WORLD TRADE ORGANIZATION

WT/DS139/R
WT/DS142/R
11 February 2000
(00-0455)

Original: English

Canada – Certain Measures Affecting the Automotive Industry

Report of the Panel

The report of the Panel on "*Canada – Certain Measures Affecting the Automotive Industry"* is being circulated to all Members, pursuant to the DSU. The report is being circulated as an unrestricted document from 11 February 2000 pursuant to the Procedures for the Circulation and Derestriction of WTO Documents (WT/L/160/Rev.1). Members are reminded that in accordance with the DSU only parties to the dispute may appeal a panel report, an appeal shall be limited to issues of law covered in the panel report and legal interpretations developed by the panel, and that there shall be no *ex parte* communications with the panel or Appellate Body concerning matters under consideration by the panel or Appellate Body.

Note by the Secretariat: This Panel Report shall be adopted by the Dispute Settlement Body (DSB) within 60 days after the date of its circulation unless a party to the dispute decides to appeal or the DSB decides by concensus not to adopt the report. If the Panel Report is appealed to the Appellate Body, it shall not be considered for adoption by the DSB until after the completion of the appeal. Information on the current status of the panel Report is available from the WTO Secretariat.

I. PROCEDURAL HISTORY

1.1 This proceeding has been initiated by two complaining parties, Japan and the European Communities.

A. CONSULTATIONS

1.2 In a communication dated 3 July 1998 (WT/DS139/1), Japan requested consultations with Canada in accordance with Article 4 of the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU), pursuant to Article XXIII of the General Agreement on Tariffs and Trade 1994 (GATT), Article 8 of the Agreement on Trade-Related Investment Measures (TRIMs Agreement) (to the extent that Article 8 invokes Article XXIII of GATT 1994), Articles 4 and 30 of the Agreement on Subsidies and Countervailing Measures (SCM Agreement) (to the extent that Article 30 refers to Article XXIII of GATT 1994), and Article XXIII:1 of the General Agreement on Trade and Services (GATS), with respect to certain Canadian measures affecting the automotive industry. Japan and Canada held consultations in Geneva on 27 August 1998, but these consultations did not result in a resolution of the dispute.

1.3 In a communication dated 17 August 1998 (WT/DS142/1), the European Communities requested consultations with Canada pursuant to Article 4 of the DSU, Article XXIII:1 of GATT 1994, Article 8 of the TRIMs Agreement, Articles 4 and 30 of the SCM Agreement, and Article XXIII:1 of the GATS, concerning certain measures affecting the automotive sector. The European Communities and Canada held consultations on 21 September and 13 November 1998, but these consultations did not result in a resolution of the dispute.

1.4 On 12 November 1998 Japan (WT/DS139/2) and on 14 January 1999 the European Communities (WT/DS142/2) each requested the establishment of a panel pursuant to Articles 4.7 and 6 of the DSU.

B. ESTABLISHMENT AND COMPOSITION OF THE PANEL

1.5 At its meeting on 1 February 1999, the DSB established a Panel pursuant to the requests by Japan and the European Communities. The DSB agreed, pursuant to Article 9.1 of the DSU, that a single panel should examine both complaints.

1.6 At that meeting, the parties to the dispute agreed that the Panel should have standard terms of reference provided for in Article 7.1 of the DSU. The terms of reference of the Panel are the following:

> "To examine, in the light of the relevant provisions of the covered agreements cited by Japan and the European Communities in documents WT/DS139/2 and WT/DS142/2 respectively, the matter referred to the DSB by Japan and the European Communities in those documents and to make such findings as will assist the DSB in making the recommendations or in giving the rulings provided for in those agreements".

1.7 On 15 March 1999, the European Communities and Japan jointly requested the Director-General, pursuant to Article 8.7 of the DSU, to determine the composition of the Panel. The Director-General accordingly determined the composition of the Panel (WT/DS139 and 142/3) as follows:

Chairman:	Mr. Ronald Saborío Soto
Members:	Mr. Timothy Groser
	Mr. Rudolf Ramsauer

1.8 India, Korea and the United States reserved their third-party rights in the dispute.

C. PANEL PROCEEDINGS

1.9 The Panel met with the parties on 14 and 15 June 1999 and on 13 and 14 July 1999. The Panel held a third-party session on 15 June 1999.

II. BACKGROUND

2.1 This dispute concerns Canadian measures which accord to certain motor-vehicle manufacturers established in Canada the right to import motor vehicles with an exemption from the generally applicable customs duty.

2.2 To qualify for the exemption, an eligible manufacturer's local production of motor vehicles (including in certain cases the production of parts) must achieve a minimum amount of Canadian value added (CVA), and its local production must maintain a minimum ratio ("production-to-sales" ratio) with respect to its sales of motor vehicles in Canada.

A. THE AUTO PACT

2.3 The measures at issue in this case stem from the Agreement Concerning Automotive Products Between the Government of Canada and the Government of the United States (the "Auto Pact"), a treaty between Canada and the United States concluded in January 1965. Under the Auto Pact, Canada agreed to accord duty-free treatment to vehicles and original equipment manufacturing parts[1] of the United States[2], provided the importer met the definition of a motor vehicles "manufacturer" under the terms of the Auto Pact. An Auto Pact manufacturer must have produced in Canada, during the base year (1963-64), motor vehicles of the class it is importing, and (i) must have maintained a ratio of the sales value of its local production of vehicles of that class to the vehicles of that class sold in Canada of a prescribed minimum, and (ii) must have achieved a minimum amount of CVA in its local production of motor vehicles (including in certain cases the production of parts therefor).[3] The Auto Pact also provided that Canada could designate a manufacturer not meeting the base year criterion to import duty-free motor vehicles and original equipment manufacturing parts.[4]

1. Letters from Auto Pact manufacturer beneficiaries to Industry Canada

2.4 Prior to the conclusion of the Auto Pact, the Canadian Government requested from the Auto Pact manufacturers certain Letters specifying how each company viewed its operations in relation to the Auto Pact. While the Letters were not released publicly, those of General Motors of Canada,

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[1] Excluding tires and tubes.
[2] Article II(a) of the Auto Pact.
[3] Para. 2 of Annex A of the Auto Pact defines a manufacturer as one that:
"(i) produced vehicles of that class in Canada in each of the four consecutive three months' periods in the base year, and
(ii) produced vehicles of that class in Canada in the period of twelve months ending on the 31st day of July in which the importation is made,
(A) the ratio of the net sales value of which to the net sales value of all vehicles of that class sold for consumption in Canada by the manufacturer in that period is equal to or higher than the ratio of the net sales value of all vehicles of that class produced in Canada by the manufacturer in the base year to the net sales value of all vehicles of that class sold for consumption in Canada by the manufacturer in the base year, and is not in any case lower than seventy-five to one hundred; and
(B) the Canadian value added of which is equal to or greater than the Canadian value added of all vehicles of that class produced in Canada by the manufacturer in the base year."
[4] Para. 3 of Annex A of the Auto Pact.

Ltd., Ford Motor Company of Canada, Ltd., Chrysler Canada, Ltd., and American Motors[5] were made public in hearings of the US Congress on the Automotive Products Trade Act, 1965 (the US implementing legislation for the Auto Pact).

2.5 The Letters address similar issues, and some of them are framed in similar and, in parts, identical language. The complainants contend that these Letters contain additional CVA requirements and constitute binding undertakings. The respondent contends that the Letters are not binding, that they contain no such requirements, and that the only evidence on the record indicates that the Letters are not binding. The parties' arguments relating to the status of these Letters are found in Section V (Factual Arguments of the Parties) and in Section VI (Legal Arguments of the Parties).

2. GATT Working Party examination of the Auto Pact

2.6 In March 1965 a GATT Working Party was established to examine the Auto Pact.[6] The Working Party found that the US application of the Auto Pact would violate the GATT:

> "It was the general consensus of the Working Party that, if the United States implemented the Agreement in the manner proposed, United States action would be clearly inconsistent with Article I and it would be necessary for the United States Government to seek a waiver from its GATT obligations."[7]

2.7 The United States sought and obtained a waiver under Article XXV:5.[8] In November 1996 that waiver was renewed at the request of the United States[9], until 1 January 1998[10], when the duties on imports of Canadian automotive products were fully eliminated in accordance with the provisions of the North American Free Trade Agreement (NAFTA).

2.8 When the Working Party went on to examine the relationship between Canada's Auto Pact obligations and the GATT, members noted that, in his introductory remarks, "the representative of Canada had stressed that his Government was implementing the Agreement on a most-favoured-nation basis and was extending to all contracting parties the same tariff benefits, on the same terms, as it had undertaken to grant the United States under the Agreement."[11] Although some members questioned whether Canada's application of the Auto Pact was compatible with GATT Articles I and III[12], there was no consensus in the Working Party on whether or not Canada was in violation of its GATT commitments.

B. THE CANADA - UNITED STATES FREE TRADE AGREEMENT (CUSFTA)

2.9 Trade in automotive products was also affected by the Canada – United States Free Trade Agreement (CUSFTA)[13], which entered into force 1 January 1989. The CUSFTA provided for the elimination of duties on automotive products by 1 January 1998, so long as the products qualified under CUSFTA origin rules.

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[5] American Motors was acquired by Chrysler in 1987.

[6] Report of the *Working Party on Canada – US Agreement on Automotive Products,* submitted to the Council of Representatives 19 November 1965, BISD 13S/112 (hereinafter Report of the *Working Party on Canada – US Agreement on Automotive Products*).

[7] Ibid., para. 17.

[8] Ibid., para. 15; Decision of the CONTRACTING PARTIES of 20 December 1965 granting the waiver requested by the United States, BISD 14S/37.

[9] G/L/103.

[10] Decision adopted by the General Council at is meeting of 7, 8 and 13 November 1996, WT/L/198.

[11] Report of the *Working Party on Canada – US Agreement on Automotive Products*, *supra* note 6, para. 20.

[12] Ibid., paras. 21 and 22.

[13] Exhibits EC-12 and JPN-33.

2.10 The CUSFTA also changed the Auto Pact provisions which had allowed the Canadian Government to designate additional manufacturers to benefit from the duty exemption.[14] It did so by limiting eligibility for the import duty exemption to firms falling into one of three categories:[15] (i) Auto Pact manufacturers; (ii) manufacturers designated by the Canadian Government as beneficiaries prior to the signing of the CUSFTA; and (iii) other firms which were expected to be designated by the Canadian Government by the 1989 model year.[16] In other words, the CUSFTA had the effect of closing the list of those entitled to import duty free, after a grace period for certain potential new entrants, so that the only way a company outside those categories might be authorized to import duty free pursuant to this programme would be by acquiring control of, or being acquired by, a beneficiary.[17]

C. THE NORTH AMERICAN FREE TRADE AGREEMENT (NAFTA)

2.11 The CUSFTA was suspended with the 1 January 1994 entry into force of the NAFTA, an agreement notified to the GATT as an Article XXIV free-trade area involving Canada, Mexico and the United States.

2.12 The NAFTA allows Canada to maintain the import duty exemption subject to the conditions stipulated in the CUSFTA, including those relating to Auto Pact manufacturer eligibility.

2.13 Under the NAFTA, Mexican trucks now enter Canada duty free, while other vehicles are currently subject to duties of 1.3 per cent (passenger cars) and 2.4 per cent (heavy trucks and buses), so long as these products meet the NAFTA origin rules. All such vehicles imported from Mexico will enter duty free after 1 January 2003. Under the NAFTA, all US automotive products meeting NAFTA origin rules have entered Canada duty free since 1 January 1998.

2.14 The European Communities stipulates that, although not themselves in dispute, the CUSFTA and the NAFTA are directly relevant for this dispute.[18] Japan contends that the agreements amplified and exacerbated the discriminatory effects of the measures[19], but it does not include them in its list of measures that it is challenging in this proceeding.[20]

D. CANADA'S DOMESTIC MEASURES

2.15 The provisions relating to Auto Pact manufacturers were given effect domestically in Canada through the Motor Vehicles Tariff Order (MVTO) 1965[21], known as the MVTO, and the Tariff Item 950 Regulations[22], which specified the terms under which duty free entry would be permitted. These instruments were replaced by the MVTO 1988[23] and later the MVTO 1998[24], which preserved the essential elements of the earlier legal instruments. The MVTO 1998 is the measure in effect today.

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[14] Auto Pact, Annex A, para. 3.

[15] Annex to Article 1002.1 of the CUSFTA.

[16] The last category was added in order to allow CAMI, a joint venture between General Motors and Suzuki which did not begin production until 1989, to benefit also from the Tariff Exemption.

[17] A note in the Annex to Article 1002.1 of the CUSFTA states that the duty exemption shall cease being granted if, as a result of the acquisition of control over a recipient, "the fundamental nature, scope or size of the business of the recipient is significantly altered". This provision has been reproduced in the MVTO 1998, Schedule, Part 1, para. 4. See footnote 24.

[18] See para. 5.5.

[19] See paras. 5.139 and 5.144.

[20] See para. 5.2.

[21] P.C. 1965-99, of 16 January 1965 (Exhibit EC-5 and JPN-25).

[22] P.C. 1965-100, of 16 January 1965 (Exhibit EC-5).

[23] P.C. 1987-2733, of 31 December 1987 (Exhibits JPN-32), amended in P.C. 1988-2872, of 30 December 1988 (Exhibit EC-4).

2.16 In line with the Auto Pact provisions allowing Canada to designate additional manufacturers as eligible to import duty free, beginning in 1965 the Government of Canada extended eligibility for the import duty exemption by granting Special Remission Orders (SROs)[25] to individual manufacturers that had not met the original conditions of the MVTO 1965 and its successors.

2.17 Whereas the Auto Pact calls for Canada to extend to certain manufacturers the right to import duty-free vehicles and original equipment manufacturing parts from the United States[26], the MVTO 1965 accorded the manufacturers the right with respect to "goods imported into Canada on or after 18 January 1965 from any country entitled to the benefit of the British Preferential Tariff or Most-Favoured Nation Tariff…".[27] Similarly, the import duty exemptions provided in the MVTO 1998 and current SROs apply to imports from any country entitled to Canada's MFN rate.

2.18 The MVTO 1998 and current SROs also provide a tariff exemption for the importation of certain parts and components for use as original equipment in the manufacture of motor vehicles. That exemption is not at issue in this dispute.[28]

1. The MVTO 1998

2.19 The MVTO 1998 provides an import duty exemption for the importation of automobiles[29], specified commercial vehicles[30], and buses.[31] (Throughout this Report, the terms "automobile", "specified commercial vehicle" and "bus" are used with the same meaning as in the MVTO 1998, and the term "motor vehicle" is used to designate collectively "automobiles", "specified commercial vehicles" and "buses".)

2.20 The beneficiaries of the MVTO 1998 are the same as the beneficiaries of the Auto Pact, i.e. those manufacturers of a given class of motor vehicles which produced vehicles of that class during each of the four consecutive quarters of the base year.

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[24] Exhibits EC-3 and JPN-4. The MVTO 1998 is an Order-in-Council passed by the Governor General in Council, on the recommendation of the Minister of Finance. The enabling authority is found in subsections 14 (2) and 16 (2) of Canada's Customs Tariff. The MVTO 1998 is administered by the Minister of National Revenue.

[25] Special Remission Orders are regulations adopted under authority of the Financial Administration Act, R.S.C. 1985, c. F-11, s. 23 (Exhibit JPN-3). The MVTO 1965 required companies to have produced motor vehicles in all quarters of the base year, which was defined as the 12-month period from 1 August 1963 to 31 July 1964. Any manufacturer which had not met this requirement was thus effectively prevented from qualifying for the import duty exemption.

[26] Article II(a) of the Auto Pact.

[27] MVTO 1965, para. 1 (Exhibits EC-5 and JPN-25).

[28] The tariff rate for imports of all original equipment parts was reduced to zero in 1996, irrespective of the status of the importer. See the Memorandum D10-15-21 (Exhibit EC-10).

[29] The MVTO 1998 defines the term "automobile" as "four-wheeled passenger motor vehicle having a seating capacity for not more than 10 persons, but does not include an ambulance or a hearse." It includes headings HS 87.02 or 87.03. Schedule, Part 1, 1(1).

[30] The MVTO 1998 defines the term "specified commercial vehicle" as "a truck, an ambulance or a hearse, or a chassis therefor, but does not include any of the following vehicles or chassis therefor, namely, a bus, an electric trackless trolley bus, a fire truck, an amphibious vehicle, a tracked or a half-tracked vehicle, a golf or invalid cart, a straddle carrier or motor vehicle designed primarily for off-highway use, or any machine or other article to be mounted on or attached to a truck, an ambulance or a hearse or a chassis therefor for purposes other than for loading or unloading the vehicle." It includes headings HS 87.01, 87.03 or 87.05 and chassis therefor of heading HS 87.06. Schedule, Part 1, 1(1).

[31] The MVTO 1998 defines the term "bus" as "a passenger motor vehicle having a seating capacity for more than 10 persons or a chassis therefor, but does not include any of the following vehicles or their chassis, namely, an electric trackless trolley bus, an amphibious vehicle, a tracked or half-tracked vehicle or a motor vehicle designed primarily for off-highway use." It includes heading HS 87.02 and chassis therefor of heading HS 87.06. Schedule, Part 1, 1(1).

2.21 A list of beneficiaries of the MVTO 1998 is contained in the Appendix to Memorandum D-10-16-3, issued by the Ministry of National Revenue on 10 April 1995.[32] That Appendix lists a total of 33 firms, of which 4 are identified as manufacturers of automobiles, 7 as manufacturers of buses and 27 as manufacturers of specified commercial vehicles.

2.22 The four manufacturers of automobiles listed in Memorandum D-10-16-3 are Chrysler Canada Ltd.[33], Ford Motor Company of Canada Ltd., General Motors of Canada Ltd., and Volvo (Canada) Ltd.[34]

2.23 The granting of the import duty exemption provided for in the MVTO 1998 is subject to the same type of CVA and ratio requirements as those stipulated in the Auto Pact. Specifically, the schedule to the MVTO 1998 defines a manufacturer as "a manufacturer of a class of vehicles" who:

> "(a) produced vehicles of that class in Canada in each of the four consecutive quarters of the base year; and
>
> (b) produced vehicles of a class in Canada in the 12-month period ending on July 31 in which the importation is made where
>
> > (i) the ratio of the net sales value of the vehicles produced to the net sales value of all vehicles of that class sold for consumption in Canada by the manufacturer in that period is equal to or higher than the ratio of the net sales value of all vehicles of that class produced in Canada by the manufacturer in the base year to the net sales value of all vehicles of that class sold for consumption in Canada by the manufacturer in the base year, and is not in any case lower than 75 to 100, and
> >
> > (ii) the Canadian value added is equal to or greater than the Canadian value added in respect of all vehicles of that class produced in Canada by the manufacturer in the base year."

2.24 The requirements are different for each MVTO 1998 beneficiary, depending on its level of CVA, production and sales during the base year.

2.25 A document published by Industry Canada, a department of the Federal Government of Canada,[35] indicates that the ratio requirements applicable to the MVTO 1998 beneficiaries are, "as a general rule", 95 to 100 for automobiles[36], at least 75 to 100 for specified commercial vehicles, and at least 75 to 100 for buses. That same document states that the CVA requirements have been rendered "insignificant" by inflation.

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[32] Exhibits JPN-7 and EC-9.

[33] In May 1998, Daimler-Benz and Chrysler agreed to merge their businesses. DaimlerChrysler Canada Inc. (formerly Chrysler Canada, Ltd.) is now a wholly-owned subsidiary of Daimler Chrysler Corp. (formerly Chrysler Corporation), which in turn is a wholly owned subsidiary of Daimler Chrysler AG, a holding company incorporated in Germany which also controls Daimler-Benz AG. Chrysler Canada Ltd. now imports motor vehicles of the Mercedes brand under the MVTO 1998.

[34] Volvo (Canada) Ltd. ceased the assembly of automobiles in Canada as of December 1998. Accordingly, it has apparently lost the right to import automobiles duty free under the Auto Pact as from 1 August 1999, the next model year. However, Ford Motor Corporation is purchasing the automotive division of Volvo AB and, therefore, can continue to import Volvo automobiles under the Duty Waiver.

[35] "Canada-US Automotive Products Agreement (Auto Pact Background)", Industry Canada, 10 June 1998 (Exhibit EC-20).

[36] Reflecting base-year CVA levels.

2.26 The MVTO 1998 lays down detailed rules for the calculation of the CVA.[37] In accordance with those rules, the cost items to be counted as CVA are, broadly speaking, the following:

- the cost of parts produced in Canada and of materials of Canadian origin that are incorporated in the motor vehicles;
- direct labour costs incurred in Canada;
- manufacturing overheads incurred in Canada;
- general and administrative expenses incurred in Canada that are attributable to the production of motor vehicles;
- depreciation in respect of machinery and permanent plant equipment located in Canada that is attributable to the production of motor vehicles; and
- a capital cost allowance for land and buildings in Canada that are used in the production of motor vehicles.

2.27 The same rules are applicable for calculating the CVA contained in original equipment parts for motor vehicles.[38]

2.28 The MVTO 1998 requires the beneficiaries to submit, each model year prior to their first importation, a declaration to the Minister of National Revenue, in which they declare that they will comply with the CVA and ratio requirements that model year.[39] The beneficiaries are also to submit to that Minister and to the Minister of Industry "reports that may reasonably be required by those Ministers respecting the production and sale of vehicles by the manufacturer".[40]

2.29 A manufacturer beneficiary not meeting the CVA or ratio requirements stipulated in the MVTO 1998 in any model year as to a class of motor vehicles is liable for the payment of the applicable customs duties on all imports of motor vehicles of that class made during that year. However, only duty-free imports are included in the ratio calculation. Therefore, an importer that is at risk of not meeting its production-to-sales ratio is entitled to start paying duty on any additional imports to be made without having to pay duties on what has already been imported. A manufacturer beneficiary which fails to meet the requirements in any given year does not lose the status of manufacturer beneficiary and may still qualify for the duty exemption in successive model years.

2.30 (For further discussion on administration and enforcement, see Factual Arguments of the Parties, Section V.)

2. Special Remission Orders

2.31 An administrative memorandum of Revenue Canada lists 63 firms as SRO beneficiaries[41] of which 2 are identified as manufacturers of automobiles, 5 as manufacturers of buses and 59 as

[37] MVTO 1998, Schedule, Part 1, 1(1), definition of "Canadian Value Added" , letter (a).

[38] Ibid., letter (b).

[39] MVTO 1998, Schedule, Part 1, 2 (a). The form of the declaration is set out in MVTO 1998, Schedule, Part 2.

[40] MVTO 1998, Schedule, Part 1, 2 (b). Samples of the reporting documents are provided as Exhibit EC-14.

[41] Memorandum D-10-16-2 lists the SROs for every company still manufacturing, but it does not include companies that are still in existence but no longer manufacturing. The orders for those companies remain in force, but they are not in use. (Canada's response to Question 37 from the Panel). See Exhibits EC-8 and JPN-8. Copies of all the SROs listed in the Appendix to the Memorandum appear in Exhibits EC-6 and

manufacturers of specified commercial vehicles. The two manufacturers of automobiles are CAMI Automotive Inc. (a joint venture between Suzuki Motors Corp., of Japan, and General Motors Corp., of the United States) and Intermeccanica International Inc., an artisanal manufacturer of hand-built replicas of famous cars.[42]

2.32 All SROs contain a CVA requirement and a manufacturing requirement (i.e. production-to-sales ratio requirement). The definitions of both requirements under the SROs are the same as the definitions under the MVTO 1998, though the specific levels of CVA and the ratios required vary. Because the SROs were granted after the conclusion of the Canada – US Auto Pact, different base years, or initial periods, were assigned to each SRO beneficiary.

2.33 Regarding CVA requirements, typically the SROs issued before 1984 stipulate that, during an initial period of one to two years, the CVA of the motor vehicles produced in Canada by the beneficiaries should be at least 40 per cent of their cost of production. Thereafter, the CVA should be at least the same (in dollar terms) as in the last 12 months of the initial period. Nevertheless, those SROs provide that if in any subsequent year the cost of production falls below the level of the initial period, the CVA (in dollar terms) could also be less, but in no case less than 40 per cent of the cost of production in that year. In contrast, the SROs issued from 1984 onwards provide, as a general rule, that the CVA of the motor vehicles produced in Canada by the beneficiaries (and in some cases, of the original equipment parts and components) shall be no less than 40 per cent of the cost of sales of the vehicles sold in Canada, with no reference to the values of an initial period. By way of exception, the SRO granted to CAMI[43] prescribes that the CVA of the motor vehicles and original equipment parts produced in Canada by CAMI must represent at least 60 per cent of the cost of sales of the vehicles sold in Canada by CAMI.

2.34 Regarding the production-to-sales ratio requirement, the SROs issued before 1977 set the minimum ratio at 75 to 100. Since then, almost all SROs have a ratio set at 100 to 100. In other words, the sales value of the vehicles produced in Canada by the SRO beneficiaries must be at least equal to the sales value of all the vehicles sold by them in Canada.

2.35 In terms of administration, the SROs lay down reporting obligations similar to those stipulated in the MVTO 1998 (described above), with similar consequences for a company failing to meet the requirements. As with the MVTO 1998, SRO beneficiaries at risk of not meeting their ratio requirements are entitled to start paying duty on any additional imports without having to pay duty on what has already been imported. (See also Factual Arguments of the Parties, Section V.)

III. FINDINGS AND RECOMMENDATIONS REQUESTED BY THE PARTIES

A. JAPAN'S REQUEST FOR FINDINGS AND RECOMMENDATIONS

3.1 **Japan** requests that the Panel make the following findings and recommendations:

(i) the Duty Waiver[44] is inconsistent with Article I:1 of the GATT 1994 and Articles II and XVII of the GATS;

JPN-6. A table summarising the content of the SROs appears in Exhibit EC-7, and a summary of SRO conditions and evolution over time is contained in Exhibit JPN-28.

[42] See Exhibit EC-21.

[43] P.C. 1988-2910, of 30 December 1988 (Exhibit JPN-6).

[44] Japan uses the term "Duty Waiver" collectively to refer to the MVTO 1998, the SROs, related statutory and administrative instruments, and the Letters. See also Section V.A.1.

(ii) the Duty Waiver, by virtue of the domestic content requirement, is inconsistent with Article III:4 of the GATT 1994, Article 2.1 of the TRIMs Agreement, Articles 3.1(b) and 3.2 of the SCM Agreement, and Article XVII of the GATS; and

(iii) the Duty Waiver, by virtue of the manufacturing requirement, is inconsistent with Articles 3.1(a) and 3.2 of the SCM Agreement.[45]

3.2 Finally, Japan requests that the Panel recommend that the Government of Canada bring itself into conformity with its obligations under the GATT 1994, the TRIMs Agreement and the GATS. With respect to the inconsistencies with Articles 3.1 and 3.2 of the SCM Agreement, the Government of Japan respectfully requests that the Panel recommend that the Government of Canada withdraw the prohibited subsidy "without delay" in accordance with Article 4.7 of the SCM Agreement.

B. THE EUROPEAN COMMUNITIES' REQUEST FOR FINDINGS AND RECOMMENDATIONS

3.3 The **European Communities** requests that the Panel make the following findings and recommendations:

- the CVA requirements are inconsistent with GATT Article III:4 in that they afford less favourable treatment to imported parts and materials for the manufacture of motor vehicles and parts therefor than to domestic like goods;

- the Ratio requirements are inconsistent with GATT Article III:4 in that they afford less favourable treatment to imported motor vehicles than to domestic like products with respect to their internal sale in Canada;

- the Tariff Exemption[46] is inconsistent with GATT Article I:1 because it provides an advantage to imports of automobiles originating in the United States and Mexico *vis-à-vis* imports of like products originating in other Members;

- the CVA requirements and the ratio requirements are TRIMs prohibited by Article 2.1 of the Agreement on TRIMs;

- the Tariff Exemption is a subsidy contingent upon export performance as well as upon the use of domestic over imported goods, which is therefore prohibited by Article 3 of the SCM Agreement;

- the CVA requirements are inconsistent with GATS Article XVII because they afford more favourable treatment to Canadian services used in the manufacture of motor vehicles and parts therefor than to like services of other Members; and

[45] The manufacturing requirement would also be inconsistent with Article III:4 of the GATT 1994 and Article 2.1 of the TRIMs Agreement.

[46] The European Communities uses the term "Tariff Exemption" collectively to refer to (i) the tariff exemption for the importation of motor vehicles, as well as the CVA requirements and production-to-sale "ratio" requirements attached thereto, contained in the Auto Pact, as supplemented by the Letters, and in the MVTO 1998; and (ii) the tariff exemptions for the importation of motor vehicles, and the CVA requirements and "ratio" requirements attached thereto, provided for in the SROs. See also Section V.A.1.

- the Tariff Exemption is inconsistent with GATS Article II because it accords more favourable treatment to US suppliers of wholesale trade services for automobiles than to like service suppliers of other Members.

3.4 The European Communities further requests the Panel to find that, by committing the above violations, Canada has nullified and impaired benefits accruing to the European Communities under the cited Agreements.

3.5 The European Communities also requests the Panel to recommend that Canada bring the measures into conformity with its obligations under the GATT, the TRIMs Agreement and the GATS.

3.6 Finally, the European Communities requests the Panel to recommend, pursuant to Article 4.7 of the SCM Agreement, that Canada withdraw the subsidy without delay and to specify in its recommendation the time period within which the subsidy must be withdrawn.

C. CANADA'S REQUEST FOR FINDINGS AND RECOMMENDATIONS

3.7 **Canada** requests that the Panel make the following findings and recommendations:

3.8 Neither Japan nor the European Communities has demonstrated that the measures at issue violate Canada's WTO obligations. More particularly:

- They have failed to show that the measures violate Article I of the GATT 1994: there is no discrimination against products based on national origin;
- They have failed to show that the measures violate Article III of the GATT: they do not have any effect on the competitive position of imported parts and vehicles in the Canadian market;
- They have failed to show that the measures violate the TRIMS Agreement: the measures are not investment measures, they are not trade-related, they do not violate Article III of the GATT 1994 and in any event they are not included on the Illustrative List;
- They have failed to show that the measures violate the SCM Agreement: they are not a subsidy contingent upon export performance or upon the use of domestic over foreign goods;
- They have failed to show that insofar as the measures accord duty-free treatment they violate the GATS: the measures do not affect services and in any event there is no discrimination against foreign wholesale service suppliers or in favour of service suppliers of certain countries, nor is there any evidence that the companies identified by the claimants compete with each other, or in the case of Article XVII, that Canada has made a relevant commitment; and
- They have failed to show that insofar as the measures contain a CVA requirement they violate Canada's commitments under the GATS: the measures do not discriminate against foreign service suppliers.

3.9 In the light of the foregoing, Canada requests that the claims of Japan and the European Communities be dismissed.

IV. REQUEST FOR PRELIMINARY RULING

A. JAPAN'S ARGUMENT GIVING RISE TO CANADA'S REQUEST FOR A PRELIMINARY RULING

4.1 **Japan** argues as follows:

4.2 Despite the fact that the Government of Japan does not discuss in detail the inconsistency of the manufacturing requirement with Article III:4 of the GATT 1994 or Article 2.1 of the TRIMs Agreement in its arguments to the same extent as was discussed in its Request for the Establishment of a Panel (WT/DS139/2), the Government of Japan reserves its right to elaborate during the course of the panel deliberation on these claims already contained in the said request.

4.3 In discussing how an eligible manufacturer can meet the conditions for the import duty exemption, Japan notes the following:

> "…this manufacturing requirement (the production-to-sales ratio) would be inconsistent with Article III:4 of the GATT 1994, because the manufacturing requirement requires the Auto Pact Manufacturers to increase production of motor vehicles in Canada and this in turn would lead to increased sales of such domestic motor vehicles in the Canadian market beyond the level of sales that would have occurred in the absence of this requirement, thereby upsetting the balance of conditions of competition for sales of like imported motor vehicles. In this regard, the manufacturing requirement would 'affect' the internal sale, purchase or use of products within the meaning of Article III:4 of the GATT 1994."[47]

B. CANADA'S REQUEST FOR A PRELIMINARY RULING

4.4 **Canada** responds as follows:

4.5 Japan purports to reserve the "right to elaborate during the course of the panel deliberation" on its claims regarding the alleged inconsistency of "the manufacturing requirement with Article III:4 of the GATT 1994 or Article 2.1 of the TRIMS Agreement." Canada objects to this reservation and requests this Panel to rule as a preliminary matter that it is not open for Japan or the European Communities to proceed as Japan has proposed to do. As this Panel is well aware, the fundamental tenet of due process requires that the responding party must know the case it is to meet. To permit Japan to develop its claims only when it chooses to do so would necessarily prejudice Canada's ability to defend itself in this action, and would risk offending the basic principle of fairness enshrined in the maxim *audi alteram partem*.[48] WTO panels and the Appellate Body have made it abundantly clear that procedural fairness requires that the complaining party set out its case at the commencement of proceedings and it is not open to it to eke out its claims incrementally during the various stages of the case.[49]

4.6 Prior to its first substantive meeting with the parties, the Panel invited Japan and the European Communities to file a response to Canada's request. Japan responded by reiterating its right to elaborate its claims at a later time; the European Communities did not file a response.

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[47] See footnote 397.

[48] Let the other side be heard.

[49] Appellate Body Report on *European Communities – Regime for the Importation, Sale and Distribution of Bananas*, adopted on 25 September 1997, WT/DS27/AB/R (hereinafter Appellate Body Report on *EC – Bananas III*), paras. 127-128, 143.

C. THE PANEL'S DECISION

4.7 On 14 June 1999 at the first substantive meeting with the parties, the Chairman read out the following decision by the **Panel**:

4.8 The Panel recalls that Japan has stated the following:

> "Despite the fact that the Government of Japan does not discuss in detail the inconsistency of the manufacturing requirement with Article III:4 of the GATT 1994 or Article 2.1 of the TRIMS Agreement in its arguments to the same extent as was discussed in its Request for the Establishment of a Panel (WT/DS139/2), the Government of Japan reserves its right to elaborate during the course of the panel deliberation on these claims already contained in the said request".

4.9 The Panel further recalls Canada's objection to this reservation by Japan and Canada's request to the Panel "to rule as a preliminary matter that it is not open for Japan or the European Communities to proceed as Japan has proposed to do".

4.10 Having carefully considered this matter, including the arguments of each of the parties to the dispute, the Panel has come to the following conclusions:

4.11 First, the Panel does not consider that this is a situation where, as argued by Canada, the complaining party is permitted "to eke out its claims incrementally during the various stages of the case". In making this argument, Canada refers to the Appellate Body decision in *European Communities – Regime for the Importation, Sale and Distribution of Bananas* (EC – *Bananas III)*. However, the situation here is unlike that in *EC – Bananas III*, where the Appellate Body stated that "Article 6.2 of the DSU requires that the *claims*, but not the *arguments*, must all be specified sufficiently in the request for the establishment of a panel in order to allow the defending party and any third parties to know the legal basis of the complaint" (WT/DS27/AB/R, para. 143). In the case before us there is no Article 6.2 issue of specificity of the measures identified in the panel request. Japan in this dispute has not attempted to reserve a right to present a new claim at a later stage of the proceedings; rather, it appears that Japan has simply indicated that it may wish to further elaborate its arguments as to claims already set out in the panel request and in its initial arguments. As such, the Panel does not consider, at this stage, that Canada is likely to be prejudiced in its ability to defend itself in this action.[50]

4.12 Second, to the extent any issue of procedural fairness should arise, for example, as to the right of rebuttal by Canada should Japan wait until a later stage of these proceedings to develop its arguments as to its GATT Article III:4 and TRIMS Article 2.1 claims with respect to the "manufacturing requirement" (production-to-sales ratio requirement), the Panel will ensure such procedural fairness by providing Canada with adequate opportunity to respond to any such further elaboration by Japan of its arguments under these claims.

4.13 Third, in addition to ensuring procedural fairness, it is of course necessary to set a cut-off date beyond which no new argumentation as to the claims in issue may be accepted, except upon a showing of good cause. In the instant case, the Panel considers that no new argumentation should be introduced beyond the second panel meeting with the parties, except in response to any questions posed by the Panel or otherwise upon a showing of good cause.

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[50] See the Appellate Body Report on *EC – Bananas III*, *supra* note 49, para. 141, where the Appellate Body states that, in its view, "there is a significant difference between the *claims* identified in the request for the establishment of a panel, which establish the panel's terms of reference under Article 7 of the DSU, and the *arguments* supporting those claims, which are set out and progressively clarified in the first written submissions, the rebuttal submissions and the first and second panel meetings with the parties".

[Parties' arguments and replies to questions in Sections V through VIII deleted from this version]

IX. INTERIM REVIEW

9.1 On 27 October 1999, Canada and Japan requested the Panel to review certain aspects of the interim report that had been transmitted to the parties on 13 October 1999, in accordance with Article 15.2 of the DSU.[795] The European Communities indicated that it had no comments. As for a possible review meeting with the Panel, Canada and Japan expressed a preference to respond in writing to each other's comments. The Panel thus invited the parties to submit written responses to each other's comments by 11 November 1999; Canada and Japan did so. No further comments were accepted after that date.

9.2 We have reviewed the arguments and suggestions presented by Canada and Japan and have finalized our report, taking into account those comments by the parties which we considered justified.

9.3 For the descriptive part (i.e. Sections I-VIII), where requested, we inserted language found in the original submissions of the parties, unless that language already appeared in the descriptive part. These insertions may be found in paragraphs 5.132-5.138, 5.142-5.143, 5.217-5.220, 6.15, 6.42-6.45, 6.66, 6.91-6.94, 6.121-6.123, 6.162, 6.190-6.194, 6.274, 6.361-6.363, 6.436, 6.450, 6.792, and 6.1134-6.1137, as well as in footnotes 34 and 308; Canada's *Figures 1-7* were also inserted. Although appearing in the Legal Arguments section (Section VI), paragraphs 5.90-5.116 and 5.271 were duplicated in Section V for completeness, as requested. Paragraph 4.6 and footnotes 44, 46 and 275 were added for clarification, as requested. Paragraphs 2.3-2.6, 2.8, 2.10, 2.14, 2.29, 2.35 and 6.417, as well as footnote 33, were revised in the light of Canada's comments. In addition, other typographical and technical refinements were made. Paragraph 4.3 was left intact despite a request that it be deleted.

9.4 For both the Findings and the Conclusions and Recommendations sections (i.e. Sections X and XI), we made minor linguistic, typographical and technical corrections and also added clarifications. Specifically, footnotes 800 and 811 were added for clarification, as requested; paragraph 10.4 was revised, with paragraphs 10.3-10.6 reordered; and terminology as to the measures at issue was corrected in paragraphs 10.264, 10.290, 10.308, 11.1(g) and 11.1(i).

9.5 A number of more substantive modifications were also made in response to comments from the parties. In particular, paragraph 10.39 was revised as requested to reflect Canada's position better. In that paragraph, the key issue is Canada's view of what constitute "origin-neutral" conditions on importers, referred to in the second sentence, to which no objection was posed. A sentence summarizing Canada's argument as to the relevant test of Article I:1 consistency was deleted from the end of the paragraph because these ideas are already presented in paragraph 10.35. Paragraph 10.44 was revised as requested to provide a more accurate reflection of Canada's position on the issue of intra-firm trade in the automotive sector; the basic point of the paragraph – i.e. that the importers will import only from related parties – is not altered. Paragraphs 10.52-10.54 were revised to provide a more detailed reflection of Canada's arguments, thus adding balance. Paragraph 10.81 has been revised to make it clear that the idea expressed in this paragraph is not that use of imported products prevents a manufacturer from benefitting from the import duty exemption, but rather that the use of imported products does not contribute to meeting the conditions for benefitting from the exemption. Paragraphs 10.83 and 10.84 were revised to reflect better Canada's position that measures only affect the internal sale or use of products if they have a potential effect under current circumstances and not, as previously stated in paragraph 10.83, if they have an actual effect under current circumstances. Paragraphs 10.225, 10.230, 10.292 and 10.293 were revised to reflect Canada's comment that their

[795] The descriptive part of the report (i.e. Sections I-VIII) was issued to the parties on 5 August 1999 for comment. On 20 August 1999 Canada and Japan submitted comments and the European Communities indicated that it did not wish to do so.

argument that the import duty exemption is not a measure affecting trade in services does not also extend to the CVA requirements.

9.6 In addition, and taking into consideration Japan's view that remedies may be a relevant consideration when determining whether to apply judicial economy, we have elaborated on Section X.C.2 (Claims under the SCM Agreement: CVA requirements) by undertaking an examination of the consistency of the CVA requirements with Article 3.1(b).[796]

X. FINDINGS

A. INTRODUCTION

1. Measures at issue

10.1 The parties to this dispute disagree as to the consistency with various provisions of the GATT 1994 (GATT), the TRIMs Agreement, the SCM Agreement and the GATS, of an exemption from customs duties accorded by Canada on the importation of motor vehicles subject to certain conditions ("import duty exemption"). This import duty exemption arises out of Canada's implementation of the Auto Pact, which was concluded between Canada and the United States in January 1965. It is currently applied by Canada pursuant to the Motor Vehicles Tariff Order 1998 (MVTO 1998) and a number of Special Remission Orders (SROs).[797]

10.2 The MVTO 1998 provides that the importation of certain categories of motor vehicles[798] is free from payment of the otherwise applicable MFN tariff if imported by a manufacturer of a category of motor vehicles in accordance with the conditions set out in the schedule to the MVTO 1998. The schedule to the MVTO 1998 provides that the term "manufacturer" means:

> "…a manufacturer of a class of vehicles who
>
> (a) produced vehicles of that class in Canada in each of the four consecutive quarters of the base year; and
>
> (b) produced vehicles of a class in Canada in the 12-month period ending on July 31 in which the importation is made where
>
> > (i) the ratio of the net sales value of the vehicles produced to the net sales value of all vehicles of that class sold for consumption in Canada by the manufacturer in that period is equal to or higher than the ratio of the net sales value of all vehicles of that class produced in Canada by the manufacturer in the base year to the net sales value of all vehicles of that class sold for consumption in Canada by the manufacturer in the base year, and is not in any case lower than 75 to 100, and

[796] Initially we chose not to examine claims under Article 3 of the SCM Agreement regarding the CVA requirements. Japan took issue with this decision with respect to claims under Article 3.1(b) of the SCM Agreement but not claims under Article 3.1(a) of that Agreement. Hence, we only elaborated findings on those claims under 3.1(b).

[797] The MVTO 1998 and the SROs also provide for an import duty exemption with respect to certain parts and components for use as original equipment in the manufacture of motor vehicles. That exemption has not been contested in this dispute.

[798] We note that the MVTO 1998 defines "motor vehicles" as comprising (i) automobiles, (ii) specified commercial vehicles, and (iii) buses. The SROs follow this definition.

(ii) the Canadian value added is equal to or greater than the Canadian value added in respect of all vehicles of that class produced in Canada by the manufacturer in the base year."

The term "base year" means the 12-month period beginning on 1 August 1963 and ending on 31 July 1964.

10.3 A number of motor vehicle manufacturers who had no production operations in Canada during the 1963-64 base year have been accorded the right to import motor vehicles duty free into Canada pursuant to company-specific SROs which provide that the manufacturers must meet criteria with respect to the ratio between the net sales value of vehicles produced in Canada and the net sales value of all vehicles sold for consumption in Canada and with respect to the Canadian value added in the production of motor vehicles.

10.4 In sum, to qualify for the import duty exemption, an eligible manufacturer of a class of vehicles must meet the following conditions: (1) a manufacturing presence in Canada which, with respect to the MVTO 1998, is expressed in terms of a base year, along with local production of vehicles of the class being imported in the current year ("manufacturing presence"); (2) a production-to-sales ratio requirement, as reflected in the MVTO 1998 and the SROs ("ratio requirement"); and (3) a Canadian value added requirement, as reflected in the MVTO 1998 and the SROs ("CVA requirement"). We also note that, according to complainants, additional CVA requirements are contained in various Letters of Undertaking.[799]

10.5 In 1989, the category of motor vehicle manufacturers eligible for the import duty exemption under the then applicable MVTO or pursuant to company-specific SROs was closed in accordance with an obligation assumed by Canada under the Canada-United States Free Trade Agreement.[800]

10.6 While the eligibility for the import duty exemption provided for under the MVTO 1998 and the SROs is thus confined to certain motor vehicle manufacturers, the right of those manufacturers to import motor vehicles duty free is not subject to a limitation with respect to the origin of such vehicles.

10.7 We note the difference in product coverage of the various claims of Japan, on the one hand, and the European Communities on the other. The product coverage of Japan's claims – those under the GATT, the TRIMS Agreement, the SCM Agreement and the GATS – includes the three categories of "motor vehicles" as defined in the MVTO 1998 (with certain exceptions not relevant to this proceeding), including "automobiles", "buses" and "specified commercial vehicles".[801] Similarly, the product coverage of the European Communities' claims under GATT Article III, the TRIMS Agreement, the SCM Agreement and Article XVII of the GATS also include all three categories of motor vehicles.[802] However, the European Communities' claims under GATT Article I and GATS Article II are limited in their product coverage to "automobiles" as defined in the MVTO 1998.[803]

10.8 For the purposes of our analysis of all the parties' claims, unless otherwise specified, in referring to "product(s)" we mean to include all three categories of "motor vehicles" as defined in the MVTO 1998.

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[799] Although we note the statement by the European Communities in Section V.A.1(b), *supra*, that it is also challenging the Canada-US Auto Pact as such, no claims are made as to the Auto Pact as distinct from those made against the MVTO 1998, the SROs and the Letters of Undertaking.

[800] We note that the Canada-United States Free Trade Agreement as such is not at issue in this dispute.

[801] See *supra* para. 2.19.

[802] See *supra* para. 5.20.

[803] See *supra* para. 5.19.

2. Order of consideration of claims

10.9 In our analysis of the legal issues in this case, we shall follow the order in which the complainants presented their claims. Accordingly, we shall first address claims under GATT Article I:1, followed by those under GATT Article III:4, and those under the TRIMs Agreement. We shall then turn to claims under the SCM Agreement. Finally, we shall address claims under the GATS.

3. Rules of treaty interpretation

10.10 Article 3.2 of the DSU directs panels to clarify WTO provisions "in accordance with customary rules of interpretation of public international law". It is generally considered that the fundamental rules of treaty interpretation set out in Articles 31 and 32 of the Vienna Convention have attained the status of rules of customary international law. These Vienna Convention articles provide as follows:

> ARTICLE 31
> *General rule of interpretation*
>
> 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.
>
> ARTICLE 32
> *Supplementary means of interpretation*

> 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.

10.11 As noted by the Appellate Body in its report on *Japan – Alcoholic Beverages*, "Article 31 of the Vienna Convention provides that the words of the treaty form the foundation for the interpretive process: 'interpretation must be based above all upon the text of the treaty'. The provisions of the treaty are to be given their ordinary meaning in their context. The object and purpose of the treaty are also to be taken into account in determining the meaning of its provisions".[804]

10.12 Our understanding of these rules of interpretation is that, even though the text of a term is the starting-point for any interpretation, the meaning of a term cannot be found exclusively in that text; in seeking the meaning of a term, we also have to take account of its context and to consider the text of the term in light of the object and purpose of the treaty. Article 31 of the Vienna Convention explicitly refers to the "ordinary meaning to be given to the terms of the treaty in their [the terms'] context and in the light of its [the treaty's] object and purpose".[805] The three elements referred to in Article 31 – text, context and object and purpose – are to be viewed as one integrated rule of interpretation rather than a sequence of separate tests to be applied in a hierarchical order.[806] Of course, context and object and purpose may simply confirm the textual meaning of a term. In many cases, however, it is impossible to give meaning, even "ordinary meaning", without looking also at the context and/or object and purpose.[807]

10.13 It is in accordance with these rules of treaty interpretation that we will examine the WTO provisions at issue in this case.

B. CLAIMS UNDER THE GATT AND THE TRIMS AGREEMENT

1. Claims Under Article I:1 of the GATT

(a) Introduction

10.14 As described above in the introductory section of the findings, Canada accords an import duty exemption on motor vehicles if imported by importers who meet certain conditions. This import duty exemption is provided for in the MVTO 1998 and certain SROs.

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[804] Appellate Body Report on *Japan – Alcoholic Beverages, supra* note 271, pp. 11-12.

[805] See Appellate Body Report on *Brazil – Measures Affecting Dessicated Coconut*, adopted on 20 March 1997, WT/DS22/AB/R, p. 15.

[806] "The Commission by heading the article 'General rule of interpretation' in the singular and by underlining the connection between paragraphs 1 and 2 and again between paragraph 3 and the two previous paragraphs, intended to indicate that the application of the means of interpretation in the article would be a single combined operation. All the various elements, as they were present in any given case, would be thrown into the crucible and their interaction would give the legally relevant interpretation". Yearbook of the International Law Commission (1966) Vol. II, A/CN.4/SER.A/1966/Add.1, 219 and 220.

[807] To find "ordinary meaning", reference is often made to an authoritative language dictionary. However, very few – if any – words have only one dictionary meaning. Thus, even the step of choosing the relevant dictionary meaning(s) in pursuit of "ordinary meaning" – often the very first step in treaty interpretation – necessarily involves a reference to the context in which the word is used. Referring to the object and purpose of an agreement may also be indispensable to arriving at the meaning of a word.

10.15 The European Communities and Japan claim that this import duty exemption is inconsistent with Article I:1 of the GATT, which provides in relevant part:

> "With respect to customs duties and charges of any kind imposed on or in connection with importation ..., any advantage, favour, privilege or immunity granted by any contracting party to any product originating in … any other country shall be accorded immediately and unconditionally to the like product originating in … the territories of all other contracting parties."

10.16 The parties do not dispute that the import duty exemption is an "advantage" within the meaning of Article I:1 with respect to "customs duties and charges of any kind on or in connection with importation". It is also not in dispute that there are imported products which do not benefit from this exemption which are like imported products which benefit from the exemption.

10.17 Two main arguments have been advanced with respect to the alleged inconsistency of this import duty exemption with Article I:1. Firstly, Japan argues that the import duty exemption is inconsistent with Article I:1 because, by conditioning the exemption on criteria which are unrelated to the imported product itself, Canada fails to accord the exemption immediately and unconditionally to like products originating in the territories of all WTO Members. Secondly, both the European Communities and Japan argue that the limitation of the eligibility for the import duty exemption to certain motor vehicle manufacturers is inconsistent with Article I:1 on the grounds that it entails *de facto* discrimination in favour of products of certain countries.

(b) Whether the import duty exemption is awarded "immediately and unconditionally"

10.18 We first consider the argument of Japan that, by making the import duty exemption conditional upon criteria which are unrelated to the imported product itself, Canada fails to accord the import duty exemption immediately and unconditionally to like products originating in all WTO Members. By "criteria unrelated to the imported products themselves," Japan means the various conditions which confine the eligibility for the exemption to certain motor vehicle manufacturers in Canada.

10.19 We note that in developing this argument, Japan refers to the Concise Oxford Dictionary definition of the word "unconditional" as meaning "not subject to conditions", and cites *Indonesia Autos*[808] and *Belgian Family Allowances*[809], as well as the *Working Party Report on the Accession of Hungary*[810], as authority for the proposition that the subjecting of an advantage to *any* condition *unrelated to the product* is inconsistent with Article I:1.

10.20 We also recall Canada's response that Japan misinterprets the "immediately and unconditionally" clause in Article I:1 and that Article I:1 contains no prohibition of origin-neutral terms and conditions on importation that apply to the *importers* as opposed to the *products* being imported. According to Canada, Article I:1 prohibits only conditions related to the national origin of the imported product. Canada thus argues that it is entitled to treat like products differently so long as the distinction in treatment is based on criteria other than national origin. Canada argues that in the instant case the conditions under which the import duty exemption is accorded are consistent with Article I:1 in that they are based on the activities of importing manufacturers and not on the origin of the products. Canada further argues that to hold otherwise would be to "read Article II out of the

[808] Panel Report on *Indonesia – Autos, supra* note 270.
[809] Panel Report on *Belgian Family Allowances*, *supra* note 276.
[810] Report of the *Working Party on the Accession of Hungary, supra* note 276.

GATT", given that Article II specifically contemplates tariff bindings being subject to "terms, *conditions* or qualifications"[811].

10.21 We note that the argument of Japan that the import duty exemption is inconsistent with Article I:1 because it is conditioned upon criteria that are unrelated to the imported products is distinct from Japan's argument that the import duty exemption violates Article I:1 because it discriminates in practice in favour of products of certain countries. Thus, Japan advances an interpretation of Article I:1 which distinguishes between, on the one hand, the issue of whether the advantage arising out of the import duty exemption is accorded "unconditionally" as required by Article I:1, and, on the other, the issue of whether that advantage is accorded without discrimination as to the origin of products.

10.22 As explained below, we believe that this interpretation of Japan does not accord with the ordinary meaning of the term "unconditionally" in Article I:1 in its context and in light of the object and purpose of Article I:1. In our view, whether an advantage within the meaning of Article I:1 is accorded "unconditionally" cannot be determined independently of an examination of whether it involves discrimination between like products of different countries.

10.23 Article I:1 requires that, if a Member grants any advantage to any product originating in the territory of any other country, such advantage must be accorded "immediately and unconditionally" to the like product originating in the territories of all other Members. We agree with Japan that the ordinary meaning of "unconditionally" is "not subject to conditions". However, in our view Japan misinterprets the meaning of the word "unconditionally" in the context in which it appears in Article I:1. The word "unconditionally" in Article I:1 does not pertain to the granting of an advantage *per se*, but to the obligation to accord to the like products of all Members an advantage which has been granted to any product originating in any country. The purpose of Article I:1 is to ensure unconditional MFN treatment. In this context, we consider that the obligation to accord "unconditionally" to third countries which are WTO Members an advantage which has been granted to any other country means that the extension of that advantage may not be made subject to conditions with respect to the situation or conduct of those countries. This means that an advantage granted to the product of any country must be accorded to the like product of all WTO Members without discrimination as to origin.

10.24 In this respect, it appears to us that there is an important distinction to be made between, on the one hand, the issue of whether an advantage within the meaning of Article I:1 is subject to conditions, and, on the other, whether an advantage, once it has been granted to the product of any country, is accorded "unconditionally" to the like product of all other Members. An advantage can be granted subject to conditions without necessarily implying that it is not accorded "unconditionally" to the like product of other Members. More specifically, the fact that conditions attached to such an advantage are not related to the imported product itself does not necessarily imply that such conditions are discriminatory with respect to the origin of imported products. We therefore do not believe that, as argued by Japan, the word "unconditionally" in Article I:1 must be interpreted to mean that making an advantage conditional on criteria not related to the imported product itself is *per se* inconsistent with Article I:1, irrespective of whether and how such criteria relate to the origin of the imported products.

10.25 We thus find that Japan's argument is unsupported by the text of Article I:1. We also consider that there is no support for this argument in the GATT and WTO reports cited by Japan. A review of these reports shows that they were concerned with measures that were found to be inconsistent with Article I:1 not because they involved the application of conditions that were not related to the imported product but because they involved conditions that entailed different treatment of imported products depending upon their origin.

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[811] *Supra* para. 7.97.

10.26 Thus, the measure at issue in *Belgian Family Allowances* was "the application of the Belgian law on the levy of a charge on foreign goods purchased by public bodies when these goods originated in a country whose system of family allowances did not meet specific requirements."[812] The panel determined that this levy was an internal charge within the meaning of Article III:2 of the GATT and found that it was inconsistent with Article I:1:

> "According to the provisions of paragraph 1 of Article I of the General Agreement, any advantage, favour, privilege or immunity granted by Belgium to any product originating in the territory of any country with respect all matters referred to in paragraph 2 of Article III shall be granted immediately and unconditionally to the like product originating in the territories of all contracting parties. Belgium has granted exemption from the levy under consideration to products purchased by public bodies when they originate in Luxemburg and the Netherlands, as well as in France, Italy, Sweden and the United Kingdom. If the General Agreement were definitively in force in accordance with Article XXVI, it is clear that the exemption would have to be granted unconditionally to all other contracting parties (including Denmark and Norway). *The consistency or otherwise of the system of family allowances in force in the territory of a given contracting party with the requirements of the Belgian law would be irrelevant in this respect, and the Belgian legislation would have to be amended insofar as it introduced a discrimination between countries having a given system of family allowances and those which had a different system or no system at all, and made the granting of the exemption dependant on certain conditions*."[813] (*emphasis added*)

10.27 Similarly, the reference made by Japan to the *Working Party Report on the Accession of Hungary* concerns tariff exemptions and reductions granted in the framework of co-operation contracts. The GATT Secretariat, in response to a request for a legal opinion, commented that "the prerequisite of having a co-operation contract in order to benefit from certain tariff treatment appeared to imply conditional most-favoured-nation treatment and would, therefore, not appear to be compatible with the General Agreement".[814]

10.28 With respect to the Panel Report on *Indonesia – Autos,* we note that the panel determined that certain customs duty and tax benefits provided by Indonesia to imports of "National Cars" and parts and components thereof from Korea were advantages within the meaning of Article I, and that these "National Cars" and their parts and components imported from Korea were like other similar motor vehicles and parts and components from other Members. The panel then proceeded to

> "…examine whether the advantages accorded to national cars and parts and components thereof from Korea are unconditionally accorded to the products of other Members, as required by Article I. The GATT case law is clear to the effect that any such advantage (here tax and customs duty benefits) cannot be made conditional on any criteria that is not related to the imported product itself."[815]

Significantly, in support of the statement that "the GATT case law is clear to the effect that any such advantage (…) cannot be made conditional on any criteria that is not related to the imported product itself", the panel referred to the Panel Report on *Belgian Family Allowances.*[816] As discussed above, that Panel Report dealt with a measure which distinguished between countries of origin depending upon the system of family allowances in force in their territories. We further note that, following this

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[812] Panel Report on *Belgian Family Allowances*, *supra* note 276, para. 1.
[813] Ibid., para. 3.
[814] Report of the *Working Party on the Accession of Hungary, supra* note 276, para. 12.
[815] Panel Report on *Indonesia – Autos, supra* note 270, para. 14.143.
[816] Ibid., para. 14.144.

statement, the panel on *Indonesia – Autos* identified certain conditions which entailed discrimination between imports of the subject products from Korea and like products from other Members, and found that these measures were thus inconsistent with Article I of the GATT.[817] The statement in the Panel Report that an advantage within the meaning of Article I "cannot be made conditional on any criteria that is not related to the imported product itself" must therefore in our view be seen in relation to conditions which entailed different treatment of like products depending upon their origin.

10.29 In sum, we believe that the panel decisions and other sources referred to by Japan do not support the interpretation of Article I:1 advocated by Japan in the present case according to which the word "unconditionally" in Article I:1 must be interpreted to mean that subjecting an advantage granted in connection with the importation of a product to conditions not related to the imported product itself is *per se* inconsistent with Article I:1, regardless of whether such conditions are discriminatory with respect to the origin of products. Rather, they accord with the conclusion from our analysis of the text of Article I:1 that whether conditions attached to an advantage granted in connection with the importation of a product offend Article I:1 depends upon whether or not such conditions discriminate with respect to the origin of products.

10.30 In light of the foregoing considerations, we reject Japan's argument that, by making the import duty exemption on motor vehicles conditional on criteria that are not related to the imported products themselves, Canada fails to accord the exemption immediately and unconditionally to the like product originating in the territories of all WTO Members. In our view, Canada's import duty exemption cannot be held to be inconsistent with Article I:1 simply on the grounds that it is granted on conditions that are not related to the imported products themselves. Rather, we must determine whether these conditions amount to discrimination between like products of different origins.

(c) Whether the import duty exemption discriminates in favour of motor vehicles of certain countries

10.31 We thus turn to the issues raised by the complainants to support their view that the import duty exemption involves discrimination in favour of motor vehicles of certain countries. We begin by recapitulating the main arguments of the parties.

10.32 Japan argues that, by virtue of the eligibility restriction, the import duty exemption accorded by Canada on motor vehicles discriminates in practice by according an advantage to motor vehicles from certain countries while effectively denying the same advantage to like motor vehicles originating in the territories of other WTO Members. Japan submits that, although the beneficiaries of the import duty exemption are ostensibly permitted to import motor vehicles of any national origin, in practice they have chosen and will continue to choose to import the products of particular companies from particular countries, in consideration of their previous history of transactions, capital relationships, and the nationality of companies investing in the beneficiaries. In the view of Japan, this means that the eligibility restriction and other conditions attached to the exemption effectively limit access to the advantage to certain Members having the companies with which the beneficiaries have certain commercial relationships. Japan further argues that the discriminatory nature of the exemption was strengthened due to the fact that the list of eligible importers has been frozen since 1 January 1989. As evidence of the discriminatory character of the import duty exemption, Japan adduces statistics which show that in 1997, 96% of Sweden's imports into Canada, and 94% of Belgium's were duty-free (in both cases these were imports of Volvos and of Saabs, the latter partly owned by GM, with Volvo Canada and GM Canada both being eligible manufacturer beneficiaries). Japan compares this with just under 30% of duty-free imports for the whole of the European Communities, and of just under 5% for Korea and just under 3% for Japan.[818] Japan also points to the fact that Volvos and Saabs are imported under the import duty exemption from Belgium or Sweden while like vehicles produced by

[817] Ibid., paras. 14.145-148.
[818] *Supra* Japan's Table 6.

Japanese manufacturers are imported subject to the MFN rate.[819] We note that at the initial stage of this proceeding Japan's argument concentrated on the discrimination in favour of imports from Belgium and Sweden as compared with imports from Japan; subsequently Japan has also contended that there is discrimination in favour of imports from the United States and Mexico.

10.33 The European Communities argues that, although the import duty exemption on its face is non-discriminatory in that it applies equally with respect to all imports of automobiles by the beneficiaries, irrespective of their country of origin, in reality the main beneficiaries are subsidiaries of US companies with large manufacturing facilities in the United States and Mexico, and the benefit of the exemption therefore accrues almost exclusively to imports from these two countries. In support of this, the European Communities states that in 1997, imports of automobiles from the United States and Mexico accounted for 97% of all duty-free imports into Canada, when in contrast imports from these two countries accounted for only 80% of all imports of automobiles into Canada.[820] According to the European Communities, this "disproportionate" share is not a result of commercial factors but is the result of the import duty exemption. Moreover, whereas in 1997 the vast majority of imports from Mexico and the United States benefited from the import duty exemption, most imports from other sources were subject to customs duties.[821]

10.34 Both Japan and the European Communities argue that their claim that the import duty exemption gives rise to *de facto* discrimination is supported by relevant GATT and WTO Panel Reports.

10.35 Canada argues that the claim of the complainants that the import duty exemption involves *de facto* discrimination in favour of products of certain countries is without foundation in law or in fact. According to Canada, GATT and WTO dispute settlement cases demonstrate that to prove a *de facto* violation of Article I:1 it must be shown that a criterion that is neutral on its face is in fact able to be met only by products of a particular origin or origins such that national origin determines the tariff treatment the product receives. In the case at hand, there are no such criteria that determine the origin of the products which may be imported under the import duty exemption. In the view of Canada, the mere limitation of the number of eligible importers is not inconsistent with Article I:1 given that there are no conditions restricting the origin of products imported by the beneficiaries. In this connection, Canada submits that there is no basis in GATT and WTO case law for the view that a *de facto* violation of Article I:1 can be established on the basis of the commercial decisions of importers with respect to their sources of supply.

10.36 Canada further submits that the complainants have failed to adduce evidence supporting their claim of discrimination. The lack of factual support for this claim is illustrated by the fact that the complainants differ on which third countries benefit from the allegedly more favourable treatment. In addition, the statistics adduced by the complainants to demonstrate that the products of some countries receive a disproportionate share of the duty-free benefit do not provide evidence of discrimination. With respect to the data presented by Japan, Canada argues that these data are inaccurate, incomplete and irrelevant to the establishment of a violation of Article I:1. In any event, even Japan's data show that in 1996 there were 1,776 duty-free import sales of vehicles from Sweden, compared with 4,502 duty-free import sales from Japan. Canada also submits data[822] showing that during the years 1991-98 Japanese-origin vehicles have benefitted from the import duty exemption to a much greater extent than have vehicles of Belgium, Sweden and several other WTO Members. Canada rejects as irrelevant Japan's comparison between luxury models imported from Belgium and Sweden and luxury models imported from Japan. With respect to the statistics adduced by the European Communities, Canada argues that the European Communities fails to explain how these statistics constitute evidence of

[819] *Supra* Japan's Tables 9 and 10.
[820] *Supra* EC's Table 1.
[821] *Supra* EC's Table 2.
[822] *Supra* Canada's Figure 4.

discrimination within the meaning of Article I:1, and that, even if it were true that an advantage is granted *de facto* to products of the United States and of Mexico, such advantage would be exempted from Article I:1 by virtue of Article XXIV.

10.37 In respect of this disagreement between the parties on whether or not the import duty exemption accorded by Canada under the MVTO 1998 and SROs involves discrimination in favour of products of certain countries, we note first that Japan and the European Communities do not contest the fact that this exemption applies to imports from any country entitled to Canada's MFN rate. We therefore consider that the fundamental legal question before us is how the MFN requirement in Article I:1 must be applied to a measure which, on the one hand, involves a limitation to certain importers of an advantage granted in connection with the importation of a product but which, on the other hand, does not impose conditions regarding the origin of the products which can benefit from such advantage. More specifically, the question arises whether such a measure can be considered to give rise to *de facto* discrimination between like products originating in the territories of different Members.

10.38 In this regard, we note that GATT/WTO jurisprudence has established that Article I:1 encompasses both *de jure* and *de facto* forms of discrimination.[823] The instant case differs from situations addressed in some of the Panel Reports referred to by the parties with respect to the issue of *de facto* discrimination under Article I:1 in that in the present case such discrimination is alleged to arise from conditions with regard to the importers eligible for the import duty exemption rather than from conditions applied with respect to the products imported by such importers: the complainants essentially argue that there is *de facto* discrimination as a result of the fact that only certain importers in Canada qualify for the import duty exemption. In their view, this effectively limits the benefit of that exemption to the products of certain Members in whose territories are located companies related to those importers.

10.39 By contrast, Canada submits that Article I:1 does not prohibit the imposition of origin-neutral terms and conditions on importation that apply to importers as opposed to the products being imported. As we understand this argument, Canada takes the view that terms and conditions that apply to importers are "origin-neutral" if they do not provide for limitations with respect to the origin of products which may be imported by the importers.

10.40 Though we do not contest the validity of the proposition that Article I:1 does not prohibit the imposition of origin-neutral terms and conditions on importation that apply to importers, we believe that the interpretation advocated by Canada of what "origin-neutral" means in this context is unduly narrow. We see no basis in the text of Article I:1 to hold that, where a measure reserves an import duty exemption to certain importers, the consistency of that measure with Article I:1 depends solely on whether or not there are restrictions on the origin of products imported by such importers. Rather, we believe that account should also be taken of the possibility that the limitation of the exemption to certain importers may by itself have a discriminatory impact on the treatment of like products of different origins.

10.41 As described above in the introductory section of these findings, the category of importers eligible for the import duty exemption accorded by Canada under the MVTO 1998 and the SROs is confined to manufacturers who were present in Canada in a particular base year and who meet certain performance requirements. In addition, since 1989 no new motor vehicle manufacturers have been able to qualify for the exemption. We note in this regard that among the manufacturers who currently benefit from the exemption are companies which have links of ownership or control with motor vehicle producers based in certain countries. Thus, with respect to automobiles, the current

[823] See Appellate Body Report on *EC – Bananas III*, *supra* note 49, para. 232. See also Panel Report on *EEC – Beef from Canada*, *supra* note 282; Panel Report on *Spain – Unroasted Coffee*, *supra* note 282; and Panel Report on *Japan – SPF Lumber, supra* note 282.

beneficiaries of the MVTO 1998 are fully-owned subsidiaries of General Motors, Ford, Chrysler and Volvo.[824] On the other hand, there are automobile manufacturers in Canada which are subsidiaries of companies based in other countries and which do not enjoy the import duty exemption.

10.42 We consider that, for the purpose of determining whether the limitation of eligible importers has an impact on the origin of products imported under the import duty exemption, the foreign affiliation of automobile manufacturers in Canada which benefit from the import duty exemption, as compared with the foreign affiliation of automobile manufacturers who are not entitled to the exemption, is of particular significance when viewed in conjunction with the evidence before us regarding the predominantly, if not exclusively, "intra-firm" character of trade in automotive products.

10.43 In this regard, we note the arguments and evidence presented by the complainants that the global automotive industry is highly integrated and characterized by a high degree of intra-firm trade. In particular, evidence adduced in this proceeding shows that the import patterns of the major automotive corporations in Canada are such that they import only their own make of motor vehicles and those of related companies.[825] Thus, General Motors in Canada imports only GM motor vehicles and those of its affiliates; Ford in Canada imports only Ford motor vehicles and those of its affiliates; the same is true of Chrysler and of Volvo. These four companies all have qualified as beneficiaries of the import duty exemption. In contrast, other motor vehicle companies in Canada, such as Toyota, Nissan, Honda, Mazda, Subaru, Hyundai, Volkswagen and BMW, all of which also import motor vehicles only from related companies, do not benefit from the import duty exemption. The evidence also shows that General Motors has imported Saabs and Suzukis duty free into Canada and that General Motors has an ownership in the foreign producers of these vehicles. Similarly, between 1971-1993 when Mitsubishi and Chrysler ran a joint venture, Chrysler imported motor vehicles from Mitsubishi into Canada duty-free, but these imports ceased after the termination of the joint-venture affiliation.

10.44 We further note the statement by Canada that it is characteristic of the globalized automotive industry that there be some sort of capital, manufacturing or similar relationship between the automobile manufacturers and companies from which they import.[826] We also note that, as part of its defence to the claims raised under Article II of the GATS, Canada stresses the vertical integration between distributors and manufacturers of motor vehicles and the fact that distributors will not import and distribute motor vehicles produced by other manufacturers unless there is that capital, manufacturing or similar relationship.

10.45 We conclude from this analysis that the limitation of the eligibility for the import duty exemption to certain importers in Canada who are affiliated with manufacturers in certain countries affects the geographic distribution of the imports of motor vehicles under the import duty exemption. While these eligible importers are not in law or in fact prevented from importing vehicles under the exemption from any third country, in view of their foreign affiliation and the predominantly, if not exclusively, "intra-firm" character of trade in this sector, imports will tend to originate from countries in which the parent companies of these manufacturers, or companies related to these parent companies, own production facilities. Whether or not a like product of a WTO Member in practice benefits from the import duty exemption depends upon whether producers in the territory of that Member are related to any of the eligible Canadian motor vehicle manufacturers. Thus, in reality the conditions on which Canada accords the import duty exemption on motor vehicles entail a distinction between exporting countries depending upon whether or not producers in such countries are related to the eligible manufacturers. We therefore consider that, in a context of intra-firm trade, the limitation

[824] We note the recent changes that have occurred in the ownership of Chrysler and Volvo, as described in the factual arguments section of this report, and, in the case of Volvo, the implications of these changes for its status as a beneficiary of the import duty exemption.

[825] See Exhibit JPN-10.

[826] *Supra* para.7.119.

of the availability of the import duty exemption to certain manufacturers, including fully-owned subsidiaries of firms based in a very limited number of third countries, discriminates as to the origin of products which will benefit from the import duty exemption.

10.46 We note Canada's argument that the origin of products imported under the import duty exemption is determined by commercial decisions of the importers and that such decisions cannot be the basis for finding a violation of Article I:1. In this regard, we wish to stress that, in finding that the conditions attached to the import duty exemption discriminate as to the origin of products imported under this exemption, we are not denying that the decisions taken by individual importers as to the sourcing of their supplies are commercial decisions in which the Government of Canada is not involved. In our view, however, the issue is not whether the Government of Canada is somehow directing importers to import from particular sources; it clearly is not. While there is no involvement of the Government of Canada in decisions by individual importers, what is attributable to the Government of Canada is that, as a result of the limitation of the number of eligible importers, the geographic distribution of imports benefitting from the import duty exemption is determined by the commercial decisions of a closed category of importers mainly consisting of subsidiaries of firms based in certain countries, rather than by the commercial decisions of a broader, open-ended group of importers.

10.47 We have carefully considered the evidence provided by the parties with respect to the origin of imports under the import duty exemption. In this respect, we note in particular the argument of Canada that the available evidence, such as the data contained in Canada's Figure 4, shows that imports under the import duty exemption originate from a number of countries, including Japan, Belgium and Sweden, and that in recent years imports from Japan have accounted for a greater percentage of imports under the import duty exemption than imports from some other countries, such as Sweden, Belgium and the United Kingdom.

10.48 We consider that the evidence presented by Canada shows that the conditions attached to the import duty exemption do not prevent imports of motor vehicles from a range of countries, including the complainants, from benefitting from the exemption. This evidence also confirms the point made by Canada that the eligible manufacturers have affiliations with companies in a range of countries. At the same time, we do not believe that these data are in contradiction with our view that the import duty exemption favours products of certain countries depending upon the affiliation of producers located in those countries to the importers in Canada who are eligible for the import duty exemption. We note in this connection that other data before us, presented by the European Communities and Japan, reveal very significant differences between the percentages of imports of automobiles from individual countries that have benefitted from the import duty exemption. The difference between the United States, Mexico, Sweden and Belgium, on the one hand, and other European countries and Japan on the other - not to mention other major motor vehicle producers such as Korea - is particularly striking.[827] We also consider significant the data presented by the European Communities and Japan regarding imports of automobiles from different sources as percentages of total imports under the import duty exemption.[828] We therefore believe that the fact that imports under the import duty exemption have originated from a number of countries, as a consequence of the capital relationship between eligible importers and producers in those countries, does not warrant a conclusion that the import duty exemption is accorded on equal terms to like products of different origin.

10.49 As explained above, our view of the discriminatory character of the import duty exemption is based on an analysis of the consequences, in the context of an industry characterized by intra-firm trade, of the limitation of the number of eligible importers to manufacturers with particular foreign affiliations. We believe that, while not of decisive importance, the historical context of the import

[827] *Infra* EC's Table 2, Japan's Table 6.
[828] *Infra* EC's Table 1, Japan's "New" Figure 4.

duty exemption provides further support for this view. We recall that this measure stems from a bilateral agreement between Canada and the United States designed to resolve a long-standing trade dispute between Canada and the United States over trade in automotive products. This agreement was designed *inter alia* to achieve rationalization of production in the North-American market. From the perspective of Canada this involved the granting of import duty exemptions as an encouragement to US owned motor vehicle manufacturers to expand their production operations in Canada. We therefore consider that at the outset the import duty exemption was expected to benefit mainly imports from particular sources.

10.50 In light of the foregoing considerations, we **find** that, by reserving the import duty exemption provided for in the MVTO 1998 and the SROs to certain importers, Canada accords an advantage to products originating in certain countries which advantage is not accorded immediately and unconditionally to like products originating in the territories of all other WTO Members. Accordingly, we find the application of this measure to be inconsistent with Canada's obligations under Article I:1of the GATT.

(d) Applicability of Article XXIV of the GATT

10.51 Having found that the import duty exemption is inconsistent with Article I:1 of the GATT, we now turn to the arguments of the parties with respect to the applicability of Article XXIV to the exemption.

10.52 We note that Canada raises Article XXIV in response to the complaint of the European Communities that Canada has accorded duty-free treatment on a basis inconsistent with Article I of the GATT, because most of the vehicles that receive duty-free treatment originate in the United States or Mexico. Canada notes that it had formed a free-trade area with the United States and Mexico and, therefore, granting duty-free treatment to products of its free-trade partners is exempt from Article I:1 by reason of Article XXIV.

10.53 The European Communities submits that there is currently no free-trade area between Mexico and Canada; that the import duty exemption is neither part of nor required by NAFTA; that, to the extent the import duty exemption is based on an international agreement, that agreement – the Auto Pact – lacks the necessary coverage to bring it within the ambit of Article XXIV; and that the import duty exemption is not a measure necessary for the formation of a free-trade area.

10.54 Canada contests the arguments of the European Communities, indicating that there is no doubt about the existence of a free-trade area between Canada, the United States and Mexico; that Article XXIV status does not require the total elimination of all duties among the members of a free-trade area; that the European Communities is in error in arguing that the measures in dispute are not part of NAFTA because the NAFTA specifically provides for the continuation of duty-free treatment pursuant to the Auto Pact; that in any event nothing in Articles I or XXIV states that preferential duty-free treatment is exempt from Article I only to the extent that it is "part of" or "required by" the principal agreement establishing the free-trade area, and that the objective of a free-trade area is, if nothing else, duty-free treatment among its Members.

10.55 We recall that in our analysis of the impact of the conditions under which the import duty exemption is accorded, we have found that these conditions entail a distinction between countries depending upon whether there are capital relationships of producers in those countries with eligible importers in Canada. Thus, the measure not only grants duty-free treatment in respect of products imported from the United States and Mexico by manufacturer-beneficiaries; it also grants duty-free treatment in respect of products imported from third countries not parties to a customs union or free-trade area with Canada. The notion that the import duty exemption involves the granting of duty-free treatment of imports from the United States and Mexico does not capture this aspect of the measure. In our view, Article XXIV clearly cannot justify a measure which grants WTO-inconsistent duty-free

treatment to products originating in third countries not parties to a customs union or free trade agreement.

10.56 We further note that the import duty exemption does not provide for duty-free importation of all like products originating in the United States or Mexico and that whether such products benefit from the exemption depends upon whether they are imported by certain motor vehicle manufacturers in Canada who are eligible for the exemption. While in view of the particular foreign affiliation of these manufacturers, the exemption will mainly benefit products of the United States and Mexico, products of certain producers in these countries who have no relationship with such manufacturers are unlikely to benefit from the exemption. Thus, in practice the import duty exemption does not apply to some products that would be entitled to duty-free treatment if such treatment were dependant solely on the fact that the products originated in the United States or Mexico. We thus do not believe that the import duty exemption is properly characterized as a measure which provides for duty-free treatment of imports of products of parties to a free-trade area.

10.57 Based on the foregoing considerations, we **find** that Article XXIV of the GATT does not provide a justification for the inconsistency with Article I of the import duty exemption made pursuant to the measures at issue. We see no need to address other issues raised by the parties regarding the application of Article XXIV to the import duty exemption.

2. Claims Under Article III:4 of the GATT and the TRIMs Agreement

10.58 The claims presented under Article III:4 of the GATT pertain to conditions concerning the level of Canadian value added and the maintenance of a certain ratio between the net sales value of vehicles produced in Canada and the net sales value of vehicles sold for consumption in Canada.

10.59 We note that the complainants have also raised claims under the TRIMs Agreement with respect to these aspects of the measures at issue in this dispute. Both complainants claim that the conditions regarding Canadian value added are inconsistent with Article 2.1 of the TRIMs Agreement. The European Communities claims that the conditions regarding the maintenance of a ratio between the net sales value of motor vehicles produced in Canada and the net sales value of motor vehicles sold for consumption in Canada are also inconsistent with that provision.

10.60 We note that, in two recent dispute settlement proceedings, consideration has been given to the issue of the sequence of the examination of claims raised with respect to the same measure under Article III:4 of the GATT and the TRIMs Agreement.

10.61 In *EC – Bananas III* (ECU), claims were raised under Article III:4 of the GATT and Article 2.1 of the TRIMs Agreement regarding aspects of the European Communities' import licensing procedures for bananas. The panel in that dispute decided to treat the claims under Article 2.1 of the TRIMs Agreement together with its consideration of the claims under Article III:4 of the GATT.[829] The panel found that the allocation to certain operators of a percentage of the licences allowing the importation of third-country and non-traditional ACP bananas at in-quota tariff rates was inconsistent with the requirements of Article III:4 of the GATT.[830] In light of that finding, the panel did not consider it necessary to make a specific ruling on whether this aspect of these import licensing procedures was also inconsistent with Article 2.1 of the TRIMs Agreement.[831]

10.62 In *Indonesia – Autos*, claims under Article III:4 of the GATT and Article 2.1 of the TRIMs Agreement were raised with respect to certain local content measures applied by Indonesia regarding automobiles. The panel in that dispute decided that it should first examine the claims under the

[829] Panel Report on *EC – Bananas III (ECU)*, *supra* note 269, para. 7.168.
[830] Ibid., para. 7.182.
[831] Ibid., paras. 7.185-7.187.

TRIMs Agreement on the grounds that "the TRIMs Agreement is more specific than Article III:4 as far as the claims under consideration are concerned".[832] After finding that the measures at issue were inconsistent with Article 2.1 of the TRIMs Agreement,[833] the panel determined that it was not necessary to make a finding on the question of whether these measures were inconsistent with Article III:4 of the GATT.[834]

10.63 In the present dispute, the parties have not explicitly addressed this question of which of the claims raised under Article III:4 of the GATT and Article 2.1 of the TRIMs Agreement should be examined first. Implicit in the order in which they have presented their claims is the view that these claims should be addressed first under Article III:4 of the GATT. While we are aware of the statement made by the Appellate Body in *EC – Bananas III*, and referred to by the panel in *Indonesia – Autos,* that a claim should be examined first under the agreement which is the most specific with respect to that claim, we are not persuaded that the TRIMs Agreement can be properly characterized as being more specific than Article III:4 in respect of the claims raised by the complainants in the present case. Thus, we note that there is disagreement between the parties not only on whether the measures at issue can be considered to be "trade-related investment measures" but also on whether the Canadian value added requirements and ratio requirements are explicitly covered by the Illustrative List annexed to the TRIMs Agreement. It would thus appear that, assuming that the measures at issue are "trade-related investment measures", their consistency with Article III:4 of the GATT may not be able to be determined simply on the basis of the text of the Illustrative List but may require an analysis based on the wording of Article III:4. Consequently, we doubt that examining the claims first under the TRIMs Agreement will enable us to resolve the dispute before us in a more efficient manner than examining these claims under Article III:4.

10.64 In light of the foregoing considerations, we decide that, consistent with the approach of the panel in *EC – Bananas III*, we will examine the claims in question first under Article III:4 of the GATT.

(a) CVA requirements

10.65 The European Communities and Japan claim that Canada acts inconsistently with Article III:4 of te GATT by reason of conditions with respect to the level of CVA requirements as set forth in the MVTO 1998, SROs and certain Letters of Undertaking.

10.66 We first examine the claims raised with regard to the CVA requirements provided for in the MVTO 1998 and the SROs and next examine the claims raised with regard to the CVA requirements contained in the Letters of Undertaking.

(i) CVA requirements provided for in the MVTO 1998 and in the SROs

10.67 The MVTO 1998 provides that one of the conditions which must be met by a manufacturer in order to be eligible for duty-free importation of motor vehicles is that the Canadian value added in the production of vehicles of a class is equal to or greater than the Canadian value added in respect of all vehicles of that class produced in Canada by the manufacturer in the base year.[835] The term "base year" in this context means the 12 month period beginning on August 1, 1963 and ending on July 31, 1964. Because the Canadian value added requirement is expressed in terms of value added in the base year, it is essentially a requirement to achieve a fixed nominal amount of value added.

[832] Panel Report on *Indonesia – Autos, supra* note 270, para. 14.63.
[833] Ibid., para. 14.91.
[834] Ibid., para. 14.93.
[835] *Supra* para. 2.23.

10.68 CVA requirements as a condition for eligibility for duty-free importation of motor vehicles are also provided for in the SROs.[836] In SROs issued before 1984, these CVA requirements are expressed in terms of a combination of a specified percentage of cost of production and a level of Canadian value added achieved during the base period applicable to each individual SRO. SROs issued after 1984 contain CVA requirements expressed in terms of a percentage of cost of sales.[837]

10.69 In this connection, the term "Canadian value added" has been defined as including (i) the costs of parts produced in Canada and of materials of Canadian origin that are incorporated in the motor vehicles; (ii) direct labour costs incurred in Canada; (iii) manufacturing overheads incurred in Canada; (iv) general and administrative expenses incurred in Canada that are attributable to the production of motor vehicles; (v) depreciation in respect of machinery and permanent plant equipment located in Canada that is attributable to the production of motor vehicles, and (vi) a capital cost allowance for land and buildings in Canada that are used in the production of motor vehicles.[838]

10.70 The complainants claim that the CVA requirements in the MVTO 1998 and the SROs are inconsistent with Article III:4 by reason of the treatment accorded to imported parts, materials and non-permanent equipment for use in the production of motor vehicles.

10.71 Article III:4 of the GATT provides in relevant part:

> "The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use."

10.72 Accordingly, in order to substantiate this claim, it must be demonstrated that (i) the CVA requirements involve a law, regulation or requirement affecting the internal sale, offering for sale, purchase, transportation, distribution or use of such imported parts, materials and non-permanent equipment, and (ii) this law, regulation or requirement accords less favourable treatment to imported parts, materials and non-permanent equipment products than that accorded to like domestic products.[839]

10.73 We note that it has not been contested in this dispute that, as stated by previous GATT and WTO panel and appellate body reports, Article III:4 applies not only to mandatory measures but also to conditions that an enterprise accepts in order to receive an advantage,[840] including in cases where the advantage is in the form of a benefit with respect to the conditions of importation of a product.[841] The fact that compliance with the CVA requirements is not mandatory but a condition which must be met in order to obtain an advantage consisting of the right to import certain products duty-free therefore does not preclude application of Article III:4.

10.74 We further note that the parties agree that the MVTO 1998 and the SROs are legal instruments that fall within the scope of the notion of "laws, regulations or requirements" within the meaning of Article III:4. In addition, it has not been contested that the distinction made between domestic products and imported products in the definition of Canadian value added is based solely on

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[836] *Supra* para. 2.32.
[837] *Supra* para. 2.33.
[838] *Supra* para. 2.26.
[839] See, e.g., Panel Report on *US – Gasoline, supra* note 306, para. 6.5, and Panel Report on *Japan – Film*, *supra* note 93, para. 10.369.
[840] See, e.g., Panel Report on *EEC – Parts and Components*, *supra* note 127, para. 5.21.
[841] See, e.g., Appellate Body Report on *EC – Bananas III*, *supra* note 49, para. 211.

origin and that, consequently, there are imported products which must be considered to be like the domestic products the costs of which are included in the definition of Canadian value added.

10.75 However, the parties disagree on whether or not the CVA requirements affect the "internal sale,…or use" of imported products within the meaning of Article III:4 and provide less favourable treatment in this respect to imported products than to like domestic products. The arguments of the parties on these issues can be briefly summarized as follows.

10.76 Central to the claim of the European Communities and Japan is the fact that the definition of Canadian value added for purposes of the MVTO 1998 and the SROs includes the costs of domestic parts, materials and non-permanent equipment, but excludes the costs of like imported products. The complainants argue that, as a result of the exclusion of imported products from the definition of Canadian value added, the CVA requirements affect the "internal sale,..or use" of products because they modify the conditions of competition between domestic and imported products, and that the CVA requirements accord less favourable treatment to imported products by providing an incentive to use domestic products. They reject Canada's argument that, because the CVA requirements do not stipulate that use of domestic products is a necessary condition and can be easily met on the basis of labour costs alone, they play no role in parts sourcing decisions, and therefore do not affect the "internal sale,…or use" of products. According to the complainants, this argument disregards the discrimination against the use of imported products resulting from the exclusion of the costs of imported products from the definition of Canadian value added. In addition, the complainants consider that this argument is inconsistent with the principle articulated in GATT and WTO case law according to which Article III should be interpreted in light of its objective of protecting the effective equality of competitive opportunities and with the principle that the actual trade effects of a measure are in this respect of no legal relevance. The complainants also contest that the evidence adduced by Canada actually shows that motor vehicle manufacturers can easily meet the CVA requirements on the basis of labour costs alone.

10.77 Canada argues that the CVA requirements in the MVTO 1998 and the SROs do not in law require the use of domestic products because they can be met on the basis of other elements of value added, such as labour costs. Canada also submits that, as a factual matter, evidence shows that the required CVA amounts are at such a low level that they can be easily met through labour costs alone. Because the use of domestic products is not in law or in fact required, the CVA requirements do not affect the conditions of competition between imported and domestic products and do not play a role in parts sourcing decisions of the motor vehicle manufacturers. As a consequence, the CVA requirements do not affect the "internal sale,…or use" of imported products, nor do they provide less favourable treatment to imported products. Thus, in the view of Canada, there is an important distinction to be made between, on the one hand, a value added requirement which does not necessitate the use of domestic products and, on the other, a local content requirement which can only be met by the use of domestic products. According to Canada, the notion that the mere inclusion of domestic products in the definition of a value added requirement is *per se* inconsistent with Article III:4 is contradicted by relevant GATT and WTO panel reports and is inconsistent with established principles of burden of proof in WTO dispute settlement because it would free complainants from having to demonstrate that contested measures have any effects on the conditions of competition between imported and domestic products. Canada submits that the Illustrative List in the TRIMs Agreement confirms its view that the use of domestic products must be required in order for a local content or value added requirement to be inconsistent with Article III:4.

10.78 In our examination of the merits of these arguments, we take into account certain well established considerations regarding the interpretation of Article III:4. The "no less favourable treatment obligation" in Article III:4 has been consistently interpreted as a requirement to ensure effective equality of opportunities between imported products and domestic products. In this respect, it has been held that, since a fundamental objective of Article III is the protection of expectations on

the competitive relationship between imported and domestic products, a measure can be found to be inconsistent with Article III:4 because of its potential discriminatory impact on imported products.[842] The requirement of Article III:4 is addressed to "relative competitive opportunities created by the government in the market, not to the actual choices made by enterprises in that market."[843] Both in relation to Article III:2 and Article III:4 it has been established that the actual trade effects of a disputed measure are not a decisive criterion in determining whether the requirements of these provisions are met in a given case.[844] Finally, as stated by the Appellate Body, a determination of whether there has been a violation of Article III:4 does not require a separate consideration of whether a measure affords protection to domestic production.[845]

10.79 As noted above, Canada's principal argument in response to the claim that the CVA requirements provide less favourable treatment within the meaning of Article III:4 is that these requirements do not affect the "internal sale,… or use" of imported products because they do not in law or in fact require the use of domestic products and therefore play no role in the parts sourcing decisions of manufacturers.

10.80 With respect to whether the CVA requirements affect the "internal sale,…or use" of products, we note that, as stated by the Appellate Body, the ordinary meaning of the word "affecting" implies a measure that has "an effect on" and thus indicates a broad scope of application.[846] The word "affecting" in Article III:4 of the GATT has been interpreted to cover not only laws and regulations which directly govern the conditions of sale or purchase but also any laws or regulations which might adversely modify the conditions of competition between domestic and imported products.[847]

10.81 We note that it is undisputed that the definition of Canadian value added includes the costs of domestic, i.e. Canadian, parts, materials and non-permanent equipment but excludes the costs of imported parts, materials and non-permanent equipment. Given that the CVA requirements are among the conditions that must be met to obtain the benefit of duty-free importation of motor vehicles, the exclusion of imported products from the calculation of the Canadian value added means that, whereas the use of domestic products by a manufacturer in Canada can contribute to the fulfilment of a condition necessary to obtain an advantage, the use of imported products cannot contribute to the fulfilment of this condition.

10.82 In light of our interpretation of the word "affecting" in Article III, we consider that a measure which provides that an advantage can be obtained by using domestic products but not by using imported products has an impact on the conditions of competition between domestic and imported products and thus affects the "internal sale,… or use" of imported products, even if the measure allows for other means to obtain the advantage, such as the use of domestic services rather than products. Consequently, the CVA requirements, which confer an advantage upon the use of domestic products and deny that advantage in case of the use of imported products, must be regarded as measures which "affect" the "internal sale,… or use" of imported products, notwithstanding the fact that the CVA requirements do not in law require the use of domestic products.

10.83 We also see no merit in Canada's argument that the CVA requirements do not in practice "affect" the internal sale or use of imported parts and materials because the CVA levels are so low that they can be easily met on the basis of labour costs alone. As discussed above, based on the ordinary meaning of the term "affecting", the CVA requirements must be considered to affect the internal sale

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[842] Panel Report on *US – Section 337, supra* note 280, paras. 5.11 and 5.13.
[843] Panel Report on *US – Malt Beverages, supra* note 427, para. 5.31.
[844] See, e.g., Appellate Body Report on *Japan – Alcoholic Beverages, supra* note 271, p. 16; Panel Report on *EC – Bananas III (ECU)*, *supra* note 269, para. 7.179.
[845] Appellate Body Report on *EC – Bananas III*, *supra* note 49, para. 216.
[846] Ibid., para. 220.
[847] Panel Report on *Italian Agricultural Machinery, supra* note 390, para. 12.

or use of imported products because they have an effect on the competitive relationship between imported and domestic products by conferring an advantage upon the use of domestic products while denying that advantage if imported products are used. Thus, we consider that the fact that it is easier to meet the CVA requirements and thus to obtain the benefit of the import duty exemption if domestic products are used than if imported products are used is sufficient to find that these requirements affect the internal sale or use of products, and we do not believe that we need to examine how important the CVA requirements are under present circumstances as a factor influencing the decisions of motor vehicle manufacturers in Canada regarding the choice between domestic parts, materials and non-permanent equipment, on the one hand, and imported parts, materials and non-permanent equipment, on the other.

10.84 The idea that a measure which distinguishes between imported and domestic products can be considered to affect the internal sale or use of imported products only if such a measure is shown to have an impact under current circumstances on decisions of private firms with respect to the sourcing of products is difficult to reconcile with the concept of the "no less favourable treatment" obligation in Article III:4 as an obligation addressed to governments to ensure effective equality of competitive opportunities between domestic and imported products, and with the principle that a showing of trade effects is not necessary to establish a violation of this obligation. In this respect, it should be emphasized that, contrary to what has been argued by Canada, the present case does not involve "the possibility of a future change in circumstances creating the potential for discrimination" or "discrimination that might exist after a change in circumstances that could occur at some unspecified time in the future."[848] Rather, the present case clearly involves formally different treatment of imported and domestic products albeit that the actual trade effects of this different treatment may be minimal under current circumstances. We therefore disagree with Canada's assertion that the CVA requirements do not entail a "current potential for discrimination under present circumstances."[849] As a consequence, whether or not in practice motor vehicle manufacturers can easily meet the CVA requirements of the MVTO 1998 and the SROs on the basis of labour costs alone does not alter our finding that the CVA requirements affect the internal sale or use of products. We therefore do not consider it necessary to examine the factual issues raised by the parties in support of their different views on this matter.

10.85 In light of the foregoing considerations, we find that the CVA requirements affect the internal sale or use in Canada of imported parts, materials and non-permanent equipment for use in the production of motor vehicles. We further consider that the CVA requirements accord less favourable treatment within the meaning of Article III:4 to imported parts, materials and non-permanent equipment than to like domestic products because, by conferring an advantage upon the use of domestic products but not upon the use of imported products, they adversely affect the equality of competitive opportunities of imported products in relation to like domestic products.

10.86 In the latter regard, we note Canada's argument that GATT and WTO panel reports and the Illustrative List in the TRIMs Agreement support its view that a local content requirement or a value added requirement is inconsistent with Article III:4 only if the use of domestic products is required.

10.87 We find this argument not persuasive. First, the equality of competitive opportunities between domestic and like imported products is affected if a measure accords an advantage to the sale or use of domestic products but not to the sale or use of like imported products, regardless of whether or not that advantage can also be obtained by other means. The less favourable treatment of imported products which is the result of the denial of the advantage in case of sale or use of imported products is not negated by the fact that the advantage may also be obtained by other means than sale or use of domestic products. We therefore find that Canada's argument is unsupported by the plain meaning of the "no less favourable treatment" obligation in Article III:4.

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[848] *Supra* paras. 6.335and 6.336.
[849] *Supra* para. 6.336.

10.88 Second, while it is true that GATT and WTO panel reports which have found local content requirements to be in violation of Article III:4 have dealt with conditions which could only be met through the use of domestic products,[850] nothing in the reasoning in these reports suggests that they support the general proposition that measures relating to local content or value added are inconsistent with Article III:4 only if the use of domestic products is a necessary condition.

10.89 Third, as to Canada's argument that the Illustrative List in the TRIMs Agreement supports its view that a measure linking an advantage to the use of domestic products is inconsistent with Article III:4 only if the measure "requires" the use of domestic products, we consider that by definition the illustrative nature of the List means that it does not constitute an exhaustive statement of measures incompatible with Article III:4.

10.90 In light of the foregoing considerations, we **find** that Canada acts inconsistently with Article III:4 of the GATT by according less favourable treatment to imported parts, materials and non-permanent equipment than to like domestic products with respect to their internal sale or use as a result of the application of CVA requirements as one of the conditions for eligibility for the import duty exemption of motor vehicles under the MVTO 1998 and the SROs.

10.91 In light of the finding in the preceding paragraph, we do not consider it necessary to make a specific ruling on whether the CVA requirements provided for in the MVTO 1998 and the SROs are inconsistent with Article 2.1 of the TRIMs Agreement. We believe that the Panel's reasoning in *EC – Bananas III* as to why it did not make a finding under the TRIMs Agreement after it had found that certain aspects of the EC' licensing procedures were inconsistent with Article III:4 of the GATT also applies to the present case.[851] Thus, on the one hand, a finding in the present case that the CVA requirements are not trade-related investment measures for the purposes of the TRIMs Agreement would not affect our finding in respect of the inconsistency of these requirements with Article III:4 of the GATT since the scope of that provision is not limited to trade-related investment measures. On the other hand, steps taken by Canada to bring these measures into conformity with Article III:4 would also eliminate the alleged inconsistency with obligations under the TRIMs Agreement.

(ii) Commitments with regard to CVA contained in certain Letters of Undertaking

10.92 In addition to the provisions regarding Canadian value added contained in the MVTO 1998 and the SROs, the complainants contest the consistency with Article III:4 of the GATT of conditions regarding Canadian value added contained in certain Letters of Undertaking, dated 13 and 14 January 1965, which were addressed by four Canadian motor vehicle producers[852] to the Canadian Minister of Industry.

10.93 In response to a question from the Panel, Canada indicated that other manufacturers had also submitted letters containing undertakings regarding Canadian value added. Canada subsequently provided copies of eighteen such letters written over the period 1965-1984. We consider that, since the complainants in their arguments specifically mention only the four Letters of Undertaking written on 13 and 14 January 1965, these other letters are not at issue.

10.94 The Letters written in January 1965 set forth certain undertakings by the four companies that were additional to the requirement in the proposed Auto Pact to maintain Canadian value added at a level equal to or greater than the level of Canadian value added in the period 1 August 1963-31 July 1964. Specifically, the Letters state that the manufacturers will: (i) increase in each ensuing model

[850] Panel Report on *Italian Agricultural Machinery, supra* note 390; Panel Report on *Canada – FIRA, supra* note 126; Panel Report on *Indonesia – Autos, supra* note 270.

[851] Panel Report on *EC – Bananas III (ECU)*, *supra* note 269, para. 7.186.

[852] General Motors of Canada, Ltd., Ford Motors Co. of Canada, Ltd., Chrysler Canada, Ltd., and American Motors (Canada) Ltd.

year over the base model year Canadian value added in the production of vehicles and original equipment parts by an amount equal to 60 per cent of the growth in their market for automobiles sold for consumption in Canada and by an amount equal to 50 per cent of the growth in their market for commercial vehicles sold for consumption in Canada, and (ii) achieve a specified increase in the annual Canadian value added by the end of the model year 1968.

10.95 The information available to the Panel indicates that the undertakings made in 1965 by the four motor vehicle producers have not been revoked or terminated. A publication by Industry Canada dated 10 June 1998 containing background information on the Auto Pact states:

> "Assemblers also undertook to achieve CVA in vehicle assembly and/or parts production by a fixed dollar amount set for each company (1964 value) plus 60 percent of the annual growth in the value of their Canadian sales of cars, by 50 percent of growth in truck sales, and by 40 percent of growth in bus sales. These conditions are outlined in a letter of undertaking by each company and, while non-binding, typically have been met."

10.96 Japan and the European Communities submit that the conditions in these Letters with respect to the achievement of Canadian value added are "requirements" within the meaning of Article III which accord less favourable treatment to imported parts and materials than to like domestic products with respect to their internal sale or use. Canada argues that the Letters are not "requirements" covered by Article III:4.

10.97 It follows that we must first address the question of whether Article III:4 is applicable to the Letters of Undertaking as "requirements."[853] There is no dispute between the parties that these Letters are not "laws" or "regulations" for purposes of Article III:4.

10.98 While there is no disagreement between the parties as to the principle that it is possible for action of private parties to constitute a "requirement" within the meaning of Article III:4, they differ on whether or not in the case at hand the involvement of the Government of Canada has been such that the conditions mentioned in the Letters can be properly treated as "requirements."

10.99 The European Communities submits, first, that the Letters are acts which are attributable to Canada because of the role played by Canadian authorities in the submission of the Letters. In the view of the European Communities, the Letters were submitted in response to a request from the Government of Canada and their text was based on a model provided by the Canadian Ministry of Industry; the commitments made in the Letters did not advance the commercial interests of the firms; and statements made by the chief executive officers of the firms in question in a debate on the Auto Pact in the United States Congress indicate that the Letters were negotiated by the firms with the Canadian Ministry of Industry and that the Letters were regarded by Canada as a *sine qua non* for signing the Auto Pact. Second, the European Communities argues that the wording of the Letters indicates that the commitments contained therein were regarded as binding obligations. Third, the European Communities considers that the Letters are enforceable by the Government of Canada, notwithstanding that there is not explicitly a sanction attached to the non-compliance with the conditions stipulated in the Letters. Because of the link between the submission of the Letters and the conclusion of the Auto Pact, the firms in question have assumed that in case of non-compliance with the commitments given in the Letters, the Government of Canada would withdraw the import duty exemption. Finally, the European Communities refers to reporting and auditing procedures provided

[853] We note that the parties have also expressed different views on the more general issue of whether the Letters constitute "measures" which are subject to WTO disciplines. However, in connection with the claims presented under Article III:4 we only need to consider whether these conditions constitute "requirements" within the meaning of that provision.

for in the Letters and to steps taken by the Government of Canada to ascertain compliance with the commitments contained in the Letters.

10.100 Japan argues that the Letters of Undertaking were submitted by Canadian motor vehicle manufacturers, at the request of the Government of Canada, in order to obtain the advantage of the import duty exemption. Japan further submits that the commitments contained in the Letters are binding, that the Letters contain audit and reporting requirements, and that there is no expiry date in the Letters. In the view of Japan, the Letters are enforceable in that the Government of Canada can revoke or amend the MVTO 1998 or the SROs in case of non-compliance with the Letters. It is therefore irrelevant that the Letters have not been implemented in Canadian law and that the MVTO 1998 and the SROs do not provide for sanctions in the event that the commitments contained in the Letters are not complied with.

10.101 Canada denies that the Letters were required of the motor vehicle producers as a condition of Canada's signing the Auto Pact, that the Letters were negotiated between the Government of Canada and the firms in question, and that the firms have assumed that a failure to meet the commitments in the Letters would result in a withdrawal of the import duty exemption. Canada explains that at the conclusion of the Auto Pact the Canadian Government sought assurances from the affected companies that they understood the new system and provided them with a draft letter outlining what the requirements would be under the Auto Pact and what it hoped would be achieved as a result. The commitments contained in the Letters are statements of what was hoped to be achieved under Canada's implementation of the Auto Pact system. Canada submits that the Letters are not legally binding under Canadian law. The Letters are not contracts or statutory instruments. Neither the Government of Canada nor the companies consider the Letters binding in any way. Canada also submits that the Letters are not enforceable because the Government of Canada lacks the legal authority to deny the benefits under the MVTO or SROs for a failure to meet the commitments in the Letters. The Panel Reports on *Canada – FIRA* and on *EEC – Parts and Components* support the view that the Letters are not "requirements" within the meaning of Article III:4 because compliance with the Letters is neither legally enforceable nor a condition necessary to obtain an advantage. Finally, Canada points out that it does not gather information pertaining to status of compliance with the commitments contained in the Letters.

10.102 We note that several GATT and WTO Panel Reports have found that actions by private parties can constitute "requirements" within the meaning of Article III:4.

10.103 The Panel Report in *Canada – FIRA* discusses the status of certain undertakings offered by foreign investors as "requirements" within the meaning of Article III:4:

> "The Panel first examined whether the purchase undertakings are to be considered 'laws, regulations or requirements' within the meaning of Article III:4. As both parties had agreed that the Foreign Investment Review Act and the Foreign Investment Review Regulations –whilst providing for the possibility of written undertakings- did not make their submission obligatory, the question remained whether the undertakings given in individual cases are to be considered "requirements" within the meaning of Article III:4. In this respect the Panel noted that Section 9(c) of the Act refers to "any written undertakings…relating to the proposed or actual investment given by any party thereto conditional upon the allowance of the investment" and that section 21 of the Act states that 'where a person who has given a written undertaking…fails or refuses to comply with the undertaking' a court order may be made "directing that person to comply with the undertaking". The Panel further noted that written purchase undertakings –leaving aside the manner in which they may have been arrived at (voluntary submission, encouragement, negotiation, etc)- once they were accepted, became part of the conditions under which the investment proposals

> were approved, in which case compliance could be legally enforced. The Panel therefore found that the word "requirements" as used in Article III:4 could be considered a proper description of existing undertakings."[854]

10.104 The Panel Report on *EEC – Parts and Components* states the following:

> "The Panel noted that Article III:4 refers to 'all laws, regulations or requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use'. The Panel considered that the comprehensive coverage of 'all laws, regulations or requirements affecting (emphasis added) the internal sale, etc. of imported products suggests that not only requirements which an enterprise is legally bound to carry out, such as those examined by the FIRA Panel (BISD 30S/140, 158), but also those which an enterprise voluntarily accepts in order to obtain an advantage from the government constitute 'requirements' within the meaning of that provision."[855]

10.105 More recently, the question of the interpretation of the phrase "laws, regulations and requirements" in Article III:4 was considered in the Panel Report on *Japan – Film* but the Panel did not actually make findings on this question.[856]

10.106 It is evident from the reasoning of the Panel Reports in *Canada – FIRA* and in *EEC – Parts and Components* that these Reports do not attempt to state general criteria for determining whether a commitment by a private party to a particular course of action constitutes a "requirement" for purposes of Article III:4. While these cases are instructive in that they confirm that both legally enforceable undertakings and undertakings accepted by a firm to obtain an advantage granted by a government can constitute "requirements" within the meaning of Article III:4, we do not believe that they provide support for the proposition that either legal enforceability or the existence of a link between a private action and an advantage conferred by a government is a necessary condition in order for an action by a private party to constitute a "requirement." To qualify a private action as a "requirement" within the meaning of Article III:4 means that in relation to that action a Member is bound by an international obligation, namely to provide no less favourable treatment to imported products than to domestic products.

10.107 A determination of whether private action amounts to a "requirement" under Article III:4 must therefore necessarily rest on a finding that there is a nexus between that action and the action of a government such that the government must be held responsible for that action. We do not believe that such a nexus can exist only if a government makes undertakings of private parties legally enforceable, as in the situation considered by the Panel on *Canada – FIRA*, or if a government conditions the grant of an advantage on undertakings made by private parties, as in the situation considered by the Panel on *EEC – Parts and Components*. We note in this respect that the word "requirement" has been defined to mean "1. The action of requiring something; a request. 2. A thing required or needed, a want, a need. Also the action or an instance of needing or wanting something. 3. Something called for or demanded; a condition which must be complied with."[857] The word "requirements" in its ordinary meaning and in light of its context in Article III:4 clearly implies

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[854] Panel Report on *Canada – FIRA , supra* note 126, para. 5.4.

[855] Panel Report on *EEC – Parts and Components*, *supra* note 127, para. 5.21.

[856] The Panel stated: "A literal reading of the words all laws, regulations and requirements in Article III:4 could suggest that they may have a narrower scope than the word measure in Article XXIII:1(b). However, whether or not these words should be given as broad a construction as the word measure, in view of the broad interpretation assigned to them in the cases cited above, we shall assume for the purposes of our analysis that they should be interpreted as encompassing a similarly broad range of government action and action by private parties that may be assimilated to government action. " Panel Report on *Japan – Film*, *supra* note 93, para. 10.376.

[857] The New Shorter Oxford English Dictionary (Clarendon Press, 1993) Vol. II, 2557.

government action involving a demand, request or the imposition of a condition but in our view this term does not carry a particular connotation with respect to the legal form in which such government action is taken. In this respect, we consider that, in applying the concept of "requirements" in Article III:4 to situations involving actions by private parties, it is necessary to take into account that there is a broad variety of forms of government of action that can be effective in influencing the conduct of private parties.

10.108 In light of these considerations, we proceed to analyze whether in the case at hand there is a connection between the undertakings given by the four motor vehicle manufacturers and actions of the Government of Canada such that these undertakings must be regarded as "requirements" within the meaning of Article III:4. To this end, we consider first the arguments and evidence presented by the parties with respect to the nature of the involvement of the Government of Canada in the submission of the Letters. We next examine the arguments and evidence presented by the parties with respect to the question as to whether or not the commitments contained in the Letters are binding and enforceable, and whether or not the Government of Canada monitors compliance with these commitments.

10.109 With respect to the circumstances surrounding the submission of the Letters of Undertaking, the evidence before us shows that the Letters were submitted by Canadian motor vehicle manufacturers in response to a request made by the Government of Canada in the context of the anticipated conclusion of the Auto Pact between Canada and the United States.

10.110 That the Letters were submitted in response to a request from the Canadian Government is evident from the text of the Letters. First, the opening sentence of one of these Letters reads:

> "This letter is in response to your request for a statement with respect to the proposed agreement between the Governments of Canada and the United States concerning trade and production in automotive products, as you have described it to us."

10.111 Second, there is substantial similarity in structure and content and wording of the Letters. In this regard, it has been confirmed by Canada in the proceedings before the Panel that the Government of Canada provided the motor vehicle manufacturers in question with a draft letter. Third, the text of the Letters shows that the Canadian Government had made requests for specific commitments regarding Canadian value added.[858] In the proceedings before the Panel, Canada has confirmed that the Government of Canada did request undertakings respecting Canadian value added. Finally, testimony before the United States Congress of the chief executives of the companies in question also confirms that the Letters were written in response to a request by the Government of Canada.[859]

10.112 The European Communities and Canada disagree on the question of whether the Letters were the subject of "negotiations" between the companies in question and the Government of Canada.[860]

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[858] One of the Letters states: "You have requested that we should increase Canadian value added in our products by $121 million between 1964 and the end of the model year 1968, as outlined under condition (4). Also you have requested that the amount should be further increased to the extent required under condition (3) stated above."

[859] *Supra* para. 5.62.

[860] In support of its view that the Letters were negotiated with the Government of Canada, the European Communities refers to the following statements made before the US Congress: "The Canadian Government asked us to write them a letter stating our understanding of the provisions of the agreement as it was finally determined and to ask for our endorsement of the principles to the extent that we did understand them and assigned to us an objective whereby, over the 4 years that are involved in this agreement, we would undertake to increase out Canadian production or our Canadian value."

We believe that the evidence before us is not conclusive with respect to whether or not the Letters were the subject of negotiations between the motor vehicle manufacturers and the Government of Canada. However, this lack of clarity as to whether or not the content of the Letters was the subject of negotiations between the manufacturers and the Government of Canada does not detract from the undisputed evidence that the Letters were submitted in response to a request from the Government of Canada.

10.113 Another relevant aspect of the role of the Government of Canada with regard to the submission of the Letters of Undertaking concerns the relationship between the submission of these Letters and the conclusion of the Auto Pact. In this respect, the evidence before us shows that the Letters were requested by the Government of Canada, and submitted by the companies in question, in connection with the anticipated conclusion of the Auto Pact. The Letters were submitted several days before the signature of the Auto Pact. The opening sentence of each of the Letters refers to "the agreement between the Governments of Canada and the United States concerning trade and production in automotive products." It is evident that the companies had been informed of the objectives and provisions of the proposed agreement: the Letters mention the main objectives of the agreement, express the companies' support for these objectives, and note the conditions under which the Auto Pact provides for the duty-free importation of motor vehicles and certain automotive parts into Canada. In three of the Letters, the paragraph containing the undertakings with regard to Canadian value added starts with the following sentence:

> In addition to meeting these stipulated conditions *and in order to contribute to meeting the objectives of the agreement*…" (*emphasis added*)

10.114 Finally, in two Letters the implementation of the Auto Pact is mentioned as a condition for the undertakings:

"The agreement was entered into by Canada only after Canada received assurances from the Canadian vehicle manufacturers which were designed to protect and stimulate Canada's much smaller and less developed manufacturing industry."

"…it ought to be a matter of record that there have been such conversations between the Canadian Government and each of the Canadian automobile manufacturers, and that the results of those conversations –that is the letters of assurance, or statements of intentions, are an important part of this agreement as a whole from the Canadian standpoint."

"…we knew during the course of the negotiations that went on for many, many months that the Minister of Industry of Canada was holding conversations with the automobile manufacturing companies in Canada in respect of their intentions as to production under the differing conditions of the prospective agreement. …It took the Canadian government some time to formulate what was in the letters but I would say [that we became aware of the terms of the letters] in the winter certainly of 1964. …I imagine that during the separate conversations that the companies had with the Minister of Industry, that the discussion was perhaps a common one, and perhaps the Minister of Industry drafted a proposed letter that he discussed with each of them that had identical language in it, and that these letters were taken by the Canadian companies and modified to suit their particular circumstances and returned to the ministry with a lot of common language remaining."

By contrast, Canada has referred to the following statement of a chief executive of one of the companies in question:

"I can speak for General Motors and I can say that *there have been no secret agreements, there have been no negotiations.* The Canadian Government asked us to write them a letter stating our understanding of the provisions of the agreement as it was finally determined and to ask for our endorsement of the principles to the extent that we did understand them and assigned to us an objective whereby, over the 4 years that are involved in this agreement, we would undertake to increase our Canadian production or our Canadian value." (emphasis added by Canada).

> "The following comments assume that the proposed agreement for duty-free treatment has the full support of the respective Governments, and that the program may be expected to continue for a considerable period of time."
>
> and
>
> "Our undertakings are, of course, conditional upon the execution of that agreement, upon the adoption of an order in council, and regulations substantially in the form of the drafts that you have already delivered to us, and upon an acceptable response in respect of the enclosed supplementary letter."

10.115 It follows that the anticipation of the conclusion of the Auto Pact was a key factor in the decision of the companies to respond positively to the request of the Government of Canada that the companies make commitments with regard to the growth in the level of Canadian value added in their operations. The companies made their undertakings conditional upon the conclusion and implementation of the Auto Pact and viewed these undertakings as contributing to the objectives of the Auto Pact. Given that, in submitting the undertakings before the conclusion of the Auto Pact, the companies in question were motivated by expectations concerning the benefits they would derive from this agreement through the import duty exemption, it is possible to view this aspect of the relationship between the action of the private parties and the role of the Government of Canada in terms of an undertaking offered by private parties as a condition for obtaining a benefit from a government. Though the information before us does not establish conclusively that, as alleged by the European Communities, the undertakings contained in the Letters were regarded by the Government of Canada as a condition *sine qua non* for the conclusion of the Auto Pact, there is sufficient evidence to conclude that the actions of the companies manifestly depended upon (anticipated) action by the Government of Canada in the form of the conclusion of an international agreement.

10.116 We now turn to the issues raised by the parties with respect to whether or not the Letters of Undertaking are binding and enforceable and whether or not the Government of Canada monitors compliance with the Letters.

10.117 The parties differ as to whether or not the commitments contained in the Letters of Undertaking are "binding". In this respect, we note first that the Letters provide that the companies "undertake" to achieve very specific, verifiable objectives with respect to the level of Canadian value added in their operations. Several Letters discuss in detail the companies' understanding of, and their concerns regarding, particular technical aspects of the implementation of the value added criteria, notably the methodology for the computation of Canadian value added, and draw attention to factors that may limit the ability of the companies to meet the stated objectives. Second, various statements in the Letters indicate that the word "undertake" was used in the sense of a formal commitment. For example, one of the Letters states:

> "Subject to the imponderables mentioned above, it is our intention and that of our affiliates to make every effort feasible to meet the objectives of the agreement to be made between the Governments of Canada and the United States, and to achieve the indicated goal as rapidly as possible.
>
> (…)
>
> In conclusion, therefore, I am prepared to say at this time that, first (name of the company) has plans underway to increase Canadian value added by about $ 30 million in each of the first 2 years of the plan; and, second, we are continuing our studies of ways to accomplish the remainder of the program and will undertake to meet the full objective of $121 milion by the end of the model year 1968.

> It is anticipated that these studies will take between 3 and 4 months to finish, and I will be prepared to discuss the results with you when they are completed. From time to time, as requested, we will be glad to discuss our current operations and our plans for future development with the Minister of Industry, and to receive and consider his suggestions."

In three of the four Letters of Undertaking the final paragraphs read as follows:

> "(name of the company) also agrees to report to the Minster of Industry, every 3 months beginning April 1, 1965, *such information as the Minister of Industry requires pertaining to progress achieved by our company, as well as plans to fulfill our obligations under this letter*. In addition, (name of the company) understands that the Government will conduct an audit each year with respect to the matters described in this letter. (*emphasis added*)
>
> We understand that before the end of model year 1968 we will need to discuss together the prospects for the Canadian automotive industry and our company's program."

In one of these Letters, these paragraphs are preceded by the following statement:

> "The undertakings given in this letter are to be adjusted to the extent necessary for conditions not under the control of the (name of the company) or of any affiliated (name of the company) company, such as acts of God, fire, earthquake, strikes at any plant owned by (name of the company) or by any of our suppliers, and war."

10.118 In view of the specificity of the undertakings; the precision as regards the modalities of their implementation; the reference to the undertakings as "obligations"; the commitment to provide information "required" by the Ministry of Industry pertaining to "progress achieved…as well as plans to fulfill" these obligations; and the explicit reference to the need to adjust the undertakings in case of *force majeure*, it is reasonable to conclude that the companies, by submitting these Letters, accepted responsibility *vis-à-vis* the Government of Canada with respect to the achievement of the conditions contained in the Letters. We therefore consider that the commitments contained in the Letters were intended to be binding as obligations of the companies in question notwithstanding that, as argued by Canada, the Letters do not have a specific legal status under Canadian law.

10.119 Japan and the European Communities argue that the Letters are enforceable because there is nothing to prevent Canada from amending or repealing the MVTO 1998 or the SROs to withdraw the import duty exemption as a response to non-compliance with the commitments contained in the Letters of Undertaking. The European Communities also submits that, because of the link between the submission of the Letters of Undertaking and the conclusion of the Auto Pact, the beneficiaries have assumed that, were they to disregard the commitments contained in the Letters, the Canadian Government would withdraw the import duty exemption. Canada points out that the Letters are not enforceable because there is no legal basis upon which Canadian authorities can deny the right of duty free importation in response to a failure to meet a commitment in the Letters. In Canada's view, whether or not the letters could be made enforceable through amendments to the MVTO and the SRO is irrelevant as the WTO Agreements only deal with measures actually applied by Members. Canada further rejects as unsupported by evidence the argument of the European Communities that there has been a tacit understanding between the companies and the Government that the import duty exemption would be revoked in case of non-compliance with the commitments provided for in the Letters.

10.120 The information before us shows that Canada has not taken steps to create specific legal authority under its domestic law that would enable the Government of Canada to take action in

response to a failure by the companies to meet the commitments given in the Letters of Undertaking. Specifically, there is nothing in the legal instruments adopted by Canada in connection with its domestic implementation of the Auto Pact to indicate that the import duty exemption can be withdrawn in case of a failure to meet these commitments. In this respect, we consider that the arguments of the European Communities and Japan regarding steps that Canada could take to make the Undertakings enforceable by amending relevant regulations are somewhat speculative.

10.121 However, we do not believe that the issue of whether or not the Letters of Undertaking are enforceable through the use of sanctions in case of non-compliance through the withdrawal of the import duty exemption is of decisive importance. Rather, the procedures for the provision of information to the Minister of Industry, the commitment "to discuss together the prospects for the Canadian industry and our company's program" and the conduct of a yearly audit demonstrate that the Government of Canada would play an active role in ascertaining implementation of the commitments. The choice of an informal mechanism with regard to the implementation of the Letters rather than a formal enforcement mechanism involving the possibility of sanctions in case of non-compliance does not mean that there was no active involvement of the Government of Canada with regard to compliance with these commitments. In the latter regard, we note that in the proceedings before the Panel Canada has confirmed that at least until model year 1996 it gathered information on an annual basis with respect to the achievement of the Canadian value added levels stipulated in the Letters of Undertaking.

10.122 In sum, the evidence before the Panel shows that: (i) in making the undertakings contained in the Letters, the companies acted at the request of the Government of Canada; (ii) the anticipated conclusion of the Auto Pact was a key factor in the decision of the companies to submit these undertakings; (iii) the companies accepted responsibility *vis-à-vis* the Government of Canada with respect to the implementation of the undertakings contained in the Letters, which they described as "obligations" and in respect of which they undertook to provide information to the Government of Canada and indicated their understanding that the Government of Canada would conduct yearly audits; and (iv) at least until model year 1996, the Government of Canada gathered information on an annual basis concerning the implementation of the conditions provided for in the Letters.

10.123 In light of this evidence, we consider that the involvement of the Government of Canada in the action taken by the four companies was such that the commitments contained in the Letters of Undertaking can be regarded as "requirements" within the meaning of Article III:4. Where a government requests a firm to make commitments as specific as those contained in the Letters of Undertaking and to record them in writing in letters addressed to the government, and these commitments are described by the firms as "obligations" in respect of the fulfilment of which they undertake to provide information to, and to consult with, the government, it is evident that there is action of private parties directed by, or at the very least expected by, the government. That the Letters do not have a specific legal status under Canadian law in the sense that they are not contracts or statutory instruments does not negate the fact that government action was effective in inducing companies to make commitments *vis-à-vis* the Canadian Government with respect to the conduct of their business operations in Canada in a manner that was regarded as binding by the companies. The ordinary meaning of the term "requirement" does not support the proposition that, where a government induces a firm to make a clearly specified, verifiable commitment *vis-à-vis* that government to act in a particular manner, such a commitment only qualifies as a "requirement" if it is embodied in an instrument with a defined legal status under the law of the country in question.

10.124 We note Canada's argument that, regardless of the past status of the Letters, they are not "requirements" today. Canada submits that, even before the complaints had brought this case, Canada had publicly stated that the Letters were not binding, and that it has stopped making any effort to verify whether companies achieved the amounts contained in the Letters.

10.125 We note that, except for the conditions relating to the achievement of a specific level of Canadian value added in 1968, the commitments made in the Letters of Undertaking were not limited in time. The commitments to increase Canadian value added by a specified percentage of market growth applied to "each model year over the preceding model year." The Letters contain no expiry date. Evidence before the Panel indicates that the undertakings have not been terminated.

10.126 The information before us does not indicate that the companies in question no longer consider themselves to be bound *vis-à-vis* the Government of Canada in respect of the commitments contained in the Letters. On the contrary, statements made in October and November 1997 by chief executive officers of the Ford Motor Company of Canada and of Chrysler Canada Ltd. suggest that these companies continued to regard these commitments as binding on them ("each member must meet a 60 per cent Canadian value added commitment" and "we have exceeded those requirements by a country mile").[861] We also note that in a publication dated 10 June 1998 which provides background information on the Auto Pact, Industry Canada explicitly mentions commitments made by manufacturers with respect to Canadian value added:

> "Assemblers also undertook to achieve CVA in vehicle assembly and/or parts production by a fixed dollar amount set for each company (1964 value) plus 60 percent of the annual growth in the value of their Canadian sales of cars, by 50 percent of growth in truck sales, and by 40 percent of growth in bus sales. These conditions are outlined in a letter of undertaking by each company and, while non-binding, typically have been met."

10.127 This clearly suggests that as recently as June 1998 the Government of Canada viewed such undertakings as part of its policy respecting the implementation of the Auto Pact and that at least at that time the Government of Canada possessed the information necessary to ascertain the status of compliance with the conditions contained in the Letters of Undertaking. Finally, while Canada has indicated that it has ceased verifying compliance with the undertakings, we recall that nothing in the information before us suggests that the Government of Canada has taken steps to terminate the Undertakings.

10.128 Under these circumstances, we believe that the information provided by Canada during the Panel proceedings that it has recently ceased gathering information on the CVA amounts contained in the Letters of Undertaking is not a sufficient basis for us to conclude that the Letters should no longer be treated as "requirements" within the meaning of Article III:4 as of the date on which the terms of reference of this Panel were established.

10.129 We consider that, as requirements within the meaning of Article III:4, the commitments contained in the Letters of Undertaking with respect to Canadian value added affect the internal sale or use of imported products and afford less favourable treatment to imported products than to like domestic products because these commitments are easier to meet if domestic products are used than if imported products are used. In this connection, we recall that in our analysis of the claims raised with respect to the CVA requirements provided for in the MVTO 1998 and the SROs we have rejected Canada's argument that a measure relating to the use of domestic products is inconsistent with Article III:4 only if that measure in law or in fact requires the use domestic products. Similarly, we recall our view expressed in that connection that the actual trade effects of the CVA requirements are of no legal consequence in the context of Article III:4. We therefore do not believe it is necessary to examine the arguments of the parties on the question of whether or not the commitments contained in the Letters of Undertaking in practice can easily be met by the firms in question.

10.130 In light of the foregoing considerations, we **find** that Canada acts inconsistently with Article III:4 of the GATT by according less favourable treatment to imported products than to like

[861] *Supra* paras. 5.49 and 5.50.

domestic products with respect to their internal sale or use as a result of the conditions contained in Letters of Undertaking with respect to Canadian value added.

10.131 For reasons explained in paragraph 10.91, we do not consider it necessary to make a finding on whether these conditions are inconsistent with Article 2.1 of the TRIMs Agreement.

(b) Ratio requirements

10.132 We now proceed to examine whether Canada acts inconsistently with Article III:4 of the GATT by reason of the provisions of the MVTO 1998 and of the company-specific SROs which stipulate that, as a condition for eligibility for duty-free importation of motor vehicles, manufacturers must maintain a certain ratio between the net sales value of vehicles produced in Canada and the net sales value of all vehicles of that class sold for consumption in Canada ("ratio requirements").

10.133 We note that, while the European Communities explicitly requests us to find that these ratio requirements are inconsistent with Article III:4 of the GATT, Japan's initial presentation of its arguments does not include a request for such a finding.[862] In this argumentation, Japan presents several arguments on this issue and reserves its right to elaborate on the claims presented on this matter in Japan's request for the establishment of a panel.[863] At the first meeting with the parties, we rejected a preliminary objection raised by Canada with respect to Japan's reservation of its right to elaborate on these claims.[864] At that meeting, we also posed several questions to Japan on the arguments presented by Japan in its initial argumentation regarding the inconsistency of the ratio requirements with Article III:4.[865] Though Japan responded that it would address the issues raised by the Panel in its rebuttal, Japan's subsequent argumentation is completely silent on the matter of the alleged inconsistency of the ratio requirements with Article III:4.

10.134 In light of the fact that Japan's request for findings as set out in its initial argumentation does not include the issue of the inconsistency of the ratio requirements with Article III:4, that subsequently Japan has offered no further argumentation on this matter during the course of the panel proceedings, and that it has not responded to our questions on this issue, we conclude that Japan has not presented a claim that the ratio requirements are inconsistent with Article III:4 of the GATT. Alternatively, assuming *arguendo* that the arguments presented by Japan in its initial argumentation can properly be described as amounting to a claim, we find that Japan has failed to substantiate this claim. We therefore limit ourselves to a consideration of the claim raised by the European Communities.

10.135 The European Communities claims that the ratio requirements provided for in the MVTO 1998 and the SROs are inconsistent with Article III:4 because they provide less favourable treatment to imported motor vehicles than to like domestic motor vehicles with respect to their internal sale.

10.136 As noted above, the parties agree that the MVTO and the SROs are covered by the term "laws, regulations or requirements" in Article III:4. It is also undisputed that the ratio requirements apply to imported and domestic motor vehicles that are like products within the meaning of Article III:4.

10.137 In the view of the European Communities, the ratio requirements "affect" the internal sale of motor vehicles because they provide an incentive to limit the sales of imported motor vehicles, thereby modifying the conditions of competition between those vehicles and domestic motor vehicles the internal sale of which is not subject to any similar restriction.

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[862] *Supra* para. 3.1.
[863] *Supra* para. 4.2.
[864] *Supra* Section VI.C.
[865] Question 14 from the Panel.

10.138 In support of its view that the ratio requirements afford less favourable treatment to imported motor vehicles than to like domestic vehicles with respect to their internal sale, the European Communities submits that the ratio requirements place a maximum limit on the total sales value of all motor vehicles sold for consumption in Canada which in practice operates so as to restrict exclusively the sales of imported motor vehicles. While an increase in the sales value of motor vehicles produced in Canada by the beneficiary will automatically give rise to an identical increase in the value of permitted domestic sales, an increase in imports of motor vehicles does not entail an increase in the value of permitted domestic sales. As a result, the beneficiaries cannot, without losing the entitlement to the import duty exemption, sell in Canada any imported motor vehicles in excess of a certain amount which is directly related to the sales value of their domestic production of motor vehicles. Because no similar limit is placed on the internal sale of domestic motor vehicles, the ratio requirements afford less favourable treatment to imported motor vehicles with respect to their internal sale in Canada.

10.139 In response to questions from the Panel, the European Communities has stated that it claims that the ratio requirements limit the internal sale in Canada of motor vehicles *imported under the tariff exemption*[866] and that the ratio requirements are internal measures in the sense of Article III and not border measures because "they limit the right to sell in Canada vehicles already imported in Canada under the tariff exemption."[867] We therefore proceed on the understanding that the claim of the European Communities concerns the implications of the ratio requirements with respect to the internal sale of those motor vehicles which have been imported duty-free.

10.140 Canada submits that the ratio requirements do not fall within the scope of Article III:4 because they do not affect the internal sale of any motor vehicles in Canada, imported or domestic. In the view of Canada, the argument of the European Communities that the ratio requirements entail a restriction on the internal sale of imported motor vehicles rests on a misunderstanding of the operation of the ratio requirements. In this regard, Canada points out that, since manufacturers can always ensure that they stay within their ratios by paying duty on imported motor vehicles, the ratios cannot limit the internal sale of imported vehicles. The ratio requirements have an effect on the importation of motor vehicles in that they limit the total value of motor vehicles that a manufacturer may import duty-free. However, the ratio requirements do not affect the conditions of sale of motor vehicles after their importation. In this connection, Canada argues that the European Communities fails to make a distinction between measures affecting the importation of products and measures affecting imported products after their importation.

10.141 In light of the claim of the European Communities and the counterarguments of Canada, we must determine whether and how the ratio requirements affect the conditions of the internal sale in Canada of motor vehicles imported under the import duty exemption, i.e. motor vehicles imported duty-free by beneficiaries of the MVTO 1998 and of the company-specific SROs, as compared with the conditions of sale of like vehicles produced in Canada by the beneficiaries. Specifically, we must establish whether or not the ratio requirements entail a restriction on "the right to sell in Canada vehicles already imported under the tariff exemption", as alleged by the European Communities and as contested by Canada.

10.142 The ratio requirements mean that a certain ratio must be maintained between the net sales value of vehicles produced by a manufacturer and the net sales value of all vehicles of that class sold for consumption in Canada by the manufacturer. The net sales value of all vehicles sold for consumption in Canada includes the value of domestic vehicles and the value of vehicles which have been imported duty free but does not include the value of motor vehicles on the importation of which import duties have been paid. As a consequence of the ratio requirements, the net sales value of all

[866] *Supra* para. 7.164.
[867] *Supra* para. 7.165.

vehicles of a class sold for consumption in Canada by a manufacturer cannot exceed the sales value of vehicles of that class produced in Canada by the same manufacturer by a certain amount.

10.143 Since the ratio requirements apply to "the net sales value of all vehicles of that class sold for consumption in Canada" there is no formal distinction between vehicles on the basis of their origin. Thus, on its face, the limitation on the sales value of vehicles sold for consumption in Canada operates without distinction between imported and domestic vehicles. The question before us is whether in practice this limitation has the effect of restricting the internal sale of motor vehicles which have been imported duty-free, without imposing a similar restriction on the internal sale of like domestically produced motor vehicles.

10.144 We note that, if a vehicle imported under the import duty exemption is sold for consumption in Canada, the sales value of that vehicle will lead to an increase in the net sales value of vehicles sold for consumption in Canada but will not affect the net sales value of vehicles produced in Canada. The ratio between these values will therefore decline. On the other hand, in the case of a domestically produced vehicle, production and sale of such a vehicle lead to identical increases in the net sales value of vehicles produced in Canada and the net sales value of vehicles sold for consumption in Canada. Hence, the ratio between these values will not be affected.

10.145 It follows that, as a result of the ratio requirements, the net sales value of vehicles sold for consumption in Canada and imported duty-free is subject to a limitation. The maximum possible sales value of vehicles sold for consumption in Canada and imported duty-free is realized if a manufacturer exports its entire production of domestically produced vehicles, in which case the net sales value of vehicles sold for consumption in Canada and accounted for by vehicles which have been imported duty free is equal to the net sales value of the vehicles produced in Canada by the manufacturer.

10.146 However, the notion of a limitation of the net sales value of motor vehicles sold for consumption in Canada and imported duty free is not by itself sufficient to find in favour of the claim of the European Communities. Rather, to substantiate this claim, it must be shown that this limitation arises from a restriction on the internal sale of such imported motor vehicles. In other words, it must be demonstrated that, because of the ratio requirements, motor vehicles which have been imported duty-free are subject to a restriction as regards the internal sale of such vehicles in Canada.

10.147 In this respect, we note that, where the net sales value of duty-free imported motor vehicles sold for consumption in Canada reaches the limit allowed under the ratio requirements, the beneficiary is no longer entitled to duty-free treatment of imports. Further sales in Canada of imported motor vehicles will therefore be sales of vehicles on which import duties will have been paid. At the same time, vehicles already imported duty-free will not be affected. We note that the European Communities has not contested Canada's explanation of this aspect of the operation of the ratio requirements.[868]

10.148 We therefore consider that the effect of the ratio requirements in limiting the share of the net sales value of all vehicles sold for consumption in Canada which is accounted for by vehicles that have been imported duty-free is a direct consequence of the fact that, beyond a certain value of imports, further imports of motor vehicles become subject to payment of import duty. This limitation on the net sales value of duty-free imported motor vehicles is not effected through a restriction on the internal sale of such motor vehicles subsequent to their importation. While the European Communities claims that the ratio requirements "limit the right to sell in Canada vehicles already imported under the Tariff Exemption", it has not shown how the ratio requirements could create a situation in which a motor vehicle manufacturer who has been allowed to import a vehicle duty-free is subsequently confronted with a limitation of his "right to sell" such a vehicle in Canada. What is

[868] *Supra* para. 6.369.

referred to by the European Communities as a "limitation" on the internal sale of such vehicles in fact is a limitation on the value of vehicles that can be imported duty-free.

10.149 For purposes of Article III, the manner in which the ratio requirements affect the treatment accorded to motor vehicles with respect to the conditions of their importation is irrelevant. That there is a limitation on the net sales value of vehicles which can be imported duty-free therefore cannot constitute a grounds for finding a violation of Article III:4. The fact that internal sales of domestic vehicles are not subject to a "similar" limitation is also without relevance. By definition, a violation of Article III cannot be established on the basis of a comparison between the conditions of internal sale of domestic products with the conditions of importation of imported products.

10.150 In light of the foregoing considerations, we **find** that the European Communities has failed to demonstrate that, by applying ratio requirements under the MVTO 1998 and the SROs as one of the conditions determining the eligibility of duty-free importation of motor vehicles, Canada is according to motor vehicles imported duty free less favourable treatment with respect to their internal sale than to like domestic motor vehicles. The claim of the European Communities regarding the inconsistency of the ratio requirements with Article III:4 must therefore be rejected. Because of this finding with respect to the claim of the European Communities regarding the consistency of the ratio requirements with Article III:4 of the GATT, we must also reject the claim of the European Communities that these requirements are inconsistent with Article 2.1 of the TRIMs Agreement. We note in this regard that the European Communities claims that these ratio requirements are trade-related investment measures which are inconsistent with Article 2.1 of the TRIMs Agreement because they violate Article III:4 of the GATT.

C. CLAIMS UNDER THE SCM AGREEMENT

10.151 The European Communities and Japan claim that the import duty exemption provided by the Canadian Government to certain motor vehicle manufacturers under the MVTO 1998 and the SROs constitutes a subsidy within the meaning of Article 1 of the Agreement on Subsidies and Countervailing Measures (SCM Agreement). They further claim that, because this import duty exemption is accorded upon fulfilment of certain ratio requirements and CVA requirements, it is contingent upon export performance within the meaning of Article 3.1(a) of the SCM Agreement and contingent upon the use of domestic over imported goods within the meaning of Article 3.1(b) of the SCM Agreement and is thus prohibited under those provisions.

1. Ratio requirements

10.152 In the view of the European Communities and Japan, the import duty exemption constitutes "revenue . . . foregone" which is "otherwise due", and hence a financial contribution exists within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement. This import duty exemption confers a benefit on the manufacturers in question in that the manufacturers are allowed to retain funds that they would otherwise have been obliged to pay as import duties. The complainants further consider that the import duty exemption is contingent, in law and in fact, upon export performance, because eligibility for it is based on the fulfilment of production-to-sales ratios which require a manufacturer beneficiary to export.

10.153 Canada contends that the import duty exemption does not represent a subsidy within the meaning of Article 1 of the Agreement or an export subsidy within the meaning of Article 3.1(a) of the Agreement. The overriding purpose of the SCM Agreement is to discipline subsidies that distort trade, and it would be contrary to the objective of trade liberalisation to characterise a measure that facilitates imports as an improper trade distortion. Further, the import duty exemption is unlike any of the practices identified in the Illustrative List of Export Subsidies contained in Annex I to the SCM Agreement (Illustrative List).

10.154 Canada submits that the ratio requirements do not make the import duty exemption contingent in law upon export performance, because nothing in either the MVTO 1998 or any of the SROs indicates that the import duty exemption is available only on the condition that the subject manufacturers achieve any particular export performance. Canada also argues that the ratio requirements do not make the import duty exemption contingent in fact upon export performance, because the import duty exemption is not "tied to" exportation or export earnings within the meaning of footnote 4 of the SCM Agreement. In this context, Canada explains how, in its view, the import duty exemption is entirely independent of export volume.

(a) Order in which issues will be addressed

10.155 Article 3.1(a) of the SCM Agreement provides that subsidies "within the meaning of Article 1" which are contingent upon export performance are prohibited. Consequently, in order for a measure to be an export subsidy within the meaning of Article 3.1(a) of the SCM Agreement, it must be a subsidy within the meaning of Article 1 of that Agreement. Accordingly, we will first examine whether the import duty exemption identified by the European Communities and Japan is a subsidy within the meaning of Article 1 of the SCM Agreement, and then consider whether that subsidy is contingent upon export performance within the meaning of Article 3.1(a) of the Agreement.

(b) Whether the import duty exemption is a subsidy within the meaning of Article 1

10.156 Article 1.1 of the SCM Agreement provides, in relevant 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:
>
> . . .
>
> (ii) government revenue that is otherwise due is foregone or not collected (e. g. fiscal incentives such as tax credits) (*footnote omitted*);
>
> . . .
>
> and
>
> (b) a benefit is thereby conferred."

It is clear from Article 1.1 that two criteria must be met in order for a subsidy to exist within the meaning of that Article. First, there must be a financial contribution by a government. Second, a benefit must thereby be conferred. We will consider each criterion in turn.

(i) Financial contribution by a government

10.157 The European Communities argues that, because customs duties are imposed, collected and appropriated by the Canadian Government, they constitute "government revenue". Given that the importation of motor vehicles into Canada is, in principle, subject to customs duties, an exemption from such duties means that the Canadian Government is "foregoing" revenue that would otherwise be "due". A financial contribution therefore exists within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement. Japan argues that "government revenue" is raised through internal taxes and other charges, including customs duties. Since government revenue is foregone when a customs duty is waived, the import duty exemption amounts to a financial contribution

10.158 Canada argues that an import duty exemption for goods does not necessarily constitute revenue foregone under Article 1.1(a)(1)(ii). If it did, then a subsidy would exist whenever a Member unilaterally applied a rate of duty lower than its bound rate. To define such a programme as "subsidies" would be contrary to the object and purpose of the WTO Agreement, which explicitly identifies tariff reductions as contributing to the objectives of the Agreement.

10.159 It will be recalled that, under Article 1 of the SCM Agreement, there is a financial contribution and hence a possible subsidy where "government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)". The term "revenue" has been defined, *inter alia*, as "[t]he annual income of a government or State, from all sources, out of which public expenses are met".[869] The word "otherwise" has been defined, *inter alia*, to mean "in other circumstances".[870] The adjective "due" has been defined, *inter alia*, to mean "[t]hat is owing or payable as an obligation or debt".[871]

10.160 Examining the Canadian import duty exemption in light of the ordinary meaning of the words above, we consider that customs duties represent "government revenue". In respect of whether the customs duties at issue in this case represent government revenue otherwise due, we recall that the import duty exemption is accorded to particular importers and not to others, and further consider that, in the absence of the import duty exemption, imports by manufacturer beneficiaries which are shielded from duties by that exemption would be subject to duties. In respect of whether those customs duties represent the foregoing of government revenue otherwise due, we recall that Canada applies an MFN duty on motor vehicles originating in non-NAFTA countries at the rate of 6.1 per cent. We further recall that certain duties continue to apply with respect to imports originating in NAFTA countries. While light trucks from Mexico and all motor vehicles from the United States enter Canada duty-free under the NAFTA, motor vehicles from Mexico other than light trucks are subject to 1.3 or 2.4 per cent duties.[872] Finally, we recall that, in order for motor vehicles to qualify for the preferential duty treatment applicable with respect to imports originating in NAFTA countries, they must satisfy certain rules of origin and reporting requirements which are not applicable in order to receive the import duty exemption at issue in this dispute. Thus, even motor vehicles imported from Mexico and the United States in a tariff category subject to zero duty would not necessarily be eligible for duty-free treatment absent the import duty exemption. Accordingly, absent the import duty exemption accorded to certain companies under the MVTO 1998 and the SROs, those companies would be liable to pay duties of up to 6.1 per cent on the motor vehicles in question. We find, therefore, that the import duty exemption constitutes the "foregoing" of government revenue which is "otherwise due".

10.161 We now address Canada's argument that, if an import duty exemption were necessarily treated as revenue foregone, a subsidy would exist every time a WTO Member applied a rate lower

[869] The New Shorter Oxford English Dictionary (Clarendon Press, 1993), Vol. 2, 2579.
[870] Ibid., 2032.
[871] The New Shorter Oxford English Dictionary (Clarendon Press, 1993), Vol. 1, 761.
[872] See *supra* footnote 492.

than its bound rate, and this would be contrary to the object and purpose of the WTO Agreement, which explicitly identifies tariff reductions as contributing to the objectives of the Agreement. In our view, a Member's bound rate merely represents the *maximum* duty a Member may impose in respect of imports from WTO Members; the mere fact that a WTO Member applies a level of duties lower than the bound rate would not mean that it is foregoing revenue that is "otherwise due". More importantly, while the preamble to the WTO Agreement recognises that the "substantial reduction of tariffs" contributes to fulfilling certain objectives of the WTO Agreement, it does not follow that tariff reductions will always be WTO-consistent. For example, the reduction of tariffs in a discriminatory manner could give rise to a violation of Article I of GATT 1994. Similarly, we consider that the foregoing of government revenue otherwise due, in the form of customs duties, and in a manner which is specific within the meaning of Article 2, may give rise to a subsidy which is subject to the disciplines of the SCM Agreement.[873]

10.162 Canada also argues that, if an import duty exemption were necessarily treated as revenue foregone, a subsidy would exist every time generalised preferences or duty drawbacks were granted by a WTO Member. In our view, however, these examples advanced by Canada involve factual and legal considerations distinct from those in the case at hand. For instance, a generalised system of preferences accords favourable treatment to certain products from certain countries, and *all* such products from those countries receive favourable treatment. That situation is distinct from the case at hand, where *some* importers of a product – the manufacturer beneficiaries – are accorded favourable treatment as compared with other importers of *the same product from the same country*. As for duty drawbacks, item (i) of the Illustrative List indicates the circumstances in which the remission or drawback of import charges on imported inputs consumed in the production of the exported product constitutes an export subsidy. When read in conjunction with footnote 1 to the SCM Agreement, item (i) would appear to indicate – although this is not an issue we need decide in this dispute – that non-excessive duty drawback is not to be considered a subsidy within the meaning of Article 1 of the Agreement.

10.163 Having concluded that the Canadian import duty exemption constitutes the "foregoing" of government revenue which is "otherwise due" within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement, we find that it gives rise to a financial contribution within the meaning of Article 1.1(a)(1) of the Agreement.

(ii) Benefit

10.164 Having found that a financial contribution exists on the part of the Canadian Government through the import duty exemption provided to certain motor vehicle manufacturers, we must now consider the second criterion set out in the definition of a subsidy in Article 1, that is, benefit.

10.165 A benefit has been defined, *inter alia*, as "(An) advantage".[874] Further, the Appellate Body has stated in *Canada – Aircraft*:

> "The dictionary meaning of 'benefit' is 'advantage', 'good', 'gift', 'profit', or, more generally, 'a favourable or helpful factor or circumstance'. (*footnote omitted*) . . . These definitions also confirm that the Panel correctly stated that 'the ordinary

[873] Our conclusions in this respect are consistent with those reached by the panel in *Indonesia – Autos*. In that dispute, the panel found that exemptions from import duties involved the foregoing of government revenue otherwise due. Panel Report on *Indonesia – Autos, supra* note 270, para. 14.155.

[874] The New Shorter Oxford English Dictionary (Clarendon Press, 1993), Vol. 1, 214.

> meaning of 'benefit' clearly encompasses some form of advantage.' (*footnote omitted*)"[875]

In our view, the fact that the manufacturer beneficiaries need not pay customs duties that would otherwise be due – and that would be paid by non-qualifying manufacturers – constitutes just such an advantage. We find that the financial contribution made through the import duty exemption, therefore, confers a benefit within the meaning of Article 1.1(a)(2) of the SCM Agreement.

(iii) Illustrative List as context

10.166 Canada posits that footnotes 1 and 5, in conjunction with items (g), (h) and (i) of the Illustrative List of Export Subsidies, make it clear that non-excessive exemption or remission programmes are not subsidies. Footnote 1 to Article 1.1(a)(1)(ii) excludes certain non-excessive exemptions or remissions such as duty drawbacks from the definition of a "subsidy", notwithstanding that they confer a benefit directly on exports. It is therefore difficult, in Canada's view, to justify extending the definition of "subsidy" to capture non-excessive duty exemptions or remissions on imports.

10.167 We note that Canada does not contend that the measure at issue here falls within the scope of footnote 1. Rather, it would appear that Canada is making the contextual argument that, based on a principle derived from footnotes 1 and 5 and items (g), (h) and (i) of the Illustrative List, "non-excessive exemptions [from] or remissions" of duties are not subsidies, and that the import duty exemption in this case is just such a "non-excessive" exemption or remission. In response to a question from the Panel, Canada explains that "[a]n excessive duty rebate would, in practical terms, be no different from a legal duty exemption coupled with a cash subsidy."[876]

10.168 We recall that footnote 1 to Article 1.1(a)(1)(ii) provides that:

> "In accordance with the provisions of Article XVI of GATT 1994 (Note to Article XVI) and the provisions of Annexes I through III of this Agreement, the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy."

Items (g), (h) and (i) of the Illustrative List (i. e., Annex I referred to in footnote 1) provide further elaboration regarding the application of this principle.

10.169 Item (i) of the Illustrative List relates to import charges, and is thus most closely related to the measures at hand. Under item (i), the remission or drawback of import charges "in excess of those levied on imported inputs that are consumed in the production of the exported product" is a prohibited export subsidy. Thus, the concept of "excessive" remission or drawback of import charges involves a comparison between the import duties levied on inputs consumed in the production of an exported product[877], on the one hand, and the amount of the remission or drawback granted on the other. In the case at hand, Canada has never contended that the import duty exemption in question represents the remission or drawback of import charges on imported inputs that are consumed in the production of exported products. On the contrary, qualifying motor vehicle manufacturers earn an import duty exemption in respect of motor vehicles that are sold in the Canadian market. Nor has Canada made any effort to demonstrate that the amount of the import duty exemption was calculated as a function of, or in fact bears any relationship to, the import charges levied on imported inputs that are consumed

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[875] Appellate Body Report on *Canada – Measures Affecting the Export of Civilian Aircraft*, adopted on 20 August 1999, WT/DS70/AB/R (hereinafter Appellate Body Report on *Canada – Aircraft*), para. 153.

[876] *Supra* para. 7.236.

[877] As defined in footnote 61 to Annex II of the SCM Agreement.

in the production of an exported product. Thus, we fail to understand how the concept of "excessive" exemption or remission is of relevance to this dispute, or in what sense it could be said that Canada's import duty exemption in this case is not "excessive".[878]

10.170 Having concluded that the import duty exemption represents a financial contribution by the Canadian Government and that a benefit is thereby conferred, we **find** that the import duty exemption constitutes a subsidy within the meaning of Article 1 of the SCM Agreement.

(iv) Specificity

10.171 We note that Article 1.2 of the SCM Agreement states:

> "A subsidy as defined in paragraph 1 shall be subject to the provisions of Part II ['Prohibited Subsidies'] or shall be subject to the provisions of Part III ['Actionable Subsidies'] or V ['Countervailing Measures'] only if such a subsidy is specific in accordance with the provisions of Article 2."

10.172 We further note that Article 2.3 of the SCM Agreement states:

> "Any subsidy falling under the provisions of Article 3 shall be deemed to be specific."

Given that the central issue of the claims under the SCM Agreement in this dispute is whether the import duty exemption falls within the provisions of Article 3, we need not, and do not, address the question of specificity separately.

(c) Whether the import duty exemption is "contingent . . . upon export performance"

10.173 In the previous section, we have concluded that the import duty exemption under the MVTO 1998 and the SROs gives rise to a financial contribution that confers a benefit, and thus represents a subsidy within the meaning of Article 1 of the SCM Agreement. We now consider whether that subsidy is contingent upon export performance within the meaning of Article 3.1(a) of the Agreement.

10.174 Article 3.1 of the SCM Agreement provides, in relevant part:

> "Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:
>
> (a) subsidies contingent, in law or in fact (*footnote omitted*), whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I (*footnote omitted*);

10.175 The European Communities and Japan argue that the import duty exemption is contingent upon export performance by reason of the ratio requirements. The European Communities explains how, where the required ratio is 100:100 or higher, a beneficiary cannot sell in Canada any value of motor vehicles imported under the import duty exemption unless it exports an equivalent value of domestically manufactured motor vehicles. Where the requirement is less than 100:100, by exporting

[878] Our views with respect to paragraphs (g) and (h) of the Illustrative List, relating to indirect taxes, are similar. Put simply, an export subsidy exists under these two items if the Member exempts or remits indirect taxes "in excess" of the amount of indirect taxes that would be payable if the product were sold in the domestic market. Given that the measure in question here has no relation to the amount of indirect taxes that would be payable if the exported product had been sold in the domestic market, we fail to grasp how the concept of "excessive" remission is relevant to the case at hand.

part of its domestic production, a beneficiary would see the value of motor vehicles which it may import duty-free into Canada increase by an amount equal to the value of the exported vehicles. It would therefore qualify for a larger subsidy than if it sold all its domestic production in Canada. The ratio requirements hence function as requirements to export. Japan explains how, where the ratio requirement is 100:100, the only way for a manufacturer beneficiary importing motor vehicles and selling them in Canada to maintain compliance with this requirement is to export the vehicles it produces. Where the ratio requirement is less than 100:100, the only way for a manufacturer beneficiary importing motor vehicles and selling them in Canada to maintain compliance with this requirement is to export the vehicles it produces, but a lower requirement imposes a lesser degree of pressure in comparison with the situation in which the requirement is 100:100.

10.176 In Canada's view, even if there is a subsidy, there is no export contingency in law. A subsidy is export-contingent in law where the underlying legal instruments establishing that subsidy expressly provide for it to be available only on condition of export performance. The relevant legal condition for the import duty exemption is achievement of a production-to-sales ratio, and neither production nor sales, nor a ratio of the one to the other, is synonymous with exportation.

10.177 Canada further argues that there is no export contingency in fact, because the import duty exemption is available to manufacturer beneficiaries whether they export or not and the import duty exemption is entirely independent of export volume. Specifically, there is no direct nexus between receipt of the import duty exemption and the exportation of vehicles. Not only are there no penalties if exports do not take place or bonuses if additional exports do take place, but the benefit of the import duty exemption can be increased while exports are decreased. The only way to increase the benefit of the import duty exemption is to increase imports, which can be done even while decreasing production and exports.

10.178 As a threshold matter, we note the disagreement of the parties regarding the concepts of "in law" and "in fact" export contingency. The European Communities argues that, where the requirement to export is stated expressly in the law or is implicit in other requirements that are so stated in the law, the subsidy is contingent in law upon export performance. Where the requirement to export does not result from the terms of the law, or at least from those terms alone, but from factual elements outside the law, the subsidy is contingent in fact upon export performance. Japan does not specifically address this issue. Canada, on the other hand, argues that a subsidy is contingent in law upon export performance where the underlying legal instruments of that subsidy expressly provide that the subsidy is available to enterprises only on condition of export performance. In response to a question from the Panel, Canada argues that a subsidy is contingent in fact upon export performance where there is no express requirement to export, but the facts and circumstances are such that there is an implicit requirement to export.

10.179 The term "law" has been defined, *inter alia*, as "that which is laid down, ordained, or established."[879] Following from this definition, export contingency *in law*, in our view, must refer to the situation where one can ascertain, on the face of the law (or other relevant legal instrument), that export contingency exists. In other words, an examination of the terms of the underlying legal instruments of the subsidy in question would suffice to determine whether or not export contingency in law exists. We do not mean by this, however, that the terms of the law must – as Canada suggests – "expressly provide" that the subsidy is contingent upon export performance, but rather, that the existence of export contingency can be demonstrated on the basis of the law or other relevant legal instrument, without reference to external factual elements.

10.180 We find confirmation of our view on this issue in a recent statement of the Appellate Body in *Canada – Aircraft*:

[879] Black's Law Dictionary (West Publishing Co.,1968, Fourth Edition), 1028.

> "In our view, the legal standard expressed by the word 'contingent' is the same for both *de jure* or *de facto* contingency. There is a difference, however, in what evidence may be employed to prove that a subsidy is export contingent. *De jure export contingency is demonstrated on the basis of the words of the relevant legislation, regulation or other legal instrument*. Proving *de facto* export contingency is a much more difficult task. There is no single legal document which will demonstrate, on its face, that a subsidy is 'contingent . . . in fact . . . upon export performance'. Instead, the existence of this relationship of contingency, between the subsidy and export performance, must be *inferred* from the total configuration of the facts constituting and surrounding the granting of the subsidy, none of which on its own is likely to be decisive in any given case."[880] (*first emphasis added*)

10.181 In light of our view regarding the distinction between "in law" and "in fact" export contingency, we now consider whether the Canadian import duty exemption is contingent in law upon export performance.

10.182 We note that the ratio requirements applicable to the MVTO 1998 beneficiaries are, "as a general rule", 95:100 for automobiles, at least 75:100 for SCVs and at least 75:100 for buses.[881] With respect, specifically, to the four automobile manufacturer beneficiaries under the MVTO 1998, Canada has stated, in response to a question from the Panel, that the amounts of the ratio requirements are confidential.[882] Canada adds that they range from the low-80s:100 to the high-90s:100, and the average of the four amounts is approximately 95:100. We further note that the SROs issued prior to 1997 set the minimum ratio requirement at 75:100. Regarding the SROs issued since 1997, almost all such SROs have the ratio requirement set at 100:100.[883]

10.183 The word "contingent" has been defined, *inter alia*, as "conditional, dependent".[884] Further, the Appellate Body has stated in *Canada – Aircraft*:

> "In our view, the key word in Article 3.1(a) is 'contingent'. As the Panel observed, the ordinary connotation of 'contingent' is 'conditional' or 'dependent for its existence on something else'. (*footnote omitted*) This common understanding of the word 'contingent' is borne out by the text of Article 3.1(a), which makes an explicit link between 'contingency' and 'conditionality' in stating that export contingency can be the sole or 'one of several other *conditions*'."[885]

10.184 In light of the above ordinary meaning of the word "contingent", we first examine the situation in which the ratio requirement is 100:100 or higher[886]. For instance, a company selling $100 worth of motor vehicles in Canada must produce $100 worth of motor vehicles in Canada in order to receive an import duty exemption for its imports of motor vehicles. However, for every unit value of motor vehicles that it imports duty-free, it would have to export an equivalent unit value of motor

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[880] Appellate Body Report on *Canada – Aircraft, supra* note 875, para. 167.

[881] *Supra* para. 2.25.

[882] *Supra* para. 7.3. We recall the Appellate Body's statement in *Canada – Aircraft*: " . . . [A] panel has broad legal authority to request information from a Member that is a party to a dispute, and . . . a party so requested has a *legal duty* to provide such information." (*emphasis added*) While we do not consider that the precise amounts of the ratio requirements for the MVTO manufacturers are necessary to our analysis, we note that the Appellate Body further stated: " . . . [A] panel should be willing expressly to remind parties – during the course of dispute settlement proceedings – that a refusal to provide information requested by the panel may lead to inferences being drawn about the inculpatory character of the information withheld." Appellate Body Report on *Canada – Aircraft, supra* note 875, paras. 197 and 204.

[883] *Supra* para. 2.34.

[884] The New Shorter Oxford English Dictionary (Clarendon Press, 1993), Vol. 1, 494.

[885] Appellate Body Report on *Canada – Aircraft, supra* note 875, para. 166 (*emphasis in original*).

[886] We note that one ratio requirement – that for Navistar International – is higher than 100:100.

vehicles produced in Canada, in order to maintain its production-to-sales ratio. Notwithstanding the fact that the requirement is set out as a production-to-sales ratio, we fail to see how a manufacturer beneficiary could access the import duty exemption – and still maintain its production-to-sales ratio – without exporting. In cases where the production-to-sales ratio is 100:100, the only way to import any motor vehicles duty-free is to export, and the amount of import duty exemption allowed is directly dependent upon the amount of exports achieved. Given that, where the ratio requirement is 100:100, it is impossible to import duty-free without exporting, the import duty exemption is clearly "conditional" or "dependent" upon exportation.

10.185 Canada contends that a manufacturer beneficiary subject to a 100:100 ratio requirement which is in fact performing at a higher-than-required ratio could increase its duty-free imports while at the same time reducing its exports. We agree with Canada that such a situation is in fact possible. Thus, for example, a manufacturer might, in year x, produce $500 worth of motor vehicles in Canada, export $450 worth of motor vehicles from Canada, import $50 worth of motor vehicles pursuant to the import duty exemption and thus, in total, sell $100 worth of motor vehicles in Canada. In this case, the manufacturer beneficiary has achieved a production-to-sales ratio of 500:100. The following year, that manufacturer beneficiary might continue to produce $500 worth of motor vehicles in Canada, but reduce its exports to $400 while increasing its duty-free imports to $100 (leaving an actual production-to-sales ratio of 500:200, well in excess of the required ratio). Under these circumstances, the manufacturer beneficiary has decreased its exports while increasing the amount of its duty-free imports (and thus the amount of the subsidy).

10.186 Canada considers that the type of situation set out above establishes that there is no sufficient "nexus" between the exports and the subsidy and that the import duty exemption is not, therefore, "contingent . . . upon export performance". We disagree. In our view, the situation posited by Canada simply demonstrates that a manufacturer beneficiary may in a given year choose not to fully exercise its entitlement to the import duty exemption, while in a subsequent year more fully availing itself of that entitlement. Looked at from another angle, it could be said that the manufacturer beneficiary exceeded the production-to-sales ratio necessary in order to obtain the amount of import duty exemption it required, and that it therefore had a certain margin of flexibility to reduce exports and/or increase duty-free imports in subsequent years. The fact remains, however, that the manufacturer beneficiary could not have imported *any* motor vehicles duty-free in either year without exporting an equivalent value of motor vehicles in that year. Thus, the subsidies are clearly contingent upon export performance, in as much as the import duty exemption obtained was conditional or dependent upon exporting an equivalent value of motor vehicles. The fact that the manufacturer beneficiary exceeded the amount of exports necessary to obtain the amount of subsidy in question in no way changes this.

10.187 We have noted that ratio requirements for some manufacturer beneficiaries are set at 100:100 or higher and for others at less.[887] We have examined the situation in which the ratio requirement is 100:100 in light of the ordinary meaning of the word "contingent". Accordingly, we now consider the situation in which the ratio requirement is less than 100:100 in light of the ordinary meaning of the word "contingent".

10.188 Let us assume that the ratio requirement is 75:100, the "minimum allowable ratio requirement"[888]. A manufacturer beneficiary sells $100 worth of motor vehicles in Canada and must, therefore, produce $75 worth of motor vehicles in Canada in order to satisfy the ratio requirement. Having done so, it is entitled to import $25 worth of motor vehicles duty-free or, in other words, has a duty-free "allowance" or "entitlement" of up to $25. Admittedly, no exports have occurred, nor do they need to, for the manufacturer beneficiary to receive the import duty exemption up to this amount. We accept that the import duty exemption is not contingent upon export performance up to this amount.

[887] See *supra* para. 10.182.
[888] *Supra* para. 7.1.

10.189 However, if the manufacturer beneficiary wishes to import any amount *above* its duty-free "allowance" and still receive the import duty exemption, it would have to export an amount equivalent to that exceeding this "allowance", so as to ensure that the production-to-sales ratio remains unaltered. In the present case, if it wishes to import $75 rather than $25 worth of motor vehicles duty-free, which is $50 more than its "allowance", it would have to export $50 worth of motor vehicles. For every unit value of duty-free imports above the "allowance", it is required to export an equivalent unit value of its production in Canada. Indeed, other things being equal, the more the manufacturer beneficiary exports, the more it can import duty-free. For instance, if it then exports $100 worth of motor vehicles, it can import $125 worth of motor vehicles duty-free. In our view, the relationship between the import duty exemption and export performance in this situation is such that the former is "conditional" or "dependent" on the latter.

10.190 Of course, the manufacturer beneficiary could steadily increase its domestic production and its domestic sales, all the while respecting the 75:100 ratio, and the value of duty-free imports that it is allowed would increase proportionally without any exports occurring. However, this does not change the fact that, to import duty-free in excess of its "allowance", the manufacturer beneficiary is obliged to export an amount equivalent to that in excess.

10.191 We therefore find that, with the exception of the one situation where the ratio requirement is less than 100:100 and the manufacturer beneficiary wishes to access an import duty exemption only up to the amount of its duty-free "allowance", there is a clear relationship of contingency between the import duty exemption and export performance. The fact that, where the ratio requirement is less than 100:100, some amount of import duty exemption is accessible without exports occurring cannot possibly mean that the import duty exemption in its totality should be considered not to be export-contingent. In other words, the import duty exemption is contingent upon export performance even if, where the ratio requirement is less than 100:100, the manufacturer beneficiary may fulfil it to receive a certain amount of import duty exemption without exporting, because*, in order to receive a greater amount of import duty exemption, it is obliged to export*.

10.192 We note that it is the *law* (or other relevant legal instrument) – the MVTO 1998 and the SROs – that creates this construct, *i.e.*, an import duty exemption upon condition of meeting certain ratio requirements. It is the *law* that determines what a particular manufacturer beneficiary's ratio requirement will be. And, in the case of a ratio requirement lower than 100:100, although the manufacturer beneficiary has a choice as to the amount of the import duty exemption it wishes to access, it is the *law* that determines the consequences of that choice for the manufacturer beneficiary, or, otherwise put, it is the *law* that then establishes contingency upon export performance. We **find**, on the basis of our foregoing discussion, that the MVTO 1998 and the SROs demonstrate, on their face, that the import duty exemption is contingent upon export performance, and we have not needed to refer ourselves to "the total configuration of the facts constituting and surrounding the granting of the subsidy"[889]. Being demonstrable "on the basis of the words of the relevant legislation, regulation or other legal instrument"[890], export contingency in respect of the Canadian import duty exemption exists in law.

10.193 With specific reference to the four MVTO automobile manufacturer beneficiaries, Canada claims, in response to a question from the Panel, that there is no statutory instrument setting out the ratio requirement.[891] Canada submits that the actual ratio requirement for each MVTO automobile manufacturer beneficiary was determined on a company-by-company basis for each class of vehicle. Each company was informed of the production-to-sales ratio it had achieved in the base year, and that is the ratio that each company must maintain in order to qualify as an MVTO manufacturer

[889] Appellate Body Report on *Canada – Aircraft, supra* note 875, para. 167.
[890] Ibid.
[891] *Supra* para. 7.3.

beneficiary each year.[892] We consider, however, that, while no statutory instrument sets out the ratio requirement for each automobile manufacturer beneficiary, it is the Canadian Government which determined, *pursuant to the MVTO 1998*, the ratio requirement for each automobile manufacturer beneficiary. That is, the MVTO 1998 requires that each automobile manufacturer beneficiary be subject to a ratio requirement and establishes a formula on the basis of which the individual ratio requirement for each automobile manufacturer beneficiary is to be calculated. Thus, the existence of export contingency with respect to the four MVTO automobile manufacturer beneficiaries can be determined on the basis of the MVTO 1998 itself.

10.194 We note that the European Communities and Japan have, *in the alternative*, made an argument as to export contingency in fact. Having found that the Canadian import duty exemption is contingent in law upon export performance, we need not, and do not, address this argument.

10.195 Having examined the import duty exemption in light of the ordinary meaning of the text of Article 3.1(a), we now address what Canada considers to be the context in which Article 3.1(a) must be interpreted, *i.e.* the Illustrative List. Canada argues that the Illustrative List is an important guide to identifying the practices that constitute export subsidies, and the Canadian import duty exemption is unlike any of the measures in the Illustrative List. Canada emphasises that, in each of the practices identified in the Illustrative List, there is a clear and direct nexus between the subsidy and the exported product, and the amount of the subsidy increases with the volume of exports. We recall, however, that the test set out in Article 3.1(a) is contingency upon export perfomance, and not a "nexus" between the subsidy and the exported product. And we have established that the import duty exemption is contingent upon export performance by reason of the ratio requirements.

10.196 Canada posits that, because the only remissions of import charges identified in the Illustrative List are those that are both excessive and linked directly to an exported product, only such remissions of import charges may be considered subsidies contingent upon export performance. We recall that Article 3.1(a) prohibits "subsidies contingent . . . upon export performance, *including those illustrated in Annex I* [the Illustrative List]". It is thus reasonable, in our view, to consider that the Illustrative List may be of some utility in informing the notion of export contingency in certain precise situations. We find it difficult to accept, however, that the practices identified in the Illustrative List represent a circumscription – in the manner suggested by Canada – of the conditions under which a subsidy is deemed to be contingent upon export performance. Indeed, the use of the words "including" and "illustrated" makes it clear that, while all practices identified in the Illustrative List are subsidies contingent upon export performance, there may be other practices not identified in the Illustrative List that are also subsidies contingent upon export performance.

10.197 Accordingly, the Illustrative List does not establish any general definition of the circumstances in which an exemption or remission is to be considered an export subsidy. Specifically, we do not find any basis in the cited provisions – or, for that matter, anywhere else in the SCM Agreement – for Canada's view that, because the only remissions of import charges identified in the Illustrative List are those that are both excessive and linked directly to an exported product, only such remissions of import charges may be considered subsidies contingent upon export performance. Item (i) is the only one in the Illustrative List that deals with the remission of import charges, but it is specific to imported inputs. It cannot be considered to establish a general rule as to *all* remissions of import charges.

10.198 Turning now to the object and purpose of the SCM Agreement, Canada submits that the purpose of the SCM Agreement is to discipline subsidies that distort trade, and that the only real effect on trade of the Canadian import duty exemption is to increase the volume of duty-free imports into Canada of vehicles that would not qualify for such treatment under the NAFTA. Canada also argues that, even assuming that the import duty exemption can be considered a subsidy, it is a subsidy

[892] *Supra* para. 7.2.

of imports, not of exports. In response to a question from the Panel, Canada submits that, in the alternative, the import duty exemption is a production-based subsidy by virtue of the production-to-sales ratio requirements.

10.199 In order for a measure to fall within the scope of the SCM Agreement's prohibition of export subsidies, it need only be a subsidy within the meaning of Article 1 which is contingent upon export performance within the meaning of Article 3.1(a). In this case, while the subsidy in question is provided through the mechanism of a duty exemption for imports and thus arguably "facilitates imports", that does not change the fact that the subsidy is contingent upon export performance and thus falls within the scope of Article 3.1(a). In any event, and whether or not it also "facilitates imports", a subsidy which is contingent upon export performance can be expected to affect exporters' behaviour. Thus, even if a showing that an export subsidy did not have any "real effect" on exports were a defence to a claim under Article 3.1(a) – which of course it is not – Canada has not convinced us that the subsidy in question has not had any "real effect" in increasing Canadian exports of motor vehicles. Finally, we note that Canada's argument could, taken to its extreme, lead to the conclusion that a financial contribution in the form of the foregoing of import duties could never give rise to an export subsidy or, indeed, to any subsidy. Item (i) of the Illustrative List, however, clearly foresees that the excessive remission or drawback of certain import charges constitutes a prohibited export subsidy.

10.200 We recall Japan's argument that the Canadian import duty exemption falls within item (a) of the Illustrative List of Export Subsidies, that is, "the provision by governments of direct subsidies to a firm . . . contingent upon export performance." Having established that the Canadian import duty exemption violates Article 3.1(a) of the SCM Agreement by reason of its being contingent upon export performance, we need not, and do not, address this argument.

10.201 For the reasons discussed in this section, we **find** that the Canadian import duty exemption is a subsidy within the meaning of Article 1 of the SCM Agreement which is "contingent . . . in law . . . upon export performance" within the meaning of Article 3.1(a) of the Agreement. We therefore **find** that Canada acts inconsistently with its obligations under Article 3.1(a) of the SCM Agreement.

2. CVA requirements

10.202 In the previous section of this report, we concluded that the import duty exemption provided by the Canadian Government to certain motor vehicle manufacturers under the MVTO 1998 and the SROs constitutes a subsidy within the meaning of Article 1 of the SCM Agreement (*supra* paras. 10.156-10.170). We now consider whether, as the European Communities and Japan claim, the import duty exemption is contingent upon the use of domestic over imported goods within the meaning of Article 3.1(b) of the SCM Agreement because it is accorded upon fulfilment of certain Canadian value-added ("CVA") requirements, and is thus prohibited under that provision.

(a) Factual considerations

10.203 We recall that three types of CVA requirements are at issue in this dispute.

10.204 *First*, there are the CVA requirements under the MVTO 1998 itself. Under the MVTO 1998, a manufacturer is entitled to benefit from the import duty exemption if, *inter alia*, that manufacturer's total Canadian value added with respect to a class of vehicles is equal to or greater than that manufacturer's total value added with respect to that same class of vehicles in the base year. The term "Canadian Value Added" is defined in the MVTO 1998 as including: (i) the cost of parts produced in Canada and of materials of Canadian origin that are incorporated in the motor vehicles; (ii) direct labour costs incurred in Canada; (iii) manufacturing overheads incurred in Canada; (iv) general and administrative expenses incurred in Canada that are attributable to the production of motor vehicles; (v) depreciation in respect of machinery and permanent plant equipment located in Canada that is

attributable to the production of motor vehicles; and (vi) a capital cost allowance for land and buildings in Canada that are used in the production of motor vehicles.

10.205 *Second*, there are CVA requirements in the SROs. SROs issued after 1984 typically require that the total CVA of a manufacturer's vehicles produced in Canada in a given year must be at least 40 per cent of the cost of sales of vehicles sold in Canada in the same year. By way of exception, one manufacturer (CAMI) must meet a requirement that the total CVA of its vehicles and original equipment manufacturing parts produced in Canada in a given year must be at least 60 per cent of the cost of sales of vehicles sold in Canada in the same year.

10.206 *Third*, there are Letters of Undertaking. Letters signed by General Motors, Ford, Chrysler and American Motors provide for two additional commitments with respect to CVA, i.e., to increase in each ensuing model year over the base model year CVA in the production of vehicles by an amount equal to 60 per cent of the growth in their market for automobiles sold for consumption in Canada and by an amount equal to 50 per cent of the growth in their market for commercial vehicles sold for consumption in Canada, and to achieve a stipulated increase in the annual CVA by the end of model year 1968.

(b) Arguments of the parties

10.207 The European Communities acknowledges that access to the import duty exemption is not explicitly conditioned upon the use of domestic over imported goods, but that it is rather conditioned upon reaching a certain level of CVA. It asserts, however, that because the use of domestic parts and materials may be sufficient, or at least contribute, to meeting the CVA requirements, the import duty exemption is contingent in law upon the use of domestic over imported goods. In short, the European Communities considers that Article 3.1(b) prohibits any condition that gives preference to domestic over imported goods, irrespective of whether in practice domestic goods are actually used by the beneficiary. The European Communities further argues in the alternative that the import duty exemption is in fact contingent upon the use of domestic over imported goods. In this respect, the European Communities asserts that parts and materials amount on average to as much as 80 per cent of the cost of sales of motor vehicles assembled in Canada.

10.208 Japan claims that the import duty exemption is contingent in law upon the use of domestic over imported goods, in that Article 3.1(b) prohibits subsidies that are contingent upon a condition that *requires* the use of domestic over imported goods, as well as subsidies contingent on a condition that *favours* the use of domestic over imported goods. Japan further argues in the alternative that the import duty exemption is contingent in fact upon the use of domestic over imported goods in the case of the SROs to automobile manufacturers and the Letters of Undertaking which impose 60 per cent CVA requirements.

10.209 Canada responds that the import duty exemption is not contingent in law on the use of domestic over imported goods. Moreover, Canada contends that Article 3.1(b) contains no reference to contingency in fact and extends only to contingency in law. Even if Article 3.1(b) did extend to contingency in fact, the import duty exemption is not contingent in fact upon the use of domestic goods, because the words "contingent upon" should be interpreted to apply to subsidies that are *conditional upon* or *tied to* the use of domestic over imported goods. The import duty exemption is available to manufacturers whether or not they use domestic goods, provided they meet their CVA requirements. Canada points to the fact that a manufacturer may include in the calculation of CVA not only goods, but direct labour costs, overhead, general and administrative expenses, depreciation and capital cost allowance for land and buildings.

(c) Contingency in Law

10.210 We first consider whether the Canadian import duty exemption is contingent in law upon the use of domestic over imported goods.

10.211 Article 3.1 provides, in relevant part:

> "Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:
>
> ……
>
> (b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods."

10.212 In our examination of the complainants' claims under Article 3.1(a) of the SCM Agreement, we examined the concepts of "in law" and "in fact" export contingency (*supra* paras. 10.178-10.179) and concluded that export contingency in law refers to the situation where one can ascertain, on the face of the law (or other relevant legal instrument), that export contingency exists. Equally, contingency in law upon the use of domestic over imported goods must refer to the situation where the contingency is demonstrable "on the basis of the words of the relevant legislation, regulation or other legal instrument"[893] rather than "the total configuration of the facts constituting and surrounding the granting of the subsidy"[894]. Accordingly, we must first examine the legal instruments in question here in order to determine whether eligibility for the import duty exemptions is contingent in law upon the use of domestic over imported goods.

10.213 As we noted in the section of our report relating to claims under Article 3.1(a) of the SCM Agreement, the word "contingent" has been defined, *inter alia*, as "conditional, dependent".[895] It is in light of this ordinary meaning of the word "contingent" that we must examine whether, under the CVA requirements outlined above, access to the import duty exemption is conditional or dependent upon the use of domestic over imported goods.

10.214 We recall the view of the European Communities and Japan that Article 3.1(b) extends to subsidies contingent on a condition that favours or gives preference to the use of domestic over imported goods. The complainants argue that the words "over imported" would be redundant if this provision were interpreted to mean simply "contingent on the use of domestic goods". We note however that the text of Article 3.1(b) refers to subsidies "contingent upon the use" of domestic over imported goods. This language thus creates a direct link between the subsidy and the use of domestic goods. We do not believe that the addition of the words "over imported" can be construed to weaken that link. Rather, we believe that they were intended simply to emphasize that such subsidies are prohibited because of their probable adverse effects on other Members.

10.215 The European Communities further argues that its interpretation furthers the object and purpose of Article 3.1(b), which it considers to be to avoid that subsidies be used to discriminate between domestic and imported goods used in the manufacture of other goods. We recognize that Article 3.1(b) in some sense has its roots in Article III:4 of GATT and in certain interpretations of that provision, which relates to non-discrimination. We do not consider however that Article 3.1(b) *ipso facto* has the same scope as Article III:4. To the contrary, while Article III:4 of GATT speaks of "treatment no less favourable" and of requirements "affecting" internal sale, Article 3.1(b) speaks of subsidies "contingent upon the use of domestic over imported goods". We are unwilling to import

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[893] Appellate Body Report on *Canada – Aircraft*, *supra* note 875, para. 167.
[894] Ibid.
[895] The New Shorter Oxford English Dictionary (Clarendon Press, 1993), *supra* note 884.

into Article 3.1(b) legal principles derived from the interpretation of a text which differs so markedly from that of Article 3.1(b).

10.216 In applying these principles to the case at hand, we note that, while under the MVTO 1998 and SROs access to the import duty exemption is contingent upon satisfying certain CVA requirements,[896] a value-added requirement is in no sense synonymous with a condition to use domestic over imported goods. In this regard, we recall that the definition of "CVA" in the MVTO 1998 includes, in addition to parts and materials of Canadian origin, such other elements as direct labour costs, manufacturing overheads, general and administrative expenses and depreciation. Thus, and depending upon the factual circumstances, a manufacturer might well be willing and able to satisfy a CVA requirement without using any domestic goods whatsoever. Under these circumstances, it would be difficult for us to conclude that access to the import duty exemption is contingent, i.e. conditional or dependent, in law on the use of domestic over imported goods within the meaning of the SCM Agreement.

10.217 Finally, we recall the European Communities' argument that Article 3.1(b) prohibits subsidies contingent, *whether solely or as one of several other conditions*, on the use of domestic over imported goods. The European Communities concedes that this may cover the situation where a subsidy is simultaneously subject to two or more cumulative conditions (including the use of domestic over imported goods). The European Communities asserts, though, that this may also cover the situation where a subsidy is subject to two or more alternative conditions, so that compliance with any of them gives a right to the subsidy. If one of those conditions is "the use of domestic over imported goods" the subsidy must be deemed prohibited by Article 3.1(b), even if it is also possible to qualify for the subsidy by complying with other alternative non-prohibited conditions, such as using domestic labour or domestic services. Thus, the European Communities argues that the use of domestic over imported goods need not be a "necessary" condition in order for a subsidy to be prohibited under Article 3.1(b) of the SCM Agreement.

10.218 According to Canada, use of the clause "whether solely or as one of several other conditions" in Article 3.1(a) and (b) of the SCM Agreement means that the use of domestic goods or export performance does not have to be the only condition for the receipt of the subsidy. There may also be additional conditions to fulfil, but each condition must be mandatory. Canada contends that the clause is not satisfied simply because the use of domestic goods or export performance is among the ways to qualify for the subsidy. In the context of Article 3.1(a), for example, Canada denies that a subsidy is contingent on export performance if receipt of the subsidy depends on either exporting or selling domestically.

10.219 The basic disagreement between the parties concerns whether the phrase "several other conditions" in Article 3.1(b) of the SCM Agreement would include several *alternative* conditions (including the use of domestic over imported goods). We do not consider it necessary to resolve this disagreement, since we are not confronted with a situation where the bestowal of a subsidy is contingent in law on the fulfilment of several alternative conditions. The import duty exemption at issue is contingent in law on three clear conditions, all of which must be met: (1) manufacturing presence, (2) ratio requirements, and (3) CVA requirements. The use of domestic over imported goods is not an alternative condition, in law, for access to the import duty exemption. For that reason, the question of whether the prohibition in Article 3.1(b) applies in circumstances where the use of domestic over imported goods is one of several, alternative, conditions for the bestowal of a subsidy does not arise.

[896] However, with regard to the CVA requirements in the Letters of Undertaking, we recall our observation in para. 10.120 that the legal instruments adopted by Canada in connection with the implementation of the Auto Pact do not provide for the authority to withdraw the import duty exemption in case of a failure to meet the commitments contained in these Letters. Compliance with these commitments is not explicitly a factor in determining the eligibility for the import duty exemption.

(d) Contingency in fact

10.220 Having concluded that the import duty exemptions in this dispute are not contingent *in law* upon the use of domestic over imported goods, we must now consider the complainants' assertion in the alternative that those exemptions are contingent *in fact* upon the use of domestic over imported goods.

10.221 We note the disagreement of the parties as to whether Article 3.1(b) extends to the situation where a subsidy is contingent in fact upon the use of domestic over imported goods. In this context, we recall that Article 3.1 is, as clearly indicated by its chapeau, the provision that sets out the subsidies prohibited under the SCM Agreement. Paragraphs (a) and (b) are both part of Article 3.1 and manifestly similar. It is hard to imagine how the inclusion of the words "in law or in fact" in paragraph (a) and the absence of such words in paragraph (b) could be but a reflection of the intention of the drafters. We further recall that the Appellate Body has held in *Japan – Alcoholic Beverages* that "omission must have some meaning".[897] That two provisions so alike and juxtaposed together should differ from each other in such specific respect signals, in our view, that the omission of the words "in law or in fact" from Article 3.1(b) was deliberate and that Article 3.1(b) extends only to contingency in law.

10.222 For the reasons discussed in this section, we are unable to find that the Canadian import duty exemption is a subsidy within the meaning of Article 1 of the SCM Agreement which is "contingent … upon the use of domestic over imported goods" within the meaning of Article 3.1(b) of the Agreement. We reject the European Communities' and Japan's claim accordingly.

D. CLAIMS UNDER THE GATS

1. Introduction

10.223 The complainants argue that the import duty exemption granted to some manufacturers/wholesalers of motor vehicles in Canada ("manufacturer beneficiaries") by the MVTO 1998 and by the SROs, is inconsistent with Canada's obligations under Article II of the GATS, in that it grants more favourable treatment to suppliers of the United States than to suppliers of the European Communities and Japan. Japan alone claims that the import duty exemption is inconsistent with Canada's obligations under Article XVII of the GATS in that it grants more favourable treatment to Canadian suppliers of wholesale trade services for motor vehicles, which benefit from duty-free treatment, than to Japanese suppliers, which do not.

10.224 Both complainants also claim that the CVA requirements in the MVTO 1998 and in the SROs are inconsistent with Article XVII of the GATS, in that they require manufacturers of motor vehicles to achieve a minimum of Canadian value added in order to benefit from the import duty exemption, therefore according more favourable treatment to services supplied in Canada than to services of other Members supplied through modes 1 ("cross-border supply") and 2 ("consumption abroad"). The complainants point out that the CVA requirements create an incentive for manufacturer beneficiaries to procure services from suppliers established in Canada to the detriment of services supplied through modes 1 and 2.

10.225 Canada rejects the claims of the complainants on the grounds, first, that the import duty exemption is not a measure affecting trade in services within the meaning of Article I of the GATS. With respect to the Article II claim, Canada argues that the import duty exemption does not modify the conditions of competition in favour of services and service suppliers of the United States, for two reasons: (i) there are European and Japanese wholesale trade service suppliers of motor vehicles which benefit from the import duty exemption; and (ii) due to vertical integration between

[897] Appellate Body Report on *Japan – Alcoholic Beverages*, *supra* note 271, p. 18.

manufacturers and wholesalers in the motor vehicle industry, there is no effective competition at the wholesale trade level, so that granting the import duty exemption to manufacturer beneficiaries cannot be said to affect competition. With respect to the claim by Japan that the import duty exemption also violates Article XVII of the GATS, Canada responds that it has no specific commitments in wholesale trade services for motor vehicles and that therefore it is not bound by the national treatment obligation in this sector. In addition, Canada argues that there are no "like" Canadian and Japanese suppliers of wholesale trade services for motor vehicles to whom national treatment would apply and that, as for Article II, due to vertical integration between manufacturers and wholesale trade service suppliers, there is no competition which can be affected at the wholesale trade level.

10.226 With respect to the claim that the CVA requirements in the MVTO 1998 and in the SROs violate Article XVII of the GATS, Canada responds that a series of circumstances exclude that these measures could violate any of its specific commitments: (i) Canada has inserted relevant limitations to its commitments in the relevant sectors; (ii) the supply of many of the relevant services through modes 1 and 2 is not technically feasible; (iii) where it is technically feasible, the supply of the relevant services through modes 1 and 2 suffers from a competitive disadvantage, due to the inherent foreign character of these services and not to the CVA requirements; and (iv) most manufacturer beneficiaries achieve the required proportion of Canadian value-added through their employment of Canadian labour so that the effect of the CVA requirements on their procurement of services is minimal.

10.227 In addition, if the Panel were to find that the import duty exemption was a measure affecting trade in services within the meaning of Article I of the GATS, Canada endorses the suggestion made by the United States in its third-party submission that Article V:1 would apply to any alleged violation of Article II arising from a provision of the NAFTA, such as the measures at issue in this case.

10.228 In our consideration of the claims raised under the GATS, we first examine the general issue of whether the measures, which the complainants claim to be in violation of Articles II and XVII of the GATS, constitute "measures affecting trade in services" within the meaning of Article I of the GATS. Second, we examine the consistency of the import duty exemption, granted under the MVTO 1998 and the SROs, with Article II and with Canada's specific commitments under Article XVII of the GATS in wholesale trade services. We then consider the compatibility of the CVA requirements in the MVTO 1998 and in the SROs with Canada's specific commitments under Article XVII of the GATS in various services sectors related to the production of motor vehicles, which the complainants claim to be affected by the CVA requirements. Finally, we address the role of Article V of the GATS with respect to the import duty exemption, which the complainants claim to be in violation of Article II of the GATS.

2. Measures affecting trade in services

10.229 The complainants argue that the import duty exemption and the CVA requirements in the MTVO 1998 and in the SROs are "measures affecting trade in services" within the meaning of Article I of the GATS. They note that the panel and the Appellate Body in *EC – Bananas III*[898] found that the term "affecting" has a broad scope of application and that accordingly no measures are *a priori* excluded from the scope of application of the GATS. They also point out that the panel in *EC – Bananas III* found that the list of matters in Article XXVIII(c) in respect of which measures by Members affecting trade in services can be taken is an illustrative one and that the word "affecting" in Article XXVIII cannot be read as meaning merely "in respect of".

10.230 Canada responds that the import duty exemption is not a "measure affecting trade in services" within the meaning of Article I of the GATS, because, as a tariff measure, it affects the goods themselves and not the supply of distribution services. According to Canada, the import duty

[898] Panel Report on *EC – Bananas III*, *supra* note 269.

exemption does not affect a manufacturer in its capacity as a service supplier and in its supply of a service.

10.231 We note that Article I:1 of the GATS establishes that "this Agreement applies to measures by Members affecting trade in services". The panel and the Appellate Body in *EC – Bananas III* found that the term "affecting" in Article I of the GATS has a broad scope of application and that accordingly no measures are *a priori* excluded from the scope of application of the GATS. The panel in *EC – Bananas III* pointed out that:

> " ... the drafters [of the GATS] consciously adopted the terms 'affecting' and 'supply of a service' to ensure that the disciplines of the GATS would cover any measure bearing upon conditions of competition in supply of a service, regardless of whether the measure directly governs or indirectly affects the supply of the service."[899]

10.232 The Appellate Body upheld this finding of the panel and noted that:

> " ... the use of the term 'affecting' reflects the intent of the drafters to give a broad reach to the GATS. The ordinary meaning of the word 'affecting' implies a measure that has 'an effect on', which indicates a broad scope of application."[900]

10.233 The Appellate Body also found that, in addition to measures affecting trade in goods as goods and measures affecting the supply of services as services, falling respectively and exclusively within the scope of the GATT 1994 or GATS:

> "there is yet a third category of measures that could be found to fall within the scope of both the GATT 1994 and the GATS. These are measures that involve a service relating to a particular good or a service supplied in conjunction with a particular good. In all such cases in this third category, the measure in question could be scrutinized under both the GATT 1994 and the GATS."[901]

10.234 We note that Article I of the GATS does not *a priori* exclude any measure from the scope of application of the Agreement**.** The determination of whether a measure affects trade in services cannot be done in abstract terms in isolation from examining whether the effect of such a measure is consistent with the Member's obligations and commitments under the GATS. In this case, the determination of whether the MVTO 1998 and SROs are measures affecting trade in services within the meaning of Article I of the GATS should be done on the basis of the determination of whether these measures constitute less favourable treatment for the services and service suppliers of some Members as compared to those of others (Article II) and/or for services and service suppliers of other Members as compared to domestic ones (Article XVII).

10.235 Therefore, we do not address the issues of whether the MVTO 1998 and SROs affect trade in services in isolation from the issue of whether such measures have an effect that is inconsistent with an obligation in the Agreement.

3. Claims Under Article II of the GATS

10.236 The complainants claim that the import duty exemption granted by the MVTO 1998 and SROs to some manufacturers/wholesalers of motor vehicles – the manufacturer beneficiaries – violates Article II of the GATS in that it constitutes more favourable treatment accorded to services

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[899] Panel Report on *EC – Bananas III (USA)*, *supra* note 269, para. 7.281.
[900] Appellate Body Report on *EC – Bananas III*, *supra* note 49, para. 220.
[901] Ibid., para. 220.

and service suppliers of the United States than that accorded to those of other Members. We note that Article II (1) of the GATS establishes that:

> "With respect to any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country".

10.237 The complainants argue that the import duty exemption constitutes *de facto* discrimination because, although the criteria for obtaining the exemption contained in the MTVO 1998 and SROs are not based on nationality, in fact all the beneficiaries are suppliers of the United States. Japan also claims that the import duty exemption is inconsistent with the requirement in Article II that treatment no less favourable be granted "immediately and unconditionally". Canada argues that among the beneficiaries of the exemption there are companies which are suppliers of the European Communities and of Japan. It argues further that it is not possible to maintain that the measure modifies the conditions of competition among wholesale trade suppliers of motor vehicles because, due to vertical integration and exclusive distribution between manufacturers and wholesalers of motor vehicles, there is no competition to be affected at the wholesale trade level.

(a) Whether the import duty exemption affects wholesale trade services

10.238 The complainants claim that the import duty exemption affects the supply of wholesale trade services, as it modifies the conditions of competition between the beneficiaries of the duty-free treatment and other wholesale trade service suppliers of imported motor vehicles which do not benefit from the same treatment. In particular, the import duty exemption would directly affect the cost of the goods being distributed and indirectly affect the cost and/or profitability of the related wholesale trade services. Canada responds that the import duty exemption is not a measure affecting trade in services within the meaning of Article I of the GATS, because, as a tariff measure, it affects the goods themselves and not the supply of distribution services. According to Canada, such measures do not affect a service supplier in its capacity as service supplier and in its supply of a service. On the basis of the Report of the Appellate Body in *EC – Bananas III*, Canada argues that the import duty exemption is a measure falling exclusively within the scope of the GATT 1994, as it affects trade in goods as goods, unlike other measures which involve a service relating to a particular good or a service supplied in conjunction with a particular good, which are subject to both the GATT 1994 and the GATS.

10.239 We note that if, on the one hand, it could be argued that the import duty exemption directly affects trade in goods and that it does not directly govern the supply of distribution services, on the other hand it cannot be maintained that it does not indirectly affect the supply of distribution services. Like the measures at issue in the *EC – Bananas III* case, the import duty exemption granted only to manufacturer beneficiaries bears upon conditions of competition in the supply of distribution services, regardless of whether it directly governs or indirectly affects the supply of such services. In our view, therefore, the import duty exemption falls in the third category of measures, identified by the Appellate Body in *EC – Bananas III*, as involving "a service relating to a particular good or a service supplied in conjunction with a particular good", which "could be scrutinized under both the GATT 1994 and the GATS".

10.240 Canada points out that potentially all tariff measures could be found to affect trade in services, and particularly distribution services. It therefore argues that, if it is found that the import duty exemption is a measure affecting trade in services, other tariff measures would have to be seen as "measures affecting trade in services", which might lead to the anomalous result that some measures which are legal under the GATT could be found to be in violation of the GATS. For example,

differential tariffs which are legal under GATT Articles XXIV and VI might be found to violate Article II of the GATS.

10.241 Canada also points out that its view that tariff measures cannot be considered measures affecting trade in services is supported by Addendum 1 to the Scheduling Guidelines (*Scheduling of Initial Commitments in Trade in Services: Explanatory Note - Addendum*, MTN.GNS/W/164/Add.1) which provides the following answer to question 6 on whether it is "necessary to reserve the right to impose customs duties and regulations on the movement of goods in relation to the supply of a service":

> "There is no requirement in the GATS to schedule a limitation to the effect that the cross-border movement of goods associated with the provision of a service may be subject to customs duties or other administrative charges. Such measures are subject to the disciplines of the GATT.".

10.242 In the present case the issue of measures which maybe legal under the GATT but constitute a violation of the GATS does not arise. More importantly, the issue before us is not the effect of the differential between the MFN rate of duty and the preferential zero-duty itself, but rather, the effect of measures which reserve access to duty-free goods to a closed category of service suppliers, while excluding others.

10.243 We note that although the answer to the question on custom duties in the Addendum to the Scheduling Guidelines makes it clear that Members are not required to schedule customs duties, the measures which are claimed to be inconsistent with the GATS in this case are not "customs duties and regulations on the movement of goods in relation to the supply of a service", but regulations which reserve access to duty-free goods to a closed category of service suppliers, i.e. manufacturer beneficiaries, while excluding others. Canada would not therefore be required to schedule the differential tariff rates applied to imports of motor vehicles; it would only be required to schedule limitations and/or list MFN exemptions relating to measures which prevent certain distributors from having access to the right to import motor vehicles duty free.

10.244 The complainants argue that there is no difference in nature between the import duty exemption and the measures at issue in the *EC – Bananas III* case. The first, like the second, confers a tariff advantage on a restricted category of suppliers, which allows them to import and resell under more favourable conditions. The complainants note that the tariff quota at issue in *EC – Bananas III* did not prevent operators from obtaining licences, as licences were freely tradeable. However, importers who had been allocated licences by the European Communities would be able to retain the "tariff quota rent" (the advantage of importing in-quota goods at preferential rates), while other operators would have to buy licences at an additional cost on the market. The complainants also note that if it is the case that the measures at issue in *EC – Bananas III* and the import duty exemption are of the same type, differences in the intensity of their restrictive effect should not matter in the determination of whether the measures affect trade in services, as there is no *de minimis* rule in Article II or XVII of the GATS.

10.245 Regarding the analogy with the measures at issue in the *EC – Bananas III* case, Canada responds that the measure which determined the allocation of licences in that case directly affected the importers/distributors of bananas, while in the present case the differential duty on motor vehicles affects only trade in goods. Moreover, according to Canada, in *EC – Bananas III* the issue of the effect on distribution services of an existing differential duty was not even addressed by the panel. Canada also makes the point that, unlike differential duties such as those resulting from the import duty exemption, the quota for the allocation of licences in *EC – Bananas III* made it impossible for some distributors to obtain licences and this restrictive effect was not mitigated by the fact that the licences were freely tradeable, as the tariff quota rent charged by licence holders was substantial.

10.246 We note that both sets of measures allow some wholesale trade service suppliers to import and resell under more favourable conditions, while putting at a competitive disadvantage other suppliers, who have to pay the tariff or buy licences out of the tariff quota. Canada's claim that the tariff quota and licensing system in *EC – Bananas III*, unlike the import duty exemption under the Auto Pact, "was critical to the scope and profitability of the provision of services by the independent banana distributors and to the ability of even the integrated distributors to import at all" appears to be based on a quantitative assessment of the effect of the measures at issue, rather than on a distinction between tariff measures and import quotas: in the *EC – Bananas III* case, in spite of the quota system, licences were freely tradeable, so that the effect of the system was to put some distributors at a competitive disadvantage rather than to prevent them from selling in-quota bananas. In both cases there is an economic disadvantage. We note, therefore, that it is not relevant to distinguish between the measures at issue in *EC – Bananas III* and the measures at issue in this case on the basis of the *extent* of their effect on trade in services.

(b) Whether service suppliers are "like"

10.247 The complainants argue, and Canada does not contest, that manufacturer beneficiaries and non-manufacturer-beneficiaries provide "like" services and are "like" service suppliers, irrespective of whether their services are supplied with respect to motor vehicles imported by the manufacturer beneficiaries or with respect to motor vehicles imported by non-manufacturer-beneficiaries, and regardless of whether or not they have production facilities in Canada.

10.248 We agree that to the extent that the service suppliers concerned supply the same services, they should be considered "like" for the purpose of this case.

(c) Whether treatment no less favourable is accorded

(i) Structure of competition in the wholesale trade services market

10.249 Canada argues that it is not possible to establish whether treatment no less favourable has been granted or not, due to vertical integration and exclusive distribution arrangements existing in the motor vehicle industry between manufacturers and wholesale trade service suppliers, which exclude any actual or potential competition at the wholesale trade level. Canada points out that the characteristics of the motor vehicles industry also prevent vertically integrated companies from wholesaling vehicles manufactured by other companies. According to Canada, this factor should distinguish this case from *EC – Bananas III*, where it was held that, in spite of vertical integration, the characteristics of the industry allowed even operators forming part of vertically integrated companies to enter the wholesale service market.

10.250 The complainants point out that, in spite of vertical integration and exclusive distribution agreements in the motor vehicle industry, it is possible to establish less favourable treatment of wholesale trade services suppliers because there is potential competition among wholesalers for the procurement of vehicles from manufacturers and actual competition for sales to retailers of directly competitive vehicles. They argue that the existence of potential competition for purchases from manufacturers is confirmed by the fact that in the past Chrysler, a company of United States origin, distributed in Canada vehicles manufactured by Mitsubishi, a company of Japanese origin. The complainants also rely on the ruling of the Appellate Body in *EC – Bananas III*, which held that "even if a company is vertically integrated ... to the extent that it is also engaged in providing 'wholesale trade services' ... that company is a service supplier within the scope of the GATS."[902]

10.251 Canada responds that the Chrysler-Mitsubishi relationship is not a good example of competition in the wholesale trade market, as the two companies were related through a joint venture

[902] Ibid., para. 227.

agreement. It also contests that actual competition exists for sales to retailers, as, due to exclusive distribution arrangements between manufacturers and wholesalers, retailers will always have to address the same wholesaler for a particular brand of vehicle.

10.252 We note that in the *EC – Bananas III* case the Appellate Body found that:

> " ... even if a company is vertically integrated ... to the extent that it is also engaged in providing 'wholesale trade services' ... that company is a service supplier within the scope of the GATS". [903]

10.253 In our view, vertical integration of production and distribution does not exclude the possibility of considering the distribution operator as a service supplier, which may be affected in its capacity as a service supplier by measures such as the import duty exemption, regardless of whether actual competition exists in the wholesale trade market. We also note that vertical integration might determine the absence of actual competition among wholesalers with respect to the procurement of vehicles from manufacturers, but it neither rules out potential competition in the wholesaler-manufacturer relationship, nor actual competition in the wholesaler-retailer relationship. Although due to the existing structure of the market, wholesale trade service suppliers procure their vehicles from the same manufacturers, no government measure prevents even a vertically integrated wholesale distributor from approaching different manufacturers for the procurement of motor vehicles. Regarding competition for sales to retailers, the fact that, due to exclusive distribution arrangements between manufacturers and wholesalers, retailers have to address the same wholesaler for a particular brand of vehicle (absence of intra-brand competition), does not exclude competition among wholesalers providing directly competitive vehicles (inter-brand competition).

10.254 We therefore **find** that vertical integration and exclusive distribution arrangements between manufacturers and wholesalers in the motor vehicle industry do not rule out the possibility that treatment less favourable may be granted to suppliers of wholesale trade services for motor vehicles. We also **find** that vertical integration and exclusive distribution arrangements do not preclude potential competition among wholesalers for the procurement of vehicles from manufacturers and actual inter-brand competition for sales to retailers.

(ii) Manufacturing presence and closed list of Auto Pact manufacturer beneficiaries

10.255 The complainants argue that although the criteria for eligibility for the import duty exemption are not expressly based on nationality, the import duty exemption constitutes *de facto* discrimination under Article II of the GATS as all or almost all services suppliers of other Members who benefit from the exemption are of the United States. Canada responds that not only is nationality not a criterion for granting the import duty exemption under the Auto Pact, but also that the measures do not *de facto* grant more favourable treatment to the suppliers of one Member, namely, the United States. Canada points out that at least two manufacturer beneficiaries are of EC origin (Volvo Canada Ltd. and DaimlerChrysler Canada Inc.), and one is a 50/50 joint venture between juridical persons of Japan and the United States (CAMI Automotive Inc.). This claim is rejected by the European Communities and Japan. In their replies to question 57 from the Panel both complainants have maintained that the import duty exemption results in *de facto* discrimination, but have also pointed out that in their view the existence of a closed list of manufacturer beneficiaries constitutes formally different treatment.

10.256 We note that Article XXVIII(m) of the GATS provides the following definition of a "juridical person of another Member":

> "'juridical person of another Member' means a juridical person which is either:

[903] Ibid., para. 227.

(i) constituted or otherwise organized under the law of that other Member, and is engaged in substantive business operations in the territory of that Member or any other Member; or

(ii) in the case of the supply of a service through commercial presence, owned or controlled by:

1. natural persons of that Member; or

2. juridical persons of that other Member identified under subparagraph (i)."

10.257 In our view, DaimlerChrysler Canada Inc. is a service supplier of the United States within the meaning of Article XXVIII(m)(ii)(2) of the GATS, because it is controlled by DaimlerChrysler Corporation, a juridical person of the United States according to subparagaph (i) of Article XXVIII(m). What is relevant, therefore, is that DaimlerChrysler Corporation is a juridical person of the United States. The fact that, in turn, DaimlerChrysler Corporation may be controlled by a juridical person of another Member is not relevant under Article XXVIII of the GATS. In order to define a "juridical person of another Member" Article XXVIII(m) of the GATS does not require the identification of the ultimate controlling juridical or natural person: it is sufficient to establish ownership or control by a juridical person of another Member, defined according to the criteria set out in subparagraph (i).[904]

10.258 Regarding CAMI Automotive Inc., it appears that it is a company jointly owned by Suzuki Motor Co. of Japan and by General Motors Corp. of the United States. The European Communities have argued that, although CAMI is jointly owned by juridical persons of Japan and of the United States, it should be regarded as a juridical person of the United States as it is controlled by General Motors Corp., a juridical person of the United States. The European Communities points out that General Motors Corp. is the largest single shareholder of Suzuki Motor Co. and that Japanese nationals constitute a minority in the board of directors of CAMI. In our view, however, no evidence has been presented which would allow the Panel to determine which juridical person "controls" CAMI, within the meaning of Article XXVIII(n)(ii) of the GATS.

10.259 As regards Volvo Canada Ltd., it should be noted that ownership and control of this company passed from Volvo AB of Sweden to Ford Motor Co. of the United States in January 1999, when the former agreed to sell its passenger car business to the latter. As a consequence, Volvo Canada Ltd. is now a juridical person of the United States according to Article XXVIII(m) of the GATS. Moreover, as Volvo Canada Ltd. closed its Canadian plant in December 1998, it would lose its right to import motor vehicles duty free under the import duty exemption.

10.260 The MVTO 1998 restricts eligibility for the import duty exemption to manufacturers who had operated in Canada in the base year 1963-64, while SROs allowed other individual manufacturers to qualify until 1989, subject to manufacturing presence and CVA requirements referring to different base years. Eligibility for SROs, however, ended in 1989, effectively freezing the *status quo* of the beneficiaries of the import duty exemption. This is confirmed by Canada's reply to question 37 from the Panel, which says that the list of manufacturers under the SROs cannot be expanded, but only

[904] In the *EC – Bananas III* case, on the point of the determination of the origin of a juridical person, the panel stated that: "… suppliers which are commercially present within the EC territory and owned or controlled by, for example, Del Monte Mexico would be entitled to benefit from GATS rights because it would not matter under Article XXVIII(m) of GATS whether Del Monte Mexico was owned or controlled by natural or juridical persons of Jordan, i.e. a WTO non-Member, as long as Del Monte Mexico was incorporated in Mexico and engaged in substantive business operations in the territory of Mexico or any other Member." See, Panel Report on *EC – Bananas III (USA)*, *supra* note 269, footnote 493, para. 7.318.

updated to reflect a change in a company's name or to remove companies that have ceased manufacturing. The category of manufacturer beneficiaries is therefore currently a closed one, so that after 1989 it became impossible for other manufacturers/wholesalers to fulfil the criteria required in order to qualify for the import duty exemption.

10.261 Although none of the criteria for granting the import duty exemption is expressly based on nationality, the manufacturing presence requirement, referring to the period 1 August 1963 – 31 July 1964 in the MVTO 1998, has allowed only three service suppliers of the United States (Chrysler Canada Ltd., General Motors of Canada Ltd. and Ford Motor Company of Canada Ltd.) and one service supplier of Sweden (Volvo Canada Ltd.) to qualify for the import duty exemption.[905] It was noted above that Volvo Canada Ltd. recently passed under the control of a juridical person of the United States (Ford Motor Co.). SROs have been used to expand the category of manufacturer beneficiaries by allowing two other manufacturers/wholesalers of automobiles (Intermeccanica of Canada and CAMI, a 50/50 joint venture between Suzuki Motor Co. of Japan and General Motors Corp. of the United States) and several manufacturers/wholesalers of buses and specified commercial vehicles to qualify for the import duty exemption.

10.262 In our view, the import duty exemption, as provided in the MVTO 1998 and SROs, results in less favourable treatment accorded to services and service suppliers of any other Member within the meaning of Article II:1 of the GATS, as such benefit is granted to a limited and identifiable group of manufacturers/wholesalers of motor vehicles of some Members, selected on the basis of criteria such as the manufacturing presence in a given base year. We also note that the manufacturing presence requirements in the MVTO 1998 and in the SROs explicitly exclude suppliers of wholesale trade services of motor vehicles, which do not manufacture vehicles in Canada, from qualifying for the import duty exemption. In addition, the fact that in 1989 the Government of Canada stopped granting SROs makes the list of the beneficiaries of the import duty exemption a closed one. As a result, manufacturers/wholesalers of motor vehicles of some Members can import vehicles into Canada duty-free, while manufacturers/wholesalers of other Members are explicitly prevented from importing vehicles duty free into Canada.

10.263 We do not address separately the claim by Japan that the import duty exemption is inconsistent with the requirement in Article II that treatment no less favourable be accorded "immediately and unconditionally", as in our view this claim is addressed by our finding relating to whether the import duty exemption constitutes "treatment less favourable" within the meaning of Article II of the GATS.

10.264 In light of the foregoing, we **find** that with respect to the import duty exemption, granted to a limited number of manufacturers/wholesalers of motor vehicles, Canada has failed to accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than it accords to like services and service suppliers of any other country. We **find**, therefore, that the import duty exemption accorded pursuant to the MVTO 1998 and the SROs is inconsistent with the requirements of Article II:1 of the GATS.

4. Applicability of Article V of the GATS

10.265 In its third-party submission the United States claims that the MVTO 1998 and SROs, to the extent that they provide more favourable treatment to service suppliers of the United States, are subject to the exception to Article II of the GATS conferred by Article V:1 of the GATS. According to the United States this is so, because the more favourable treatment the complainants are seeking to

[905] The MVTO 1965, which implemented the Canada-US Auto Pact in Canada, originally applied to six automobile producers (American Motors, Chrysler, Ford, General Motors, Studebaker and Volvo), all of North American origin with the exception of Volvo, and to a number of producers of specified commercial vehicles and buses.

condemn is being accorded by a member of an economic integration agreement of the type specified by Article V:1, the North American Free Trade Agreement (NAFTA), to the service suppliers of another Member of that agreement. The United States also points out that the services provisions of NAFTA clearly fall within the terms of GATS Article V:1. Canada does not invoke Article V, as it maintains that the MVTO 1998 and SROs are not measures affecting trade in services within the meaning of Article I of the GATS. However, if the Panel were to find that the MVTO 1998 and SROs were measures affecting trade in services inconsistent with Article II of the GATS, Canada argues that they are covered by Article V:1 of the GATS.

10.266 The complainants argue that Article V cannot apply to the facts of this case, because the MVTO 1998 and SROs are unilateral measures and cannot be considered an "agreement" within the meaning of Article V:1 of the GATS (the original Auto Pact is no longer being implemented by the United States). The complainants also point out that even if the MVTO 1998 and SROs were to be considered an agreement within the meaning of Article V:1 of the GATS, this would lack the substantial sectoral coverage required by Article V:1(a), it would fail to eliminate substantially all discrimination in the sense of Article XVII between or among the parties (Article V:1(b)) and it would raise the overall level of barriers to trade in services in the sector (Article V:4). Both complainants also point out that the MVTO 1998 and SROs cannot be considered a part of NAFTA, as NAFTA contains prohibitions on import duty exemptions and perfomance requirements. They note that NAFTA does not require, it merely allows Canada to maintain the MVTO 1998 and SROs by means of express exceptions.

10.267 We note that Article V:1 of the GATS provides in relevant part:

> "1. This Agreement shall not prevent any of its Members from being a party to or entering into an agreement liberalizing trade in services between or among the parties to such an agreement, provided that such an agreement:
>
> (a) has substantial sectoral coverage (*footnote omitted*), and
>
> (b) provides for the absence or elimination of substantially all discrimination, in the sense of Article XVII, between or among the parties, in the sectors covered under subparagraph (a), through:
>
> (i) elimination of existing discriminatory measures, and/or
>
> (ii) prohibition of new or more discriminatory measures"

10.268 We note the argument of the United States that the measures at issue in this case are covered by Article V:1 of the GATS because they are accorded by a member of NAFTA to the service suppliers of another member of the same economic integration agreement. In our view, however, the MVTO 1998 and SROs are measures which cannot be considered as part of NAFTA provisions on liberalization of trade in services; rather, NAFTA members have agreed to allow their continued implementation through specific exceptions granted to Canada. Paragraph 1 of Annex 300-A.1 of NAFTA states that "Canada and the United States may maintain the Agreement Concerning Automotive Products between the Government of Canada and the Government of the United States of America". Annex I – Canada of the NAFTA also states that "Canada may grant waivers of custom duties conditioned, explicitly or implicitly, on the fulfilment of performance requirements".

10.269 Even assuming that the MVTO 1998 and the SROs could be brought within the scope of the services liberalization provisions of NAFTA, we note that the import duty exemption under the MVTO 1998 and SROs is accorded to a small number of manufacturers/wholesalers of the United States to the exclusion of all other manufacturers/wholesalers of the United States and of Mexico. The MVTO 1998 and SROs, therefore, provide more favourable treatment to only some and not all

services and service suppliers of Members of NAFTA, while, according to Article V:1(b), an economic integration agreement has to provide for "the absence or elimination of substantially all discrimination, in the sense of Article XVII", in order to be eligible for the exemption from Article II of the GATS.

10.270 Although the requirement of Article V:1(b) is to provide non-discrimination in the sense of Article XVII (National Treatment), we consider that once it is fulfilled it would also ensure non-discrimination between all service suppliers of other parties to the economic integration agreement. It is our view that the object and purpose of this provision is to eliminate all discrimination among services and service suppliers of parties to an economic integration agreement, including discrimination between suppliers of other parties to an economic integration agreement. In other words, it would be inconsistent with this provision if a party to an economic integration agreement were to extend more favourable treatment to service suppliers of one party than that which it extended to service suppliers of another party to that agreement.

10.271 Moreover, it is worth recalling that Article V provides legal coverage for measures taken pursuant to economic integration agreements, which would otherwise be inconsistent with the MFN obligation in Article II. Paragraph 1 of Article V refers to "an agreement liberalizing trade in services". Such economic integration agreements typically aim at achieving higher levels of liberalization between or among their parties than that achieved among WTO Members. Article V:1 further prescribes a certain minimum level of liberalization which such agreements must attain in order to qualify for the exemption from the general MFN obligation of Article II. In this respect, the purpose of Article V is to allow for ambitious liberalization to take place at a regional level, while at the same time guarding against undermining the MFN obligation by engaging in minor preferential arrangements. However, in our view, it is not within the object and purpose of Article V to provide legal coverage for the extension of more favourable treatment only to a few service suppliers of parties to an economic integration agreement on a selective basis, even in situations where the maintenance of such measures may explicitly be provided for in the agreement itself.

10.272 In light of the foregoing, we **find** that Article V:1 of the GATS does not exempt Canada from its obligations under Article II of the GATS with respect to the MVTO 1998 and SROs.

5. Claims Under Article XVII of the GATS – import duty exemption

10.273 Japan alone claims that the import duty exemption also violates Article XVII of the GATS in that it constitutes more favourable treatment accorded to Canadian services and service suppliers, which have the right to import vehicles duty free, than to Japanese ones who do not.

10.274 We note that Article XVII of the GATS establishes that:

> "1. In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers. (*Footnote reads:* Specific commitments assumed under this Article shall not be considered to require any Member to compensate for any inherent competitive disadvantages which result from the foreign character of the relevant services or service suppliers.)
>
> 2. A Member may meet the requirement of paragraph 1 by according to services and service suppliers of any other Member, either formally identical treatment or formally different treatment to that it accords to its own like services and service suppliers.

> 3. Formally identical or formally different treatment shall be considered to be less favourable if it modifies the conditions of competition in favour of services or service suppliers of the Member compared to like services or service suppliers of any other Member."

10.275 Japan claims that the import duty exemption affects the supply of wholesale trade services, as it modifies the conditions of competition between Canadian beneficiaries of the duty-free treatment and foreign wholesale trade service suppliers of imported motor vehicles which do not benefit from the same treatment. In particular, the import duty exemption would directly affect the cost of the goods being distributed and indirectly affect the cost and/or profitability of the related wholesale trade services.

10.276 Canada argues that the import duty exemption is not a measure affecting trade in services within the meaning of Article I of the GATS, because, as a tariff measure, it affects the goods themselves and not the supply of distribution services. According to Canada, such measures do not affect a service supplier in its capacity as service supplier and in its supply of a service. Canada further argues that: (i) it has not undertaken commitments in wholesale trade services of motor vehicles; (ii) if it had undertaken commitments it did not need to schedule custom duties as national treatment limitations; (iii) there are no "like" Canadian and Japanese suppliers of wholesale trade services for motor vehicles in Canada; and (iv) as with Article II, it is not possible to argue that the import duty exemption modifies the conditions of competition among wholesale trade suppliers of motor vehicles because, due to vertical integration and exclusive distribution between manufacturers and wholesalers of motor vehicles, there is no competition to be affected at the wholesale trade level.

10.277 Our analysis with respect to the Article II claim on how the import duty exemption affects wholesale trade services of motor vehicles, within the meaning of Article I of the GATS, also applies to this claim under Article XVII of the GATS (see above, paragraphs 10.239-10.246).

(a) Whether Canada has undertaken commitments on wholesale trade services of motor vehicles

10.278 Japan argues that Canada's Schedule of Specific Commitments includes wholesale trade of motor vehicles either under the general entry "B. Wholesale trade services" or under the more specific entry "Sale of motor vehicles including automobiles and other road vehicles", United Nations Provisional Central Product Classification (CPC) number 6111. Japan also points out that under "B. Wholesale trade services", Canada lists a limitation for the state of Saskatchewan applying to "sale of motor vehicles". According to Japan, by inserting this limitation Canada is implying that its commitments on wholesale trade services also include wholesale services for motor vehicles. Canada responds that its entry "B. Wholesale trade services" expressly refers to CPC 622, which excludes distribution of motor vehicles and that the insertion of a limitation with respect to motor vehicles is a scheduling error. It also points out that CPC entry "6111" is inscribed under the heading "C. Retail services" and therefore should be read as a commitment only on retail services for motor vehicles.

10.279 We note that the CPC entry 622 (Wholesale trade services) does not have a sub-heading for motor vehicles, and that sub-heading 62282 (Wholesale trade services of transport equipment other than motor vehicles, motorcycles and bicycles) expressly excludes motor vehicles. In our view, the fact that Canada has inscribed a limitation applying to motor vehicles with respect to the entry "Wholesale trade services (622)" in its schedule does not in itself constitute sufficient evidence to conclude that it has undertaken a commitment on wholesale trade services of motor vehicles.

10.280 Nevertheless, Canada has also listed in its schedule of commitments an entry for "Sale of motor vehicles including automobiles and other road vehicles" with an explicit reference to CPC number 6111. In the United Nations Provisional Central Product Classification, the entry "6111 Sale of motor vehicles including automobiles and other road vehicles" includes two sub-headings: "61111

Wholesale trade services of motor vehicles"; and "61112 Retail sales of motor vehicles". In our view, if Canada had meant to limit this commitment only to retail services it should have inscribed entry 61112 (Retail sales of motor vehicles) in its schedule rather than 6111 (Sale of motor vehicles).

10.281 We note that there is a discrepancy between the inclusion of the whole CPC entry 6111 and the heading of the commitment ("C. Retailing services") in page 48 of Canada's schedule. However, the fact that entry 6111 has been listed under the heading C. Retailing services does not constitute sufficient evidence to exclude a commitment with respect to wholesale trade services of motor vehicles. If the heading were to prevail, the systemic impact would be that all unqualified CPC numbers in Members' schedules of commitments, referring to clearly and precisely defined subsectors, would be undermined, at least when their combination with headings is inconsistent. For these reasons we consider that the description of the CPC should prevail and that the commitments contained in page 48 of Canada's schedule also apply to wholesale trade of motor vehicles.

10.282 We **find** therefore that, by inscribing the CPC entry "6111 Sale of motor vehicles including automobiles and other road vehicles" in its schedule of specific commitments, Canada has undertaken a commitment also covering "61111 Wholesale trade services of motor vehicles".

(b) Whether services are "like"

10.283 Japan contends that there are "like" Japanese and Canadian wholesale service suppliers of motor vehicles, including automobiles as well as buses and specified commercial vehicles. Canada contests the existence of like wholesale service suppliers. Japan points out that while some Canadian suppliers have qualified for the import duty exemption under SROs (Intermeccanica and three manufacturers of buses and specified commercial vehicles), Japanese suppliers cannot import vehicles duty-free, unless they acquire, or are acquired by, a Canadian subsidiary of one of the existing manufacturer beneficiaries.

10.284 Canada points out that Intermeccanica is "unlike" any Japanese wholesale service supplier of motor vehicles because it is not a wholesaler but only a manufacturer and even if it were a wholesaler, its size, sales volumes and the products it manufactures are vastly different from those of any of the establishments identified by Japan as suppliers of wholesale trade services of motor vehicles. According to Japan, the scale of companies and the nature of the products they supply should not affect the determination of likeness, insofar as service suppliers supply services listed in the same CPC category. In this respect Japan argues that Intermeccanica is "like" other Japanese suppliers of wholesale trade services for motor vehicles in Canada.

10.285 In our view, Intermeccanica, which manufactures and sells directly to consumers a small number of vehicles (artisanal replica racing cars) per year, should not be considered a supplier of wholesale trade services of motor vehicles, as it does not seem to be supplying "wholesale trade services of motor vehicles" as defined in CPC 6111.

10.286 With respect to wholesale trade services suppliers of buses and specified commercial vehicles, Canada argues that Japan has failed to identify any Canadian or Japanese suppliers of these services. Japan contests this allegation, arguing that there is at least one Japanese supplier operating in Canada (Hino Diesel Trucks) and that other Japanese wholesale trade service suppliers of motor vehicles have the capability to produce and distribute buses or specified commercial vehicles. Japan also points out that in response to question 2(4) from Japan, Canada has listed 15 companies which have imported and distributed vehicles other than automobiles under the MVTOs and SROs at least once in the last 10 years. According to Japan, at least three of these companies are of Canadian origin in accordance with Article XXVIII(m) of the GATS.

10.287 In response to a supplemental question from the Panel, Japan has produced supporting material to demonstrate that three companies which were granted the import duty exemption under

SROs, A. Girardin Inc., Michel Corbeil Inc., and Western Star Trucks Inc., are juridical persons of Canada according to Article XXVIII(m) of the GATS. In response to another supplemental question from the Panel, Canada has confirmed that, to its knowledge A. Girardin Inc. and Michel Corbeil Inc. are Canadian-owned companies. Regarding Western Star Trucks Inc., Canada has pointed out that it is wholly owned by another Canadian incorporated company (Western Star Trucks Holding Ltd.), which in turn is controlled by a Singaporean incorporated company (Western Star International).

10.288 Canada, however, argues that Japan has failed to prove that the three Canadian companies, which have benefited from the import duty exemption, are suppliers of wholesale trade services. Canada points out that these companies may import buses or chassis for specified commercial vehicles as inputs for finished vehicles; they may re-import vehicles of their own manufacture that have been exported for modification in other countries; or they may import vehicles as retailers. Canada points out, however, that none of these activities would constitute supply of wholesale trade services, which consists principally in re-selling merchandise, according to the definition contained in Section 6 of the CPC.

10.289 Regarding wholesale trade services of buses and specified commercial vehicles, we note that Japan has identified one Japanese service supplier and argued that Japanese wholesale suppliers of automobiles could enter the market. We further note that the CPC entry "6111 sale of motor vehicles including automobiles and other road vehicles" also includes wholesale trade of buses and specified commercial vehicles. In our view, however, there is no clear evidence before the Panel that the Canadian manufacturers of buses and specified commercial vehicles, which benefit from the import duty exemption, also supply wholesale trade services of motor vehicles as defined in the CPC. Canada has contested that these companies are "like" suppliers of wholesale trade services for motor vehicles and Japan, with whom the burden of proof rests, has not produced evidence to demonstrate the contrary. We note that, in the absence of "like" domestic service suppliers, a measure by a Member cannot be found to be inconsistent with the national treatment obligation in Article XVII of the GATS.

10.290 Accordingly, we **find** that Japan has failed to demonstrate that the import duty exemption accorded pursuant to the MVTO 1998 and the SROs constitutes treatment less favourable accorded to Japanese service suppliers than that accorded to like Canadian service suppliers.

6. Claims Under Article XVII of the GATS – CVA requirement

10.291 The CVA requirements in the MVTO 1998 and in SROs require manufacturer beneficiaries to achieve a minimum of Canadian value-added, a part of which may be made up through the purchase of services supplied in Canada, as a condition for obtaining the import duty exemption. With respect to services, Canadian value-added means the part of the following costs that is reasonably attributable to the production of motor vehicles: (i) the cost of maintenance and repair work executed in Canada on buildings, machinery and equipment used for production purposes; (ii) the cost of engineering services, experimental work and product development work executed in Canada; (iii) administrative and general expenses incurred in Canada. The European Communities notes that CVA also includes (iv) "fire and insurance premiums, in respect of production inventories and the production plant and equipment, paid to a company authorised by federal or provincial law to carry on business in Canada or a province".

(a) CVA requirements as affecting services related to the production of motor vehicles

10.292 The complainants argue that the CVA requirements provide an incentive for the beneficiaries of the import duty exemption to use services supplied within the Canadian territory rather than like services supplied in or from the territory of other Members, thus modifying the conditions of competition among them. Canada does not contest the claim that CVA requirements affect the supply of services.

10.293 We note that the CVA requirements, in stipulating that only services supplied domestically may count toward CVA, affect directly the services which are supplied through modes 1 and 2**.** We therefore need to determine whether such effect is consistent with Canada's commitments under Article XVII.

(b) Whether services affected by the CVA requirements are covered by Canada's specific commitments in services

10.294 The complainants argue that all services affected by the CVA requirements are included in Canada's schedule of specific commitments, while none of the limitations inscribed cover the CVA requirements. Canada points out that relevant national treatment limitations have been inscribed for potentially affected services listed by the complainants.

10.295 In addition, the complainants argue that there are several services affected by the CVA requirements which can be supplied though modes 1 and 2, where Canada has scheduled no limitations and that, even in those sectors where limitations have been scheduled, such limitations do not exempt Canada from its Article XVII obligations with respect to the CVA requirements.[906] They point out that the CVA requirements are not listed as limitations in Canada's schedule of commitments and that other limitations such as nationality, residency or establishment requirements, which would impede the supply of a service cross-border, cannot be used to justify the CVA requirements. For this purpose the complainants refer to the answer to question 7 in the Addendum 1 to the Scheduling Guidelines (*Scheduling of Initial Commitments in Trade in Services: Explanatory Note - Addendum*, MTN.GNS/W/164/Add.1).[907] Canada responds that limitations which it had scheduled such as nationality, residency or establishment requirements make the supply of a service through modes 1 and 2 impossible, so that where these limitations exist, the CVA requirements cannot violate Article XVII.

10.296 We note that Canada has undertaken specific commitments in all the sectors listed by the complainants as being affected by the CVA requirements and that it has inscribed some partial limitations on national treatment with respect to some of these sectors. In our view, however, even the national treatment limitations which have been scheduled, however restrictive, cannot be deemed

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[906] (1) With respect to the first CVA requirement, "maintenance and repair work executed in Canada on buildings, machinery and equipment used for production purposes," the complainants note that Canada has included the following services in its schedule of specific commitments: *repair services incidental to metal products, machinery and equipment including computers and communication equipment on a fee or contract basis (CPC 8861 to 8866)*; (2) with respect to the second CVA requirement, "engineering services, experimental work and product development work executed in Canada," the complainants note that Canada's has included the following services in its schedule of specific commitments: *engineering services (CPC 8672)*; (3) With respect to the third CVA requirement, "administrative and general expenses incurred in Canada," the complainants note several services sectors included in Canada's schedule of specific commitments including: *professional services, computer related services, other business services, banking services, telecommunication services, courier services and travel services*; (4) With respect to the fourth CVA requirement, "fire and insurance premiums, in respect of production inventories and the production plant and equipment, paid to a company authorised by federal or provincial law to carry on business in Canada or a province" the European Communities notes that Canada has included the following services in its schedule of specific commitments: *non-life insurance services (CPC 8129)*.

[907] "*How relevant is a reservation for a residence requirement, nationality condition or commercial presence requirement under cross-border trade: does that not rather imply that cross-border trade is not allowed and therefore the correct entry should be 'unbound'?*"

"It is correct to use the term 'unbound' for a mode of supply in a given sector where a Member wishes to remain free to introduce or maintain measures inconsistent with market access or national treatment. However, it has been pointed out by participants that in some cases there is advantage in inscribing a particular limitation (e.g., a residency requirement or a commercial presence requirement) instead of the term 'unbound' in that trading partners have the certainty that there are no other limitations with respect to the cross-border mode. (See also para. 8 of the scheduling guide on residency requirements, and para. 6 on nationality requirements.)"

to also cover the CVA requirements. Only a specific limitation referring to the CVA requirements or an "unbound" entry would achieve this effect, as the inscription of another specific limitation (such as a residency requirement or a commercial presence requirement) would imply that there are no other limitations than the one listed with respect to the cross-border mode.

10.297 We find, therefore, that Canada has undertaken specific commitments in those sectors which the complainants claim to be affected by the CVA requirements, and that the limitations that have been listed do not cover the CVA requirements.

(c) Technical feasibility and inherent competitive disadvantage of modes 1 and 2 services

10.298 Canada points out that with respect to the first CVA requirement relating to services, "maintenance and repair work executed in Canada on buildings, machinery and equipment used for production purposes", there can be no discrimination against services supplied through modes 1 and 2, as cross-border supply and consumption abroad of these services are not technically feasible. On hotel and other lodging services and food and beverages services, it argues that choices regarding these services are dictated by geography and have nothing to do with the CVA requirements. According to Canada, the competitive disadvantage in the foreign provision of many services listed by the complainants as being affected by the CVA requirements is inherent in the foreign character of these services and, as stated in footnote 10 to Article XVII, should not be regarded as a national treatment restriction.

10.299 The complainants argue that even if inherent disadvantages due to foreign character existed for some modes 1 and 2 services, the disadvantages caused by the CVA could not be considered inherent. They point out that Canada's argument that modes 1 and 2 services relating to the production of motor vehicles are already inherently disadvantaged due to their foreign character contradicts the very aim of the CVA requirements, that is, to favour services supplied in Canada. In addition the complainants note that footnote 10 to Article XVII only exempts Members from having to compensate for inherent competitive disadvantages due to foreign character, while in this case Canada would only be required to abstain from taking a measure which creates a disadvantage for modes 1 and 2 suppliers.[908]

10.300 We consider that, although the supply of some repair and maintenance services on machinery and equipment through modes 1 and 2 might not be technically feasible, as they require the physical presence of the supplier, all other services listed by the complainants as being affected by the CVA requirements, including some consulting and advisory services relating to repair and maintenance of machinery, can be supplied through modes 1 and 2. We further consider that treatment less favourable granted to services supplied outside Canada cannot be justified on the basis of inherent disadvantages due to their foreign character. Footnote 10 to Article XVII only exempts Members from having to compensate for disadvantages due to foreign character in the application of the national treatment provision; it does not provide cover for actions which might modify the conditions of competition against services and service suppliers which are already disadvantaged due to their foreign character.

10.301 We therefore find that lack of technical feasibility only excludes the supply of some repair and maintenance services on machinery and equipment through modes 1 and 2 from Canada's national treatment obligation. We also find that any eventual inherent disadvantages due to the foreign character of services supplied through modes 1 and 2 do not exempt Canada from its national treatment obligation with respect to the CVA requirements.

[908] Footnote to Article XVII states: "Specific commitments assumed under this Article shall not be considered to require any Member to compensate for any inherent competitive disadvantages which result from the foreign character of the relevant services or service suppliers."

(d) Whether it is relevant that CVA requirements might be met on the basis of labour costs alone

10.302 Canada argues that, considering that (1) any possible effects of the CVA requirements impinge only on services supplied through modes 1 and 2, (2) relevant limitations have been inscribed in the schedule for the services sectors at issue, (3) the supply of some services through modes 1 and 2 is not technically feasible, and (4) no compensation is due for any inherent competitive disadvantage resulting from the foreign character of services; the complainants' national treatment claims should thus be limited to certain services that constitute "general and administrative expenses". According to Canada the inclusion of this last category of services in the list of CVA eligible expenses, however, does not affect the conditions of competition between Canadian and foreign service suppliers, as there is evidence that most of the qualifying manufacturers exceed their CVA requirement on the basis of labour costs alone.

10.303 The complainants note that the national treatment obligation in Article XVII of the GATS, like that of Article II of the GATT, protects competitive opportunities, not actual trade flows. They note that, if measures such as the CVA requirements create an incentive for using locally supplied services, it is not necessary to show that they have any actual effect on trade flows. Therefore, even if the CVA requirements were met by all manufacturer beneficiaries on the basis of labour costs alone, such measure would still constitute a violation of Article XVII, so long as there was discrimination in favour of services supplied in Canada against like services supplied outside Canada. Moreover, the complainants point out that with respect to the Article XVII claim, Canada argues that most of the qualifying manufacturers exceed their CVA requirements on the basis of labour costs alone, thus admitting implicitly that some manufacturers might not do so.

10.304 We note that Article XVII requires each Member to accord to services and service suppliers of any other Member treatment no less favourable than it accords to its own like services and service suppliers, and that it defines treatment less favourable as formally different or formally identical treatment which modifies the conditions of competition in favour of domestic services and service suppliers. In our view, the CVA requirements may affect the conditions of competition between services supplied in Canada and services of other Members supplied from outside Canada through modes 1 and 2, even where a manufacturer meets its CVA requirements on the basis of labour costs alone. In fact, CVA requirements constitute an incentive to purchase services supplied in Canada and such incentive will be effective unless the requirements for a given period of time have already been met through labour costs. Moreover, even where for a given period of time it is clear that CVA requirements are going to be met on the basis of labour costs alone, thus rendering redundant any possible incentive to purchase services supplied in Canada, there is no evidence that the CVA requirements will also be met in the future on the basis of labour costs alone and that, consequently, there will be no discriminatory effect on trade in services.

10.305 We, therefore, find that the fact that most manufacturer beneficiaries currently exceed their CVA requirements on the basis of labour costs alone does not undermine the role of the CVA requirements as a discriminatory incentive favouring services supplied in Canada against services supplied from outside Canada through modes 1 and 2.

(e) Whether treatment no less favourable is accorded

10.306 The complainants argue that the phrases "executed in Canada" and "incurred in Canada" prevent the inclusion in the CVA requirements of all services supplied under modes 1 and 2. The complainants therefore claim that the CVA requirements constitute less favourable treatment granted to like services and service suppliers of other Members, in that they create an economic incentive for manufacturer beneficiaries to purchase services supplied in Canada, thus modifying the conditions of competition in favour of services supplied in Canada compared to those of other Members supplied

through modes 1 and 2 (from and in the territory of other Members). Canada points out that the supply of services through modes 3 ("commercial presence") and 4 ("presence of natural persons") is unaffected by the CVA requirements as all mode 3 and 4 suppliers, Canadian and non-Canadian, can benefit from the CVA requirements.

10.307 We note that the CVA requirements in the MVTO 1998 and SROs do not discriminate between domestic and foreign services and service suppliers operating in Canada under modes 3 and 4. This observation, however, does not suffice to conclude that the requirements of Article XVII are met. In our view, it is reasonable to consider for the purposes of this case that services supplied in Canada through modes 3 and 4 and those supplied from the territory of other Members through modes 1 and 2 are "like" services. In turn, this leads to the conclusion that the CVA requirements provide an incentive for the beneficiaries of the import duty exemption to use services supplied within the Canadian territory over "like" services supplied in or from the territory of other Members through modes 1 and 2, thus modifying the conditions of competition in favour of services supplied within Canada. Although this requirement does not distinguish between services supplied by service suppliers of Canada and those supplied by service suppliers of other Members present in Canada, it is bound to have a discriminatory effect against services supplied through modes 1 and 2, which are services of other Members.

10.308 In light of the foregoing, we **find** that the CVA requirements on manufacturer beneficiaries contained in the MVTO 1998 and the SROs accord less favourable treatment to services of other Members supplied though modes 1 and 2 and are therefore inconsistent with Canada's obligations under Article XVII of the GATS.

XI. CONCLUSIONS AND RECOMMENDATIONS

A. CONCLUSIONS

11.1 In light of the above findings, we **conclude** as follows:

(a) Canada acts inconsistently with Article I:1 of the GATT 1994 by according the advantage of an import duty exemption to motor vehicles originating in certain countries, pursuant to the MVTO 1998 and the SROs, which advantage is not accorded immediately and unconditionally to like products originating in the territories of all other WTO Members;

(b) the inconsistency of these measures with Article I:1 of the GATT 1994 cannot be justified under Article XXIV of the GATT 1994;

(c) Canada acts inconsistently with Article III:4 of the GATT 1994 by according less favourable treatment to imported parts, materials and non-permanent equipment than to like domestic products with respect to their internal sale or use, as a result of application of the CVA requirements as one of the conditions determining eligibility for the import duty exemption on motor vehicles under the MVTO 1998, the SROs and as a result of conditions concerning CVA requirements contained in certain Letters of Undertaking;

(d) the European Communities has failed to demonstrate that Canada acts inconsistently with Article III:4 of the GATT 1994 by applying ratio requirements under the MVTO 1998 and the SROs as one of the conditions determining eligibility for the import duty exemption on motor vehicles;

(e) Canada acts inconsistently with its obligations under Article 3.1(a) of the SCM Agreement by granting a subsidy which is contingent in law upon export performance, as a result of the application of the ratio requirements as one of the conditions determining eligibility for the import duty exemption on motor vehicles under the MVTO 1998 and the SROs;

(f) The European Communities and Japan have failed to demonstrate that Canada acts inconsistently with its obligations under Article 3.1(b) of the SCM Agreements by granting a subsidy which is contingent upon the use of domestic over imported goods, as a result of the application of the CVA requirements as one of the conditions determining eligibility for the import duty exemption on motor vehicles under the MVTO 1998 and the SROs;

(g) Canada acts inconsistently with Article II of the GATS by failing to accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country, with respect to the granting of the import duty exemption to a limited number of manufacturers/wholesalers of motor vehicles pursuant to the MVTO 1998 and the SROs;

(h) the inconsistency of these measures with Article II of the GATS cannot be justified under Article V of the GATS;

(i) Japan has failed to demonstrate that the import duty exemption granted pursuant to the MVTO 1998 and the SROs constitutes treatment less favourable accorded to Japanese suppliers of wholesale trade services of motor vehicles than that accorded to like Canadian service suppliers, within the meaning of Article XVII of the GATS; and

(j) Canada acts inconsistently with Article XVII of the GATS by according treatment less favourable to services and service suppliers of other Members, supplied through modes 1 and 2, than it accords to its own like services and service suppliers, as a result of the application of the CVA requirements as one of the conditions determining eligibility for the import duty exemption on motor vehicles under the MVTO 1998 and the SROs.

11.2 Under Article 3.8 of the DSU, in cases where there is infringement of the obligations assumed under a covered agreement, the action is considered *prima facie* to constitute a case of nullification or impairment of benefits under that agreement. Accordingly, we conclude that to the extent that Canada has acted inconsistently with the provisions of the covered agreements, as described in the preceding paragraph, it has nullified or impaired benefits accruing to the complainants under those agreements.

B. RECOMMENDATIONS

11.3 With respect to our conclusions regarding Canada's obligations under Articles I:1 and III:4 of the GATT 1994, and Articles II and XVII of the GATS, the Panel *recommends* that the Dispute Settlement Body request Canada to bring its measures into conformity with its obligations under the WTO Agreement.

11.4 With respect to our conclusions regarding Canada's obligations under the SCM Agreement, we note that Article 4.7 of the SCM Agreement provides:

> "If the measure in question is found to be a prohibited subsidy, the panel shall recommend that the subsidising 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."

11.5 Accordingly, we **recommend** that the Dispute Settlement Body request Canada to withdraw the export subsidy without delay.

11.6 With respect to the time-period within which the measure must be withdrawn, Article 4.7 of the SCM Agreement requires a Member to withdraw the prohibited subsidy "without delay" and it is "in this regard" that a panel must specify a time-period within which the prohibited subsidy must be withdrawn. The noun "delay" has been defined to mean, *inter alia*, "the action or process of delaying; procrastination; lingering; putting off", while the verb to "delay" has been defined, *inter alia*, as to "put off to a later time; postpone, defer".[909] Thus, in its ordinary meaning, the phrase "without delay" suggests that the Member must not put off, postpone or defer action, but must rather act as quickly as possible to withdraw the prohibited subsidy. Thus, in examining what time-period would represent withdrawal "without delay" in a particular case, we consider that we may take into account the nature of the steps necessary to withdraw the prohibited subsidy. We do not, however, agree with Canada that we should take into account the existence or absence of adverse or trade-distorting effects resulting from the prohibited subsidy, nor the time required to design replacement measures, as these factors are not related to the consideration of what time-period would represent withdrawal "without delay".

11.7 Applying these principles to the case at hand, we note that the MVTO 1998 and the SROs are both Orders-in-Council, and as such are acts of the executive, and not the legislative, branch of government. The amendment or revocation of an act of the executive branch can normally be effectuated more quickly than would be the case if legislative action were required. In light of the foregoing and of the information before the Panel, we consider that a time-period of 90 days would be appropriate.[910] We therefore **recommend** that the Dispute Settlement Body request Canada to withdraw the export subsidy within 90 days.

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[909] The New Shorter Oxford English Dictionary (Clarendon Press, 1993), Vol. 1, 623.

[910] We note that, in those disputes involving a prohibited subsidy in which legislative action was not required, panels have specified a time-period of 90 days. See Panel Report on *Australia – Automotive Leather*, *supra* note 748; Panel Report on *Brazil – Aircraft, supra* note 490; Panel Report on *Canada – Aircraft, supra* note 495.