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***BRAZIL - EXPORT FINANCING PROGRAMME FOR  
AIRCRAFT***

**FIRST WRITTEN SUBMISSION OF CANADA**

**3 NOVEMBER 1998**

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**BRAZIL - EXPORT FINANCING PROGRAMME FOR AIRCRAFT****FIRST WRITTEN SUBMISSION OF CANADA****I. INTRODUCTION**

1. At issue in this dispute is whether the *Programa de Financiamento às Exportações* (PROEX), the export financing support programme of Brazil, confers export subsidies on sales of Brazilian regional aircraft that are prohibited under Article 3 of the *Agreement on Subsidies and Countervailing Measures* (SCM Agreement).

2. Canada will show that payments made by the Government of Brazil under the "Interest Equalisation" component of PROEX<sup>1</sup> on export sales of Brazilian regional aircraft constitute subsidies within the meaning of Article 1. Canada will further prove that such subsidies are contingent on export performance and are therefore prohibited by Article 3.

3. PROEX payments are financial contributions by the Government of Brazil that, in the case of exported Brazilian aircraft, reduce the cost of such aircraft to the purchaser. The purchaser (for example, an airline) may receive these payments in one of two ways. First, PROEX payments may be used to lower the rate of interest paid by a purchaser by up to 3.8 percentage points per year. The net benefit conferred on a purchaser as a result of such an interest rate reduction can amount to as much as half of the total interest that would be payable by a purchaser in the absence of the payments. Second, a purchaser may, instead, receive these payments in the form of a lump-sum payment that reduces the cost of the aircraft by at least 13 to 15 percent.

4. The payments are made even where the financing is done by a non-Brazilian entity. The payments are made even in circumstances where the purchaser borrows funds, at commercial rates based on its own credit-worthiness, from non-Brazilian creditors in financial markets outside of Brazil. The payments are made even where elements of the financing are guaranteed by non-Brazilian multinational corporations. The payments are not made in return for any goods or services. The payments are never repaid and are not required to be repaid. The payments operate directly to increase the exports of Brazilian regional aircraft.

5. In short, in the regional aircraft market, PROEX payments are grants tied to the purchase of Brazilian regional aircraft exports. Such grants are subsidies within the meaning of Article 1. As they are contingent on export performance, these grants constitute prohibited subsidies within the meaning of Article 3.

6. PROEX subsidies to Brazilian regional aircraft have resulted in serious distortions in the regional aircraft market -- the market for jet and turboprop aircraft that have between 20 and 90 seats.

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<sup>1</sup> Referred to as "PROEX payments" or "PROEX subsidies" in this submission.

7. In view of the damage caused by PROEX subsidies, Canada brought this matter to the attention of Brazil two years ago and attempted to resolve it through negotiation, both within and outside the framework of the WTO dispute settlement mechanism. Despite expressions of concern by Canada and other members of the WTO, Brazil has, contrary to Article 3.2, continued to grant and maintain such prohibited subsidies.

8. Further, Brazil has done nothing to phase out these export subsidies. Indeed, it has expanded the scope and availability of PROEX subsidies. It has progressively increased expenditures under PROEX, both generally and more specifically with respect to regional aircraft. It has increased the value of the financing to which PROEX subsidies apply from 85 percent to 100 percent of the purchase amount. It has, in practice, waived Brazilian content requirements and increased the period in which PROEX subsidies are available from ten to fifteen years. It has increased the term for which PROEX subsidies are available for spare parts and engines for regional aircraft. Finally, it has made PROEX subsidies available as lump-sum grants and therefore more attractive to purchasers.

9. Canada seeks a resolution of this matter before the WTO that will put an end to the serious market distortions caused by PROEX subsidies. Canada seeks a finding that payments made under PROEX on export sales of Brazilian regional aircraft constitute export subsidies prohibited by Article 3. Canada requests that the panel recommend, in accordance with Article 4.7, that Brazil withdraw without delay PROEX subsidies granted under the "Interest Equalization" component of PROEX, as set out in paragraph 80 below.

## II. THE HISTORY OF THIS DISPUTE

10. On June 18, 1996, Canada requested that Brazil enter into consultations pursuant to Article 4 of the SCM Agreement and Article 4 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (DSU). The consultations were held in Geneva on July 22 and 25, 1996. In the course of these consultations and at a meeting of the SCM Committee convened to review a number of notifications under Article 25 of the SCM Agreement on July 23-24,<sup>2</sup> Brazil denied that PROEX payments were subsidies.

11. Brazil subsequently expressed the view, in a letter dated September 23, 1996,<sup>3</sup>

that even if aspects of PROEX were covered by Article 3, Brazil would be permitted to phase out PROEX under the developing country provisions of the SCM Agreement.

12. Following high-level discussions between Ministers, Canada and Brazil entered into another round of consultations, held in Geneva on November 4, 1996. At these consultations Canada and Brazil agreed to further negotiations to find a mutually satisfactory resolution of the dispute on the basis of a set of disciplines broadly reflecting the OECD *Arrangement on Guidelines for Officially Supported Export Credits*. These talks, held in Brasilia on November 21 and 22, 1996, led to an exchange of proposals for the resolution of this dispute in the course of the following months. On March 10, 1997, Brazil requested consultations on a range of Canadian programmes and practices.

13. After continuing negotiations between officials, further high-level consultations between the two Governments in January 1998 resulted in the appointment by the Prime Minister of Canada and the President of the Federative Republic of Brazil of special envoys with the mandate of reviewing the dispute and offering recommendations for the resolution of the matter. The envoys met with officials from the two governments in the course of performing their mandates and issued a report to the Parties on April 17, 1998.

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<sup>2</sup> July 22-26, 1996, G/SCM/M/11, October 24, 1996.

<sup>3</sup> Brazil's response to Canada's request for the establishment of a Panel regarding PROEX dated September 23, 1996, from Carlos Antonio da Rocha Paranhos, Minister-Counsellor at the Brazilian Mission in Geneva to the Chairman of the Dispute Settlement Body. Documentary Annex tab 1.

<sup>4</sup>

14. The Prime Minister and the President publicly endorsed the report on May 7, 1998, and set in motion yet another round of negotiations to try to resolve the dispute by the end of June 1998. Unfortunately, these negotiations did not achieve a mutually satisfactory resolution.

15. On July 23, 1998, the Dispute Settlement Body (DSB) established a Panel under Article 4 of the SCM Agreement.

16. The terms of reference of the Panel are:

“To examine, in the light of the relevant provisions of the SCM Agreement, the matter referred to the DSB by Canada in document WT/DS46/5 and to make such findings as will assist the DSB in making the recommendations or in giving the rulings provided for in that agreement.”

**III. ISSUES TO BE DECIDED BY THIS PANEL**

17. Canada requests that the Panel:

- find and conclude that payments made under the “Interest Equalization” component of PROEX on exported Brazilian regional aircraft constitute subsidies within the meaning of Article 1, and that these subsidies are contingent on export performance and therefore prohibited under Article 3.1;
- find and conclude that Brazil must neither grant nor maintain PROEX subsidies, in accordance with Article 3.2; and
- recommend that Brazil withdraw PROEX subsidies without delay, in accordance with Article 4.7.



#### IV. STATEMENT OF FACTS

##### A. The regional aircraft market

18. The regional aircraft market (commercial aircraft with 20-90 seats) is served by both turboprop and jet aircraft. Turboprop aircraft are produced by Embraer, the Brazilian manufacturer of regional and military aircraft,<sup>5</sup> Bombardier of Canada,<sup>6</sup> the German-American company Fairchild-Dornier, and ATR, a joint venture between Alenia of Italy and Aerospatiale of France. Saab of Sweden and British Aerospace of the United Kingdom also produce some turboprop aircraft, but have announced that they are exiting the business.

19. A discrete market for regional jet aircraft did not exist before the introduction of the Canadair Regional Jet (CRJ) aircraft by the Canadian manufacturer Bombardier in 1993. Although small four-engine jet aircraft aimed at short-haul routes had been in operation for some time, what has become known as the "twinjet" regional jet (RJ) "has revolutionized the industry."<sup>7</sup> It has opened up new opportunities on long routes that did not have enough traffic to justify a larger jet. It allows smaller markets not served by major carriers to be hooked up, through regional airlines, to "hubs" -- centres of operations for such carriers. It has also been successfully used to replace larger jets on more heavily traveled routes during off-peak hours. Finally, the regional jet has replaced turboprops on some, generally longer (300 miles or more), routes.<sup>8</sup>

20. In just over five years since the introduction of the 50-seat CRJ-100, two other manufacturers, Embraer and Fairchild-Dornier, have entered the market; in this period, the three manufacturers have introduced five new regional jets.<sup>9</sup> Over 750 regional jets have already been ordered.<sup>10</sup>

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<sup>5</sup> "Embraer Update", on-line: Embraer, <http://www.embraer.com/ing/embhoje.htm> (date accessed 16 October 1998). Documentary Annex tab 3.

<sup>6</sup> "Bombardier Aerospace Profile", on-line: Bombardier, [http://www.aerospace.bombardier.com/htmen/6\\_0.htm](http://www.aerospace.bombardier.com/htmen/6_0.htm) (date accessed 16 October 1998). Documentary Annex tab 4.

<sup>7</sup> "The Ubiquitous Turboprop", *Air Transport World*, May 1998, v. 35 n. 5, 53, at 10. Documentary Annex tab 5.

<sup>8</sup> The "cachement" area -- the area from which passengers could be drawn -- has been increased to 1000 nautical miles (nm) for regional airlines, allowing carriers to offer routes in new markets and non-stop service to other areas. *Ibid.*

<sup>9</sup> The 70-seat CRJ-700 by Bombardier; the 50-seat ERJ-145 and 37-seat ERJ-135 by Embraer; and the 35-seat 328JET and the 42-seat 428JET by Fairchild-Dornier.

<sup>10</sup> "Regional Fleet Forecast Predicts Continuing Move to Jets", *Commuter Regional Airline News*, June 8, 1998, v. XVI, n. 23, at 3. Documentary Annex tab 6.

21. Embraer entered the regional jet market with the certification of the EMB-145 (now ERJ-145) in 1996, followed by the launch of the 37-seat ERJ-135 in 1997.

Embraer has recently announced that it will increase its production of regional jets to 12 a month,<sup>12</sup> enough to satisfy, on its own, the demand for regional jet aircraft in this market segment for the foreseeable future.<sup>13</sup>

### B. Financing regional jet aircraft

22. At its most basic, there are only two parties in a sale of regional aircraft: the seller (the manufacturer) and the purchaser (the airline). However, no transaction is done as simply as this, for two primary reasons. First, regional aircraft are capital assets; they make economic sense for an airline when the returns on their operation exceed the costs of operation. Second, few carriers have the financial capacity to make outright purchases of such capital assets.

23. According to one market analyst, “[a]cquisition costs, especially financing programs, are the largest non-operating performance related selling point a manufacturer uses in marketing its aircraft.”<sup>14</sup> Indeed, aircraft selection is often driven by the lowest monthly financing cost, as regional airlines are motivated to purchase aircraft on the basis of profitability of given routes: the lower the financing cost, the greater the number of routes that become profitable. The financing structure of a transaction is therefore one of the most important elements in determining whether a particular aircraft would be profitable for an airline. Balancing the many variables in each financing transaction permits an airline to adjust the economics of the regional aircraft in question to its expected routing and passenger returns.

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<sup>11</sup>

<sup>12</sup> “Embraer Steps up Production to Meet Demand”, *Gazeta Mercantil*, June 8, 1998, at C-8. Documentary Annex tab 8.

<sup>13</sup> Market analysts Warburg Dillon Read notes that “[f]our manufacturers are positioned to serve specific niches in what we believe is a 125+ unit per year industry.” “Regional jets: making props passe”, Industry Report dated August 10, 1998, at 4. Documentary Annex tab 9.

<sup>14</sup> *Ibid.*, at 17.

24. 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<sup>15</sup> (for floating-rate transactions)<sup>16</sup> and U.S. Treasuries (for fixed rate transactions in U.S. dollars).<sup>17</sup> As the quality of the credit increases, the spread is reduced and so are the monthly interest payments. The quality of the credit could, in turn, be subject to guarantees and security interests. Such devices could increase the credit rating of a purchase, thereby lowering the cost of financing and the monthly payments to be made by an airline. The manufacturer of the aircraft, the manufacturer of the engines, or an official export credit agency could guarantee a financing transaction and increase its credit quality. As well, a financier would normally be granted a security interest in the aircraft, thereby increasing the credit rating<sup>18</sup> of the purchase by as much as two levels over unsecured loans.<sup>19</sup>

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<sup>15</sup> 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 U.S. 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 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 percent, or 125 basis points (bps) above three-month LIBOR. See "A-Z Glossary", *Money World*, <http://www.moneyworld.co.uk/glossary/g100253.htm>. Documentary Annex tab 10.

<sup>16</sup> 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 financing transactions, the benchmark used (to reflect the "general movements in interest rates") is the three-month or the six-month LIBOR.

<sup>17</sup> 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 U.S. dollar-denominated) the benchmark used is U.S. Treasury.

<sup>18</sup> "Credit rating", whether done by a rating agency or by a financial institution, is a measure of the degree of risk of default by an enterprise of a loan or an investment, determined on the basis of the revenue, profitability and the assets of the enterprise, as well as collateral guarantees underwriting the transactions of that enterprise and the likelihood of change in any of these variables. Such ratings may also be given to bond issues covering, for example, the purchase of capital assets by an enterprise. The market perception of the asset, its value and durability may factor in determining the rating to be given to such an issue.

<sup>19</sup> Ratings have many levels, ranging (in the case of one rating agency, Moody's) from Aaa to D (speculation grade investment, or "junk bonds"). An increase in the rating level of an enterprise or a bond issue would result in lower "spreads" applied to the issue, or lower returns expected from the investment. "A Sense of Security", *Moody's Special Comment*, Report Number 27061, October 1997, at 1. Documentary Annex tab 11.

25. The actual financing transaction can be as simple as a mortgage on the aircraft, or involve more complex, and complicated, mechanisms. The structure of each transaction is governed by tax, liquidity, or simply risk appetite considerations. U.S.-based leveraged leases (in which up to 20 percent of the purchase is through equity investment and the remainder is debt) tend to be popular for tax reasons, although other instruments are increasingly used for financing regional aircraft. For this reason, and that the largest purchasers of regional aircraft have been U.S. carriers, most financing for regional jet aircraft is offered by U.S.-based institutional debt and equity sources.

### C. The basic structure of PROEX

26. PROEX should be viewed in the light of the fact that "aggressive financing" by a manufacturer or a government could be an important determinant of success for capital goods such as regional aircraft.<sup>20</sup>

#### 1. The regulatory framework of PROEX

27. The Government of Brazil created PROEX on June 1, 1991 by Law No. 8187/91, entitled "Authorizing the Granting of Financing to the Export of Brazilian Goods and Services",<sup>21</sup> to replace the Export Financing Fund (FINEX). The subsidies committed by the Brazilian Treasury under FINEX are now maintained by PROEX.<sup>22</sup> The two programmes are

<sup>20</sup> Warburg Dillon Read notes, for example, that Embraer's "ERJ-145 line is quickly penetrating the U.S. regional jet market due, in part, to its high production rate and *aggressive financing terms.*" *Op. cit.*, Documentary Annex tab 9, at 9.

<sup>21</sup> Documentary Annex tab 12.

<sup>22</sup> PROEX, established by Law 8187/91, *ibid.*, continues to operate FINEX. Article 2 of PROEX's enabling law provided that:

Article 2 - Within the framework of operations designed to finance the export of Brazilian goods and services not covered by the provisions of the preceding article, the National Treasury may grant to the financing entity an incentive equivalent to covering the difference between the commitments made to the financee and the cost of raising the funds, to the extent that the latter exceeds the former. ...

§ 2 - The provisions of this article apply to the commitments falling due from the operations already effected, with respect to which there are pre-existing obligations of the National Treasury regarding interest rate equalization, in accordance with the Export Financing Fund - FINEX, regulated by Resolution No. 509 of January 24, 1979, of the Central Bank of Brazil.

Resolution 509 of January 24, 1979, of the Central Bank of Brazil establishing FINEX in turn provided that:

The Central Bank of Brazil ...

1 - ... authorizes the use of funds from the Export Financing Fund (FINEX) to equalize rates for export financing granted by authorized banks, through the use of their own funds or lines of credit abroad, with a view to their adjustment to the conditions in effect for similar transactions in international markets.

cont. ...

substantially the same.<sup>23</sup>

28. PROEX is "[a]imed at increasing competitiveness of Brazilian exports"<sup>24</sup> and has two components:

- a) *PROEX Financing*: the National Treasury may provide direct financing of exports of Brazilian goods and services at rates lower than the cost to the Government of Brazil of raising the funds necessary for such financing;<sup>25</sup> and
- b) *PROEX Interest Rate Equalization*: "the National Treasury may grant 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."<sup>26</sup>

29. Law 8187/91 was modified and superseded by Provisional Measure 1574 -- since reissued on a monthly basis. PROEX is now maintained by this series of Provisional Measures.<sup>27</sup> These Provisional Measures and other instruments<sup>28</sup> relating to PROEX continue

Documentary Annex tab 13.

<sup>23</sup> An explanatory document prepared by Banco do Brasil S.A. noted that "PROEX was created in mid-1991 with a purpose similar to FINEX." Banco do Brasil, "Programa de Financiamento às Exportações", *Comércio Exterior*, at 10 (2 of translation). Documentary Annex tab 14.

Indeed, monthly Provisional Measures that maintain PROEX establish even more clearly the continuity underlying the two export finance support programmes. Provisional Measure 1700-18 (and all Provisional Measures before it) returns to the original wording of the FINEX legislation. According to Article 2:

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.

1700-18, 1700-15 and 1574-7, Documentary Annex tab 15.

<sup>24</sup> "Measures to Reduce the 'Custo Brazil'", on-line: Secretariat of Economic Policy, <http://www.fazenda.gov.br/ingles/ispeart.html> (date accessed: 12 February 1998) at 6. Documentary Annex tab 16.

<sup>25</sup> Article 1 of Law 8187, *op. cit.*, Documentary Annex tab 12.

<sup>26</sup> Resolution 2380/97. Documentary Annex tab 17.

<sup>27</sup> Provisional Measure 1700-18 replaced Provisional Measure 1700-15 of June 30, 1998, *op. cit.*, Documentary Annex tab 15, and Law 8187 establishing PROEX, *op. cit.*, Documentary Annex tab 12.

Under Article 62 of the Brazilian Constitution of October 5, 1988, the President of the Republic may issue provisional measures that have the force of law. If the provisional measures are not voted on by the Brazilian Congress within a thirty-day period, or in case they are rejected by the Congress, they cease to have legal effect. However, the president is entitled to re-issue a provisional measure when it is about to expire; there is no limit on reissuance of such measures. Provisional Measures have the full force of law and are the legal measures underlying PROEX.

<sup>28</sup> Law no. 8249/91 [Documentary Annex tab 18/K]; Decree no. 2414 of December 8, 1997 [18/J]; cont. ...

the two components of PROEX with the stated objective of ensuring that the interest paid by a purchaser on the financed portion of its purchases is "compatible with those in force in the global market". The operation of the programme has not, however, changed.<sup>29</sup>

30. Canada does not challenge PROEX Financing in this dispute. It is, rather, PROEX Interest Equalization and the manner in which it is applied that is the question at issue.

## 2. PROEX Interest Equalization

31. According to the Banco do Brasil S.A., PROEX "was created ... to grant subsidies through an interest rate equalization mechanism and to regulate the application of budget appropriations to encourage exports of Brazilian goods and services."<sup>30</sup> Banco do Brasil administers PROEX Interest Equalization as agent for the Government of Brazil. Banco do Brasil does not, however, deal directly with the ultimate beneficiaries of PROEX. Designated agent banks -- such as Lloyds Bank, BankBoston or Banco do Credito Nacional S.A. -- administer PROEX for the ultimate beneficiaries of PROEX payments, the foreign purchasers of Brazilian regional jet aircraft.

32. According to BankBoston, one such agent bank, PROEX Interest Equalization:

"works by reducing the interest rate paid by the foreign importer in respect of its financing costs for the transaction. The extent of interest rate support is determined by the tenor [term] of the financing approved by PROEX for the transaction."<sup>31</sup>

33. BankBoston provides the following example:

"To illustrate how the program works, take the case of a U.S. importer of Brazilian shoes. ... [S]hoes are eligible for financing tenors of one year, and the extent of equalization available is 2.00% p.a. [per annum]. In other words, if approval of the transaction is obtained from PROEX, the U.S. importer can reduce its financing expenses for that one year period, by as much as 2.00% p.a."<sup>32</sup>

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Resolutions of the National Monetary Council nos. 2490/98 [18/D], 2452/97 [18/P], 2381/97 [18/E], 2380/97 [17], 2224/95 [18/F]; Circular DIRIN 5 [18/R]; Resolution No. 50 of the Federal Senate of June 13, 1993 [18/Q]; MICT Orders 23/98 [18/L], 18/98 [18/H], 7/98 [18/M], 121/97 [18/I], 83/97 [18/N], 53/97 [18/B], 34/97 [18/G], 33/97 [18/C] and MF/MICT Order 314/95 [18/O]; and Central Bank Circular no. 2601 [18/A].

<sup>29</sup> Article 1 of Resolution 2380/97, *op. cit.*, Documentary Annex tab 17, is almost exactly the same as Article 2 of the law establishing PROEX, Article 2 of Law 8187/91, *op. cit.*, Documentary Annex tab 12.

<sup>30</sup> Banco do Brasil, *op. cit.*, Documentary Annex tab 14, at 10 (2 of translation).

<sup>31</sup> "Financing Program Offers Incentives for Importers of Brazilian Goods", online: BankBoston, <http://www.bankboston.com/today/enews/tradetrends/tt%5Ffinancing.html> (date accessed 22 January 1998). Documentary Annex tab 19.

<sup>32</sup> *Ibid.*

34. The financing terms for which interest rate subsidies may be granted are set by Ministerial Decree.<sup>33</sup> The terms, determined by the product to be exported, vary normally from one year to ten years.<sup>34</sup> In special circumstances, the term can be extended to fifteen years; for regional jet aircraft, this is now the practice.<sup>35</sup> The length of the financing term, in turn, determines the interest rate reduction: the reduction ranges from 2 percentage points for a one-year term, up to 3.8 percentage points for a term of ten years or more.<sup>36</sup>

35. PROEX payments are guaranteed by the Government of Brazil through National Treasury Bonds issued by the Brazilian Treasury.<sup>37</sup> These bonds are issued on the presentation of evidence of exportation of the goods in question.<sup>38</sup> The Brazilian bonds are then provided through the Banco do Brasil to an agent bank for PROEX for the purpose of being redeemed and paid out to lending banks -- banks with whom purchasers of Brazilian exported goods have

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<sup>33</sup> Resolution 2380, *op. cit.*, Documentary Annex tab 17, provides in Article 4(ii) that, "[t]he maximum portion of the export eligible for equalization and the maximum equalization term shall be defined by Ministerial Decree."

<sup>34</sup> The goods are listed in the Annex to Order (Portaria) of the Minister of State for Industry, Trade and Tourism (MICT) 53/97, dated May 7, 1997. Documentary Annex tab 18/B.

<sup>35</sup> See also interview with Mauricio Botelho, President of Embraer, who noted that "[i]n special circumstances [interest rate equalization] can be extended to 15 years." "Willing to win", *Airfinance Journal*, December 1996, at 4. Documentary Annex tab 21.

<sup>36</sup> Circular Letter of the Central Bank of Brazil Number 2601/95 date November 29, 1995. Documentary Annex tab 18/A. As noted above, PROEX subsidies are *de facto* available for 15-year terms (for aircraft), while for the purpose of establishing the permitted rate reduction, the maximum term is still ten years.

<sup>37</sup> Regulation No. 2380/97, *op. cit.*, Documentary Annex tab 17, Article 5 provides that:

Amounts settled in the manner described in the preceding article are paid to the financing party in the form of National Treasury Notes of series 1 (NTN-1), the nominal value of which is adjusted for exchange rate variations.

The bonds essentially serve as long-term promissory notes: they do not bear interest and no money is disbursed on their issuance; rather, the bonds are a guarantee of payment in future. The actual disbursement of money by the Brazilian Treasury is made when the bonds are redeemed at set intervals for payment to a purchaser.

<sup>38</sup> *Ibid.* Article 6 provides that:

The issuance of the NTN-1 notes will take place only after the financing party or its legal representative declares to the Banco do Brasil S.A. that the requirements described below have been met, as evidenced by documents in its possession:

- i) In the case of a buyer's credit, for payment at sight to the Brazilian exporter, where the financing party is resident or domiciled abroad:
  - a) the goods have been shipped; and
  - b) the exchange contracts have been settled for the total value of the export ...

entered into financing transactions -- at set intervals.<sup>39</sup>

36. The agent banks may redeem the PROEX bonds and make the payments to the lending banks quarterly or semi-annually for the duration of the financing period, in accordance with the schedule of maturity of the bonds issued for this purpose. Or, the stream of payments guaranteed by the bonds may be sold on the market by a lending bank and the proceeds paid to the purchaser as a lump-sum subsidy.<sup>40</sup>

### 3. PROEX payments in operation

37. PROEX payments reduce the effective interest rate for the financing of Brazilian aircraft by up to 3.8 percentage points per year.<sup>41</sup>

38. Thus, reduced to its basic elements and using average prices and interest rates, a typical transaction in the regional aircraft market could be structured in the following way:

- a) A foreign airline concludes an agreement with Embraer to purchase an ERJ-145 for \$15.3 million.<sup>42</sup>
- b) The airline and a private lender (usually a non-Brazilian financial institution) negotiate financing with an interest rate of 7.04 percent.<sup>43</sup>

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<sup>39</sup> DIRIN PROEX 5, paragraphs 9.1 and 9.2. Documentary Annex tab 18/R.

<sup>40</sup> Ministry Order - Portaria No. 18/98 and Ministry Order - Portaria No. 121/97. Documentary Annex tabs 18/H and 18/I.

"Net present value" refers to the sum of money in current terms that would correspond to the stream of payments made to the lender in terms of time-adjusted dollars. This concept is used by firms considering investments in which current-dollar outlays (or revenues) might be traded-off for future benefits (or costs) over a period of time.

<sup>41</sup> The agent bank may charge an agency fee of 12-15 bps, which would be deducted from the 3.8 percentage point subsidy.

<sup>42</sup> All figures are in U.S. dollars unless otherwise noted. This price is based on a figure suggested by Mauricio Botelho, President of Embraer. "Willing to win", *op. cit.*, Documentary Annex tab 21, at 3.

<sup>43</sup> Corresponding to a market rate of LIBOR (5.79 percent) plus a spread of 125 bps, as of June 1998. Depending on the credit of the airline and the guarantees offered by, for example, engine manufacturers, the spread could be a few points higher or lower.



- c) The Government of Brazil, on the presentation of proof of exportation, issues treasury bonds to the agent bank for the ultimate benefit of the purchaser. These bonds guarantee the payment, at set intervals, of an amount to reduce the net interest rate payable by a purchaser by 3.65 percentage points (3.8 percentage points minus an agency fee of 15 bps).
- d) An agent bank may redeem the bonds at such intervals for payment to the lending bank<sup>44</sup> to reduce interest payments by the purchaser. Alternatively, the stream of payments guaranteed by the bonds may be sold on the market for payment to the purchaser of an amount equal to the net present value of the bonds.<sup>45</sup>

39. In the above transaction, the PROEX subsidy, when paid over the term of the financing would reduce the effective interest rate payable by airline to 3.39 percent per year -- that is, 7.04 percent minus the 3.65 percentage point subsidy.<sup>46</sup> This is less than the rate that at which the Government of the United States would be able to borrow.<sup>47</sup> Over a 15 year financing period the PROEX subsidies would total \$4.3 million.<sup>48</sup> In this transaction, PROEX subsidies would amount to more than half of the interest payments that the airline would have made without the introduction of the subsidies.

40. Alternatively, the airline may choose to receive PROEX payments in the form of a lump-sum payment equal to the net present value of the stream of payments underwritten by Brazilian long-term treasury bonds. In this example, the lump-sum payment would be \$2.45 million. The net cost of acquisition of the aircraft would thereby be reduced to \$12.8 million, a 16 percent reduction in the cost of the aircraft to the airline.

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<sup>44</sup> The agent bank may also serve as the lending bank: for example, BankBoston may finance a transaction on its own. As it is an "agent bank", it will be able to receive and redeem bonds on its own account for the benefit of the purchaser/borrower.

<sup>45</sup> For a definition of "net present value", see above, footnote 40.

<sup>46</sup> Assuming that PROEX payments are made on 100 percent of the value of the exported Brazilian regional aircraft.

<sup>47</sup> See U.S. Treasury rates for five-year, seven-year and ten-year bonds, for the period September 1992 to March 1998 in Documentary Annex tab 22.

<sup>48</sup> The amount of the subsidy over a 10-year term would be about \$3.6 million.

## V. LEGAL ARGUMENT

### A. Applicable principles of treaty interpretation

41. Article 3.2 of the DSU requires that the covered agreements be interpreted in accordance with “customary rules of interpretation of public international law.”

42. For the purposes of the WTO Agreement, the *Vienna Convention on the Law of Treaties* (Vienna Convention)<sup>49</sup> sets out applicable rules of international law. The rights and obligations of the Parties under the SCM Agreement must therefore be interpreted in accordance with the Vienna Convention, and in particular Article 31.<sup>50</sup>

43. According to Article 31 of the Vienna Convention, an international treaty must be interpreted “in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.”<sup>51</sup> According to Article 32,

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<sup>49</sup> *Vienna Convention on the Law of Treaties*, 1969, 8 ILM 679 (1969). Documentary Annex tab 24.

<sup>50</sup> *United States - Standards for Reformulated and Conventional Gasoline (Reformulated Gasoline)*, W/DSC/AB/R, Report of the Appellate Body adopted on May 20, 1997, at 18; *Japan - Taxes on Alcoholic Beverages (Japan - Liquor Tax)*, WT/[DS8/DS10/DS11]/AB/R, Report of the Appellate Body adopted on November 11, 1997 at 10; most recently reaffirmed in *India - Patent Protection for Pharmaceutical and Agricultural Chemical Products (India - Pharmaceuticals II)*, WT/DS50/AB/R, Report of the Appellate Body distributed on December 19, 1997, at paras. 33-48.

<sup>51</sup> Article 31 of the Vienna Convention provides that:

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
  - (a) any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty;
  - (b) any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
3. There shall be taken into account together with the context:
  - (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
  - (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
  - (c) any relevant rules of international law applicable in the relations between the parties.
4. A special meaning shall be given to a term if it is established that the parties so intended.

*Op. cit.*, Documentary Annex tab 24.

supplementary means of interpretation may also be referred to, to confirm an interpretation of the agreement or to resolve ambiguities in the text.<sup>52</sup>

**B. PROEX payments constitute “subsidiaries” within the meaning of Article 1.1**

44. Although governed by a complicated web of laws, regulations, presidential decrees, orders, bank circulars and practical guides, at its core PROEX is a remarkably simple affair: PROEX payments are grants by the Government of Brazil to purchasers of exported Brazilian regional aircraft. These payments reduce the purchaser’s net interest rate -- sometimes by as much as half of the interest rates available in the market -- over the term of a financed transaction. Alternatively, they may be made to the purchaser as a lump sum grant. Either way, these payments lower the cost of exported Brazilian regional aircraft for the purchaser. As such, this financial contribution by the Government of Brazil confers a benefit and constitutes a “subsidy” within the meaning of Article 1.1.

45. Article 1.1 provides in part that:

For the purposes of this Agreement, a subsidy shall be deemed to exist if:

(a)(1) there is a financial contribution by a government or any public body within the territory of a member (referred to in this Agreement as “government”), i.e. where:

- (i) a government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees); ...
- (iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments;
- ...

and

(b) a benefit is thereby conferred.

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<sup>52</sup> *Ibid.*, Article 32, which provides that:

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:

- (a) leaves the meaning ambiguous or obscure; or
- (b) leads to a result which is manifestly absurd or unreasonable.

46. Thus, to show that a programme, activity or practice constitutes a "subsidy", a complainant must show that there has been a "financial contribution by a government" and that that financial contribution has conferred a "benefit".

**1. There is a financial contribution by government**

47. PROEX payments constitute a financial contribution by government. As set out in paragraphs 27-29, PROEX is a programme of the Government of Brazil and PROEX payments are made by the Government of Brazil. PROEX payments are, therefore, financial contributions by government in the sense of Article 1.1(a)(1)(i).

48. In the alternative, if the Panel finds that the issuance of treasury bonds and payment by the Government of Brazil on the redemption of such bonds is not a "direct transfer of funds" or a "potential direct transfer of funds" within the meaning of Article 1.1(a)(1)(i), Canada submits that PROEX payments constitute an indirect financial contribution by government through a funding mechanism or a private body entrusted or directed, in the sense of Article 1.1(a)(1)(iv), to transfer payments made by the Government of Brazil upon the redemption of treasury bonds issued under PROEX to the ultimate beneficiaries.

**2. PROEX payments confer a benefit**

49. The *ordinary meaning* of "benefit" in context and with a view to the object and purpose of the SCM Agreement accords well with the dictionary definition of the term: a benefit is an advantage.<sup>53</sup> A financial contribution that is not repayable -- in other words, a grant -- bestows an advantage. Such a contribution, when made by government, directly or indirectly, amounts to a subsidy.

50. PROEX payments are, as set out in paragraphs 27-29, financial contributions by the Government of Brazil. According to the terms of the law under which they are made, they are never repaid, as indeed they are not required to be repaid. This alone demonstrates the benefit conferred by PROEX. To illustrate the nature of the benefit provided, paragraphs 51-59 set out the evidence of how PROEX payments confer a real competitive advantage to exported Brazilian regional aircraft in the international market.

51. On May 18, 1998, in a news release Embraer stated that:

*"... Embraer receives up to 3.8% equalization interest rate support from the Brazilian government to help offset high domestic interest rates carried for financing Brazilian*

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<sup>53</sup> *The Concise Oxford Dictionary of Current English*, J.B. Sykes, Ed. (Oxford: Clarendon Press, 1982) at 83; Nolan, Joseph R. and J. M. Nolan-Haley, *Black's Law Dictionary Sixth Edition*, (St. Paul: West Publishing Co., 1990) at 158. The French version of the SCM Agreement notes "*si un avantage est ainsi conféré.*" "*Avantage*" translates into "advantage"; Atkins, Beryl T., *et. al.*, *Robert Collins Dictionnaire Nouvelle Édition* (London: Collins, 1987) at 56. Documentary Annex tab 25.

exports to foreign buyers.”<sup>54</sup> [emphasis added]

52. This is a clear admission on the part of Embraer of the benefit conferred by PROEX payments. It is, however, misleading in one important respect. PROEX payments to foreign purchasers of Brazilian civil aircraft reduce the rate of interest payable by purchasers of regional aircraft by 3.8 percentage points below the rate freely negotiated in the international market by such purchasers. These payments have nothing to do with “high domestic interest rates”. Indeed, from at least as early as 1994, PROEX payments have been available where “foreign banks and credit institutions” have financed Brazilian exports.<sup>55</sup> And Resolution 2380, which sets out the criteria governing PROEX, notes specifically that, “[t]he right to interest equalization is not interrupted, excluded or transferred if the notes relating to the export credit are negotiated abroad.”<sup>56</sup>

53. Contrary to the assertions of Embraer and the Government of Brazil about “levelling the playing field”, these payments reduce the interest rate paid by purchasers of Brazilian aircraft to (often non-Brazilian) financiers to levels considerably lower than those that may be obtained in the international financing market. Airlines such as Comair, Skywest and ASA have stated that

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<sup>54</sup> “Embraer has no interest in solving the Canadian/Brazilian trade dispute via partnership with Bombardier”, Embraer News Release, 18 May 1998. Documentary Annex tab 26.

According to Botelho, PROEX:

“is designed to level the playing field in the face of international perceptions of political risk in Brazil. As a consequence, financing rates can be up to 5 percent higher *in Brazil* than in other industrial countries. ProEx compensates for these rates which would otherwise unfairly penalise Brazilian exports for political grounds, by providing a pay back to export customers.” [emphasis added]

“Family planning in regional jets”, *Interavia*, June 1998, 20 at 22. Documentary Annex tab 27.

According to another article, Botelho “said financiers typically charge higher rates for transactions *in Brazil* because it is considered a riskier business environment. PROEX, he argued, levels the playing field.” [emphasis added] “Embraer Rolls Out RJ-135 Regional Jet”, *Aviation Week & Space Technology*, May 18, 1998, at 39. Documentary Annex tab 28.

<sup>55</sup> “Brazil: Export Financing Programme – PROEX”, *Project and Trade Finance*, London, September 1994. The Article notes:

“The new PROEX, managed by Banco do Brazil as the government’s financing agent, is based on the Interest Rate Equalisation System. It means that foreign banks and credit institutions would finance Brazilian exports and the federal government would pay the funding bank (through a national representative of his choice) a spread on the interest rates that vary from 1% to 3.5% per year, according to the financing term.”

Documentary Annex tab 29, at 1.

<sup>56</sup> Article 2.1 of Resolution 2380, *op. cit.*, Documentary Annex tab 18. Article 8 provides, in turn, that:

All-purpose banks, commercial banks, investment banks, development banks, the Special Industrial Finance Agency (FINAME) and *credit or financial institutions located abroad*, including the foreign agencies of Brazilian banks, are entitled to participate in the facilities covered by this Resolution. [emphasis added]

Brazilian export subsidies brought down their financing costs by about 1.8 to 3.5 percentage points below market-based costs of financing.<sup>57</sup> PROEX payments thus reduce by about half the actual interest paid by such purchasers.<sup>58</sup> As such, they serve as an important part of the ERJ-145's success in the market.<sup>59</sup>

54. Indeed, an industry report dated August 10, 1998 observed that:

"Of the regional aircraft manufacturers, Embraer has the distinct benefit of having the most developed financing program, sponsored by the Brazilian government, called Proex. The Proex program is underwritten by the government in Brazil to enhance trade in its aircraft and nearly 1,500 other items and products from Brazil. It promised commercial airlines savings of up to \$3.5 million per aircraft. It also allows for a *subsidized interest rate* that is 3.8 percentage points less than the market rate, along with a 15-year term. ...

As mentioned, *the primary advantage Embraer has over its competitors is its Proex financing program.*"<sup>60</sup> [emphasis added]

55. As well, an investors' information circular on Embraer issued on August 26, 1998, noted the following:

**"Dependence on Government Financing.** Embraer's ERJ-145's most significant orders with American Eagle (for 42 firm orders and 25 options) and Continental (for 25 firm orders and 175 options) were made possible through the use of government

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<sup>57</sup> See Skywest Inc., *1998 Annual Report*, Documentary Annex tab 30/A; Comair Holdings, Inc., *1997 Annual Report*, Documentary Annex tab 30/B; ASA Holdings, Inc., *1996 Annual Report*, Documentary Annex tab 30/C. According to Skywest, the rate of interest on long-term debt subject to Brazilian export subsidies was 4.0 percent. Documentary Annex tab 30/A, at 16. At the same time, the unsubsidised rate of interest on its other long-term debts ranged from 6.36 to 8.5 percent. Documentary Annex tab 30/A, at 25. Comair noted, in its 1997 Annual Report, that the subsidised rate of interest on its long-term debt was between 4.25 and 4.875 percent. The rate of interest on unsubsidized debt related to its purchase of the Canadair regional jet was about 1.8 percent higher. Documentary Annex tab 30/B, at 27. ASA stated in 1996 that its subsidised rate of interest was 3.34 percent. Documentary Annex tab 30/C, at 14, 25. Interest rates on other of its long-term obligations ranged from 5.35 to 7 percent. Documentary Annex tab 30/C, at 13.

The interest rates quoted in the annual reports are 1.5 to 2.5 percentage points below LIBOR. For reference table of LIBOR for the period 1989-1998, see "Fannie Mae Libor Rates", online: Fannie Mae, [http://fanniemae.com/singlfam...siness/indexes/db\\_libor\\_index.html](http://fanniemae.com/singlfam...siness/indexes/db_libor_index.html) (date accessed 25 October 1998). Documentary Annex tab 31.

<sup>58</sup> Depending, of course, on prevailing interest rates. At market rates below about 7 percent, PROEX payments would reduce interest payments by more than half; at rates above 7 percent, the proportionate reduction would be less.

<sup>59</sup> "Aggressive financing" was noted by Warburg Dillon Read as an important contributing factor in the success of Embraer's ERJ-145. *Op. cit.*, Documentary Annex tab 9.

<sup>60</sup> *Ibid.*, at 17-18.

financing – the BNDES-Exim and Proex programs, designed to assist the country’s exporters by extending financing for up to 15 years *at interest rates below what the company could obtain on its own*. ... [W]e estimate that the bulk of the company’s orders to date have been dependant [*sic*] on the Brazilian government’s willingness (and ability) to finance the sales.”<sup>61</sup> [emphasis added]

56. The impact of PROEX subsidies in the market is precisely as stated by the investment bankers Bear Stearns: the resulting interest rates are “below what the [the purchaser] could obtain on its own”. Two concrete examples highlight clearly the benefit thus granted:

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<sup>61</sup> Bear Stearns *Buy Recommendation* for Empresa Brasileira de Aeronáutica S.A. EMBRAER, 26 August 1998, at 7. Documentary Annex tab 32.

<sup>62</sup> These aircraft were traded-in when Mesa Airlines purchased newer Dash-8 turboprops and Canadair regional jets. Bombardier agreed to make the monthly payments on the EMB-120s. See Form 10-K filing of Mesa Air Group Inc. with the Securities and Exchange Commission, SEC document 00000950153-98-000036.txt:19980114, for period ending September 30, 1997, online: Securities and Exchange Commission (SEC), <http://www.sec.gov/Archives/edgar/data/810332/0000950153-98-000036.txt> (date accessed 9 October 1998) (extract). Documentary Annex tab 33.

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cont. ...

- b) According to Form 10-K filings with the U.S. Securities and Exchange Commissions by Comair, a regional airline in the United States, variable interest rates payable for secured obligations relating to the purchase of Canadair regional jets were 6.344 percent to 6.725 percent.<sup>68</sup> The rates payable for a secured obligation in respect of purchases of Embraer products were, however, 4.25 percent to 4.875 percent, "net of the benefits of interest rate subsidies through the Brazilian Export Financing program."<sup>69</sup>

57. As noted in paragraph 36, the purchasing airline and the lending bank could agree on the payment of the net present value of the stream of payments guaranteed by the Brazilian treasury bonds. A circular

stated that such a lump-sum payment would reduce the cost of the aircraft to the U.S. purchaser by \$2.1 million.<sup>70</sup>

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<sup>68</sup> Based on six-month LIBOR, which was 5.797% in March 1998. *Op. cit.*, Documentary Annex tab 31.

<sup>69</sup> Form 10-K405, Comair Holdings Inc., SEC document: 0000950152-98-005704.txt: 19980701, for the period ending March 31, 1998, online: Securities and Exchange Commission (SEC), <http://www.sec.gov/Archives/edgar/data/835344/0000950152-98-005704.txt> (date accessed 28 August 1998).

Skywest Airlines, another purchaser of Embraer EMB-120 Brasilia regional aircraft and a beneficiary of FINEX/PROEX, stated in Form 10-Q filing before the Securities and Exchange Commission (SEC) for the quarter ending on December 31, 1997, that:

"At December 31, 1997, the Company had outstanding long-term debt, including current maturities, of approximately \$59.7 million. *Of the long-term debt, \$48.8 million was incurred in connection with the acquisition of Brasilia aircraft and is subject to subsidy payments through the export support program of the Federative Republic of Brazil.* The interest rates on \$11.0 million of the \$48.8 million of long-term debt are floating based on one month and three-month LIBOR. *The subsidy payments reduced the stated interest rates on the \$48.8 million of long-term debt to an average effective rate of approximately 4.0 percent as of December 31, 1997.* The debt is payable in either quarterly or semi-annual installments through January 2006. ..." [emphasis added]

Submission 10-Q for quarter ending on December 31, 1997, online: Securities and Exchange Commission (SEC), <http://www.sec.gov/Archives/edgar/data/793733/0000950144-98-00050.txt> (date accessed 31 July 1998).

Documentary Annex tab 36.

The one-month and three-month LIBOR as at December 31, 1997, was between 5.852% and 5.985%. Skywest would be able to get financing at LIBOR plus 70 to 100 basis points, the industry average for such airlines. The subsidy provided by PROEX in the case of Skywest decreased interest payments by approximately 2.8 percentage points. *Op. cit.*, Documentary Annex tab 31.

<sup>70</sup>



58.

59. PROEX payments amount to outright grants whether received in a stream of payments or in a lump sum. There is no obligation to repay any portion of PROEX payments received. These payments reduce the cost of exported Brazilian aircraft to the purchaser, and therefore constitute a "benefit" for the purpose of Article 1.1.<sup>72</sup> Accordingly, these payments are "subsidies" within the meaning of Article 1.1.

**C. PROEX payments are prohibited subsidies under Article 3.1**

60. PROEX subsidies are paid only on the exportation of products from Brazil. As such, these subsidies are "contingent on export performance" and therefore prohibited under Article 3.1.

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<sup>72</sup> This is further supported by reports in industry journals. In a report, "Embraer", the *Aviation Daily* of July 12, 1996 noted that:

"Embraer has established a finance subsidiary to facilitate sales of its new 50-passenger EMB-145 regional jet. Embraer Credit Corp. (ECC) will offer direct operating leases to customers and then take the paper on those transactions to the financial markets. *The transactions also will benefit from the Brazilian export bank (PROEX) interest-rate-equalization programme, which pays 3.8% on the declining balance at each quarterly or half-year payment after the 15% down payment. Over a 15 year lease period, value of the PROEX benefit can be \$3.5 million to \$3.8 million.*" [emphasis added]

Documentary Annex tab 38. In "Embraer Jet Price Edges Up" the July 1, 1996 *Commercial Aviation Report* stated the following about PROEX:

"The list price for the new jet is \$15.3 m (up from \$14.8 m in January), but launch customer discounts and an interest rate equalization programme will push actual purchase price down by more than \$2 m. The interest rate programme, called PROEX, applies to 85% of the purchase price, according to a spokesman for Embraer.[\*] *At current list price, purchasers will get back approximately \$2.2 m over 10 years.*" [emphasis added] (at 12)

Documentary Annex tab 39. And in "EMB-145 Splits the Middle in Cost and Performance" the August 1996 issue of *Business and Commercial Aviation* reported that:

"PROEX is an 'interest equalisation program' that essentially is a subsidy to make the interest rate on the transition [*sic*] competitive with other regional aircraft manufacturers. Assuming a 15-percent down payment, PROEX will pay the buyer 3.8 percent on the declining balance of the remaining 85 percent of the purchase price, less a ¼-percent PROEX bank fee. [\*] ... *The payments ... at the end of 15 years would total somewhere between \$3.5 million and \$3.8 million.*" [emphasis added]

Documentary Annex tab 40.

\* PROEX now covers 100 percent of the financing.

61. Article 3.1 provides that:

3.1 [T]he following subsidies, within the meaning of Article 1, shall be prohibited:

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

62. A subsidy is "contingent ... upon export performance" when it is conditional on or tied to exports; that is, where it is available only on condition that goods are exported.

63. The regulations supporting PROEX make it clear that it is contingent upon the exports of goods or services. The Provisional Measure continuing the operation of PROEX does so only with respect to "operations to finance the export of domestic goods or services."<sup>73</sup> Under Article 6 of Monetary Council Resolution No. 2380/97, national treasury bonds for the payment of PROEX subsidies will be issued "only after the financing party or its legal representative declares to the Banco do Brasil that ... the goods have been shipped."<sup>74</sup> According to Article 5(2) of Order 33/97, which identifies the goods eligible for PROEX subsidies, "[g]oods shall be eligible for interest equalization only if their [Registration of Export form] has been completed ..."<sup>75</sup> Indeed, Brazil noted in its official response to questions posed by Canada and other WTO Members at the Committee on Subsidies and Countervailing Measures that, "[PROEX] provides financing for Brazilian exports and not for sales in the domestic market."<sup>76</sup>

<sup>73</sup> Article 1 and 2 of Provisional Measure 1700-18, *op. cit.*, Documentary Annex tab 15.

<sup>74</sup> Resolution No. 2380/97, *op. cit.*, Documentary Annex tab 17; MICT Order 33/97, *op. cit.*, Documentary Annex tab 18/C.

The export-contingent nature of PROEX was publicly confirmed by the Minister of Foreign Affairs of Brazil in a recent interview, in which he stated that PROEX "is a general programme that applies to the majority of industrial products for export." Luis Eduardo Leal, "Brasil may go to the WTO against Canada", *Gazeta Mercantil*, January 9, 1998, at A4. Documentary Annex tab 41.

<sup>75</sup> MICT Order 33/97, *ibid.* Article 5 provides that:

For exports that are eligible under this Decree, the form "Registration of Credit Transaction - RC" must be completed prior to the "Registration of Export - RE" and prior to shipment of goods.

Para. 1 The RC is to be completed only after the RE only when the export is made on a consignment basis, including exports destined for fairs and expositions, and is subsequently negotiated with a payment term of at least one year, consist with the provisions of this Decree.

Para. 2 Goods shall be eligible for interest equalization only if their RE has been completed subsequent to approval of the respective RC under the Integrated System of Foreign Trade - SISCOMEX, except as provided in the preceding paragraph.

<sup>76</sup> G/SCM/Q2/BRA/8, 25 August 1998, at 3.

64. PROEX subsidies are, therefore, "contingent ... upon export performance" and as such constitute prohibited subsidies under Article 3.1.

#### D. The exception in Article 27

65. In a letter sent to the Chairman of the DSB and dated September 23, 1996, Brazil notified its intention to raise Article 27 as a defence if a finding were to be made that certain aspects of PROEX were inconsistent with Article 3.<sup>77</sup>

66. Article 27 provides for "Special and Differential Treatment of Developing Country Members"; as such, it is an exception to the general obligations set out in the SCM Agreement.<sup>78</sup> Subject to the conditions set out in Article 27.4, developing countries not listed on Annex VII are exempted from the application of the prohibition in Article 3 for a limited period of time.

67. The general approach to the question of burden of justification, discussed in earlier GATT panel reports, has been endorsed and followed in WTO Panel and Appellate Body Reports. Reflecting the Appellate Body Report in *Shirts and Blouses*,<sup>79</sup> the Panel in *Argentina - Footwear I* set out the burden of proof as follows:

- "a) it is for the complaining party to establish the violation it alleges;
- b) it is for the party invoking an exception or an affirmative defense to prove that the conditions contained therein are met; and
- c) it is for the party asserting a fact to prove it."<sup>80</sup>

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<sup>77</sup> *Op. cit.*, Documentary Annex tab 1.

<sup>78</sup> Article 27.2 provides that:

The prohibition of paragraph 1(a) of Article 3 shall not apply to: ...

- (b) other developing country Members for a period of eight years from the date of entry into force of the WTO Agreement, *subject to compliance with the provisions in paragraph 4.* [emphasis added]

Article 27.7 further provides that "[t]he provisions of Article 4 shall not apply to a developing country Member in the case of export subsidies which are *in conformity with the provisions of paragraphs 2 through 5.*" [emphasis added]

<sup>79</sup> *United States - Measure Affecting Imports of Woven Shirts and Blouses from India (Shirts and Blouses)*, WT/DS33/AB/R, Report of the Appellate Body adopted on 23 May 1997.

<sup>80</sup> *Argentina - Footwear I*, *op. cit.*, at para. 6.35; confirmed by the Appellate Body in *India - Pharmaceuticals II*, *op. cit.*, at para. 74.

68. Article 27.2 sets out two conditions that an “other” developing country (a country not listed on Annex VII) must meet to benefit from the eight-year exception. Such country must establish that:

- a) it is a developing country Member of the WTO for the purposes of Article 27.2; and
- b) export subsidies it grants are at a minimum in conformity with the provisions of paragraph 4 of Article 27.

69. Article 27.4, in turn, sets out three conditions.<sup>81</sup> The developing country Member must:

- a) *phase out* its export subsidies within eight years after the entry into force of the WTO Agreement, that is, by December 31, 2002;
- b) not increase the level of its export subsidies; and
- c) phase out its export subsidies in a shorter period of time than eight years if the export subsidies are inconsistent with its development needs.

70. Finally, given the nature of Article 3 as a strict prohibition subject to very few exceptions, Brazil must show that the exercise of the right under the limited and conditional exception set out in Article 27 does not “devalue” or “negate” the rights of other WTO Members under Article 3.<sup>82</sup>

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<sup>81</sup> Article 27.4 provides that:

Any developing country Member referred to in paragraph 2(b) shall phase out its export subsidies within the eight-year period, preferably in a progressive manner. However, a developing country Member shall not increase the level of its export subsidies<sup>81</sup>, and shall eliminate them within a period shorter than that provided for in this paragraph when the use of such export subsidies is inconsistent with its development needs. If a developing country Member deems it necessary to apply such subsidies beyond the 8-year period, it shall not later than one year before the expiry of this period enter into consultation with the Committee, which will determine whether an extension of this period is justified, after examining all the relevant economic, financial and development needs of the developing country Member in question. If the Committee determines that the extension is justified, the developing country Member concerned shall hold annual consultations with the Committee to determine the necessity of maintaining the subsidies. If no such determination is made by the Committee, the developing country Member shall phase out the remaining export subsidies within two years from the end of the last authorized period.

<sup>82</sup> The Appellate Body noted in its recent report on *United States - Shrimps* that:

“[B]ecause the GATT 1994 itself makes available the exceptions of article XX, in recognition of the legitimate nature of the policies and interests there embodied, the right to invoke one of those exceptions is not to be rendered illusory. The same concept may be expressed from a slightly different angle of vision, thus, a balance must be struck between the *right* of a Member to invoke an exception under Article XX and the *duty* of that same Member to respect the treaty rights of

cont. ...

71. Therefore, as the party invoking an exception Brazil has the burden of establishing that it meets the conditions set out in paragraphs 2 and 4 of Article 27, and that its exercise of its right under Article 27 does not devalue or negate the rights of other WTO Members under the SCM Agreement.

**E. Export subsidies prohibited by Article 3 must be withdrawn without delay**

72. Article 3.2 provides that “[a] Member shall neither grant nor maintain subsidies referred to in paragraph 1.”

73. As demonstrated in sections B and C, PROEX payments made on export sales of Brazilian civil aircraft constitute prohibited subsidies within the meaning of Article 3.1. Brazil must neither grant nor maintain such payments. That is to say, Brazil must not:

- enter into new arrangements by which PROEX would be paid;
- begin paying subsidies promised or committed, such as those in respect of aircraft that have yet to be delivered, including on the conversion of options to firm orders; and
- continue to pay PROEX subsidies.

74. Article 4.7 sets out the specific remedy available to Canada, as well as the grant of authority to the Panel with respect to the application of Article 3.2. 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 regard, the panel shall specify in its recommendation the time period within which the measure must be withdrawn.

75. Canada submits that the Panel may recommend the withdrawal of subsidies already granted where the circumstances of the case and the distortions caused by the subsidies in question warrant such a remedy. In this light, Canada submits that in respect of transactions entered into by Embraer and subsidies granted by Brazil in the period between the composition of the Panel and the adoption of the Report of the Panel, the Panel should make a specific recommendation, for the following reason.

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other Members. To permit one Member to abuse or misuse its right to invoke an exception would be effectively to allow that Member to degrade its own treaty obligations as well as to devalue the treaty rights of other Members. If the abuse or misuse is sufficiently grave or extensive, the Member, in effect, reduces its treaty obligations to a merely facultative one and dissolves its juridical character, and, in so doing, negates altogether the treaty rights of other members.”

*United States - Import Prohibition of Certain Shrimp and Shrimp Products (United States - Shrimps)*, WT/DS58/AB, Report of the Appellate Body circulated on October 12, 1998, at para. 156.

76. In a report issued on August 10, 1998, the investment bankers Bear Stearns gave the following advice to prospective customers of Embraer aircraft:

“Finally, cognizant that a WTO decision is eminent [*sic*] and may result in the ending of an attractive subsidy, any remaining potential customers who were considering a future purchase may decide to anticipate orders with Embraer over the 12 months before the ruling is handed down.”<sup>83</sup>

77. The particular circumstances of the regional aircraft market require that the Panel fashion a specific remedy in respect of subsidies granted to induce sales *in anticipation of an adverse ruling by the Panel*, as termination of PROEX subsidies after the adoption of the Panel report would not, in such circumstances, redress the harm that would be caused by such subsidies. Accordingly, Canada requests that the Panel recommend the withdrawal of subsidies granted pursuant to transactions entered into in the period following the composition of the Panel on October 22, 1998.

78. Canada submits that “without delay” in respect of new subsidy arrangements must mean as of the date of adoption of the Report of the Panel by the DSB. Canada further submits that “without delay” in respect of existing subsidies or subsidies already granted means as soon as practicable to terminate the arrangements and, in any event, no later than ninety days after the adoption of the Report of the Panel by the DSB.

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<sup>83</sup> *Op. cit.*, Documentary Annex tab 32, at 13.

**VI. REQUEST FOR FINDINGS AND RECOMMENDATIONS**

79. Canada requests that the Panel make the following findings and conclusions:

- PROEX payments on exports of Brazilian civil aircraft constitute subsidies within the meaning of Article 1.1 of the SCM Agreement; and
- PROEX payments on exports of Brazilian civil aircraft constitute export subsidies prohibited under Article 3 of the SCM Agreement.

80. Canada further requests, in accordance with Articles 3.2 and 4.7 of the SCM Agreement, that the Panel recommend that:

- Brazil shall not grant new subsidies under PROEX, including subsidies promised or committed, but not yet granted, on regional aircraft not yet delivered;
- Brazil shall no longer maintain existing subsidies under PROEX and must terminate such subsidies no later than three months after the adoption of the Report of the Panel by the DSB; and
- Brazil shall withdraw without delay PROEX subsidies granted pursuant to transactions entered into following the composition of the Panel on October 22, 1998.

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