the new PROEX benchmark is consistent with the marketplace. Brazil explained how the "market" for aircraft supported rates that may be lower than the CIRR rate (which was just "one example" of an appropriate benchmark). Moreover, Brazil explained how the T-bill plus 20 bps benchmark rate was fully "consistent" with the market and provided no advantage, material or otherwise, to borrowers in PROEX-backed transactions.

36. Canada's failure to explain how the T-bill plus 20 bps rate is not consistent with the market may be explained by Canada's own position on the provision of official support for exports. As Brazil explained in its First Submission, many members of the OECD, including Canada, take the position that the OECD Arrangement permits support for exports at rates equal to or above the government's own cost of funds. The OECD has not disapproved of this interpretation. Thus, members of the OECD may provide assistance at rates below the CIRR rates, consistent with their obligations under the Arrangement, provided they do so at, or above, their cost of funds. Indeed, as Canada told the Appellate Body in the case involving its own programmes, "[I]t is nonsensical to argue that the *OECD*

¹⁶ "CIRR" is the Commercial Interest Reference Rate established under the Organization for Economic Cooperation and Development's (the "OECD's") *Arrangement on Guidelines for Officially Supported Export Credits* (the "OECD Arrangement").

¹⁷ Brazil -- Export Financing Programme for Aircraft, First Submission of Brazil (10 January 2000) para. 3.

¹⁸ *Brazil -- Export Financing Programme for Aircraft*, WT/DS46/R (14 April 1999) (Adopted as Modified by the Appellate Body 20 August 1999) para. 4.92. Similarly, as the Panel noted in paragraph 4.93 of its Report, "Canada confirms its view that the appropriate benchmark is either LIBOR or US Treasury rates ..." See also, *Canada -- Measures Affecting the Export of Civilian Aircraft*, WT/DS70/R (14 April 1999) (Adopted as Modified by the Appellate Body 20 August 1999) para. 6.69 and footnote 211 ("Canada Aircraft Panel Report").

Arrangement is a better indicator of the market than the practice of commercial banks, because, in many instances, the market is more generous than the *OECD Arrangement*.¹⁹ By Canada's standards, its practice of meeting the "more generous" market is consistent with its obligations. This is not a market for Canadian firms alone, however; it is a market for all firms. Consequently, rates supported by PROEX that are below the CIRR rate, but that are based on the T-bill or LIBOR, must be deemed to be consistent with this market.²⁰

37. If this were not the case, developing countries would be placed at a permanent, structural disadvantage in the field of export credit terms. Their borrowing costs are high. Therefore, in most, if not all, circumstances, their cost of funds will exceed the "market" rate established by export credit agencies from developed countries. In Canada's view, however, developing countries with high borrowing costs can make credits available at rates no lower than the CIRR rates, while developed countries with low borrowing costs may do so, provided they lend at or above their cost of funds. As Canada told the Panel examining its programmes:

In terms of the pricing process, according to Canada, the EDC's transportation group has a committee that reviews and approves the pricing on all transactions in the civil aircraft sector. Canada argues that in setting this pricing, EDC compares what the relevant borrower has recently paid in the market for *similar terms* and with *similar security*. The EDC then prices according to that benchmark. In the absence of this benchmark, the EDC compares the relevant borrower to borrowers of comparable credit standing in the civil aviation sector for whom a similar credit history exists; the EDC then prices according to this alternative benchmark.²¹

38. There is no mention of CIRR here. Indeed, in the immediately preceding paragraph, the Panel examining Canada's programmes noted, "Canada replied that it does not seek shelter in the 'safe haven' provided in the second paragraph of item k, with respect to EDC financing under its corporate account ...".²²

39. The Panel should not countenance any attempt by Canada to impose one standard of commercial behaviour on Brazil and other developing countries, while advocating or indeed practising a less rigorous standard of behaviour for itself. In determining whether Brazil's amendments bring PROEX into conformity, the Panel must examine the amendments, and Canada's challenge thereto, by reference to the "marketplace," in accordance with the decision of the Appellate Body. The "marketplace" must necessarily be based on rates available to other actors in the market. Brazil has demonstrated that the revised PROEX programme incorporates the most appropriate benchmark for aircraft transactions – the US Treasury T-bill – and is consistent with actual market transactions. The Panel should reject any attempt by Canada to require Brazil to meet benchmarks that do not actually prevail in the marketplace.²³

¹⁹ *Canada – Measures Affecting the Export of Civilian Aircraft*, WT/DS70/AB/R (2 August 1999) (Adopted 20 August 1999) para. 87 ("Canada Aircraft Appellate Body Report").

²⁰ As we have seen, Canada has previously stated that the benchmark for aircraft financing is the US Treasury rate (not CIRR).

²¹ Canada Aircraft Panel Report, para. 6.70.

²² *Id.* para. 6.69.

²³ It should be noted that Brazil does not argue that it should be allowed to "match" credit terms offered by any other government as that term is used in Article 29 of the OECD Arrangement. These rates may well be subsidized in a manner inconsistent with both WTO and OECD requirements. Brazil is not alleging here that any of the market benchmarks to which it has referred – through the operations of loan guarantees or market windows – are in any way inconsistent with WTO or OECD requirements. Brazil is simply arguing that these are the marketplace, and that the Appellate Body's reference to market benchmarks must be interpreted with reference to actual marketplace practices.

40. For these reasons, Brazil requests that the Panel find that by requiring the net interest rate for any transaction supported by PROEX to equal or exceed an appropriate market benchmark – with the preferred benchmark being the T-bill plus 20 bps – Brazil has withdrawn the prohibited aspects of the PROEX programme and has brought PROEX into conformity with the SCM Agreement.

IV. TRANSPARENCY

41. Canada proposes that the Panel suggest to the parties, pursuant to Article 19.1 of the DSU, that they establish a reciprocal arrangement for verifying their mutual compliance with their obligations under the Subsidies Agreement.²⁴ Brazil notes that the parties have been engaged for some time in negotiations concerning these disputes and have discussed, *inter alia*, the question of verification. Brazil also notes, however, that the issue of transparency thus far has had to do with Canada's programmes, not Brazil's.²⁵

42. While Brazil does not, in principle, oppose such an agreement, it considers that resolution of the matter in the context of dispute settlement is not clearly compatible with the spirit, if not the letter, of Article 19 of the DSU. Brazil also believes that such an arrangement is better agreed to by the parties in the course of bilateral discussions. It is, in particular, fundamentally necessary for Brazil that any such arrangement involves balanced and truly reciprocal offers of transparency, not only by Brazil, but also by Canada. Discussions between the parties in this regard are on-going, but no agreement has been reached either on the specific Canadian and Brazilian programmes to be included and subjected to verification, or on the institutional framework for a potential monitoring mechanism.

V. CONCLUSION

43. Brazil requests that the Panel reject Canada's requests in their entirety, and that it find that Brazil is in full compliance with all of its obligations under the SCM Agreement, as interpreted by the Panel and the Appellate Body, with regard to PROEX interest equalization payments for aircraft.

²⁴ Canada Submission, paras. 44-46.

²⁵ Both the Panel and the Appellate Body noted Canada's failure to produce documents requested by the Panel in the original proceedings. Canada Aircraft Appellate Body Report, para. 199 ("Canada refused to provide the information requested by the Panel."). *See also* Canada Aircraft Panel Report, paras. 6.80, 6.171, 6.203, 6.258, 6.259, 6.260, 6.279, 6.303, 6.304, 6.326, 6.327, 9.176, 9.188, 9.218, 9.244, 9.253, 9.272, 9.293, 9.294, 9.299, 9.303, 9.313, 9.314 (footnote 621), 9.327, 9.345, 9.347 (footnote 633).

LIST OF EXHIBITS

Exhibit Bra-7: Canada's SIMA Handbook Inserts

ANNEX 2-3

ORAL STATEMENT OF BRAZIL

(3-4 February 2000)

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Mr. Chairman and Members of the Panel, and members of the Canadian delegation:

1. I am Carlos Simas Magahes, Minister of the Permanent Mission of Brazil in Geneva. I have already introduced my colleague, Roberto Azevedo and the other members of the Brazilian delegation. Mr. Azevedo and I will present Brazil's statement jointly, and then we will all be available to answer questions.

2. Brazil appreciates this opportunity to present its views to the Panel regarding the action it has taken to comply with the requirements of the Panel's Report, adopted as modified by the Appellate Body, concerning Brazil's export credit support measure, the Programa de Financiamento às Exportações, known as PROEX.

3. PROEX, as you know, is an interest equalization mechanism for providing official support for export credits. The Panel concluded that PROEX was a prohibited export subsidy inconsistent with Brazil's obligations under the Agreement on Subsidies and Countervailing Measures. The Appellate Body affirmed, with some important modifications. Brazil has made the changes in the original PROEX that were required by the Panel and the Appellate Body with the result that, in its present form, PROEX is consistent with all of Brazil's obligations.

4. Canada, however, disagrees. Canada claims first, that the changes made in PROEX do not bring the measure into conformity for the present and the future, and, second, that Brazil is required to dishonour the legal commitments it has made to international financial institutions and to cease payments on aircraft, subject to prior commitments, but not yet exported. In its written submissions, Brazil has explained why PROEX, in its present form, is consistent with Brazil's WTO obligations and why Brazil should not be required to dishonour its commitments on undelivered aircraft. To the extent possible, I will avoid repeating those arguments, but I fear that some repetition is necessary in addressing the second submission of Canada and the submissions of the third parties.

5. In this statement, I will discuss the changes made to PROEX, and the question of the undelivered aircraft. I will also address the implications for this case of the recently circulated Report of the Panel in the Article 21.5 proceeding in *Australia – Leather*. First, however, I want to explain to you the problems Brazil faces in the field of export credits and why it has elected to utilize a program like PROEX.

1. The Background to PROEX

6. In an ideal world, governments would not need to support export credits, but, unfortunately, we do not live in an ideal world.

7. After the Brazilian aircraft manufacturer, Embraer, developed its highly regarded and highly successful 50 seat regional jet, the ERJ-145, with its own funds, it entered the regional jet market in mid-1996. The Canadian producer, Bombardier, was already well established in the market for regional jet aircraft, having introduced its 50-seat aeroplane, the CRJ, in about 1993. Embraer was the first manufacturer from a developing country to compete in the world-wide market for passenger jet aircraft, and it remains the only developing country manufacturer to do so.

8. When it entered that market, Embraer was faced with a fact of this less than ideal world, that is, that success in the market did not depend only on having the best product at the best price. Success also depended on a manufacturer's ability to package its product with attractive export credit support from its government. This was the market established by the Canadian, United States, and European governments for their aircraft manufacturers long before Embraer came on the scene. If Embraer wanted to play in the game, it had to play by the rules already established by the developed countries.

9. The Subsidies Agreement recognizes that this world is imperfect, and that governments use export credit support to assist their exporters. Thus, while Article 3 of the Agreement would, by its terms, prohibit all forms of export credit support that met Article 1's definition of "subsidy," exceptions are made.

10. In actual practice, these exceptions apply for the most part to expensive capital goods, such as aircraft. From the perspective of a developing country like Brazil, this presents a problem. Export credit support programs for capital goods can be expensive for any government to maintain; they are inevitably expensive for developing countries to maintain. Consequently, the ability of developing countries to support their industries is limited, particularly in comparison with the ability of developed countries to do so.

11. There are several means by which governments may provide support for export credits. Article 2 of the OECD *Arrangement on Guidelines for Officially Supported Export Credits* mentions direct credits, which may take the form of financing or refinancing; guarantees or insurance; and interest rate support.

12. Direct financing requires the government to advance the entire proceeds of the loan – typically 85 percent of the cost of an aircraft. This is beyond the means of most, if not all, developing countries. A further problem with direct financing is that the government, as lender, bears the risk of default. Brazil has been forced to reject this alternative means of providing export credit support for financial reasons.

13. Guarantees are the least costly means of support for governments; indeed, they may have no cost at all. If the borrower does not default, the guarantor is never called upon to pay, and may even make a profit through the guarantee fees it receives. Unfortunately, as a practical matter, loan guarantees also are not available to developing countries. Let me explain why this is so.

14. The Panel will recall Exhibit 2 to Brazil's First Submission, which concerns a guarantee from the US Ex-Im Bank to the Chase Manhattan Bank in New York for the sale of aircraft to an airline located, it appears, in China. That Exhibit rather dramatically illustrates the impact a loan guarantee from a developed country government can have on a transaction.

15. With the security of a guarantee from the US Ex-Im Bank, Chase Manhattan is willing to finance aircraft to an airline in China for LIBOR plus three basis points – LIBOR plus, in other words, three one-hundredths of one percent. Through that guarantee, the Ex-Im bank effectively has transferred to an airline in China the credit rating of the United States Government.

16. No commercial bank in the world would lend at so low a rate to a Chinese borrower on the strength of a guarantee from Brazil or any other developing country. This is because the value of a guarantee depends upon the credit rating of the guarantor, and no developing country has the credit rating of developed countries like the United States, Canada, or the member States of the EC.

17. An indication of the magnitude of the problem Brazil would face in offering loan guarantees can be seen from a comparison of current yields on Brazilian, Canadian, and US bonds of comparable maturity. On February 1, Bloomberg reported that the yield on the 10-year US T-bill, upon which PROEX is based, was 6.64 percent. On the same day, Bloomberg also reported that the yield on the 10-year Canadian bond was 12 full basis points lower than the yield on the US bond – 6.52 percent. And also on the same day BB Securities reported the yield on the 10-year Brazilian bond at 13.53 percent, twice the yield on the Canadian bond. In practical terms, this means that Brazil must pay 13.53 percent for funds while Canada has to pay only 6.52 percent. This spread indicates the relative risks the market perceives in the two investments, Mr. Chairman, and suggests why loan guarantees are not a viable option for Brazil or other developing countries.

18. With direct lending too expensive and too risky, and with guarantees not viable commercially, Brazil settled upon interest equalization as its best option to support the financing of Embraer's aircraft. From a long-term perspective, interest rate support is not the most desirable option, indeed it may be the least desirable. After all, if a government has the resources to support direct financing, it is paid back with interest. And if it is able to offer commercially acceptable guarantees, it will make money on the premiums, as I have noted, provided defaults are not excessive. With interest equalization payments, however, there is no payback. It is all expense.

19. But Brazil and most developing countries have no choice other than to incur that expense. They cannot afford to finance exports of large capital goods directly, and markets do not readily accept their guarantees. Their exporters, however, face competition from developed country exporters who benefit from both direct financing and loan guarantees. Interest equalization is the only available alternative. In export financing, as in so many other areas, the rich seem to get richer, and the poor get poorer.

20. This, then, is the background as to why Brazil needs to use PROEX interest equalization payments to support export credits. I will now ask Mr. Azevedo to discuss the standard required by the Appellate Body and why PROEX, as revised, meets that standard.

2. The CIRR and the Market

21. Mr. Chairman and Members of the Panel, the central issue before the Panel, the Appellate Body, and again in this proceeding is whether PROEX interest equalization payments for aircraft are used by Brazil to secure a "material advantage" in the field of export credit terms as that term is used in the first paragraph of item (k) of Annex I to the Subsidies Agreement. The Panel found that they were; the Appellate Body agreed, and accordingly Brazil has made the changes necessary.

22. However, the Appellate Body also clarified an important aspect of the Panel's Report regarding the measurement of material advantage. At paragraph 178 of its Report, the Appellate Body makes clear that it is the "marketplace" and not "the terms that would have been available in the absence of a payment" that is the benchmark for determining whether PROEX is used to secure a material advantage within the meaning of the first paragraph of item (k).

23. This seems quite clear to Brazil, but Canada, at paragraph 11 of its Second Submission, disagrees. In paragraph 178, according to Canada, the Appellate Body was merely referring to the Panel's findings and not its own. Canada is mistaken.

24. In its written submission to the Appellate Body, Brazil had noted that the Panel appeared to use two different benchmarks for the term material advantage. Brazil cited paragraphs 7.23 and 7.37 of the Panel Report as suggesting that the benchmark was whether the payment resulted in the availability of export credit on terms more favorable than the terms that would otherwise have been available to the purchaser with respect to the transaction in question. In other words, Brazil argued to the Appellate Body, the Panel Report seemed to say that if a customer could obtain a rate of 9.8% from a lender to finance a Brazilian aircraft without PROEX, a material advantage would be secured if PROEX reduced the rate to 6%, regardless of the terms the customer could obtain in the marketplace from other suppliers.

25. However, Brazil noted that in paragraph 7.23 the Panel also stated "that an item (k) payment is 'used to secure a material advantage' where the payment has resulted in the availability of export credit on terms which are more favorable than the terms that would otherwise be available *in the marketplace* to the purchaser with respect to the transaction in question." Brazil then referred to several definitions of "marketplace," such as "a place or institution in which buyers and sellers of a good or asset meet." A "marketplace," Brazil concluded, is not a single transaction between a particular buyer and a particular seller, but the universe of transactions or offers for transactions among all potential buyers and sellers. This argument is reflected in paragraphs 171-177 of the Appellate Body's Report.

26. The Appellate Body resolved Brazil's confusion by assuming, at paragraph 178, that the Panel meant the latter definition, and proceeded in its analysis from there. After having made clear that it is the "marketplace" that is the benchmark, the Appellate Body discussed "one example" of a benchmark in the marketplace, the Commercial Interest Reference Rate of the OECD Arrangement, the CIRR, and concluded, however, that PROEX as it then was formulated, did not meet this or any other acceptable benchmark.

27. The only reasonable reading of the Appellate Body's extended discussion of the CIRR is that an interest equalization program like PROEX, based on the CIRR, would not provide a material advantage in the field of export credit terms, and would, therefore, be in conformity with the requirements of the Subsidies Agreement. Canada has noted the statement of the Appellate Body, at the end of paragraph 182, that the fact that a particular interest rate is below the relevant CIRR "is a positive indication" that the government payment in that case has been used to secure a material advantage in the field of export credit terms. But a "positive indication" is not conclusive proof; it is at most a rebuttable presumption. The Appellate Body did not say that CIRR was the measure of material advantage. It said the market was the measure, and that CIRR was "one example" of the market, one benchmark.

28. Canada itself has suggested other benchmarks, and has noted that its own export financing support is based on these benchmarks – LIBOR and the US T-bill. Canada asserts that its own program, based on these benchmarks, is consistent with its OECD and WTO obligations. Fair enough. In this proceeding, Brazil is not challenging those assertions. But if LIBOR and the T-bill

are acceptable benchmarks for Canada, and constitute – as Canada has repeatedly said – the marketplace, they are acceptable benchmarks for Brazil as well.

29. Canada and the two developed country third parties all disagree, apparently believing that there is one benchmark for them and another for everyone else. Let me turn to their objections.

3. Canada's Arguments

30. Canada's argument hinges on its claim that, in paragraph 178 of its Report, the Appellate Body was referring to the Panel's findings and not to its own, which obviously, as I have noted, is not the case. That point basically responds to the bulk of Canada's arguments, but let me address each one briefly.

31. First, Canada argues that Brazil improperly uses an *a contrario* argument in connection with the first paragraph of item (k). However, an *a contrario* exception to the first paragraph of item (k) is necessitated by the very language of that paragraph. Moreover, item (k) is not the only paragraph of Annex I that requires an *a contrario* exception. Shortly I will be discussing loan guarantees in greater detail, so let us look at item (j) of Annex I in the context of Canada's argument that *a contrario* interpretations of Annex I are not permitted. Item (j) certainly provides context for the text of item (k). It provides that the following is an example of a prohibited export subsidy:

The provision by governments (or special institutions controlled by governments) of export credit guarantee or insurance programmes ... at premium rates which are inadequate to cover the long-term operating costs and losses of the programmes.

32. If this text is read with an *a contrario* exception, it means that government loan guarantee programs, such as the Ex-Im Bank of the United States and Canada's Export Development Corporation, which presumably charge premium rates to cover their long term costs and losses, are permitted. (And I would add, parenthetically, that the Panel, at paragraph 6.98 of its April 1999 Report, noted that Canada's EDC provides loan guarantees).

33. But if there is no *a contrario* interpretation permitted, then all loan guarantee programs are prohibited subsidies, regardless of whether their premiums are adequate to cover long term costs and losses. That is because all of them provide a financial contribution in the form of potential direct transfers of funds, as the original Panel found, and because all of them confer a benefit. That is their *raison d'être*. I can assure you that LIBOR plus 3 basis points is an extremely beneficial rate for any airline, Chinese or otherwise.

34. Canada cannot have it both ways. Either *a contrario* exceptions to Annex I are permitted or they are not. There is nothing in the text of either item (j) or item (k) to support the conclusion that an *a contrario* exception is permitted in one but not the other. If an *a contrario* exception is not permitted in item (j), then EDC, Ex-Im Bank and a host of other government loan guarantors are providing prohibited subsidies.

35. Obviously, such a result is contrary to the clear text of item (j). And just as clearly, an *a contrario* exception is mandated by the text and context of the first paragraph of item (k). In both items, a condition or requirement for inclusion is given. In (j), it is inadequate premium rates; in (k), it is material advantage. Failure to employ an *a contrario* interpretation renders the conditional language of each item superfluous. Item (j) could just as well have read, "loan guarantees," and item (k) "payment of part or all of the costs incurred." Put differently, the conditional language of both items makes no sense unless an *a contrario* interpretation is adopted.

36. Canada's next point is that PROEX payments somehow are not "payments" as that term is used in item (k). Canada argues that because PROEX payments are available to purchasers who

finance payments outside Brazil, they are not costs incurred by a financing institution or an exporter in "obtaining credits." Let me note first that this part of the argument, by its terms, applies only when the financing institution is outside Brazil. Further, Canada argues, when the financing institution is inside Brazil, the payments are made to reduce rates "below market rates," and accordingly, the argument runs, this is not a reimbursement for the cost of "obtaining credits."

37. Neither argument has merit. Item (k) speaks of "the payment ... of all or part of the costs incurred by exporters or financial institutions in obtaining credits." When the lending institution is outside Brazil, Embraer, the exporter, faces costs in obtaining for its customer a financial package that is competitive in the market. If it cannot obtain a competitive financial package for its customer, it would be forced to take other costly action such as paying for a commercially available loan guarantee at a high premium. When the lender is inside Brazil, it is the lender itself who must obtain the dollars on the market. Inevitably, for reasons that were thoroughly discussed in the original panel, this cost is higher than the rate that must be made available to the borrower. The lender, in effect, may be called upon to lend below its cost of funds, and PROEX is intended to compensate for this cost. Thus, whether the lender is outside or inside of Brazil, PROEX is payment of all or part of the costs incurred by exporters or financial institutions in obtaining credits.

38. At note 198 of its April 1999 Report, the Panel queried whether PROEX payments reflected the cost of "obtaining" credits or of "providing" credits. There is no functional difference. What has not been obtained cannot be provided. Embraer must provide competitive credits to its potential customers. Therefore, Embraer must obtain credits or work with a financial institution that obtains them. Both incur costs in obtaining the credits they provide, and it is these costs that are the object of PROEX.

39. Next, Canada argues that Brazil's use of a benchmark of T-bill plus 20 basis points "on its face demonstrates that PROEX export subsidies secure a material advantage in the field of export credit terms."

40. Before dealing with the inadequacies of this argument, let me note a statement Canada makes at paragraph 33 of its Second Submission. "By establishing a preference for a rate below the applicable CIRR," Canada states, "Brazil has demonstrated a preference for securing advantage in the field of export credit terms." If Brazil may be permitted an *a contrario* interpretation of this statement, Canada appears to be saying that if Brazil *had* established a reference rate at the applicable CIRR, it would *not* be securing advantage in the field of export credit terms. Brazil agrees, and believes this is the only reasonable interpretation of the Appellate Body's language with regard to CIRR. Brazil also notes that by arguing here that CIRR is the market, Canada is contradicting its earlier arguments that the Appellate Body did not hold that the marketplace is the proper measurement for material advantage, as that term is used in item (k). Clearly, the Appellate Body did hold that the measure is the market.

41. But as I have noted, just because a CIRR reference point does not secure a material advantage does not mean that all other reference points of necessity do so. As the Appellate Body noted, CIRR is but "one example."

42. Canada itself, as I noted earlier, has furnished other examples: LIBOR and the T-bill. It was Canada that repeatedly told the original Panel, as well as the Panel examining Canada's programs, that the proper benchmarks were LIBOR or the T-bill. It was Canada that said, in its Second Oral Submission to the original Panel, "if PROEX simply reduced the interest rate offered to an airline to one that is above LIBOR or OECD rates, Canada would not have brought this case." Well, PROEX simply reduces the interest rate offered to an airline to one that is above LIBOR, so the question arises, why are we here? Canada, it seems to Brazil, keeps moving the goal posts.

43. The marketplace for aircraft financing includes both loan guarantees and market window operations. Canada disagrees. Let me turn now to those points.

44. Canada begins its loan guarantee argument, at paragraph 36 of its Second Submission, with a reference to the Ex-Im Bank loan guarantee documented in Exhibit 2 to Brazil's First Submission. According to Canada, "The transaction cited by Brazil is a simple US Ex-Im Bank loan guarantee under which the Government of the United States extends its own Sovereign credit risk to cover a percentage of the amount financed. In such circumstances," Canada continues, "the lending bank establishes financing terms in the light of the risk of the US government, not the borrower."

45. That is precisely the point. As Minister Magahes has explained, Governments can support export credits in several ways, with direct financing, with loan guarantees, and with interest rate support. From the point of view of the potential borrower, it makes little if any difference. The cost to the borrower is what makes all the difference.

46. To compete effectively with the LIBOR plus three basis points offered by Chase Manhattan with an Ex-Im guarantee, a government offering either direct financing or interest rate support would have to offer the borrower an equally low rate, allowing an add-on for the guarantee premium. The marketplace consists of all of the financing options available to the customer, not the mechanisms, such as guarantees, direct financing, or interest rate support, by which governments make those options available.

47. Canada's argument to the contrary is an argument of form over substance. While conceding at paragraph 38 of its Second Submission that "loan guarantees generally can be considered a form of export credit," Canada basically argues that because guarantees are treated in item (j) of Annex I while "export credit" is the subject of item (k), the two "are to be treated separately." The fact that they are treated separately for purposes of the conditions that apply – premiums in one case, material advantage in the other – does not mean they are separate for purposes of their impact in the market. Both the Subsidies Agreement and the OECD Arrangement make clear that they both are forms of export financing support, and, as the quote confirms, Canada agrees.

48. Canada also argues that the particular example offered by Brazil does not justify the changes made in PROEX because LIBOR normally is used as a base in floating rate transactions while the US Treasury bonds are normally used as a base in fixed rate transactions. The first thing that should be noted about this argument is that it would be met completely by a PROEX based on LIBOR plus three basis points plus an appropriate amount for a guarantee fee. Thus, the only remaining question concerns the relevance of Brazil's LIBOR evidence to PROEX.

49. Canada's argument is based on the assumption that longer-term interest rates always are higher than shorter-term rates. While long term rates frequently are higher, this is not always the case. Interest rates fluctuate, and at times long-term rates are lower than short term. In fact, the *Financial Times*, for the January 29-30 weekend, reported that the one-year LIBOR rate was 6 13/16 – approximately 6.81 percent – while the yield on the one-year T-bill was only 6.22 percent. The 10-year T-bill, on which PROEX is based, yielded 6.65 percent while the 30-year US bond yielded less, only 6.44 percent. This is just the opposite of what Canada assumes is always the fact.

50. PROEX is not based on the assumption that lower long-term rates are a permanent condition, Mr. Chairman. Clearly they are not. As I said, interest rates fluctuate. But the point is, as Canada admits, both LIBOR and the T-bill are legitimate, competitive benchmarks, widely used in aircraft financing. Neither is inherently higher or lower than the other. Brazil prefers to use the 10-year T-bill which, I would note, was – at the time it was selected – the higher of the two. The 10-year T-bill is the benchmark that most closely corresponds to the usual financing period for aircraft. Brazil then added 20 basis points for good measure.

51. Now Canada argues, however, that Brazil's comparison of a rate based on LIBOR to a rate based on the T-bill is an improper comparison, despite the fact, as I have noted, that Canada itself treats both rates as appropriate, competitive benchmarks. I would agree that a comparison to a T-bill transaction would be preferable, but as Minister Magahes has noted, Mr. Chairman, we live in a less than ideal world. In this less than ideal world, information on specific transactions is not normally available to the public. Brazil was somewhat fortunate to obtain the example it did obtain.

52. However, if this is a problem there is a solution. Certainly Canada has supported fixed rate financing for aircraft. Certainly, as well, has the EC, which in its third party submission also criticises Brazil's use of LIBOR as a comparison. And certainly so has the United States, which was the guarantor in the transaction set out in Brazil's exhibit. Canada, the EC, and the US could quite easily make a fair and representative selection of their own fixed-rate financing for aircraft (including financing supported by guarantees) available to the Panel and to the parties. This would resolve the matter quickly. Until they do so, however, they should not be heard to complain of the inadequacy of Brazil's evidence on the point. After all, the parties – particularly Canada as the complaining party – have an affirmative obligation to be fully forthcoming in providing information to Panels. Unless and until they do so, the Panel is more than justified in concluding that a benchmark of T-bill plus 20 basis points does not provide a material advantage over a benchmark of LIBOR plus three basis points and a guarantee fee.

53. Finally on this point, Mr. Chairman, I would note that in calculating the amount of the total guarantee fee that should be attributed to each year of the guarantee, Brazil simply divided the total amount by the number of years the guarantee would be in effect. We understand that this is a perfectly acceptable methodology in the business world. Both Canada and the EC criticize this method, but do not disclose the methods they used. Moreover, they reach different results themselves. This would seem to demonstrate that there is no single correct way to make this calculation, and that Brazil's methodology is acceptable. In concluding this point, Mr. Chairman, I would simply note that in the transaction that is the subject of Brazil's Exhibit 2, even the guarantee fee itself is financed at the LIBOR plus three basis points rate applicable to the principal of the loan. This is typical, we understand. Even the guarantee fee is financed at a rate below CIRR.

4. Market Windows

54. Mr. Chairman and Members of the Panel, totally apart from the comparison with LIBOR plus three basis points, is the question of "market window" operations. We have read and pondered the submissions of Canada and the third parties on this subject, and have to admit to some confusion. This is an important subject, Mr. Chairman, because market windows are explicitly referred to in the OECD Arrangement and are relevant to its operations. The Arrangement, in turn, provides a "safe harbour" for export credit support in the second paragraph of item (k) and, as we have learned from the Appellate Body, it has relevance for the material advantage language in the first paragraph as well.

55. Consequently, it is important that market windows be fully understood, not only by the OECD participants, but by all WTO Members, most of whom are not members of the OECD and most of whom, like Brazil, might not appreciate all of the subtleties of the workings of that organization. We ask the Panel to take advantage of the fact that the complaining party in this proceeding and the third parties are all developed country members of the OECD and participants in its Arrangement. A complete explanation by them of the market window, and a thorough description of all of their operations under the market window, would be of benefit not only to this Panel, but to all Members of the WTO.

56. Let me begin with the facts as Brazil understands them. All participants in the Arrangement – and all Members of the WTO – may take advantage of the Arrangement's CIRR in supporting export

credits. Thus, regardless of their cost of funds, all participants and all Members may make financing available at CIRR. This has nothing to do with the market window.

57. In addition, the Arrangement contains provisions that permit participants to match rates offered by others that are below the relevant CIRR. These provisions, too, have nothing to do with the market window.

58. But if all participants can lend at CIRR, and if all participants can match rates below CIRR, what is the market window and what is its function?

59. Canada has said, at paragraph 44 of its Second Submission, that, "For the purposes of market window transactions, the appropriate reference is to terms available to a recipient in the market with respect to a particular transaction." It is not clear to Brazil, Mr. Chairman, how this standard differs from the matching provisions of the OECD. We had thought that the purpose of the matching provisions was to permit official credits below the CIRR when, in a particular transaction, a potential borrower was being offered lower terms.

60. Brazil has told the Panel how it believes the market window operates and what Brazil believes its function to be. To summarize, Brazil's understanding is that certain participants in the OECD Arrangement consider that they are permitted by the Arrangement to support export credits *below* the relevant CIRR through the "market window." According to Brazil's information, these OECD participants define "official credits" as those made available below the participant's cost of funds. Credits made available at or above a participant's cost of funds, according to Brazil's information, are not considered to be "official credits" by these participants, and, therefore are not considered to be subject to the interest rates provisions of the Arrangement, including the CIRR. The OECD has not disapproved of this interpretation and this practice.

61. Now, Canada claims that Brazil confuses its market window position, but, Mr. Chairman, Canada never says what that position is. Canada states, at paragraph 48 of its Second Submission, that, "The EDC does not provide a subsidy under its Corporate Account, in the sense that in entering into financing transactions, it does not confer a benefit in accordance with the terms of Article 1 of the SCM Agreement." But this is all Canada says.

62. Mr. Chairman, I want to make clear that Brazil is not here accusing Canada's EDC, through its Corporate Account, of conferring a benefit within the terms of Article 1 of the Agreement. That is not the issue. The issue is whether Canada, through its EDC or any other agency, enters into financing transactions for aircraft in which the relevant interest rate is below CIRR. Specifically, the issue is whether it does so through so-called market window operations, and in so doing affected the market in which Embraer must operate, utilising PROEX, without securing a material advantage.

63. Canada simply has refused to address this question, arguing that Brazil is trying to raise the issue of Canada's subsidies as a justification for its own. While Brazil certainly made that argument before the original Panel, it is not doing so here. The question is not what are Canada's subsidies, but what is the market, and what is the market window's contribution to that market?

64. In this proceeding, Mr. Chairman, Brazil is not, to repeat, accusing Canada of conferring a benefit within the meaning of Article 1, but of operating through a market window at rates below CIRR, in a way that is perfectly legal and proper. Brazil is not challenging that action Mr. Chairman, Brazil just wants to participate, along with Canada and the third parties, in the market where loan guarantees and market windows permit operations below the CIRR.

65. In paragraph 43 of its Second Submission, Canada states, "'Market window' generally refers to circumstances where an export credit agency offers a recipient direct financing at terms comparable to those that the recipient would be able to obtain in the market." Of necessity, the market to which

Canada refers is a market below the CIRR. PROEX at T-bill plus 20 is designed to permit Brazilian firms to participate in that market along with firms from Canada and other Members. Minister Simas Magahas will present the remainder of Brazil's points.

5. Undelivered Aircraft

66. Let me turn briefly now to the question of the undelivered aircraft. The parties have argued this issue extensively, Mr. Chairman, and little new appears in the written submissions of Canada or the third parties that we need dwell on. Suffice it to say, as Brazil has pointed out in detail in its written submissions, that the Appellate Body made a sharp distinction between the granting of a subsidy for purposes of Article 27, and the coming into existence of a subsidy for purposes of Article 1. Neither Canada nor the third parties can contest that distinction.

67. We also note, with regret, that the EC has changed its position from the one it took before the original Panel and the Appellate Body, and now agrees with Canada that PROEX subsidies are provided when aircraft are exported, not when commitments are made. There are those in Brazil who are cynical enough to believe that this volte-face is related to the 9 December 1999 decision of the European Commission to authorize the Government of Germany and the State of Bavaria to guarantee a loan of \$350 million to Dornier Luftfahrt for the development of competing regional aircraft. But that is not a matter for this particular proceeding.

6. Australia Leather

68. Let me now turn to the question of the recent report of the Article 21.5 Panel in *Australia – Leather*. For reasons that I will discuss, Mr. Chairman, Brazil believes that *Australia – Leather* was wrongly decided, and its results should not be followed by this Panel. Nevertheless, even assuming that *Australia – Leather* was correctly decided, its results are not applicable to this case, which should be distinguished.

69. The Panel in *Australia – Leather* said, at paragraph 6.39 of its Report, that the term "withdraw the subsidy" in Article 4.7 of the Subsidies Agreement "may" encompass repayment of the subsidy. It went on, at paragraph 6.48, to say that "in the circumstances of this case, repayment is necessary in order to 'withdraw' the prohibited subsidies found to exist." The circumstances of the case before the Panel in *Australia – Leather* were very much like the circumstances before the original Panel in *Canada – Aircraft*, and very much unlike the circumstances before the original PROEX Panel and this Panel.

70. The circumstances that faced the Panel in *Australia – Leather* were those in which a subsidy was provided in a covert attempt to circumvent the rules, with unnotified subsidies that were in fact contingent upon export. These circumstances parallel in every relevant point those that faced the original Panel in *Canada – Aircraft*. In those circumstances, the Panel in *Australia – Leather* concluded that the term "withdraw the subsidy" in Article 4.7 of the Subsidies Agreement meant that Australia had to recoup the entire amount previously provided. This might have been an appropriate conclusion in a case involving a covert attempt to circumvent the rules, but that is not the case before this Panel.

71. PROEX did not involve a covert attempt to circumvent the rules, Mr. Chairman. PROEX was properly notified to the Subsidies Committee as an export subsidy. There was no attempt by Brazil to mislead anyone about anything.

72. Moreover, because of Article 27, Brazil was, at the time it notified PROEX, and for a considerable period thereafter, exempt from the prohibition of Article 3. While the Panel eventually found that Brazil was no longer eligible for Article 27, it concluded, in paragraph 7.57 of its Report, that "it is for the complaining Member to demonstrate that the developing country Member in

question is not in compliance with" the conditions of Article 27. Until that proof is made, developing countries, as the Panel concluded, are presumed to be exempt from the prohibitions of Article 3.

73. This is also the answer to the point raised by the United States at paragraph 8 of its submission to the effect that private firms could have no legitimate expectation regarding prohibited subsidies. Totally apart from the right of any private party to expect that it is entitled to rely on its government's legal position with regard to the government's international legal obligations, is the undisputed fact that post-1995, the prohibition of Article 3 did not apply to developing countries by virtue of Article 27.

74. Thus, there are valid reasons for distinguishing this case from *Australia – Leather*, and we believe the Panel should do so. However, we also believe the Panel should consider not following *Australia – Leather* on the ground that it was wrongly decided.

75. The Panel in *Australia – Leather* decided an issue that the parties did not present to it. It is highly unusual in GATT/WTO jurisprudence for panels to decide issues the parties decline to present to them. To be sure, a panel, or the Appellate Body, may question a legal interpretation or assumption of the parties, but this has not been taken as license to decide issues that have not been submitted. More typical are the remarks of the Appellate Body in its first Report, *Reformulated and Conventional Gasoline*. There the parties had cited, with approval, the language of a GATT Panel interpreting the "relating to" language of Article XX(g) of GATT 1994 as meaning "primarily aimed at."

76. "All the participants and third participants in this appeal," the Appellate Body wrote, "accept the propriety and applicability of the view of the *Herring and Salmon* report and the Panel Report that a measure must be 'primarily aimed at' the conservation of exhaustible natural resources in order to fall within the scope of Article XX(g). Accordingly, we see no need to examine this point further, save, perhaps, to note that the phrase 'primarily aimed at' is not itself treaty language and was not designed as a simple litmus test for inclusion or exclusion from Article XX(g)."

77. The Appellate Body in *Gasoline* thus decided the case that was presented by the parties, even though the parties and the Panel had adopted an interpretation of a relevant GATT 1994 Article that the Appellate Body clearly thought questionable. It signalled those doubts quite clearly, but it did not go beyond its mandate.

78. Brazil believes that the Panel in *Australia – Leather* went well beyond its mandate, and did so unnecessarily. Its radical conclusion that refund of all past amounts paid is necessary to withdraw a subsidy within the meaning of Article 4.7 certainly was not forced upon the Panel by the language of the Agreement. Consider, for example, the fact that the Panel used the second definition of "withdraw" from the Oxford Dictionary. That definition, as the Panel notes, includes the words "retract" and "pull back," which may lend some support to its conclusion. But the first definition, passed over by the Panel, includes the notion of "remove," as in "remove" something from its place or position. This definition does not support the Panel's conclusion; to the contrary, it suggests ending the offending practice rather than refunding past subsidies. To be sure, neither definition is conclusive one way or the other, but it seems unwise and unnecessary for the Panel to have moved past the first definition to reach one more supportive of its unusual conclusion. Prudence, I would submit, suggests a different approach.

79. Next, the Panel considered the context of Article 4.7, and said this context "supports the suggestion" that withdraw the subsidy requires repayment. But mere support of a suggestion is hardly a convincing argument for telling the parties to a dispute that they do not know what their dispute is about.

80. The Panel also noted the similarity of the language in Article 3.7 of the Dispute Settlement Understanding and acknowledged that this could support a conclusion contrary to the one it reached. However, the Panel then said that it did not believe Article 3.7 "requires" such an interpretation.

81. Perhaps, Mr. Chairman, Article 3.7 of the DSU does not "require" the interpretation that retroactive remedies are not called for by Article 4.7 of the Subsidies Agreement, but it certainly would "permit" such an interpretation. Such an interpretation would have been consistent with that of the parties, including the third party, and with half a century of GATT/WTO jurisprudence.

82. Brazil believes the Panel was in error to reach the conclusion that retroactive remedies "may" be permitted by Article 4.7. Brazil does not believe that such a conclusion was contemplated by the negotiators of the Subsidies Agreement; the language to which they agreed certainly does not compel such a conclusion. Accordingly, in Brazil's view, *Australia – Leather* was wrongly decided, and should not be followed by this Panel.

7. Conclusion

83. In conclusion, Mr. Chairman, Brazil requests that this Panel find that Brazil's amendments to PROEX comply fully with the recommendations and rulings of the DSB. For the reasons explained above and in Brazil's written submissions, Brazil requests that the Panel find that PROEX subsidies are granted at the time when binding letters of commitment are made.

84. In addition, Brazil requests that the Panel find that under the revised PROEX, Brazil has ensured that interest equalization is provided only insofar as necessary to meet a well-recognized marketplace benchmark.

85. Canada argues that Brazil should not be allowed to provide interest rate support below a single benchmark rate, the CIRR. But this does not reflect actual market practice. Canada asks you to interpret the Subsidies Agreement so as to deny Brazil, a developing country, the right to use export credit support to assist its exporter in the same manner and to the same degree as do Canada and other developed country Members. The language of the Subsidies Agreement makes plain that its drafters did not intend to produce such an inequitable result, and did not do so. They did not, as Canada claims, place developing countries at a stark disadvantage in the export credit marketplace. The Panel can and should interpret the Agreement so as to allow all WTO Members to operate fairly on an equal footing.

86. Thank you very much. We will be pleased to answer any questions you might have.

8. Concluding remarks of Brazil

87. Mr. Chairman and Members of the Panel:

This complex dispute involves many issues that most of us have never dealt with in our lifetimes, and probably are unlikely to deal with again. Issues of this nature require a special effort on the part of all who must become familiar with them, particularly those, like yourselves, who must decide them. Brazil therefore is particularly appreciative of the time and effort the Panel has invested in this matter. We know – from our own experience – that it has not been easy.

88. In my concluding remarks, I will be as brief as I can.

89. When all of the complex and obtuse details of the record in this case are boiled down, one central question remains: How can a producer in a developing country participate in global markets for capital goods like aircraft? Those markets are dominated by producers from developed countries, making it difficult for newcomers to compete. But Embraer has been notably successful

commercially. Its problem is not its competition. Its problem is the government financing received by its competition.

90. It cannot be disputed that aircraft are sold with government financing support. It cannot be disputed that developed countries have more options in designing the support they can make available, than do developing countries. In our remarks yesterday, we explained why loan guarantees are not a realistic option for developing countries – our credit ratings are not strong enough. We explained why direct financing is not a realistic option – the initial cost is too high. That leaves interest rate support.

91. In yesterday's question and answer session, Mr. Chairman, Brazil posed two hypothetical questions to Canada. We think it is significant that Canada answered one question, but declined to answer the other on the claimed ground that it was hypothetical. After all, if you can answer one hypothetical, why not two?

92. The Panel will recall that Brazil asked what Canada would consider to be the date of the subsidy in a hypothetical countervailing duty investigation of PROEX in Canada. This hypothetical question was answered.

93. The unanswered hypothetical question related to Brazil's Exhibit 2, the US Ex-Im guarantee of a loan to a Chinese airline at LIBOR plus 3 basis points. Brazil asked what options would be available to Canada, if a foreign competitor of the Canadian aircraft manufacturer were able to offer such terms to a potential customer. I think I am accurate in recalling that Canada's first response was that there would be no options available because this transaction involved large aircraft made by Boeing, and the Canadian manufacturer did not compete in that sector of the market.

94. Brazil then clarified the question, and noted that it was asking Canada to assume that the aircraft involved were regional aircraft. Canada then responded that the question was hypothetical and that, if I recall correctly, "there have been and will not be any such transactions in the regional aircraft market."

95. Mr. Chairman, this was no answer. Totally apart from the unjustified certainty of Canada's answer – how can it be sure there will *never* be any such transactions? – the question certainly could be answered from the current legal point of view. Are options available consistent with the requirements of the OECD Arrangement and the Subsidies Agreement, or not? Brazil submits, Mr. Chairman, that Canada *could have* answered. It just did not *want* to answer.

96. Canada did not want to answer because an accurate answer would have been that, to meet the rate on the loan guaranteed by Ex-Im Bank – which is legitimately well below CIRR – a Member could have offered its own comparable guarantee. This is an option that would be available to Canada, but not to Brazil, for the reasons we explained yesterday. The only other options of which Brazil is aware would be direct financing and interest rate support that met this legitimate market rate, and therefore did not secure a material advantage within the meaning of the first paragraph of item (k).

97. Canada has admitted that there is a market below CIRR, served not only by loan guarantees, but also by the market window. And Canada has also admitted that it has participated in that market. But Canada argues that – by some double standard it cannot justify – Brazil is not permitted to participate in that market.

98. Canada tells us, Mr. Chairman, that when it "steps through the market window," it merely acts as a commercial bank or lender, providing financing consistent with the terms available to a borrower from commercial banks. But Mr. Chairman, what commercial banks offer loan guarantees that permit

LIBOR plus 3 basis points financing? As Brazil's Exhibit showed, Mr. Chairman, commercial banks receive loan guarantees; they don't provide them.

99. Who other than Canada participates in this below-CIRR market? Canada's Exhibit 15, distributed yesterday, shows that even a Double-A rated corporations pay more than 100 basis points above T-bill for financing. Canada used that example to argue that Brazil's T-bill plus 20 basis points is inadequate.

100. But T-bill plus 100 is above CIRR, Mr. Chairman, so where is this "commercial market" below CIRR that Canada serves when it "steps through the market window"? Who are the other participants in this market? Certainly it is not those commercial entities whose activities form the basis of Canada's Exhibit 15.

101. That Exhibit represents the ideal world that would exist, Mr. Chairman, if governments were not involved in trying to improve upon it for the benefit of their exporters. That is a world in which Embraer could be highly successful if only its competitors played in that world.

102. But Embraer's competitors do not play in that world, Mr. Chairman. They benefit from financial support below CIRR from Canada, if not others. Just how much this support means can be appreciated by considering the fact that, according to Canada's Exhibit 15, a Triple-A rated borrower can pay as much as 97 points above T-bill for 10-year financing while a Chinese airline with a guarantee pays only LIBOR plus 3 points.

103. Mr. Chairman, Brazil submits that the "market" in which Canada participates when it "steps through the market window" is a market in which there are few, if any, participants other than Canada. Canada's circular, tautological, goal post-moving explanations and arguments make no sense. Of course, when Canada "steps through the market window" its terms are "market" terms. This is true by definition – they are the dominant, if not the only, terms in that so-called market. No one, that Brazil has ever heard of, is there other than Canada.

104. In the end, what it all comes down to is this: Canada is supporting exports at rates below CIRR, thereby creating a market below CIRR, albeit a market served essentially by Canada alone. It then justifies these rates, as it "steps through the market window," by asserting that they are merely market rates.

105. This conduct has not met with the disapproval of the OECD, as Brazil's Exhibit 6 to its First Written Submission shows. It is therefore a legitimate commercial market rate below CIRR. Brazil's PROEX benchmark of T-bill plus 20 does not provide a material advantage, within the meaning of item (k) when compared to this market.

106. Let me make several points as briefly as I can in conclusion. First, Canada has said that LIBOR and T-bill are only the starting points for a market rate. An appropriate amount for the risk of the borrower must be added. This is true, and Brazil has addressed this point in its First Written Submission, particularly in Exhibits 2 through 5 which set out the "exposure fee" chart of the Ex-Im Bank. In this regard, I would note that Embraer's largest customer in Europe is in Switzerland which enjoys an extremely low "exposure fee."

107. More importantly on this point, is the Ex-Im guarantee that has been so thoroughly discussed. The whole point of loan guarantees is to eliminate the risk, shifting it to the sovereign guarantor. As Canada said, in a loan guarantee, a government extends its own Sovereign credit risk to cover the risk presented by the buyer. The buyer's "risk premium," in other words, is absorbed by the guarantee.

108. I have already addressed Canada's Exhibit 15, submitted yesterday. Let me now comment on the other exhibits.

109. Canada handed out two charts. One purported to show the present value of savings as a result of reduction in interest rates. This chart would apply to *any* reduction in interest rates, including reductions that result when a government "steps through the market window."

110. Another chart purports to show that PROEX is still below the market. The chart compares PROEX to CIRR and to three airline transactions. It does not compare PROEX to the market window or to rates on loans that benefit from sovereign guarantees. It also does not appear to compare PROEX to any transactions supported by Canada. AMR, for example, is a customer of Embraer, among others. While AMR also has ordered 70 seat aircraft from Bombardier, these have not yet been delivered, and, therefore, presumably they are not part of the calculation. Northwest Airlines indeed is a customer of Bombardier, but Canada chose not to provide rates on that sale. Instead, Canada reports on a sale involving aircraft from British Aerospace.

111. Exhibit 16 is a series of "affidavits" from airline officials, all of which amount to legal *non sequiturs*. They assert the unsurprising proposition that "when comparing two equivalent aircraft offers," the officials prefer the one with the better financing. This is hardly surprising. What is surprising is that Canada, which declined to answer Brazil's question because it was hypothetical, is willing to ask the Panel to rely on such hypothetical documents.

112. The fact is that there never, never has been a competition for regional jet aircraft in which the aircraft were "equivalent." There are marked physical differences between the Bombardier and the Embraer regional jets, as the companies are only too eager to point out. More significantly, Mr. Chairman, this Exhibit confirms Brazil's position regarding T-bill plus 20. Consider:

- Canada has admitted that there is a market below CIRR.
- Canada is the major – if not the only – participant in that market.
- Brazil must be able to offer export credit support to its manufacturer sufficient to permit that manufacturer to compete in that market that is 50 or so basis points below CIRR.

113. Finally, there is Exhibit 14 which is an article from a São Paulo newspaper concerning the award of a contract to Embraer from Mesa Air. We are surprised that Canada had to go as far as São Paulo for this news.

114. According to a press report from Montreal, Bombardier said they lost the sale because their order backlog was so large they could not meet Mesa's delivery requirements. They lost business, in other words, because their business is so good. This has nothing to do with PROEX.

115. Thank you very much.

ANNEX 2-4

RESPONSES BY BRAZIL TO QUESTIONS OF THE PANEL

(14 February 2000)

The following are Brazil's written responses to the questions received from the Panel on 7 February 2000.

Q1. Canada states in its rebuttal submission that "[a] net interest rate of 20 basis points above the 10-year Treasury Bond rate is well below CIRR" (para. 33). Brazil itself states in its first submission that "Brazil chose a point of reference other than CIRR for PROEX based on evidence that, in the case of aircraft, the marketplace in fact supports lower interest rates" (para. 10). Does Brazil acknowledge that a net interest rate of 20 basis points above the 10-year Treasury Bond rate is below CIRR? If not, please provide historical examples of periods where such a net interest rate was equal to or higher than the CIRR rate?

Reply

Brazil agrees that a net interest rate of 20 basis points above the 10-year US T-bill normally is below the CIRR. This rate is consistent with the market for regional aircraft transactions, as Brazil has shown and as Canada has acknowledged. Canada has not sustained its burden in this Article 21.5 proceeding of proving that the T-bill plus 20 bps rate does not conform with Brazil's obligations under the SCM Agreement as interpreted in the Appellate Body report as adopted by the DSB.

Q2. Canada considers that, consistent with Article 3.2 of the SCM Agreement, withdrawal of a subsidy under Article 4.7 of that Agreement entails, at a minimum, ceasing to grant or maintain subsidies found to be prohibited under Article 3.1 of the SCM Agreement. Do you agree? Please explain your answer.

Reply

Brazil considers that to "withdraw the subsidy," under Article 4.7, means that Brazil can make no new legal commitments under PROEX after 18 November 1999 that constitute prohibited export subsidies. Please also see the response to question 3 below.

Q3. The Appellate Body has ruled that, for the purposes of Article 27.4 of the SCM Agreement, export subsidies for regional aircraft under PROEX are "granted" when the NTN-I bonds are issued. WT/DS46/AB/R, para. 158. Article 3.2 of the SCM Agreement provides that a Member "shall neither grant nor maintain" export subsidies. Is it your view that export subsidies for regional aircraft under PROEX are "granted" at a different point in time for the purposes of Article 3.2 than for the purposes of Article 27.4? If so, please explain the basis for that view.

Reply

The Appellate Body envisaged the possibility of different interpretations of the term "grant" as it is used in different Articles of the Agreement. Otherwise, it would not have gone to such lengths to specify, expressly, that it was speaking solely to the meaning of the term "grant" for the purposes of Article 27.4. The Appellate Body explicitly stated: "The issue in this case is when the subsidies for regional aircraft under PROEX should be considered to have been 'granted' *for the purposes of*

*calculating the level of Brazil's export subsidies under Article 27.4 of the SCM Agreement.*¹ It emphasized that at issue is "the interpretation and application of Article 27.4 *not* of Article 1."² Further, the Appellate Body distinguished between the existence of a subsidy and the point at which it is granted, and discussed the latter *only* in the context of Article 27.4. It disagreed with the manner in which the Panel expanded its discussion of the term "grant" and the point at which a subsidy is granted to include issues of interpretation of provisions of the SCM Agreement other than Article 27.4. It upheld the Panel's conclusion with respect to when the subsidies are granted but only "for the purposes of Article 27.4 of the SCM Agreement."³ It is thus quite clear that the Appellate Body deliberately and painstakingly avoided any possible interpretation of its ruling that would extend its conclusions relating to when a subsidy is "granted" beyond the scope of Article 27.4, and thereby made it abundantly clear that its discussion of the issue is relevant for the purposes of Article 27.4 only.

The requirement that a Member should not "maintain" subsidies found to be prohibited should be given its normal meaning that the prohibited subsidy should not continue in effect, certainly once it has been found to violate the SCM Agreement. The standard definition of the word "maintain" is to "go on with, continue."⁴ Similarly, the standard definition of the word "maintenir" (used in the French text of Article 3.2) is "conserver dans le même état."⁵ This also suggests that the injunction against maintaining a prohibited subsidy means that the subsidy cannot be continued in its prohibited state. Thus, Brazil has amended PROEX to ensure that the net interest rate to the borrower can be lower than the appropriate benchmark.

Brazil would note that Canada's position on this point appears to be contrary to its own practice. On 25 May 1999, the Committee on Subsidies and Countervailing Measures circulated Canada's 30 April 1999 notification of subsidies pursuant to Article XVI:1 of the GATT 1994 and Article 25 of the SCM Agreement.⁶ A number of the programmes notified have, according to the notification, been terminated yet payments based on prior commitments continue to be made. For example, the notification states that the Communications Technology R&D Incentive Programme was terminated in February 1995. However, payments are listed for 1996/7.⁷ "No new financial commitments have been made since 1 March 1995" under the Defense Industry Productivity Programme (the predecessor of TPC), yet payments totaled \$1,732,102 in 1996/97.⁸ "The last date for governmental financial commitments was 30 June 1988" for the Industrial Regional Development Programme, yet payments were made in 1996/97. According to the notification, the payments noted were "from commitments made prior to June 1988."⁹ Additionally, the Sector Campaigns (Sector Competitiveness Initiatives), designed to "enhance the international competitiveness of Canadian industry in selected sectors" was terminated in February 1995, yet payments totalled nearly \$7 million in 1996/97.¹⁰ With regard to fulfilling commitments, therefore, Canada, it would appear, advocates one rule for itself and another rule for Brazil and everyone else.

For the reasons explained in detail in paragraphs 3-26 of Brazil's Second Submission, therefore, in the case of PROEX, a financial contribution is made and a benefit is conferred within the

¹ WT/DS46/AB/R para. 154 (emphasis in original).

² *Id.* para. 156 (emphasis in original).

³ *Id.* para. 159.

⁴ The New Shorter Oxford English Dictionary on CD-ROM.

⁵ Robert, *Dictionnaire de la langue Française*.

⁶ Committee on Subsidies and Countervailing Measures, New and Full Notifications Pursuant to Article XVI:1 of the GATT 1994 and Article 25 of the Agreement on Subsidies and Countervailing Measures, Canada, G/SCM/N/38/CAN (25 May 1999).

⁷ *Id.* para. VI.

⁸ *Id.* para. VII."

⁹ *Id.* para. X.

¹⁰ *Id.* para. XVI.

meaning of Article 1 of the SCM Agreement, and a subsidy is thereby granted within the meaning of Article 3.2 of the SCM Agreement, when contracts are signed pursuant to the letters of commitment. At this point, the beneficiary has been granted an unconditional legal right to receive PROEX interest equalization. Please see also the response to question 12 below.

Q4. Canada states (first submission, para 21) that Resolution 2667 and Newsletter 2881 "only apply to future commitments. They do not apply to or in any way modify PROEX export subsidies in respect of regional aircraft that have been or will be exported after 18 November 1999 pursuant to commitments made before that date." Please confirm whether this statement is correct and, if it is not, please provide an explanation as to the precise relevance of these legal instruments to payments pursuant to letters of commitment predating the effective date of these legal instruments.

Reply

Resolution 2667 and Newsletter 2881 do not modify pre-existing PROEX commitments pertaining to aircraft to be exported after 22 November 1999.

Q5. Article 2 of Resolution 2667 provides that it shall enter into force on its date of publication. Although the Resolution is dated 19 November 1999, Exhibit Bra-1 indicates that the Resolution was published on 22 November. Were any letters of commitment in respect of regional aircraft issued between 19 and 21 November inclusive? If so, were they issued pursuant to the terms laid down in Resolution 2667?

Reply

There were no letters of commitment issued with respect to regional aircraft between 19 and 21 November 1999, inclusive.

Q6. Central Bank of Brazil Circular Letter No. 2881 sets forth maximum percentages for PROEX interest rate equalization in respect of financing up to 10 years. Canada states in its first submission (para. 20) that this Circular Letter "does not specify a maximum interest rate reduction percentage for financing terms in excess of 10 years." Is PROEX interest rate equalization available in respect of financing for a period in excess of ten years? If so, please state whether and how the maximum interest rate equalization set forth in Circular Letter No. 2881 would apply in respect of such financing.

Reply

Brazil normally foresees a maximum period of 10 years for PROEX financing. This is why both the prior programme and the amended programme specify a 10-year maximum term. That maximum was waived, and continues to be waived, however, for regional jet aircraft only. This is because it is necessary for Brazil to provide regional aircraft financing on terms that are consistent with the market. When the Brazilian manufacturer entered the regional jet market, terms in excess of 10 years had already been established in that market by Canada. The *maximum* equalization payment under Circular Letter No. 2881 remains at 2.5 percentage points, however, even if the term of the loan is greater than 10 years.

Canada has confirmed that it is consistent with the market to provide tenure terms beyond those included in the OECD Arrangement. Before the Appellate Body in *Canada – Aircraft*, Canada argued that "a financing term for regional jet aircraft of more than 10 years, and even of up to 18 years, is entirely within the bounds of commercial practice." Brazil refers the Panel to paragraph 85 of the Appellate Body's Report in *Canada – Aircraft* for this discussion.

Q7. Has Brazil issued any letters of commitment to provide interest rate equalization in respect of regional aircraft since 19 November 1999? If the answer is yes:

- Please inform the Panel of the net interest rate (as defined by the Appellate Body in WT/DS46/AB/R, para. 181) applicable to each transaction.
- Please inform the Panel as to whether that interest rate is at or above the relevant 10-year US Treasury Bond plus 20 bps?

Reply

No, Brazil has not issued any letters of commitment to provide interest rate equalization in respect of regional aircraft since 19 November 1999.

Q8. Is PROEX interest rate equalization available in respect of export credits provided at floating interest rates? If your answer is yes, please state whether and how the "preferred" interest rate based on 10-year US Treasury Bonds plus 20 bps would be applied in respect of such floating interest rates. If this "preferred" interest rate does not apply in the case of PROEX-supported export credits at floating interest rates, please explain what "floor" interest rate would be applicable in such a case.

Reply

PROEX as modified to implement the recommendations and rulings of the DSB is aimed at fixed-rate transactions. Floating rate transactions are not normally used to finance aircraft. There are no records that PROEX transactions for aircraft have involved floating rates. However, if an application were made for PROEX support for a floating rate transaction, it would be considered on its merits. As a practical matter, none is anticipated. Brazil has not determined what floor interest rate it would use in such a case. That decision would have to be based upon the circumstances prevailing at the time. Obviously, under the "new" PROEX such floor would have to be compatible with market rates. As a practical matter, Brazil has not addressed the problem in detail because it is so highly unlikely that such a proposal would occur.

Q9. Canada asserts (second submission, para. 40 and footnote 24) that, in the case of large aircraft, spreads of less than 10 bps are common, while for regional aircraft, spreads, of less than 20-30 bps would be uncommon. Please comment.

Reply

In Brazil's view, it is not the aircraft, but the airline and its credit rating that determine the amount of the credit spread. The main component of the spread is the risk of repayment by the purchaser. The degree of risk of repayment depends on the purchasing airline rather than the size of the aeroplane. For example, American Airlines, a customer of the Brazilian regional aircraft manufacturer, has an excellent credit rating. Its credit spread is, as a result, less than the spread of many airlines that purchase only large aircraft, but that happen to have poor credit ratings. In addition, the spread may be affected by the total amount of the transaction regardless of whether it is for large or for regional aircraft. Finally, it is worth noting that PROEX's spread of 20 bps above the 10-year T-bill falls within the range for regional jet aircraft transactions suggested by Canada. Again, Canada has failed to show that the T-bill plus 20 bps benchmark provides a material advantage in the market place.

Q10. Brazil states (first submission, para. 4) that the Appellate Body held that "Members are permitted to obtain an "advantage" in the field of export credit terms provided that advantage is not "material" (emphasis added)." The Appellate Body did not however address the issues of whether the first paragraph of item (k) can be used as an affirmative defence, nor whether PROEX payments are "payments" within the meaning of that item. Please comment.

Reply

Brazil believes that the Appellate Body effectively, and of necessity, did address the issue whether the first paragraph of item (k), in its *a contrario* form, can be used as an affirmative defence. The Appellate Body, at paragraph 177, noted that the word "advantage" is modified by the word "material". When it did so, it confirmed that the term "material advantage" carries significance and cannot be "read out" of the Agreement, consistent with the principles of interpretation of public international law.

Similarly, the Appellate Body's discussion of the acceptability of the CIRR as a benchmark for the first paragraph of item (k) of necessity implies the notion that PROEX payments consistent with the CIRR are payments within the meaning of that paragraph. Brazil does not believe that this can be disputed. Brazil also believes, as we have explained, that the CIRR is not the only acceptable benchmark, but that the Appellate Body instead used it as one indication of the *market*. It is the *market* that is the ultimate benchmark.

The Appellate Body's statement, in the last sentence of paragraph 187 of its Report, was that *as a jurisdictional matter only*, it could not rule on either of these issues in the abstract, since the Panel had not made any findings on either issue, and the lack of Panel findings was not appealed.

But the Appellate Body's decision on the issue that was clearly before it – "material advantage" in the first paragraph of item (k) – by necessity implies that an *a contrario* interpretation is required and that PROEX payments are "payments" within the meaning of that paragraph. Any other interpretation renders the Appellate Body's discussion of the question academic.

The Appellate Body also certainly disagrees with Canada's arguments that the Illustrative List is by definition superfluous because its only purpose is to illustrate the definition of a prohibited subsidy. Footnote 5 to the SCM Agreement makes clear that the List has a purpose other than pure illustration. The provisions of the Illustrative List must be interpreted in compliance with the rules of interpretation of public international law, which prohibit interpretations that render treaty language meaningless. This means that they must be given their ordinary meaning and full effect. The Appellate Body did so in interpreting the phrase "material advantage." Canada's denial of an *a contrario* interpretation to the material advantage clause would render that clause meaningless, and is therefore contrary to the rules of interpretation of public international law.

Canada's analysis ignores the fact that the material advantage clause was added to the language of an earlier version of item (k) and, therefore, must have had separate meaning to the negotiators who included the language.

The language of what now comprises item (k), without the material advantage clause, had its origins in rules adopted in 1958 by the Organization for European Economic Cooperation, the "OEEC," which was the predecessor of the OECD. These rules prohibited, among other practices:

- (g) The grant by governments (or special institutions controlled by governments of export credits at rates below those which they have to pay in order to obtain the funds so employed;

- (h) The government bearing all or part of the costs incurred by exporters in obtaining credit.¹¹

These provisions were included *verbatim* in a 1960 Report of a GATT Working Party on Subsidies as examples of export subsidies¹² Subsequently, they provided the basis for the Illustrative List that eventually was included in the Tokyo Round Code. It is significant, however, that in their first appearance in a GATT document, and for the next 18 years, these provisions had no material advantage clause.

When the Tokyo Round Code was concluded in 1979, the language that is now the second paragraph of item (k) was included to permit the Participants in the just-concluded OECD Arrangement to continue to take advantage of its provisions. Initially the Tokyo Round negotiators did not include a material advantage clause.

On 10 July 1978, an *Outline of an Arrangement* was circulated to the Sub-Group on Subsidies and Countervailing Measures of the Negotiating Group on No-Tariff Barriers.¹³ This Sub-Group comprised the GATT negotiators whose efforts produced the Tokyo Round Code. The draft contained a description of an Annex A, which set forth an illustrative list of export subsidies:

A list of export subsidies illustrative of the obligations in GATT Article XVI:4, as supplemented by the Arrangement. In this connection, work should build upon the 1960 Illustrative List, taking into account other work on this subject in the GATT.¹⁴

This description explicitly takes into account the OECD Arrangement, but does not mention a material advantage clause which, as of that date, had not appeared in any previous version of the Illustrative List, either in the OECD or in GATT. The first appearance of the material advantage clause in a GATT document did not occur until 19 December 1978, some 20 years after the relevant language was included in the first Illustrative List of the OEEC. This document, also an Outline of an Arrangement, contained the language that was included in the Tokyo Round Code and eventually became item (k):

The grant by governments (or special institutions controlled by [and/or acting under the authority of] governments) of export credits at rates below those which they have to pay in order to obtain the funds so employed, or the payment by them of all or part of the costs incurred by exporters or *financial institutions* in obtaining credit, *insofar as they are used to secure a material advantage in the field of export credit terms.*¹⁵

Thus, sometime after deciding to include the OECD safe-harbour clause, the GATT negotiators made two additional significant changes to the language contained in the 1960 Working Party report. First, they added the phrase "or financial institutions," and second, they added the clause, "insofar as they are used to secure a material advantage in the field of export credit terms." These additions were the last changes made in the language of item (k). They were made deliberately, and were intended by their drafters to have genuine meaning and effect. Canada's proposed

¹¹ JOHN E. RAY, *MANAGING OFFICIAL EXPORT CREDITS* 35 (Washington, D.C., Institute for International Economics 1995).

¹² BISD 9S/185 9 (Report Adopted on 19 November 1960).

¹³ General Agreement on Tariffs and Trade, Multilateral Trade Negotiations Group "Non-Tariff Measures," Sub-Group "Subsidies and Countervailing Duties," SUBSIDIES/COUNTERVAILING MEASURES, Outline of an Arrangement, MTN/NTM/W/168, 10 July 1978.

¹⁴ *Id.* page 23.

¹⁵ General Agreement on Tariffs and Trade, Multilateral Trade Negotiations, Group "Non-Tariff Measures," Sub-Group "Subsidies and Countervailing Duties," SUBSIDIES/COUNTERVAILING MEASURES, Outline of an Arrangement, MTN/NTM/W/210, 19 December 1978, page 26 (emphasis added).

interpretation of item (k) improperly treats these words as if the changes outlined here had never occurred.

Q11. The Appellate Body refers to the CIRR as a minimum commercial benchmark. Thus, it could be argued that any alternative benchmark in the marketplace for determining whether a payment is used to secure a material advantage must be undistorted by government intervention. Please comment.

Reply

The Appellate Body's statement that the CIRR is the "minimum commercial benchmark" was made in the context of its discussion of the OECD Arrangement. The CIRR is the lowest rate allowed for official credits under the interest rates provisions of that Agreement. The CIRR itself, however, is derived only in part from commercial transactions in the market. It is based on certain average rates paid for government debt securities with 100 basis points added to this average. It is, therefore, an agreement among governments to adopt a particular average rate with an arbitrary add-on. To this extent, at least, the CIRR itself is a distortion.

Moreover, the SCM Agreement itself explicitly permits government distortions – such as government loan guarantees. These permitted actions, in addition to the "market window" operations of some Participants in the OECD Arrangement, and indeed the CIRR itself, contribute to – and "distort" – the market for export credits for aircraft.

Brazil would emphasize that it has shown and Canada has acknowledged that there is a commercial market for aircraft financing at rates below the CIRR. This is the market in which Canada's EDC programme operates. Brazil's T-bill plus 20 bps rate does not provide a material advantage vis-à-vis this below-CIRR market rate, which is undistorted by government intervention.

Q12. Brazil argues (second submission, paras. 24-26) that if it does not issue bonds pursuant to letters of commitment issued before 18 November 1999, it can be sued for breach of contract.

- (a) **In this respect, please explain to whom Brazil owes an alleged contractual obligation under the letter of commitment.**
- (b) **In the original dispute in this case, Brazil submitted a legal opinion (exhibit Bra-17) stating that letters of commitment could not be annulled because they were "a perfect legal act, absolutely licit and practised based on legal provisions." In document G/ADP/W/281-G/SCM/W/291 dated 2 February 1996, Brazil stated that "[h]aving been incorporated into the Brazilian legal system by means of a Presidential decree (Decree No. 1355, dated 30 December 1994), the WTO Agreements have the same hierarchical level as laws, and are subordinate only to the Federal Constitution." Please comment.**

Reply

- (a) Brazil issues a letter of commitment that offers PROEX support for transactions specified in that letter of commitment if and when the contracts are completed within the time specified in the letter of commitment (usually 90 days).¹⁶ The letter of commitment constitutes an irrevocable conditional offer that is accepted when the contracts are signed within the period specified in the letter of commitment. The letter of commitment temporarily creates a binding legal obligation, which becomes final when the contracts are signed before the letter of

¹⁶ See, e.g., Brazil's Second Submission to the Panel, dated 4 December 1998, at paras. 46-48.

commitment expires. Pursuant to the letter of commitment, therefore, when the contract of sale is signed, the Brazilian government is legally obligated to provide PROEX equalization to the financial institution. At that point, the financial institution has an unconditional legal right to receive PROEX equalization payments.¹⁷ If a default occurs, the institution or any other party affected by the default could sue the Brazilian government for damages.

- (b) WTO Agreements are incorporated into Brazilian law and, therefore, could affect pre-existing legislation in the event of a conflict. However, Panel and Appellate Body Reports are not incorporated into Brazilian law. Accordingly, the question of whether a conflict exists and, if so, what is necessary to avoid it, would be determined by Brazilian judicial authorities.

Even if a conflict were found to exist by the Brazilian judiciary, previous legal commitments would not be affected. The PROEX letter of commitment is, under Brazilian law, a *legal act* ("*ato jurídico*") which produces immediate and binding effects.. When the parties enter into a contract that is the subject of a PROEX commitment, pursuant to the terms of that commitment, they acquire rights. At that point, the financial institution, the exporter and third parties become protected by the rules regarding pre-contractual liability and the principles of good faith, along with other provisions of law regarding affirmations and promises made during negotiations.

The Brazilian Supreme Court has held that the Administration may not annul its own acts if that annulment interferes with acquired rights. This is consistent with Article 5 of the Brazilian Federal Constitution, which provides that a law may not impair acquired rights, the perfect legal act, and *res judicata*. Consistent with Article 5 of the Constitution, Article 6 of the Introduction to the Brazilian Civil Code provides that retroactivity in the law is not possible or permitted, and that a law may not impair acquired rights and a perfect legal act. The previously signed letters of commitment, therefore, being perfect legal acts that have generated acquired rights, may not be revoked by the Government of Brazil without liability for damages.

Questions for Both Parties

Q1. The Appellate Body has referred to the CIRR as "a minimum commercial interest rate." The US dollar CIRR is however constructed on the basis of US Treasury bond yields. Further, Canada has stated (second submission, para 40) that US Treasury Bonds are fixed rate reference benchmarks, while LIBOR is a floating rate benchmark. That being the case, to what extent can CIRR rates be considered relevant to establishing a "minimum commercial interest rate" in respect of floating interest rates?

Reply

Brazil agrees that the CIRR, which is, as we have noted, itself a government-constituted rate, might not be the most appropriate benchmark for floating-rate transactions. This is simply a further illustration of why the CIRR is not the only benchmark against which PROEX or indeed any other export credit programme should be measured.

¹⁷ During this proceeding Brazil has, for the sake of convenience, used the term "letter of commitment" to refer to this entire process. As a practical matter the date of the letter of commitment and the date the contract is signed are extremely close. Brazil's legal liability begins with its letter of commitment which, as noted, is a time-limited, binding offer. If it were revoked prior to the stated time, Brazil would be liable for any damages caused by that action. Once the parties comply with the terms of the commitment by entering into a contract, then all of the legal conditions have been fulfilled.

Q2. Resolution 2667 states, inter alia, that "equalization rates shall be established on a case by case basis and at levels that may be differential." What relevance, if any, does this language have to the issues now before the Panel?

Reply

Resolution 2667 states that equalization rates shall be established on a case-by-case basis and at levels that may be differentiated simply to reflect that each transaction is different, and that different levels of support may be required or permitted in different cases. Thus, Brazil will provide PROEX support only up to an amount that will reduce the net interest rate to the level of the appropriate benchmark. Moreover, Brazil will only provide PROEX support up to the maximum of 2.5 percentage points specified in the regulations. The language quoted in the Panel's question is relevant because it establishes that while the actual amount of equalization is not fixed for every transaction, PROEX support may never result in a net interest rate below the appropriate benchmark.

Further Questions

Q1. Does Brazil incorporate by reference its arguments in the original panel proceedings with respect to (i) whether item (k) of the Illustrative List may be used to make an a contrario argument and (ii) whether PROEX payments constitute payments within the meaning of item (k)?

Reply

Brazil does incorporate by reference its arguments in the original panel proceedings with respect to both issues. Brazil considers its arguments in the Article 21.5 proceeding to be consistent with the arguments Brazil presented to the original Panel proceedings and the Appellate Body. While Brazil is not aware of any, to the extent that the Panel might consider that there are any inconsistencies in the arguments made by Brazil with respect to the issues relating to item (k) of the Illustrative List, the arguments made in the later submissions in these Article 21.5 proceedings should prevail.

ANNEX 2-5

**BRAZIL'S COMMENTS ON CANADA'S RESPONSES
TO QUESTIONS OF THE PANEL AND BRAZIL**

(17 February 2000)

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Brazil would like to make several comments on the responses of Canada to the questions presented by the Panel and Brazil. In the interests of brevity, we will not comment on every response. This should not be taken as an indication of Brazil's agreement with the responses of Canada.

I. CANADA'S RESPONSES TO THE PANEL'S 3 FEBRUARY QUESTIONS

For Canada

Question 1

Brazil has addressed this point in its submissions.

Question 2

As Brazil will point out in its comment on Canada's response to Question 11, below, Canada has not proved that "PROEX interest rate equalization provides financing on terms that are better than those available to a particular borrower in a particular transaction."

Question 3

Brazil would point out that Canada's statement that transactions consistent with CIRR require adherence to the *OECD Arrangement's* 10-year maximum repayment term for regional aircraft is an example of how Canada interprets the rules to provide a double standard between Canada and Brazil. It is uncontradicted that, despite the requirements of the *OECD Arrangement*, Canada established a repayment period of 15 to 18 years for regional jet aircraft long before Brazil ever entered the market. Canada's view that Brazil must adhere to CIRR, and that CIRR means a 10-year maximum, would mean that Brazil would be at a permanent, and unjustified disadvantage.

Question 4(a)

Canada admits that a market below CIRR exists for fixed interest-rate export credits, and that it participates in that market. Canada's reference to the "shortcomings of comparing a constructed rate such as the CIRR to commercial market pricing" implicitly acknowledges that there are more appropriate benchmarks than CIRR. Canada's view is thus that the CIRR may not always be the

appropriate benchmark for Canada, but it should be the only appropriate benchmark for Brazil, "even if Brazil could demonstrate that interest rates in the marketplace were below CIRR at some given moment." (*Canada's Response to Question 1*).

Canada's excuse is the complexity of CIRR.

Brazil also would point out that (1) the CIRR's complexity applies to Brazil as well as to Canada, and (2) Canada, as a member of the OECD shares responsibility for that complexity; Brazil, as a non-member, does not.

Question 4(b)

No comments.

Question 5(a)

No comments.

Question 5(b)

No comments.

Question 6

Canada's assumption is that a floating rate is always lower than a fixed rate. Recent events demonstrate that this is not the case, as Brazil noted at paragraph 49 of its Oral Statement to the Panel on 3 February 2000.

Question 7

The assumption underlying Canada's response is erroneous. Canada assumes that PROEX is used to compensate the *borrower* for its cost of funds. This is not the case. It is used to compensate the financial institution or the exporter for the cost of obtaining credits to provide to the borrower. *See* in this regard Brazil's comment on Canada's response to Question 11. PROEX was not used in that transaction to support American Airlines, which, as Canada noted, was subject to a rate of 7.79 per cent.

Canada's statement that PROEX support with an interest rate above CIRR confers a material advantage is contradicted by the determination of the Appellate Body.

Question 8

Brazil has no comments.

Question 9

Canada disputes Brazil's calculation of the guarantee fee in the example cited by Brazil on the basis of "EDC's standard 'yield model'" as if there were something sacrosanct about EDC and its model. Brazil does not agree. That there is more than one way to calculate the annual cost of the guarantee fee is demonstrated by the fact that the EC, the only other party or third party to calculate the amount, reached a result different from both Brazil and Canada. Brazil would also note that the example used was a "worst case" example, involving a sale to an airline apparently in China. Brazil

noted that its largest European customer is in Switzerland, and the US Export-Import Bank premium for Swiss transactions is considerably lower than for Chinese transactions.

Question 10

Canada's unsupported assertion is contradicted by Brazil's evidence. With a loan guarantee, an airline apparently located in China was able to obtain, from a commercial bank, a rate of LIBOR plus 3 basis points.

Question 11

Canada has criticized Brazil's Exhibit Bra 2 on the ground that it deals with large, rather than regional aircraft. (*See, e.g., Canada's Response to Brazil's Question 8*). However, two of Canada's three examples deal with large rather than regional aircraft – American Airlines and US Air. In Canada's view, it would appear, transactions involving large aircraft may be used to support Canada's point, but not Brazil's. Another double standard.

Furthermore, one of those carriers – American Airlines – through its American Eagle subsidiary, is a customer of the Canadian producer, Bombardier. Canada does not use that sale to illustrate its point.

The same is true of the one sale involving a regional aircraft, the sale to Northwest. This airline is also a customer of Bombardier. Canada, however, provides no examples involving Bombardier sales. This is noteworthy given that Bombardier sales account for a larger share of the regional jet market than do Embraer sales.

The Panel will recall that in March of last year, its interim report was prematurely released to the parties through error. While the original Panel proceeding was in progress, both Embraer and Bombardier bid for the Northwest business. Northwest informed the companies that it would wait for the Panel results before deciding. Late in the afternoon of the day the interim report was prematurely released, Northwest chose to purchase from Bombardier.

Brazil would also note that all three airlines are US carriers. To the extent they purchase from Boeing, there presumably is no government financing involved. The other two purchases, from British Aerospace and Airbus, might have involved government support (Canada's evidence is silent on the question), but there is no suggestion by Canada that these transactions involved the below-CIRR financing Canada admits making available.

Next, Brazil would note Canada's reference to the sale of \$190 million in asset-backed bonds to support the sale of 42 Embraer ERJs to American Airlines. The rate specified in Canada's evidence is 7.79 per cent. According to the OECD web site, accessed 16 February 2000, the applicable CIRR rate was 7.19 per cent for the period 15 January to 14 February 2000, and 7.70 per cent for the period 15 February to 14 March 2000.

Brazil submits that this evidence itself demonstrates that PROEX, which was involved in the American Airlines transaction, provides no material advantage in the field of export credit terms.

Finally, Brazil notes that throughout its answer to this question, Canada refers to basis points "above Treasury rates." This short-hand can be misleading, as there are many Treasury rates. Brazil bases PROEX on the 10-year bill. CIRR is constructed from shorter-term instruments.

Question 12

Brazil would note the continuing confusion surrounding Canada's position. Canada appears to say (1) that in the market commercial rates below CIRR occur and (2) these may be met by WTO Members without regard to either paragraph of item (k). If this is true, Brazil wonders why we are here. Or perhaps Canada means that Canada may operate in this below-CIRR environment but that Brazil may not.

Canada's answer defies logic and denies equity. Canada admits that commercial market rates can be and have been below CIRR, and that CIRR is not necessarily an appropriate benchmark for the market. Under Canada's standard, it – and not Brazil – may "step through the market window" and provide financial support below CIRR. When Canada does it, there is no "benefit" within the meaning of the SCM Agreement. When Brazil does it, Brazil is securing a material advantage.

II. FOR BOTH PARTIES

Question 1

No comments.

Question 2

Canada's own evidence, presented in response to Question 11 from the Panel, contradicts its statement that, "By design, PROEX always results in a net interest rate that is below CIRR or that is materially below market." As noted in Brazil's comments to Canada's response to Question 11, the applicable rate in the transaction cited was 7.79 per cent while the applicable CIRR, at that time, was no higher than 7.38 per cent. (The rate applicable on 14 February, the date of Canada's response).

Canada's claim that PROEX "will invariably secure a 'material advantage,' whether it is below or above CIRR" leads to the conclusion that, in Canada's view, CIRR is meaningless as a benchmark for material advantage. This statement is hard to reconcile with Canada's answer to Question 1, in which it adheres to the view that CIRR is the appropriate benchmark for measuring material advantage.

Finally, we note that Canada puts the phrase "case-by-case" basis in quotation marks, suggesting disapproval. How else, however, does Canada decide when the "market" is below CIRR?

III. CANADA'S RESPONSES TO THE PANEL'S 7 FEBRUARY QUESTION:

For Canada

Question 1

This is blatant evidence of Canada's double standard. If meeting a rate that a borrower could get on the market does not confer a benefit for Canada, then meeting that same rate does not confer a benefit for Brazil. This has nothing to do with *a contrario* interpretations of item (k). Without a benefit, there is no subsidy and item (k) becomes irrelevant, as does the question of material advantage. Canada makes these decisions, we are told, on a "case-by-case" basis. Canada does not explain why Brazil may not do the same.

IV. CANADA'S RESPONSES TO QUESTIONS FROM BRAZIL

Question 1(a)

Brazil will rely on the Panel's recollection as to Canada's statement. Brazil would note that the phrase used by Canada, "outside the terms and conditions under the *OECD Arrangement*," would encompass rates below-CIRR.

Question 1(b)

Canada's reply makes clear that it decides on a "case-by-case" basis, a privilege it is unwilling to extend to Brazil.

Questions 2(a)-(c)

No further comment.

Question 2(d)

Brazil would note that the rates to which Canada refers, as well as the rates contained in its Exhibit CDN-15, are commercial rates in domestic markets that do not reflect the presence of government Export Credit Agencies. Further, as noted in Brazil's comment on Canada's response to Question 11 from the Panel, most of these transactions involve large aircraft. By the standards Canada would apply to Brazil's Exhibit 2, these are irrelevant.

Question 3

Once again, Canada notes that it unilaterally decides on market conditions on a case-by-case basis, but does not say why Brazil is barred from doing the same.

Question 4

If market window operations below CIRR do not confer a subsidy because they do not confer a benefit, Brazil does not understand the grounds on which Canada would preclude Brazil from joining Canada in that below-CIRR market. Regardless of the financial contribution Brazil might make with PROEX, if there is no benefit, there is no subsidy.

Question 5

No further comment.

Question 6

No further comment.

Question 7

Brazil agrees wholeheartedly with Canada's statement, "There is no commercial bank that could provide such rates without the benefit of an Ex-Im Bank guarantee." That is Brazil's point. It is Brazil's further point that Brazil cannot provide a comparable guarantee, and, therefore, must find other ways to permit its exporter to be competitive with the subsidized exporters of the OECD members, such as Boeing and Bombardier.

Brazil disagrees with Canada's assertion that, "This transaction is influenced by and clearly reflects particular US-China policy issues." It may well be that the Ex-Im guarantee reflects a policy of the US government. But the rate granted by a non-government commercial bank, LIBOR plus 3 basis points, has nothing to do with such policy. That is the private rate the guarantee – whatever its motive – is able to bring to the US exporter, Boeing.

Canada has provided no evidence, beyond its assertion, that this transaction involving the US export credit agency and a major international bank is an "isolated example " and is not typical.

Question 8

Here Canada again suggests that because Brazil's example involves large aircraft, "it is completely irrelevant to the market conditions applicable to the commercial market financing of regional aircraft." By this standard, at least two-thirds of Canada's response to Question 11 is "completely irrelevant." Once again, there is one standard for Canada, another for Brazil.

Question 9

Brazil will defer to Canada's expertise regarding the *OECD Arrangement*, but would suggest that the US loan guarantee is compliant with the SCM Agreement because it conforms to item (j) of Annex I of the SCM Agreement, rather than item (k). Brazil would agree, however, that guarantees compliant with item (j) certainly are relevant to the market in which credit support under item (k) is provided.

Question 10

This appears to Brazil to be a non-answer.

ANNEX 2-6

BRAZIL'S COMMENTS ON THE INTERIM REVIEW

These comments are made in accordance with Art. 15.2 of the DSU.

In paragraph 6.41, the Panel states that it does not appear that Brazil argued that it's *a contrario* interpretation of paragraph 1 of item (k) of the Illustrative List applied even when the subsidies "do not fall within the scope of footnote 5." Brazil does not recall confining its interpretation of item (k) to the "scope of footnote 5," and certainly did not intend to do so. In this regard, Brazil notes that in the fifth paragraph of its 14 February 2000 Response to Question 10 from the Panel, Brazil said, "Footnote 5 to the SCM Agreement makes clear that the List has a purpose other than pure illustration." Beyond this, the response deals with the text of item (k), not the scope of footnote 5.

In paragraph 6.53, the third sentence begins, "Because *banks* in many cases have a lower cost of borrowing than the governments of developing countries ..." (Emphasis added). While Brazil does not dispute the accuracy of this statement, it was not the basis of Brazil's argument. If banks were the only actors in the market for aircraft financing, Brazil would not need to prove interest rate support for Embraer's transactions. It is the fact that *governments* – particularly Canada through its Export Development Corporation – are able to offer potential customers financing support on terms that are more attractive than the terms offered by banks that requires Brazil to act. Put differently, if banks were the sole providers of financing for aircraft, Embraer would not need Proex. It is precisely because banks are not the sole providers that Proex is needed. In this regard, Brazil believes that footnote 48 contains a more accurate description.

ANNEX 3-1

SUBMISSION OF THE EUROPEAN COMMUNITIES

(17 January 2000)

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I. INTRODUCTION

1. The European Communities (hereafter "the EC") makes this third party submission because of its systemic interest in the correct interpretation of the Agreement on Subsidies and Countervailing Measures ("SCM Agreement").

2. Canada claims (paragraph 29) that:

Brazil's withdrawal of prohibited PROEX export subsidies must include, at a minimum, two actions:

first, it must cease to grant subsidies found to have been prohibited, in respect of commitments made before the date of compliance for regional aircraft exported after that date; and

second, Brazil must make the necessary modifications to the programme to eliminate export subsidies in respect of future commitments.

3. In paragraph 30, Canada states that:

the above two actions constitute the only means by which Brazil could be found to have discontinued the granting of PROEX prohibited export subsidies and, accordingly, found to have withdrawn such subsidies in accordance with its obligation to implement the recommendations and rulings of the DSB.

4. Brazil only addresses the second of these actions in its first submission – the measures it has taken to bring the programme into compliance. It does not comment on existing commitments.

5. The EC would note that both Parties seem to agree that, despite the changes made to the PROEX programme, Brazil still does not comply with the terms of Article 27.2 of the SCM Agreement. In view of that, it may be legitimate for the Panel to assume that Article 3.1(a) of the SCM Agreement continues to apply to the PROEX payments.

6. The EC will comment on the facts and arguments of the parties as they appear from the Reports and the first written submissions of the parties. The arguments presently before the Panel are not however as yet fully developed and the EC anticipates that it will have more to say at the third party session of the meeting with the Panel. The EC does not consider that it is appropriate for it at this stage to discuss arguments that have not yet been developed by the parties.

7. Section III will discuss the question of when a subsidy comes into existence and consequently which subsidy payments are affected by the obligation to implement the report. Section IV discusses what Brazil considers to be the "defence" contained in the first paragraph of item (k) of the Illustrative List. Finally, Section V addresses Canada's proposal concerning a "Transparency Agreement".

II. BUSINESS CONFIDENTIAL INFORMATION

8. The EC must first recall its position on the special procedures for the protection of "Business Confidential Information."

9. The EC recognizes that certain information used in panel proceedings may be of such a nature that particular care is called for to protect it. The EC cannot accept however that protective procedures are adopted which it is impossible for the EC to follow. As the EC explained before the Appellate Body, EC officials are not allowed to enter into personal commitments to third country governments concerning the conduct of dispute settlement proceedings. Such obligations may only be undertaken by the EC, which is bound vis-à-vis other WTO Members by Article 18.2 DSU to ensure that confidential information is protected. In the case of the EC, the effectiveness of this obligation is ensured by the fact that EC officials are all bound by the EC Treaty and their terms of employment not to disclose confidential information, including business confidential information.

III. WHEN IS THE SUBSIDY "GRANTED"?

10. Canada has requested that Brazil cease to "grant" prohibited subsidies, and not that Brazil "withdraw" those subsidies. Thus, Canada's request does not require the Panel to address the question of whether the obligation to "withdraw" a subsidy may entail, at least in some cases, the obligation to request the reimbursement of all or part of a subsidy already "granted", a question which was extensively argued in the main proceeding. The EC notes that this question has not been raised either by Brazil in the parallel case concerning Canada's measures.

11. The EC agrees with Canada that, irrespective of the implications of the generally accepted principle that WTO remedies are not retroactive for the interpretation of the term "withdraw" in Article 4.7 of the SCM Agreement, the obligation to "withdraw" a prohibited subsidy implies necessarily the obligation to at least cease to "grant" that subsidy.

12. As argued by Canada, the withdrawal of a prohibited subsidy under Article 4.7 may not imply a lesser obligation than to "bring into conformity" that subsidy under Article 19.1 of the DSU. Article 3.2 of the SCM Agreement, the provision infringed by Brazil, provides that Members "shall neither grant nor maintain" prohibited subsidies. Thus, it is plain that in order to bring the measures into conformity with Article 3.2, Brazil must cease to "grant" the prohibited subsidies, as requested by Canada.

13. Canada's request, nevertheless, raises the issue of the point at which the subsidies found to be prohibited must be deemed "granted". Canada takes the view that PROEX payments are "granted" when the NTN- I bonds are issued. Consequently, Brazil should cease from issuing new NTN- I bonds from the date of compliance, even in those cases where it is required to do so by a letter of commitment. Brazil, on the other hand, has argued in the main proceeding, and appears to have assumed for the purposes of implementing the Report, that the PROEX payments are "granted" when the letters of commitment are issued. On that premise, Brazil would be prevented from issuing new

letters of commitment, but not from issuing new NTN- I bonds, unless the term "withdraw" in Article 4.7 of the ASCM had to be interpreted as requiring the reimbursement or, at least, the non-maintenance of an already "granted" subsidy.¹

14. In the main proceeding, the EC argued that the prohibited subsidies are "granted" when the sales contracts are concluded. The EC, nevertheless, agrees now with Canada's position that the subsidies are "granted" when the NTN- I bonds are issued, given the Appellate Body's conclusion that (at paragraph 158):

"For the purposes of Article 27.4, ... the export subsidies for regional aircraft under PROEX are "granted" when all the legal conditions have been fulfilled that entitle the beneficiary to receive the subsidies. We share the Panel's view that such an unconditional legal right exists when the NTN-I bonds are issued.

15. The Appellate Body's conclusion is confined by its own terms to Article 27.4 of the ASCM. Yet, the Appellate Body report gives no indication that the PROEX payments should be deemed "granted" at an earlier moment for other purposes. Indeed, the Appellate Body report does not suggest that the term "granted" may have different meanings in other contexts. Instead, the Appellate Body emphasized that it is necessary to distinguish between the issue of when a subsidy is "granted" and the issue of whether a subsidy "exists" (at paragraphs 156-157):

Consequently, for the purposes of Article 27.4, we see the issue of the *existence* of a subsidy and the issue of the point at which that subsidy is *granted* as two legally distinct issues. Only one of those issues is raised here and, therefore, must be addressed. That issue is: when is this subsidy, which admittedly exists, actually *granted*?

In our view, the Panel did not have to determine whether the export subsidies for regional aircraft under PROEX constituted a "direct transfer of funds" or a "potential direct transfer of funds", within the meaning of Article 1.1(a)(i), in order to determine when the subsidies are "granted" for the purposes of Article 27.4. Moreover, the Panel compounded its error in finding that the "financial contribution" in the case of PROEX subsidies is *not* a "potential direct transfer of funds" by reasoning that a letter of commitment does not confer a "benefit". In this way, in its interpretation of Article 1.1(a)(i), the Panel imported the notion of a "benefit" into the definition of a "financial contribution". This was a mistake. We see the issues – and the respective definitions – of a "financial contribution" and a "benefit" as two separate legal elements in Article 1.1 of the *SCM Agreement*, which *together* determine whether a subsidy *exists*, and not whether it is *granted* for the purpose of calculating the level

¹ Canada did argue, however, that if the Panel were to find that the subsidy was granted at the time of the signing of the letters of commitment that the Panel then find that Brazil cannot "maintain" the subsidy by issuing the NTN-I bonds. In view of the Panel's findings (confirmed by the Appellate Body) that the subsidy was granted when the bonds are issued it was not necessary for the Panel to rule on Canada's alternative argument. In particular, in paragraph 195 of its report the Appellate Body stated that

"Canada makes a conditional appeal. Canada requests that, if we accept Brazil's argument and reverse the finding of the Panel that the export subsidies for regional aircraft under PROEX are "granted" at the time of issuance of the NTN-I bonds for the purposes of Article 27.4 of the *SCM Agreement*, then we should also reverse the Panel's decision not to make a finding on whether Brazil had acted inconsistently with its obligations not to "maintain" export subsidies under Article 3.2 of that Agreement.¹ As we have not accepted Brazil's argument and have, therefore, not reversed the finding of the Panel on when the export subsidies for regional aircraft under PROEX are "granted", it is not necessary for us to consider this conditional appeal by Canada".

of a developing country Member's export subsidies under Article 27.4 of that Agreement. [footnotes omitted]

16. Applying those categories to the case at hand, it can be said that while the prohibited subsidies "existed" from the moment when the letters of commitment were issued (and as such could be the subject of dispute settlement), they will not be "granted" until the NTN-I bonds are issued.

17. For the above reasons, the EC considers that Brazil has not properly implemented the Report if it continues to issue NTN-I bonds after the date of compliance.

IV. DO THE CHANGES TO THE PROEX PROGRAMME BRING IT INTO COMPLIANCE?

18. Brazil did not dispute before the Panel that PROEX payments are subsidies and are contingent upon export performance. Instead, it relied on Article 27.2 and the first paragraph of item (k) of Annex I in order to excuse the violation of Article 3.1 (a).

19. Before the present implementation Panel, Brazil has not claimed that there is no violation of Article 3.1 (a) or that Article 27.2 applies. It merely relies on what it alleges to be an "affirmative defence" contained in the first paragraph of item (k).

20. The EC would recall its view that the first paragraph of item (k) is not an "affirmative defence". That provision simply deems certain practices to be prohibited export subsidies. From that, however, it cannot be inferred *a contrario* that an export credit which is not caught by the first paragraph of item (k) is not a prohibited export subsidy.

21. The Appellate Body did not find the contrary. It simply held that the conditions for the application of the "affirmative defence" invoked by Brazil were not satisfied, even if such an "affirmative defence" should be available. (The Appellate Body uses always the term "affirmative defence" between quotation marks). Therefore, the Appellate Body did not need to decide whether the first paragraph of item (k) did provide an affirmative defence.

22. For the above reasons, the EC would suggest that, before addressing Brazil's claim that the PROEX scheme no longer confers a "material advantage", the Panel should examine whether the first paragraph of item (k) provides in fact an affirmative defence.

23. Accordingly, the comments here below are submitted by the EC only in the event that the Panel was to conclude that item (k) provides an affirmative defence.

24. The EC agrees with Brazil that the benchmark for determining whether subsidies are used "to secure a material advantage" within the meaning of the first paragraph of item (k) of Annex I is "the marketplace".

25. The Appellate Body seems to have considered that the rates below the relevant CIRR may be presumed "to secure a material advantage" (at paragraph 182):

The fact that particular net interest is below the relevant CIRR is a positive indication that the government payment in that case has been "used to secure a material advantage in the field of export credits"

26. The presumption established by the Appellate Body is fully justified, having regard to the way in which the CIRR rates are determined. Nevertheless, the EC would agree with Brazil that such presumption is rebuttable. Accordingly, a Member might in some circumstances demonstrate

through positive evidence that a net interest rate below the relevant CIRR does not provide a "material advantage". The EC is of the view, however, that Brazil has failed to do so in the case at hand.²

27. Since Brazil is invoking what it claims to be an "affirmative defence", it bears the burden of proving that the floor which it has established, i.e. the 10-years United States Treasury Bonds plus a spread of 20 basis point, satisfies the test of the first paragraph of item (k). The EC considers that Brazil has not met that burden of proof.

28. Indeed, the only evidence provided by Brazil consists of an example of a loan guaranteed by the Export Import Bank of the United States. One single example cannot be considered as sufficient evidence. Moreover, there are a number of important differences between that example and the PROEX programme which cast doubts on the relevance of Brazil's example.

29. Brazil's example concerns a leasing transaction, whereas the PROEX payments are granted with respect to sales. In a leasing transaction, the lessor enjoys the additional security that it remains the owner of the financed asset until the loan is reimbursed. Hence, it can afford to charge a lower interest rate. Another significant difference is that in Brazil's example, the interest rate is based on LIBOR and is, therefore, a floating rate. Moreover, it is not correct to calculate the cost of the guarantee fee simply by allocating the amount paid up-front to the guarantor over the duration of the loan. In reality, on the basis of the facts available, the actual annualized cost of the guarantee fee would appear to be as high as 60 bps, instead of 30 bps.

30. Brazil's additional argument based on the so-called "market window" support is also flawed. The mere fact that, according to certain interpretations, the OECD Arrangement does not prevent the Participants to provide "market window" support at rates below the CIRR rates does not allow to conclude that PROEX rates do not secure a "material advantage". For that, Brazil should have provided evidence showing that the Participants to the Arrangement are actually providing "market window" support in the relevant market for aircraft at rates which are not just below the CIRR rates but also below, or at least at the same level, as those made available through the PROEX scheme. Moreover, Brazil should have demonstrated that "market window" support in the relevant market for aircraft is so widespread that the "commercial rate" is in practice the same as the "market window" rate.

V. TRANSPARENCY AGREEMENT BETWEEN CANADA AND BRAZIL

31. Canada proposes to enter into a transparency agreement with Brazil to ensure that financing complies with the SCM Agreement and asks the Panel to suggest this in its recommendations.

32. Canada and Brazil are of course free to settle their dispute in whatever way they wish so long as the settlement complies with the WTO Agreement.

33. The EC does not however consider that it would be appropriate for the Panel to suggest a transparency agreement. Canada and Brazil already have an obligation to notify all their subsidies, including the ones found by the Panel in this case. They do not seem to have fully complied with this obligation. It would appear more appropriate for the Panel to insist that Canada and Brazil fulfil their WTO commitments than to make the suggestion requested by Canada.

² The floor established by Brazil is much lower than the relevant CIRR rate. It may be estimated that, as of the date of this submission, the relevant CIRR rate is 7,38 (= yield on the 7 year bonds for US dollar + 100 bps, i.e. 6,38 + 1,00) while the PROEX rate, according to Brazil's submission, would be 6,80.

VI. CONCLUSION

34. The state of the arguments presented by the parties and the information and time for reflection available to the EC has not allowed it to make as full a contribution to the reflections of the Panel as it might have liked. It will therefore supplement its arguments at the Third Party Session in the light of the other submissions to be presented to the Panel before that meeting.

ANNEX 3-2

SUBMISSION OF THE UNITED STATES

(17 January 2000)

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I. INTRODUCTION

1. The United States welcomes this opportunity to present its views in the Article 21.5 proceeding that Canada has requested to review Brazil's implementation of the Dispute Settlement Body's ("DSB") recommendations and rulings in *Brazil -- Export Financing Programme for Aircraft*, WT/DS46/R, 14 April 1999 ("Panel Report"); WT/DS46/AB/R, 2 August 1999 ("Appellate Body Report"). The United States will comment upon Brazil's reported decision to continue issuing PROEX bonds on aircraft exported after 18 November 1999 under commitments made before that date and Brazil's rationale for its claim that its modifications to PROEX render the programme consistent with the WTO Agreement on Subsidies and Countervailing Measures ("the SCM Agreement") and the DSB's rulings and recommendations. The United States will also comment briefly on Canada's proposal to establish "verification procedures" that it claims will "facilitate a definitive resolution of this dispute."¹ The United States does not comment at this time upon the other issues raised in this proceeding.

II. MEASURES TAKEN BY BRAZIL TO COMPLY WITH THE DSB'S RULINGS AND RECOMMENDATIONS

2. Canada claims that the measures taken by Brazil in respect of the *Programa de Financiamento às Exportações* ("PROEX") and export subsidies on sales of Brazilian regional aircraft neither withdraw the export subsidies nor otherwise comply with the SCM Agreement and the findings and recommendations of the Panel and the Appellate Body² Due to the fundamental importance of this issue, the United States wishes to make certain brief observations that it hopes will assist the Panel in reaching its own determinations.

¹ Canada Submission, paras. 39-46.

² Canada Submission, para. 1.

A. THE ISSUANCE OF PROEX BONDS ON AIRCRAFT EXPORTED AFTER 18 NOVEMBER 1999 PURSUANT TO COMMITMENTS MADE BEFORE THAT DATE IS INCONSISTENT WITH BRAZIL'S OBLIGATIONS UNDER ARTICLES 3.2 AND 4.7 OF THE SCM AGREEMENT

3. Canada asserts that Brazil intends not to withdraw PROEX subsidies with respect to aircraft exported after 18 November 1999 under commitments reached before that date, and that a failure to do so would constitute a violation of Articles 3.2 and 4.7 of the SCM Agreement.³ Brazil does not respond to Canada's assertions in its submission. If Canada's description of Brazil's intentions is correct, however, then the United States agrees with Canada (and will not repeat its arguments) that Brazil's position would constitute the granting of prohibited export subsidies in violation of Article 3.2 and a failure to withdraw under Article 4.7.

4. Due to the fundamental importance of this issue, the United States submits the following additional observations, which reflect US concerns regarding the broader implications of the position of Brazil (and the EC, if it continues with the arguments it made before the Panel and the Appellate Body) on the operation of dispute settlement under the SCM Agreement.

5. Implicit in Brazil's position is the proposition that remedies in WTO dispute settlement are not retroactive, a proposition with which the United States does not disagree.⁴ However, also implicit in Brazil's position is the proposition that a subsidy comes into, and goes out of, existence simultaneously at the moment of its granting. With this proposition the United States strongly disagrees.

6. In the subsidies area, it is well-accepted that the timing and duration of a subsidy are two different things, and that a subsidy can have a duration that extends over a period of years. This concept was recognized in the Tokyo Round Subsidies Committee's *Guidelines on Amortization and Depreciation*, which called for the allocation of certain subsidies over time.⁵ This concept is also reflected in paragraph 7 of Annex IV of the SCM Agreement, which refers to subsidies "the benefits of which are allocated to future production", and which contemplates that subsidies granted prior to the entry into force of the WTO Agreement are actionable under Part III of the SCM Agreement. It also is reflected in the report of the Informal Group of Experts which was charged with fleshing out the details for calculating subsidies under Annex IV of the SCM Agreement.⁶ Finally, this concept is reflected in the countervailing duty practice of Members such as the United States, the EC, and Canada, so that, for example, a subsidy granted in 1995 will be attributed to, and be countervailable with respect to, production or exports in 1999.⁷

³ Canada Submission, paras. 16-17, 25-31.

⁴ The United States notes that the issue of the prospective nature of the remedy under Article 4.7 of the SCM Agreement is also an issue involved in the forthcoming Panel report in *Australia - Subsidies Provided to Producers and Exporters of Automotive Leather* (WT/DS126). The United States would be happy to provide additional written views on this issue to the Panel in light of that report.

⁵ BISD 32S/154.

⁶ *Report by the Informal Group of Experts to the Committee on Subsidies and Countervailing Measures*, G/SCM/W/415 (25 July 1997), paras. 1-2. The SCM Committee "took note of" this report and its recommendations at its April, 1998 meeting. *Committee on Subsidies and Countervailing Measures; Minutes of the Regular Meeting Held on 23-24 April 1998*, G/SCM/M/16 (15 July 1998), paras. 75-76.

⁷ In the case of the United States, the rules for allocating subsidies over time are set forth primarily in section 351.524 of the Department of Commerce's countervailing duty regulations. G/SCM/N/1/USA/1/Suppl.4 (29 March 1999), pages 129-131. In the case of Canada, the concept is expressed most clearly in section 27 of its *Regulations Respecting Special Import Measures*, G/SCM/N/1/CAN/3 (10 September 1997), page 174. In the case of the EC, the concept is expressed generally in Article 4.C.3(d) of Council Regulation (EC) No. 3284 of 22 December 1994, G/SCM/N/1/EEC/1 (31 March 1995), page 12, while detailed rules are included in its recently issued *Guidelines for the Calculation of the Amount of Subsidy in Countervailing Duty Investigations* (98/C 394/04), section F of which recognizes that "[a]s many subsidies have effects for a number of years,

7. In the case of a subsidy that is properly allocated over several years (as would be the case with respect to the PROEX subsidies in question), the withdrawal of that portion of the subsidy allocated to future time periods would not constitute a retroactive remedy or retroactive implementation. Instead, it would constitute prospective implementation based on a recognition of the distinction between the measure conferring a subsidy and the subsidy itself. While a subsidy comes into existence at a particular point in time, the duration of the subsidy can extend over a period of years, depending on the nature of the subsidy in question.

8. In this case, Canada has kept matters simple by merely insisting that Brazil not issue new bonds after 18 November 1999.⁸ The argument made by Brazil and the EC before the Appellate Body that a cessation of the issuance of further PROEX bonds would be disruptive to private parties proves too much. It is the rare case in which the behaviour of private parties is *not* disrupted when WTO dispute settlement results in a recommendation and ruling that a Member withdraw a measure on which private parties have come to rely or on which they have based their plans. As recognized by Appellate Body Member Beeby, "[i]n virtually every case in which a measure has been found to be inconsistent with a Member's obligations under the GATT 1994 or any other covered agreement, and therefore, must be brought into conformity with that agreement, some degree of adjustment by the domestic industry of the Member concerned will be necessary."⁹ Moreover, it is difficult to see how anyone, whether in the private or government sector, could have a legitimate expectation regarding subsidies that are prohibited by the SCM Agreement.

9. The position that a WTO dispute cannot affect prior government subsidy commitments, if accepted, would eviscerate the utility of WTO dispute settlement as a vehicle for addressing trade distortive subsidies. As an example, assume that Country X provides a \$1 billion grant to Company Y in order to allow Company Y to construct a facility that will produce widgets for export. A WTO panel finds, and the Appellate Body affirms, that the grant is a prohibited export subsidy. However, at the time when the DSB adopts the panel report, Country X already has disbursed the \$1 billion to Company Y and Company Y already has contracted for the construction of the facility.

10. As the United States understands the position of Brazil and the EC, the best remedy that could come from this case is that Country X would not be able to provide another subsidy to Company Y. However, the damage to Company Y's foreign competitors would continue as widgets produced by Company Y would continue to be subsidized by virtue of the \$1 billion grant.

11. The United States submits that this is an absurd result that is not mandated by the terms of the SCM Agreement, the DSU, or public international law, and that would render the increased disciplines of the SCM Agreement meaningless. Instead, an appropriate outcome in the above hypothetical would be, for example, a repayment by Company Y to Country X of that portion of the \$1 billion grant allocated to time periods post-dating the Dispute Settlement Body's adoption of its recommendations and rulings. Another alternative would be the conversion of that portion to a commercial rate loan from the government of Country X to Company Y. The precise method of withdrawal of the subsidy might depend upon the domestic law of Country X. If a withdrawal was

subsidies granted before the investigation period should also be investigated in order to determine what portion of such subsidy is attributable to the investigation period G/SCM/N/1/EEC/2/Suppl.2 (8 January 1999), page 9.

⁸ As the United States understands it, Canada is not asking that bonds issued prior to the establishment of the panel be repaid.

⁹ *Indonesia - Certain Measures Affecting the Automobile Industry*, WT/DS54/15, Award of the Arbitrator under Article 21.3(c) issued 7 December 1998, para. 25. Mr. Beeby also noted that "the Award of the Arbitrator in *Japan - Taxes on Alcoholic Beverages* . . . rejected the argument that adverse effects on producers (and consumers) of the products involved constitute 'particular circumstances' that should be taken into account in determining the reasonable period of time under Article 21.3(c) of the DSU." *Id.*, para. 25, note 19.

not permissible under that domestic law, then compensation or countermeasures would be appropriate.

12. The instant dispute involves a much simpler situation than the "widget" example discussed above. As the United States understands it, Canada is not demanding that Brazil recover funds already paid out or recover revenue already foregone. Instead, Canada simply is insisting that Brazil not pay out additional prohibited subsidies in the form of PROEX bonds. In the view of the United States, such a remedy is consistent with the terms of the SCM Agreement and the DSU. If such a remedy is not considered acceptable, then WTO dispute settlement is largely useless as a tool for addressing distortive subsidies.

B. BRAZIL'S POSITION ON THE CONFORMITY OF PROEX FINANCING WITH ITEM (K) OF THE ILLUSTRATIVE LIST IS BASED UPON A MISINTERPRETATION OF THE APPELLATE BODY'S DECISION

13. Canada's second claim in this proceeding is that, for new financing commitments, Brazil has failed to modify PROEX in a way that brings the programme into conformity with the SCM Agreement. Brazil disagrees, on the grounds that it has established a "floor" for future PROEX financing that does not secure a material advantage in comparison with other types of financing available in the export financing "marketplace." The United States submits that Brazil's position is based upon a misinterpretation of the Appellate Body's decision.

14. In Brazil's view, the Appellate Body held "that the appropriate reference for determining whether a material advantage is secured by PROEX interest equalization payments for aircraft is the 'marketplace' for export financing", and that the Commercial Interest Reference Rate ("CIRR") of the *OECD Arrangement on Guidelines for Officially Supported Export Credits* is but "one example" of an appropriate benchmark for making such a comparison.¹⁰ Relying on this interpretation of the Appellate Body's holding, Brazil argues that PROEX financing would not secure a material advantage within the meaning of item (k) unless it was below the CIRR rate and any other rate available in the "marketplace" for export financing. In the view of the United States, this is not what the Appellate Body said.

15. In its report, the Appellate Body characterized the issue at hand as "whether the export subsidies for regional aircraft under PROEX 'are used to secure' for Brazil 'a material advantage in the field of export terms'" within the meaning of the first paragraph of item (k) of the Illustrative List.¹¹ The Appellate Body first noted that it viewed the second paragraph of item (k) as "useful context" for interpreting the "material advantage" clause in the first paragraph. It then opined that:

[t]he *OECD Arrangement* can be appropriately viewed as one example of an international undertaking providing a specific market benchmark by which to assess whether payments by governments, coming within the provisions of item (k), are "used to secure a material advantage in the field of export credit terms." Therefore, in our view, the appropriate comparison to be made in determining whether a payment is "used to secure a material advantage", within the meaning of item (k), is between the actual interest rate applicable in a particular export sales transaction after deduction of the government payment (the "net interest rate") and the relevant CIRR.¹²

¹⁰ Brazil Submission, para. 9.

¹¹ Appellate Body Report, para. 181.

¹² *Id.* (emphasis added).

Thus, it is not correct to state that the Appellate Body identified the CIRR rate as only "one example" for determining whether a payment is used to secure a material advantage within the meaning of item (k).¹³

16. Brazil relies upon its misinterpretation of the Appellate Body's holding to argue that PROEX conforms with item (k) because two other types of financing available in the marketplace – loan guarantees and market windows – provide rates that are lower than those available through PROEX. For the following reasons, the United States submits that the existence of loan guarantees and market windows has no relevance to this dispute.

17. First, the issue in this proceeding is whether Brazil has complied with the DSB's recommendations and rulings, not whether the Appellate Body was wrong to hold that the CIRR is the appropriate benchmark for determining compliance with the material advantage clause of item (k). An Article 21.5 proceeding is not a forum for seeking modifications to the Appellate Body's findings, and Brazil's implicit attempt to do so here should be rejected. In the view of the United States, while the Appellate Body could have chosen another benchmark for determining compliance with item (k), the CIRR was an appropriate choice, since it represents an extrinsic measurement that is part of an international undertaking that is specifically recognized in the SCM Agreement.

18. Second, loan guarantees – or, more accurately, export credit guarantees – are governed exclusively by item (j) of the Illustrative List, not by item (k). The provision by governments of export credit guarantee programmes at premium rates which are inadequate to cover the long-term operating costs and losses of the programmes constitute prohibited export subsidies under item (j) of the Illustrative List. Such programmes have no relevance, however, to determining whether PROEX conforms with item (k).

19. Third, Brazil's discussion of so-called "market windows" mischaracterizes the status of such practices under the *OECD Arrangement*. Brazil claims in its submission that:

Some Participants in the Arrangement take the position that "official support" consists only of the provision of support at rates below the government's cost of funds. Support at rates equal to or above the government's cost of funds, in the view of these Participants, is so-called "market window" support. In the view of these Participants, so long as support is provided above the government's cost of funds – through the "market window" – it may be provided at rates below CIRR rates and remain consistent with the requirements of the Arrangement.¹⁴

Brazil then claims that the failure of the Participants in the *OECD Arrangement* to "reach a conclusion" on the issue of market windows and the definition of official support means that market windows are not inconsistent with the obligations under the *OECD Arrangement* in the view of the OECD.¹⁵ In Brazil's view, this means that countries that use market window financing are "in conformity with the Arrangement" and that Brazil may then use market windows as a benchmark for judging the conformity of its own financing with the obligations of item (k).

20. The United States agrees with Brazil that the issue of "market windows" has not been resolved in the OECD. However, there is no language in the *OECD Arrangement* which suggests that the definition of "official support" is limited to financing that is below the cost of funds to the providing government. Moreover, to date, there has been no special regime in the *OECD*

¹³ *Id.*, para. 182. Indeed, the Appellate Body went so far as to state that "[t]he fact that a particular *net* interest rate is below the relevant CIRR is a positive indication that the government payment in that case has been 'used to secure a material advantage in the field of export credit terms.'" *Id.*

¹⁴ Brazil Submission, para. 19.

¹⁵ Brazil Submission, para. 23.

Arrangement that establishes financial rules for "market windows" that differ from the CIRR. In the absence of such rules, the only relevant benchmark established in an "international undertaking" for purposes of the second paragraph of item (k) remains the CIRR.

21. Therefore, when the Appellate Body employs "*OECD Arrangement*" rates for purposes of determining the existence of a "material advantage" in the first paragraph of item (k), the only relevant rate that currently exists is the CIRR. It goes without saying that the failure of the OECD to reach agreement on the treatment of "market windows" for purposes of the *OECD Arrangement* has no bearing upon whether "market window" financing complies with item (k).

22. The United States has nothing further to add on the issue of whether Brazil's amendments to PROEX comply with the rulings and recommendations of the Dispute Settlement Body.

III. CANADA'S PROPOSAL FOR "VERIFICATION PROCEDURES"

23. Finally, the United States wishes to comment briefly on Canada's proposal to establish "verification procedures," which it asserts will "facilitate a definitive resolution of this dispute."¹⁶ Canada is willing to accept similar procedures in *Canada -- Measures Affecting the Export of Civilian Aircraft*¹⁷ if Brazil agrees to accept the procedures in this case. Canada asserts that "it would be useful if the Panel were to suggest that the Parties develop such procedures, consistent with its authority under Article 19.1 of the DSU."¹⁸

24. In the view of the United States, if they so desire, Canada and Brazil certainly may agree to establish procedures that would enable each party to monitor the other's compliance with the rulings and recommendations applicable to the programmes at issue. However, the United States disagrees that Article 19.1 of the DSU would permit the Panel to suggest such procedures. By its plain terms, Article 19.1 permits a panel to suggest ways to implement the recommendations that it makes after concluding that a measure is inconsistent with a covered agreement. It does not permit – or even contemplate – that a panel may take further steps and play some role in monitoring the implementation process itself. As the Appellate Body stated in *India – Patent Protection for Pharmaceutical and Agricultural Products*:

[a]lthough panels enjoy some discretion in establishing their own working procedures, this discretion does not extend to modifying the substantive provisions of the DSU. . . . Nothing in the DSU gives a panel the authority to disregard or to modify other explicit provisions of the DSU.¹⁹

25. Furthermore, the United States observes that nothing would prevent Canada and Brazil from agreeing on "transparency" procedures under Article 25 of the DSU, which permits parties by mutual agreement to resort to arbitration as an alternative to dispute settlement. Article 25.2 of the DSU explicitly permits parties to agree on the procedures to be followed in that context.²⁰

26. Lacking additional details, the United States is not in a position to comment upon the actual structure that the verification procedures would take. Once again, this presumably would be an issue for the parties to decide among themselves.

¹⁶ Canada Submission, paras. 39-46.

¹⁷ WT/DS70/R and WT/DS70/AB/R adopted on 20 August 1999.

¹⁸ Canada Submission, para. 46.

¹⁹ *India – Patent Protection for Pharmaceutical and Agricultural Products*, WT/DS50/AB/R, 19 December 1997, para. 92.

²⁰ DSU, art. 25.2.

IV. CONCLUSION

27. The United States thanks the Panel for providing an opportunity to comment on the important issues at stake in this proceeding, and hopes that its comments will prove to be useful.

ANNEX 3-3

ORAL STATEMENT OF THE EUROPEAN COMMUNITIES

(4 February 2000)

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1. Introduction

28. The European Communities makes this third party submission because of its systemic interest in the correct interpretation of the *SCM Agreement* and the correct application of the DSU.

29. The EC is in particular most concerned by the fact that the recent Article 21.5 panel on *Australia – Automotive Leather*¹ has considered itself entitled to interpret the WTO Agreement as allowing retroactive remedies. Since similar issues may be involved in this case and the present Panel may have to confront the question, the EC feels it must devote some time today to explaining why the approach of the Article 21.5 panel on *Australia – Automotive Leather* is a serious error.

2. Panels may not decide extra petitum

30. The Panel in this case ought not to reach the issue of retroactivity of remedies which proved so problematic in the Article 21.5 report by the *Australia – Automotive Leather* since the terms of reference of this Panel are carefully circumscribed² as covering only aircraft delivered after 18 November, whether pursuant to contracts entered into before 18 November or after 18 November 1999. In this case the time of delivery corresponds to the time of export and to the time when NTN-1 bonds are issued. This is according to the Appellate Body the time when the subsidy is granted.

31. WTO dispute settlement is a *member-driven* process that can only be initiated by members and is continuously under the control of the parties who are free to choose the panellists they desire and to terminate the process when they wish. The DSU expressly states that the purpose of dispute settlement is to *preserve* the rights and obligations of Members, that it cannot add to or diminish those

¹ Report by the Panel on *Australia – Subsidies Provided to Producers and Exporters of Automotive Leather*, WT/DS126/RW, 21 January 2000.

² WT/DS46/13 of 26 November 1999.

rights and that it should encourage amicable settlements and aim at a satisfactory resolution of disputes.

32. The Appellate Body made clear in *India – Patent Protection*³ that a claim that has not been made in the request for the establishment of the panel cannot be the subject of a finding by a panel and explained this *inter alia* on the grounds of procedural fairness.⁴

33. Although there is in principle no bar to the parties or the panel developing new *arguments* during the process, the EC considers that this does not allow new arguments to be developed by a panel which declare or assume the existence of rights that the parties have not claimed. Such action raises the same systemic and procedural fairness concerns as arise when a panel makes findings on a new claim.

34. The Panel may not therefore find in this case that Brazil has failed to implement the report retrospectively since Canada has only asked for a finding that the report has not been implemented with respect to deliveries made after 18 November 1999.

3. The requirement to withdraw subsidies can only be prospective

35. However, since it cannot be excluded that arguments about retroactive remedies under the *SCM Agreement* may arise in this case and in view of the unacceptability of retroactive remedies for the EC, and we are sure for other Members, the EC will now set out its view and comment on the *Australia – Automotive Leather* report.

36. The EC agrees with the parties to this dispute and the other third party that the remedy under Article 4 *SCM Agreement*, like all other remedies under the WTO dispute settlement system, can only be, and were only intended by the Members to be, *prospective* in nature. They are not intended to and indeed cannot remove the effects of a trade distortion or restriction situated in the past.

3.1 The text and context of the relevant provisions

37. The terms "withdraw the measure" or "withdraw the subsidy" in Article 4.7 *SCM Agreement* do not require retroactive implementation any more than the term "bring the measure into conformity" in Article 19.1 DSU.

38. The term "withdraw" is a general term which may cover many different concepts including revocation, repeal, repayment of money, liquidation of an interest or a neutralization of an effect. The definitions in the New Shorter Oxford Dictionary include:²⁵

Take back or away (something bestowed or enjoyed).
Cause to decrease or disappear.
Remove (money) from a place of deposit.

39. It is used in Article 4.7 precisely because there may be many ways of implementing a panel report concerning export subsidies – as the EC will discuss in more detail below.

40. It does not imply a retroactive remedy but rather in the context a prospective remedy. If an investment is withdrawn the investor may receive more or much less than he put in. A right, or even

³ Report by the Panel on *India – Patent Protection for Pharmaceutical and Agricultural Chemical Products – Complaint by the European Communities and their Member States*, WT/DS79/R, 24 August 1998, at paragraphs 85 - 90.

⁴ See esp. paragraph 88.

²⁵ New Shorter English Oxford Dictionary - CD - January 1997.

an obligation, to withdraw does not imply recovering exactly the sum originally invested. Indeed Articles 3.7 and 26.1(b) DSU also use the term "withdrawal of the measure" when referring to implementation in the sense of Article 19.1 DSU and this has been held to mean only prospective implementation in the report of the Article 21.5 panel in *European Communities – Bananas – Recourse by Ecuador*,⁵ where the panel held that:

In framing this issue for consideration, we do not imply that the European Communities is under an obligation to remedy past discrimination. Article 3.7 of the DSU provides that "... the first objective of the dispute settlement is usually to secure the withdrawal of the measures concerned if these are found to be inconsistent with the provisions of any of the covered agreements." This principle requires compliance *ex nunc* as of the expiry of the reasonable period of time for compliance with the recommendations and rulings adopted by the DSB. If we were to rule that the licence allocation to service suppliers of third-country origin were to be "corrected" for the years 1994 to 1996, we would create a retroactive effect of remedies *ex tunc*. However, in our view, what the EC is required to ensure is to terminate discriminatory patterns of licence allocation with *prospective* effect as of the beginning of the year 1999.

41. In the same way, the Article 22.6 Report on the recourse to Article 22 DSU by the US in *EC – Bananas*,⁶ considered that the level of nullification and impairment had to be assessed as it existed at the end of the reasonable period of time (which may, for a number of reasons, be different from that which existed before). This supports the view that the obligation to implement only relates to the future, not the past.

42. An additional element of context supporting the non-retroactivity of remedies in the WTO is the fact that both Articles 19.1 DSU and 4.7 *SCM Agreement* allow Members a period of time in which to implement panel reports. Since these provisions do not require *immediate* implementation, why should they be interpreted to require *retroactive* implementation?

3.2 The object and purpose of the WTO Agreement

43. The above interpretation is fully supported by a consideration of the object and purpose of the WTO Agreement.

44. The fundamental reason why WTO remedies are not retroactive is that the objective of the WTO are the removal of restrictions on trade, not compensation for past restrictions or the creation of rights to retaliate by restricting trade in the future. This objective can only be achieved by ensuring that trade-restricting or trade distorting-measures are removed for the future. Past trade restrictions or distortions *cannot* be remedied. In particular, creating new restrictions and distortions in the future cannot eliminate the fact that trade was distorted or restricted in the past but in fact only frustrate the object and purpose of the WTO Agreement. The situation is very different from legal procedures that seek to provide monetary compensation.

45. Specifically, in the case of subsidies, a benefit and a corresponding trade advantage that has been enjoyed in the past cannot be removed. All that can be removed is the benefit that is yet to be enjoyed. A requirement to remove more than the prospective benefit in an effort to "punish" or "deter" or "compensate" would logically mean that the company concerned suffers a *disadvantage* for the

⁵ Report by the Panel on *European Communities – Regime for the Importation, Sale and Distribution of Bananas – Recourse to Article 21.5 by Ecuador*, WT/DS27/RW/ECU, 12 April 1999, at paragraph 6.105.

⁶ *European Communities - Regime for the Importation, Sale and Distribution of Bananas - Recourse to Arbitration by the European Communities under Article 22.6 of the DSU*.

future. This would not remove the earlier benefit and the resulting restrictions or distortions of trade but merely create new ones contrary to the fundamental objectives of the WTO.

46. Indeed, the *Australia – Automotive Leather* panel did itself recognize that there was no intent in the *SCM Agreement* that the remedy attempt to restore the *status quo ante* or to provide reparation or compensation when it ruled that there was no basis on which to add interest to the amount to be repaid.

47. An additional purpose of the WTO and in particular the dispute settlement is to provide "security and predictability to the multilateral trading system" (Article 3.2 DSU). This purpose is also frustrated by retroactive remedies.

48. It is clear that the operation of the WTO Agreement can *affect* the rights and obligations of private operators even though as international law, it cannot *create* rights and obligations for private operators except where this expressly provided for.⁷ The EC is firmly of the view that the WTO Agreement and the *SCM Agreement* in particular do not have direct effect in municipal legal systems – that is they are not "self-executing". This fact has consequences for the degree of interference in private rights that the WTO Agreements were intended to give rise.

49. The EC would observe more generally that under the *SCM Agreement* there is a distinction to be drawn between the interest of private parties in the continuation of a law or other general measure and the individual rights arising out of a particular act of a government, such as the grant of a subsidy. The former can be withdrawn, the latter cannot be simply be revoked under the constitutional systems of most WTO Members.

50. Consequently, the EC considers that the obligation to "withdraw" the prohibited export subsidy in Article 4.7 *SCM Agreement* can only be to withdraw the general measure or programme to the extent that it is contrary to the *SCM Agreement* and, as regard individual or "one-off" subsidies to withdraw that portion of it that corresponds to the future effects, that is the prospective benefit, and not that which corresponds to effects which have occurred in the past.

51. The panel in *Australia – Automotive Leather* relied in fact heavily on a different "object and purpose" argument to support its interpretation. This was that a retroactive remedy was necessary in order to allow an effective remedy.⁸

52. The *Australia – Automotive Leather* panel expressly states in paragraph 6.37: "we decline to read 'withdraw the subsidy' in a manner that does not give it effective meaning." Its motivation is explained in paragraph 6.35 as follows:

In our view, terminating a programme found to be a prohibited export subsidy, or not providing, in the future, a prohibited subsidy, may constitute withdrawal in some cases. However such actions have no impact and consequently no enforcement effect, in the case of prohibited subsidies granted in the past. Under Australia's approach ... prohibited export subsidies granted in the past and for which there is no continuing export contingency, would be beyond the effective reach of a recommendation to "withdraw the subsidy," no matter how clear the violation of Article 3.1(a) of the *SCM Agreement* might be.⁹

⁷ This view is confirmed by the Report by the Panel on *United States – Sections 301-310 of the Trade Act of 1974*, WT/DS152/R, 22 December 1999, at paragraph 7.72.

⁸ Paragraphs 6.35 to 6.38 of the report.

⁹ Paragraph 6.34.

53. The *Australia – Automotive Leather* panel seems to be saying that its rigorous interpretation of the terms of the *SCM Agreement* would lead to a different conclusion to that it arrives at in this case where the defending party would have to take some other unpalatable action. It seems therefore that the basis for the Panel's finding is that the need for a *deterrent effect* in the *SCM Agreement*.

54. The EC would observe that this approach based on requiring an effective remedy or a deterrent effect might mean that a subsidy which is paid in instalments over, say, 10 years would be treated differently to a subsidy of equivalent value paid immediately. In the former case, if the *Australia – Automotive Leather* panel had been confronted with the former subsidy it might have considered that that cessation of future payments was sufficient withdrawal (on the basis that there would have been an "effective remedy"). In the latter case it would have required repayment of the whole amount. This would treat equivalent subsidies differently for no good reason and elevate form over substance. The approach advocated by the EC and the parties in that case would allow the two cases to be treated consistently.

55. The EC contests that the *SCM Agreement* or any other WTO Agreement is intended to have any deterrent effect. The remedies are intended to be purely remedial. In some cases it may not be possible to remedy a violation except by clarifying the Agreements in such a way that future violations will be avoided.

56. But the "need for an effective remedy" argument of the *Australia – Automotive Leather* panel is in any event misguided since the correct approach of withdrawing the prospective portion of the benefit of the financial contribution does provide an effective remedy. The *Australia – Automotive Leather* panel's reason for rejecting this approach was, apart from its wrong interpretation of the word "withdraw", simply that "the valuation of the benefit of a subsidy, its allocation over time, and the calculation of the "prospective portion" thereof, are complicated questions, for which there are no guidelines in the *SCM Agreement*."¹⁰

57. This is not acceptable. WTO dispute settlement generally and subsidy proceedings in particular will often involve complex issues of fact but this is no reason for a panel to abandon its mission and require, for example, the repayment of the whole of the financial contribution rather than just a part. This is just as unacceptable as saying that since it is difficult to calculate a precise amount, no amount need be repaid.

3.3 Past practice

58. The absence of a remedy for past and consummated violations has always been a well-known feature of the GATT/WTO system. It is established and accepted that it can lead in some cases to there being no remedy at all for the complaining party. The EC considers that this established practice confirms the conclusions it reaches above.

59. A useful discussion of the practice of the GATT Contracting Parties is contained in the panel report under the Agreement on Government Procurement on *Norway - Procurement of Toll Collection Equipment for the City of Trondheim*.¹¹ In the WTO, panels have also always operated on the basis that remedies cannot be retroactive and the EC has already referred the Panel to the reports in the banana litigation.

3.4 Application to subsidies and the present case

¹⁰ Paragraph 6.44 of the *Australia – Automotive Leather* Report.

¹¹ See e.g. the discussion in the panel report under the Agreement on Government Procurement on *Norway - Procurement of Toll Collection Equipment for the City of Trondheim*. GPR/DS.2/R, adopted on 13 May 1992, paras. 4.21, 4.24 and 4.26.

60. There may be several ways of withdrawing a prohibited export subsidy in a particular case. The application of the above principles to the case of prohibited export subsidies must bear in mind that such subsidies are made up of three elements. First there must be a financial contribution. Second, for there to be a subsidy, the financial contribution must give rise to a benefit to the recipient. Third the subsidy is only prohibited if it is contingent upon export performance. Each of these elements may have components that are past and components that only arise in the future.

61. Withdrawing the measure or prohibited export subsidy may be achieved by effectively withdrawing any of these elements. Of course in some circumstance the choice may be constrained by the practical impossibility of withdrawing an element.

62. It may in some cases be impossible to withdraw one or other of these elements. Thus the *Australia – Automotive Leather* panel noted that removal of the export contingency was not possible in that case since the contingency was found to exist at the date of grant which was in the past. But equally, withdrawal of effects that have already been manifested, including a benefit which has been enjoyed in the past, is also not possible. The only effects that can be prevented, that is the only benefit that can be withdrawn, is the benefit that is yet to be enjoyed in the future. Attempting to withdraw a benefit enjoyed in the past by ordering the repayment of the whole of the financial contribution paid simply imposes a penalty on the company (even though the panel attempts to deny this) for the future which may even create a new and additional distortion of trade contrary to the object and purpose of the WTO Agreement.

63. As Brazil correctly notes, the economic beneficiary of the PROEX subsidies is Embraer whose export of aircraft is thereby facilitated. This benefit is enjoyed at the time the export sale takes place which is when the NTN-1 bonds are issued. It is not an investment subsidy which is enjoyed over a period of time as the US wrongly assumes without giving any reasons. If the subsidy is to be withdrawn by withdrawing the benefit, then this means that no more subsidies under the old PROEX should be given for export sales after the 18 November 1999. The fact that the Brazilian government may be contractually committed to provide PROEX support for export sales after that date cannot excuse the failure to withdraw the subsidy from that date. A government cannot contract out of its *SCM Agreement* obligations.

64. Brazil's argument that it might be sued for breach of contract is also without merit and does not prevent it from implementing the report by ceasing new PROEX payments for exports occurring after 18 November. If it is sued by anyone, this will be the other party to the assistance, the foreign airline or the bank. If Brazil has to pay compensation to these persons because it cancels a commitment to give PROEX support on a future export of an aircraft, this will not benefit Embraer and will not make withdrawal of the subsidy by this means impracticable.

4. When do PROEX subsidies exist?

65. The Panel will recall that the question of when PROEX subsidies exist is a question which was much debated in the original proceedings and before the Appellate Body. The EC view was that the most appropriate moment for considering a subsidy to come into existence is the point in time when all the legal conditions for its grant (or payment) are irrevocably fulfilled. Before that time there is merely an expectation that the subsidy will be available and the benefit cannot be considered to yet be enjoyed. The Appellate Body appears to share that view,¹² although there is some uncertainty arising from the fact that the Appellate Body expressly stated that it did not need to decide when a subsidy exists, only when it is granted for the purpose of Article 27.4 *SCM Agreement*.

¹² Paragraph 158 of the Appellate Body Report.

66. Brazil argues that it became legally bound to grant PROEX subsidies on the sale of a large number of aircraft before 18 November 1999 and that these are subsidies which need not, indeed cannot, be withdrawn.

67. The EC is not however aware of any change in the PROEX scheme as it applies to those aircraft which would change the conclusion of the Panel and the Appellate Body in the original proceeding that all the legal conditions for the grant of PROEX subsidies are not fulfilled until the aircraft are exported which is the same as the time that the bonds are issued. This is of course a factual question and the EC cannot comment further in the absence of factual information.

68. There is one legal issue on which the EC will comment however. In Section D (paragraphs 13 to 23) of its second written submission, Brazil argues that a finding that the subsidy is granted only at the time when the aircraft is exported would reduce the injury provision in Article 5, which is applicable in both Parts III and V of the SCM Agreement, to inutility as regards the aircraft sector. Brazil claims that because aircraft are ordered in advance, in combination with a financing package, injury to other competitors is effectively suffered when the order is made. If it were considered that the subsidy is only granted when each export is made, the Member suffering injury would have to wait until aircraft were actually imported into its territory before being able to impose a countervailing duty or request dispute settlement under Part III, since prior to this moment there would be no subsidy. However, by this stage the injury, in terms of lost jobs, output etc would have already been suffered by the domestic producers, and could not be repaired.

69. The EC would make the following comments:

- It is clear that the application of countervailing duty rules to the export of large capital goods poses some problems since there is not a continuous flow of imports and continuous injury as is assumed for the purpose of these proceedings. However, the EC does not consider that a possible difficulty of applying countervailing duty rules (which may also exist in other cases) should determine the interpretation to be given to the notion of subsidy.
- The Panel and the Appellate Body have not decided that export subsidies for aircraft only exist when aircraft are exported *in general*, merely that the operation of the PROEX scheme as they understood it implied that the subsidy in that case was only granted at a point in time that coincided with export. It is not therefore possible to draw any general conclusions for the interpretation of the *SCM Agreement* from this factual situation. In any event, if Brazil is arguing that the factual situation is different, it should seek to demonstrate this.
- The EC considers that Brazil's speculation about the implications of the Appellate Body's apparent views on the appropriate moment a subsidy "exists" for Part III of the *SCM Agreement* is unconvincing. First the EC notes that Article 5 *SCM Agreement* only incorporates the definition of "injury" from the countervailing duty rules and not the other conditions in Article 15. It provides that the "subsidy" should not cause injury not actual imports. Part III of the *SCM Agreement* must also be applicable to subsidy *programmes* as well as individual payments. In this case, the mere *availability* of a subsidy will be relevant as the panel found in the *US – Foreign Sales Corporations* case.¹³ In the case of subsidy programmes such as the PROEX, injury *in the importing country* may often be felt even though the industry in the exporting country has not yet secured the benefit of the financial contribution (but this is merely available to it). Brazil's explanation of the functioning of the aircraft market shows how this can arise. The *potential availability* of subsidies may affect the intensity of competition for an order and thus cause injury, even before the subsidy is paid.

¹³ Report by the Panel on *United States – Tax Treatment for "Foreign Sales Corporations"*, WT/DS108/R, 8 October 1999, at paragraphs 7.174 - 7.175.

5. Item (k) of the Illustrative List

70. The EC now comes to the issue of Item (k) of the Illustrative List. It has been possible up to now for both the Panel and the Appellate Body to avoid deciding on the relationship between Article 3.1(a) *SCM Agreement* and the Illustrative List, by rejecting Brazil's arguments even assuming that the first paragraph of Item (k) is an "affirmative defence".

71. The arguments have now developed to a state that this may no longer be possible. The US is now stating that Item (k) is not an exception but a constituent part of the definition of subsidy and the prohibition in Article 3.1(a) *SCM Agreement*. A consequence of this would seem to be that Canada has to prove that the new PROEX payments are inconsistent with what it regards as the sole relevant definition of export subsidy in the first paragraph of Item (k).

72. The EC repeats that the US position is untenable.

73. The EC view is that the first paragraph of item (k) is not an "affirmative defence". That provision simply deems certain practices to be prohibited export subsidies. From that, however, it cannot be inferred *a contrario* that an export credit which is not caught by the first paragraph of item (k) is not a prohibited export subsidy.

74. The Appellate Body did not find the contrary. It simply held that the conditions for the application of the "affirmative defence" invoked by Brazil were not satisfied, even if such an "affirmative defence" should be available. (The Appellate Body uses always the term "affirmative defence" between quotation marks). Therefore, the Appellate Body did not need to decide whether the first paragraph of item (k) did provide an affirmative defence.

75. The EC has set out in its written submission the defects it sees with Brazil's arguments seeking to bring the new PROEX outside the scope of the first paragraph of Item (k).

ANNEX 3-4

ORAL STATEMENT OF THE UNITED STATES

(4 February 2000)

1. Mr. Chairman and Members of the Panel, it is my honour to appear before you today to present the views of the United States as a third party in this Article 21.5 proceeding. I know that the Panel has already read our written submission, so I will not restate those points here. My comments will be brief, and will focus primarily on the comments contained in the EC's and Canada's briefs of 17 January. Although I had not planned to do so, I will also comment briefly on the panel's decision in the *Australian Leather* case, given the EC's comments this morning.

2. The first issue that I would like to address today is the EC's and Canada's comments concerning whether item (k) of the Illustrative List constitutes an "affirmative defence" under the SCM Agreement. The United States respectfully submits that item (k) does not create an affirmative defence that has the effect of negating the otherwise applicable and independent provisions of the SCM Agreement. Rather, item (k) -- as well as the other items in the Illustrative List -- sets forth the standard for determining whether the particular type of financing described therein does or does not constitute a prohibited export subsidy.

3. The United States would also like to comment briefly on Canada's and the EC's comments regarding whether item (k) gives rise to an *a contrario* interpretation. The United States agrees with Canada that the Appellate Body did not opine on this issue. In fact, the Appellate Body pointedly declined to do so on the grounds that the Panel did not rule on the issue and the lack of a Panel finding was not appealed.¹ To the extent that Brazil is implying that the Appellate Body *did* make a finding on this issue, it is mistaken.

4. In our view, the Panel does not need to reach this issue. We recall the Panel's statement in its original decision (at para. 7.17) that, in order to rule for Brazil, it needed to find in Brazil's favour on three points. First, it needed to find that PROEX payments are "the payment by [governments] of all or part of the costs incurred by exporters or financial institutions in obtaining credits." Then, it needed to find that PROEX payments are not "used to secure a material advantage in the field of export credit terms" within the meaning of item (k). If the Panel were to answer both of these points in Brazil's favour, then, and only then, would it need to determine whether PROEX payments are permitted if they are not used to secure a material advantage.

5. The United States believes that the Panel should only address the third point if it needs to. The question whether the Illustrative List permits *a contrario* interpretations has been thoroughly briefed in another case and is before the Appellate Body at this time.

6. In the event that the Panel concludes that it does need to address this issue, however, then the United States provides the following additional comments. The United States submits that the only logical reading of item (k) is that a practice which is described by item (k), but which does not secure a material advantage in the field of export credit terms, does not constitute an export subsidy prohibited by the SCM Agreement. With respect to the so-called *a contrario* interpretation, one must begin with footnote 5 to Article 3.1(a), which provides that "[m]easures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement." Footnote 5 makes clear that a practice referred to by the Illustrative List as *not*

¹ Report of the Appellate Body, *Brazil -- Export Financing Programme for Aircraft*, WT/DS46/AB/R, 2 August 1999, para. 187.

constituting an export subsidy is not prohibited by Article 3.1(a) or any other provision of the SCM Agreement. Thus, if PROEX subsidies constitute "export credits" or "payments" within the meaning of item (k), but do not run afoul of the standards set forth in item (k), no further analysis is needed; the PROEX subsidies are not prohibited under any provision of the SCM Agreement.

7. Because footnote 5 seems clear, the opponents of the "*a contrario*" interpretation focus on the word "illustrative". Specifically, while everyone involved in this dispute appears to agree that the Illustrative List is "illustrative", they disagree on the manner in which it is illustrative. The opponents of the "*a contrario*" interpretation argue that if a particular type of financial contribution is described by a particular paragraph in the Illustrative List, but cannot be considered an export subsidy under the standard contained in the particular paragraph, that financial contribution nonetheless can be found to be an export subsidy under some other standard.

8. In the view of the United States, this is not what the drafters intended when they used the term "illustrative". Instead, a more reasonable interpretation is that the drafters used the term "illustrative" simply to signify that not all types of financial contributions are covered by the Illustrative List. For example, the reimbursable loans under Technology Partnerships Canada – loans that were found to be export subsidies in the companion case to this dispute – do not fall under any of the items in the Illustrative List, and their status as prohibited or permitted would not be governed by the Illustrative List. However, where a paragraph of the Illustrative List *does* address a particular type of financial contribution, that paragraph sets forth the standard for determining whether the financial contribution is or is not an export subsidy.

9. Consider, for example, paragraph (j) of the Illustrative List, which deals with export guarantee and insurance programmes. Looking just at the standard for premium rates, premium rates give rise to an export subsidy if they are "inadequate to cover the long-term operating costs and losses of the programmes." Implicit in paragraph (j), however, is the notion that premium rates do not give rise to an export subsidy if they are "adequate" to cover long-term operating costs and losses. Thus, on its face, paragraph (j) provides Members with a predictable standard to use in establishing and administering export guarantee and insurance programmes.

10. Under the approach advocated by Canada and the EC, however, any predictability is lost. For example, if paragraph (j) was only "illustrative" in the way that term is interpreted by Canada and the EC, there would be numerous ways in which an export insurance or guarantee programme could be considered to be an export subsidy even though the premium rates conform to the standard in paragraph (j). If premium rates were inadequate to cover *short-term* operating costs *or* losses, a programme could be considered to be an export subsidy. If premium rates were inadequate to cover short- or long-term *non-operating* costs, a programme could be considered to be an export subsidy. If premium rates were less than what an exporter might pay for comparable coverage in the marketplace, there could be an export subsidy under a "benefit to recipient" approach. This would be particularly true in a situation where a specific export transaction involves an unusually severe risk of non-payment or currency fluctuation. The permutations are endless.

11. Furthermore, the counter-arguments made on this issue are not persuasive. The EC has argued previously that in order for footnote 5 to exclude a measure from the prohibitions of the SCM Agreement, there has to be "a clear statement in Annex I that a measure *does not constitute* an export subsidy"² or "an 'affirmative statement' in the Illustrative List to the effect that a measure does not constitute an export subsidy."³

² FSC Panel Report, para. 4.932 (emphasis in original).

³ *Brazil Aircraft*, para. 77.

12. However, the text of footnote 5 does not require such a "clear" or "affirmative" statement, and there is a reason for this: the drafters had a different intent. Footnote 5 first appeared in the third draft agreement prepared by the Chairman of the Negotiating Group on Subsidies.⁴ In this draft, footnote 5 appeared for the first time – as footnote 4 to Article 3.1(a). Footnote 4 read as follows: "Measures *expressly* referred to in the Illustrative List as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement." (Emphasis added). Thus, the original version of footnote 5 had an additional word – "expressly" – which, had it been retained, might have supported the EC interpretation.

13. The word "expressly" was not retained, however. In the very next draft, the word was deleted from the footnote (still numbered as footnote 4).⁵ This change demonstrates that the drafters intended to expand, rather than restrict, the scope of footnote 5. The change also demonstrates that the drafters did not intend the sort of narrow construction of footnote 5 advanced by Canada and the EC.

14. The second principal counter-argument is that the US approach somehow would transform the Illustrative List into an exhaustive list that allegedly would allow "all sorts of measures" to escape the export subsidy prohibition. For example, in the past, the EC has cited item (a) of the Illustrative List – which prohibits "direct subsidies" – and claimed that under the US approach, *indirect* export subsidies would escape item (a) and, thus, prohibition under Article 3.1(a).⁶

15. However, this is a mischaracterization of the US position. First, as previously noted, the US position is *not* that the Illustrative List is exhaustive. Instead, the US position is that the Illustrative List does not deal with all possible financial contributions, but for those that it does deal with, it establishes, by virtue of footnote 5, a dispositive legal standard insofar as prohibited subsidies are concerned. Second, in the case of the item (a) example, the US position is that item (a) simply does not address "indirect" subsidies. Thus, indirect subsidies do not "escape" any prohibition. Instead, the standard for a prohibited *indirect* subsidy must either be found elsewhere in the Illustrative List or, if the provisions of the Illustrative List are silent, in the general principles of Articles 1 and 3.1(a) of the SCM Agreement.

16. Finally, the opponents of the "*a contrario*" position have never been able to explain how their approach to footnote 5 and the Illustrative List does not render various portions of the Illustrative List ineffective. For example, Canada and the EC have been unable to explain how their approach does not render the "material advantage" clause of item (k) superfluous; *e.g.*, under this approach, a below-cost export credit is prohibited *whether or not* it secures a material advantage. Because such an outcome is incorrect under public international law, a correct interpretation of footnote 5 and the Illustrative List is that the provisions of the Illustrative List are controlling with respect to the measures addressed therein.

17. Shifting focus, the United States would like to comment briefly on Brazil's reference to US Export Import Bank loan guarantees and market windows used by certain countries, including Canada. On one hand, for the reasons contained in our written submission, the United States agrees with the EC and Canada that Brazil's discussion of loan guarantees and market windows is an apples and oranges discussion that is not relevant to this dispute. On the other hand, the United States does not necessarily agree with their analyses of these instruments. The United States submits for example that the failure of the OECD to reach agreement on the treatment of "market windows" for purposes of the *OECD Arrangement* does not mean that market windows are consistent with the *Arrangement*. For present purposes, suffice it to say that the status of these instruments under the SCM Agreement is an issue for another day.

⁴ MTN.GNG/NG10/W/38/Rev. 2 (2 November 1990).

⁵ MTN.GNG/NG10/W/38/Rev. 3 (6 November 1990).

⁶ FSC Panel Report, para. 4.933-4.934.

18. Finally, the United States would like to comment briefly on certain broader points that we hope will influence the spirit in which the Panel evaluates this dispute.

19. This proceeding, as well as the companion proceeding brought by Brazil against Canada, is extremely important, for it revolves around the critical issue of compliance with DSB rulings and recommendations and the resultant effect on the SCM Agreement's ability to discipline prohibited and injurious subsidies.

20. As the Panel noted in its opinion in the *Canadian Aircraft* case, subsidies by their very nature involve situations where governments insert themselves into the marketplace by providing benefits to favoured companies, that is, financial contributions on better than market terms. While the SCM Agreement allows certain non-injurious subsidies, it flatly prohibits export subsidies. These two cases are a good example of why this is so.

21. When a government chooses to provide an export subsidy, it effectively is deciding to interfere in the marketplace to provide its producers with an unjustified advantage over their foreign competitors *in their competitors' home markets and in third country markets*. Inevitably, this provokes a response from the affected countries and their producers. For example, Brazil argued before the Appellate Body that PROEX subsidies were intended to match the subsidies provided by the Government of Canada to Bombardier. The result is a ruinous subsidy competition that distorts the world trading system, punishes taxpayers, and bleeds off resources that might be better used for other purposes. The governments concerned may well want to call off this competition; effective rules on export subsidies, effectively enforced, can make this possible.

22. Finally, I would like to comment briefly on the panel's decision in the *Australian Leather* Article 21.5 proceeding. If the Panel would like a detailed response on this issue, I would prefer to provide it in writing. However, I am happy to provide some initial oral comments.

23. As an initial matter, the United States agrees that the panel's decision in the *Leather* case is not directly relevant to this dispute, because Canada is not seeking the repayment of PROEX subsidies. Instead, Canada simply is insisting that Brazil not pay out additional prohibited subsidies in the form of PROEX bonds. For this reason, the Panel does not need to reach the issue addressed by the *Leather* panel.

24. If the Panel is nonetheless interested in our views, then I would simply observe that the *Leather* panel has spoken, so it is appropriate to conclude that its determination is definitive with regard to that case. The United States intends to support adoption of the report at the next meeting of the Dispute Settlement Body.

25. However, the *Leather* panel was considering a particular type of subsidy, namely, a large, non-recurring grant that was given in the past. The panel itself acknowledged that the proper manner of withdrawing a prohibited export subsidy may differ from case to case.

26. While the panel's conclusion in *Leather* went beyond the position that we took, we cannot fault the logic of that conclusion.

27. This concludes my comments. On behalf of the United States, I thank the Panel for providing us with the opportunity to provide our views. I would be happy to address any questions that the Panel or the parties may have.

ANNEX 3-5

RESPONSES OF THE EUROPEAN COMMUNITIES
TO QUESTIONS POSED BY THE PANEL

(14 February 2000)

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QUESTIONS FROM THE PANEL

1. The European Communities (hereafter "the EC") makes the following brief comments on the questions from the Panel in this case.

QUESTION 1 TO CANADA

Please state your views about whether, under the "material advantage" clause as interpreted by the Appellate Body, the CIRR is the exclusive benchmark for determining whether a material advantage has been secured, or whether as argued by Brazil, a different benchmark might prevail if it could be demonstrated that interest rates in the marketplace were lower than the CIRR.

Response

2. The EC does not believe that the CIRR is the exclusive benchmark for assessing material advantage under the first paragraph of item (k). It notes that the Appellate Body considered the OECD Arrangement could be "appropriately viewed as one example of an international undertaking providing a specific market benchmark."¹

¹ Report by the Appellate Body on *Brazil – Export Financing Programme for Aircraft*, AB-1999-1, WT/DS46/AB/R, 2 August 1999, at paragraph 181.

QUESTION 3 TO CANADA

Please state whether, in the view of Canada, Participants to the Arrangement are required to respect the CIRR (a) in respect of "pure cover"; (b) in respect of floating interest rate transactions.

Response

3. Participants to the Arrangement are not required to respect CIRR in respect of "pure cover".
4. The EC would point out that floating rates cannot technically respect the CIRR, but that in order to provide an "equivalent" solution a reasonable margin, depending on the currency and on the credit period, should be added on top of floating rates.
5. Any party not using the CIRR but something below would have to base its defence on the first paragraph of item (k) and provide evidence that demonstrates its compliance therewith.

QUESTION 5 TO CANADA

Canada states (second submission, footnote 24) that, in order to compare a floating interest rate expressed in LIBOR to a US Treasury Bond, a "swap spread" must be added. Has any Canadian government agency (including the Export Development Corporation), since 1 January 1998, in respect of regional aircraft:

- (a) **provided floating interest-rate export credits the initial interest rate of which was below the CIRR applicable as of the date of the transaction less the relevant swap spread prevailing as of that date ?**
- (b) **provided guarantees in respect of floating interest-rate export credits the initial interest rate of which was below the CIRR applicable as of the date of the transaction less the relevant swap spread prevailing as of that date ?**

If your answer is affirmative, please inform the Panel as to the initial interest rate applicable to the export credit(s) in question, the 10-year US Treasury Bond rate prevailing as of the date the export credit was provided and the relevant swap spread prevailing as of that date.

Response

6. Swap rates are rates used for first class banks in high income OECD Countries. According to preliminary information available to the EC, taking the Euro as a reference currency, albeit for a short period of time, suggests that the differences between the 7 year swap rate and the corresponding CIRR are between 30 and 80 basis points.

QUESTION 6 TO CANADA

Canadian Exhibit CDN-11 appears to establish a "swap spread" between floating interest rates and 7-year fixed interest rates. Canada however uses this swap spread to compare a floating interest rate to a 10-year US Treasury Bond rate. Please explain.

Response

7. The reason why the 7 year bullet bonds are used as base rate for longer term CIRR is that the average life of this instrument is equivalent to long term credit with semi annual instalments.

QUESTION 7 TO CANADA

The Appellate Body has stated that "the appropriate comparison to be made in determining whether a payment is 'used to secure a material advantage', within the meaning of item (k), is between the actual interest rate applicable in a particular export transaction after deduction of the government payment (the 'net interest rate') and the relevant CIRR" (WT/DS46/AB/R, para. 54). It could be argued that whether PROEX interest rate equalization results in a net interest rate below CIRR will depend upon the initial, pre-equalization interest rate, and PROEX interest rate equalization does not necessarily result in a below-CIRR net interest rate in any given transaction. Please comment.

Response

8. The EC observes that to the extent that the Panel is being asked to examine in this case whether the PROEX programme has been brought into conformity with the SCM Agreement or not, it is not necessary to examine individual transactions but rather whether PROEX still allows export subsidies to be granted.

QUESTION 10 TO CANADA

Canada states (second submission, para. 51) that "a rate of 10-year Treasury Bonds + 20 bps is, under no circumstance, available to the purchasers of regional aircraft in direct financing at market rates". Is such a rate available to the purchasers of regional aircraft through modalities other than direct financing, e.g., through loan guarantees ? Please support your answer.

Response

9. 20 basis points on top of the 10 year bond would be equivalent to a 50 basis point margin against the 100 basis points required in the CIRR system. Since the average difference between a 10 year bond and a 7 year one (the longer benchmark for building the CIRR) is in the range of 20-30 bp, this solution would give a rate which would be 50 bp lower than the CIRR.

QUESTION 12 TO CANADA

The Appellate Body refers to the CIRR as a minimum commercial rate, and it could be argued that it was for that reason that it chose the CIRR as reference point for evaluating material advantage. Canada has stated that commercial rates below CIRR are possible. Does this not suggest that, to the extent that a commercial rate below CIRR exists, that commercial rate should represent the reference point for evaluating material advantage?

Response

10. The EC notes that the Appellate Body stated in paragraph 182 of its Report that:

In any given case, whether or not a government payment is used to secure a "*material* advantage", as opposed to an "advantage" that is not "*material*", may well depend on where the *net* interest rate applicable to the particular transaction at issue in that case stands in relation to the range of commercial rates available. The fact that a particular

net interest rate is below the relevant CIRR is a positive indication that the government payment in that case has been "used to secure a material advantage in the field of export credit terms".

11. It seems clear to the EC from this that the existence of a single case of a commercial rate below CIRR is not sufficient to reduce the benchmark.

QUESTION 2 TO BRAZIL

Canada considers that, consistent with Article 3.2 of the SCM Agreement, withdrawal of a subsidy under Article 4.7 of the Agreement entails, as a minimum, ceasing to grant or maintain subsidies found to be prohibited under Article 3.1 of the SCM Agreement. Do you agree? Please explain your answer.

Response

12. In the view of the EC the word "maintain" in Article 3.2 SCM Agreement is used to refer to subsidy programmes, and the word "grant" to refer to the individual payments under the programmes. Thus a Member may not maintain export subsidy programmes and may not grant export subsidies in any other way (ad hoc or under other programmes).

QUESTION 3 TO BRAZIL

The Appellate Body has ruled that, for the purpose of Article 27.4 of the SCM Agreement, export subsidies for regional aircraft under PROEX are "granted" when the NTN-1 bonds are issued. WT/DS46/AB/R, para. 158, Article 3.2 of the SCM Agreement provides that a Member "shall neither grant or maintain" export subsidies. Is it your view that export subsidies for regional aircraft under PROEX are "granted" at a different point in time for the purposes of Article 3.2 then for the purposes of Article 27.4 ? If so, please explain the basis for that view.

Response

13. The EC finds it difficult to consider that the word "grant" should have a different meaning in Article 3.2 than in Article 27 SCM Agreement.

QUESTION 12 TO BRAZIL

Brazil argues (second submission, paras. 24-26) that if it does not issue bonds pursuant to letters of commitment issued before 18 November 1999, it can be sued for breach of contract.

- (a) In this respect, please explain to whom Brazil owes an alleged contractual obligation under the letter of commitment.**
- (b) In the original dispute in this case, Brazil submitted a legal opinion (exhibit BRA-17) stating that letters of commitment could not be annulled because they were "a perfect legal act, absolutely licit and practised based on legal provisions". In document G/ADP/W/281-G/SCM/W/291 dated 2 February 1996, Brazil stated that, "[h]aving been incorporated into the Brazilian legal system by means of a Presidential decree (Decree No. 1355, dated 30 December 1994), the WTO Agreements have the same hierarchical level as laws, and are subordinate only to the Federal Constitution". Please comment.**

Response

14. The EC cannot comment on the Brazilian legal system but would observe that the fact that an international agreement "has the same hierarchical level as laws" does not necessarily mean that it had direct effect or is "self executing." Even less does it imply that where the granting of a contractual right may involve a breach of the relevant international agreement (by the State), that contractual obligation should be considered void.

ANNEX 3-6

**RESPONSES OF THE UNITED STATES
TO QUESTIONS OF THE PANEL**

(14 February 2000)

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QUESTIONS POSED ON 3 FEBRUARY 2000

For Canada

Q1. Please state your views about whether, under the "material advantage" clause as interpreted by the Appellate Body, the CIRR is the exclusive benchmark for determining whether a material advantage has been secured, or whether, as argued by Brazil, a different benchmark might prevail if it could be demonstrated that interest rates in the marketplace were lower than the CIRR.

Response

The CIRR is the exclusive benchmark for determining whether a "material advantage" has been secured, as that term is used in item (k).

Q3. Please state whether, in the view of Canada, Participants to the Arrangement are required to respect the CIRR (a) in respect of "pure cover"; (b) in respect of floating interest rate transactions.

Response

With respect to question (a), in the view of the United States, Participants to the Arrangement are not required to respect the CIRR in respect of "pure cover" because pure cover is governed by item (j). "Pure cover" for export credits by a Participant is provided through export credit guarantee or insurance programmes. Item (j) sets forth the benchmark for insurance and guarantee programmes; *i.e.*, premium rates charged must not be inadequate to cover the long-term operating costs and losses of the programme.

With respect to question (b), under the Arrangement, there are no provisions for an official floating interest rate. Therefore, floating interest rates are prohibited by the Arrangement unless arrived at through pure cover.

Q8. To what extent do you consider the OECD Arrangement is legally binding on Canada?

Response

The OECD Arrangement is not a treaty that creates formal rights and obligations under international law, but is a "gentleman's agreement" among the Participants. Canada has agreed to abide by the guidelines contained in the Arrangement. In that sense, all export credit activity by Canada, including all export credit activity of the Export Development Corporation, is bound by the Arrangement.

Q12. The Appellate Body refers to the CIRR as a minimum commercial rate, and it could be argued that it was for that reason that it chose the CIRR as reference point for evaluating material advantage. Canada has stated that commercial rates below CIRR are possible. Does this not suggest that, to the extent that a commercial rate below CIRR exists, that commercial rate should represent the reference point for evaluating material advantage?

Response

No. Because the CIRR is the exclusive internationally agreed upon reference point for evaluating the minimum level for officially-supported export credits, it is the appropriate reference point for evaluating material advantage.

For Brazil

Q1. Canada states in its rebuttal submission that "[a] net interest rate of 20 basis points above the 10-year Treasury Bond rate is well below CIRR" (para. 33). Brazil itself states in its first submission that "Brazil chose a point of reference other than CIRR for PROEX based on evidence that, in the case of aircraft, the marketplace in fact supports lower interest rates" (para. 10). Does Brazil acknowledge that a net interest rate of 20 basis points above the 10-year US Treasury Bond rate is below CIRR? If not, please provide historical examples of periods where such a net interest rate was equal or higher than the CIRR rate.

Response

The United States notes that a review of 30 years of data (1970-1999) shows that at no point during that period did the long-term CIRR (monthly average of the 7-year U.S. treasury bond + 100 bps -- applicable to transactions with a repayment term greater than 8.5 years) go below the monthly average 10-year treasury bond + 20 bps. On average during that period, the long-term CIRR was 73 bps higher than the 10-year treasury bond + 20 bps benchmark proposed by Brazil.

Q2. Canada considers that, consistent with Article 3.2 of the SCM Agreement, withdrawal of a subsidy under Article 4.7 of the SCM Agreement entails, as a minimum, ceasing to grant or maintain subsidies found to be prohibited under Article 3.1 of the SCM Agreement. Do you agree? Please explain your answer.

Response

The United States agrees with Canada. For one thing, the remedy flowing from a finding that an obligation has been violated should bear some relationship to the obligation itself. In this case, because the obligation is to not grant or maintain a prohibited subsidy, the remedy should result in the offending Member adhering to that obligation.

In addition to this general observation, however, one meaning of "withdraw" is to "refrain from proceeding with (a course of action, a proposal, etc.)".¹ Thus, the ordinary meaning of "withdraw" in this context would be to refrain from granting or maintaining subsidies found to be prohibited.

Q3. The Appellate Body has ruled that, for the purposes of Article 27.4 of the SCM Agreement, export subsidies for regional aircraft under PROEX are "granted" when the NTN-1 bonds are issued. WT/DS46/AB/R, para. 158. Article 3.2 of the SCM Agreement provides that a Member "shall neither grant nor maintain" export subsidies. Is it your view that export subsidies for regional aircraft under PROEX are "granted" at a different point in time for the purposes of Article 3.2 than for purposes of Article 27.4? If so, please explain the basis for that view.

Response

In the view of the United States, in the context of this case, the PROEX subsidies are "granted", for purposes of Article 3.2, when the NTN-1 bonds are issued.

Q10. Brazil states (first submission, para. 4) that the Appellate Body held that "Members are permitted to obtain an "advantage" in the field of export credit terms provided that advantage is not "material" (emphasis added). The Appellate Body did not however address the issues of whether the first paragraph of item (k) can be used as an affirmative defense, nor whether PROEX payments are "payments" within the meaning of that item. Please comment.

Response

The Panel is correct in its description of what the Appellate Body did and did not address. In the view of the United States, the PROEX payments constitute "payments by [an export credit agency] of all or part of the costs incurred by . . . financial institutions in obtaining credits" within the meaning of the first paragraph of item (k).

With respect to the status of item (k), the United States disagrees that the first paragraph constitutes an "affirmative defense". Instead, for the reasons set forth in the *Statement of the United States at the Third Party Session*, 4 February 2000, paras. 2-16, the first paragraph of item (k) sets forth the standard for determining when an export credit or a "payment" constitutes a prohibited export subsidy under the SCM Agreement. Thus, the first paragraph is not an "affirmative defense" or an "exception" to something else. Accordingly, if the PROEX payments are found to be "payments" within the meaning of the first paragraph, the burden is on the complainant – Canada – to demonstrate that those payments are inconsistent with the requirements of the first paragraph.

Q11. The Appellate Body refers to the CIRR as a minimum commercial benchmark. Thus, it could be argued that any alternative benchmark in the marketplace for determining whether a payment is used to secure a material advantage must be undistorted by government intervention. Please comment.

Response

¹ *New Shorter Oxford English Dictionary* (1993).

There is no alternative benchmark in the marketplace to the CIRR for determining whether a payment is used to secure a material advantage. The CIRR is the exclusive benchmark for this determination.

For both parties

Q1. The Appellate Body has referred to the CIRR as "a minimum commercial interest rate". The US dollar CIRR is however constructed on the basis of US Treasury bond yields. Further, Canada has stated (second submission, para. 40) that US Treasury Bonds are fixed rate reference benchmarks, while LIBOR is a floating rate benchmark. That being the case, to what extent can CIRR rates be considered relevant to establishing a "minimum commercial interest rate" in respect of floating interest rates?

Response

CIRR rates cannot be considered relevant to establishing a "minimum commercial interest rate" in respect of floating interest rates. There are no provisions for floating interest rates in the Arrangement, therefore, official floating interest rates are prohibited by the Arrangement. Floating interest rates are only allowed under the Arrangement when they are arrived at through pure cover. For purposes of determining whether floating rate financing confers material advantage for the purposes of item (k), floating rate financing confers material advantage if it is constructed in such a way that it could drop below CIRR levels.

FURTHER QUESTIONS

For Canada

Q1. Canada stated at the meeting with the Panel on 4 February 2000 that, if the Export Development Corporation provides financing at rates equal to or higher than its borrowing costs, but below the CIRR, that practice may still not constitute a subsidy because no benefit is conferred. That would mean that there may exist a market benchmark lower than the CIRR. Does Canada agree that if Brazil, for instance, used that same benchmark, which is lower than the CIRR, no subsidy would exist as per the Canadian argument because no benefit is conferred?

Response

The Export Development Corporation (EDC) is subject to the terms of the Arrangement when providing export credits. If EDC provides financing rates below the CIRR, Canada is conferring a benefit. Whether or not such financing constitutes a prohibited export subsidy under the first paragraph of item (k) is a separate question and one which is not the subject of this proceeding.
