

SIMULATION EXERCISE

International Negotiations Related to the Provision of Subsidies to Civil Aircraft Manufacturers and Compliance with WTO Dispute Settlement Decisions

Country Teams: Republic of Brazil and Canada

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I Introduction

The following background information and instructions are designed to provide students with a working knowledge of international trade issues related to subsidies and WTO dispute settlement enforcement..

For purposes of this simulation, certain factual information related to the practices of the negotiating parties has been intentionally developed as hypothetical information, ie. certain facts and figures have been invented to facilitate a short term negotiation simulation. The general background and information related to the relevant laws, regimes and agreements is factual, although students will need to supplement the information on specific WTO agreements and cases through their own research.

Background

Since 1996 Canada and Brazil have engaged in a series of negotiations over the provision of government sponsored financing and interest rate equalization payments by the Brazilian government to civil aircraft exporters. Canada alleged these payments violated certain provisions of the WTO Agreement on Subsidies and Countervailing Measures (ASCM). Since 1996 the parties have met over 30 times at all levels, to try and resolve the problems. In June of 1996, Canada requested a WTO panel on the relevant issues, but subsequently withdrew this request in October as negotiations continued. Discussions on a mutually acceptable solution between the two countries continued throughout 1996 and early 1997, but in March of 1997 Brazil also requested WTO consultations regarding certain Canadian subsidies and export financing programs, which it argued also violated the ASCM. In 1998 both countries appointed distinguished, Special Envoys who made recommendations on resolving the dispute, but to no avail. No mutually acceptable resolution was found to either the Canadian or Brazilian claims and on July 23, 1998 two WTO panels were established to hear the arguments of each country against the other's programs. The United States and the European Union participated in the cases as Third Parties.

On April 14, 1999 the two panels released their final reports. The respective panels found both Canada and Brazil to be in violation of their WTO commitments. Canada was requested to bring two programs, "Technology Partnerships Canada" and "Canada Account" debt financing into compliance with the ASCM (Articles 3.1(a) and 3.2). The panel found that both programs had been used to provide an illegal export subsidy to the regional aircraft industry. The panel hearing Canada's claim against Brazil found that Brazil's "Proex" export financing program was an illegal export subsidy under ASCM Article 3.1 (a). Both countries were requested to withdraw the prohibited subsidies within 90 days.

On May 3, 1999 both Canada and Brazil appealed the respective decisions against their programs. On August 2, 1999 the Appellate Body (AB) of the WTO, while reversing the panel on one peripheral issue, agreed with both Panels that the specified programs of both parties were prohibited export subsidies. The AB concurred with the Panels that both Parties should be requested to bring their respective programs into compliance with the ASCM by withdrawing the prohibited subsidies within 90 days. The AB decision was formally adopted by the Dispute Settlement Body (DSB) on August 20th.

On November 18, 1999 Canada submitted to the Dispute Settlement Body (DSB) a status report on its implementation of the decision, which it alleged remedied all the violations identified by the AB. On November 23rd Brazil served notice of its intent to seek remedies under Article 21.5 of the Dispute Settlement Understanding (DSU), alleging that Canada had not complied with the DSB ruling. At the same time, Canada took identical steps against Brazil alleging non-compliance with respect to "Proex".

The matter of compliance was heard by WTO Panels and on May 9, 2000 the Panels individually ruled that Canada had complied with the DSB decision with respect to the "TPC" program but not with respect to the "Canada Account" debt financing program. The Brazil Panel ruled that Brazil had not complied with the DSB decision regarding "Proex". On May 22nd Brazil appealed the findings of both Article 21.5 Panels arguing that one Panel had erred in finding that Canada had complied with the earlier Panel ruling with respect to "TPC" and that the other had erred in ruling that Brazil had not complied with the earlier Panel decision with respect to the "Proex" program. Canada did not appeal the decision that it had not

complied with respect to the Canada Account debt financing scheme and has indicated it will make the changes necessary to comply.

On July 21st the AB issued rulings denying both claims by Brazil and upholding the Article 21.5 Panels' decision on "TPC" compliance and "Proex" non-compliance. According to reliable reports compliance with the ruling will require the removal of subsidies on as many as 900 ordered but undelivered EMBRAER regional aircraft (2 to 4 billion dollars according to some estimates), as well as elimination of the subsidy on all future orders.

Canada has announced its intention to retaliate against Brazil's non-compliance as provided for under WTO enforcement mechanisms. Such retaliation is likely to take the form of a 100% tariff on some, or even all, Brazilian imports into Canada. Canada has alleged that the value of "Proex" subsidies in total may approach 5 billion dollars and has threatened retaliation of up to 700 million dollars US per year for seven years. Given the current volumes of trade between the two countries, this would effectively eliminate Brazilian exports to Canada. In addition to the tariff hikes, Canada has also threatened withdrawal of benefits under the Uruguay Round textiles and apparel agreement. Canada has indicated a willingness to negotiate however. A Canadian official has commented that "I am reasonably optimistic we will get a deal before we have to impose this...". The official said that Canada was also prepared to discuss some limited degree of conformity on "Proex" coupled with compensation to Canada.

This negotiation simulation is designed to take place during the month of September, 2000, prior to the imposition of retaliatory measures by Canada.

II (a) Factual Background and Supplemental Information Common to All Parties to the Simulation

The facts common to all parties to this international negotiation exercise revolve around the trading relationship between Canada and Brazil, the development of the civil aircraft industry in both countries and the international marketplace for regional aircraft.

Canada and Brazil are the world's largest producers of regional aircraft (20 -90 seat passenger jets and turboprops). Both countries have "national champion" producers: "Bombardier Aerospace", a division of Bombardier Inc. in Canada and "EMBRAER" in Brazil. Both companies are profitable, publically traded, private sector corporations and are among the four largest commercial aircraft manufacturers in the world. (EMBRAER was privatized in 1994 with the Brazilian government maintaining a minority stake and a "golden share") Both export over 80% of their production. Embraer is Brazil's largest exporter and accounts for almost 4% of Brazil's global exports.

The trading relationship between Canada and Brazil is not a large one. In 1999 Canadian exports to Brazil represented about \$567 million, less than .5 % of total Canadian exports. Canadian exports to Brazil were primarily newsprint, coal and potassium chloride. In some years telecommunications equipment has been important. Brazilian exports to Canada are about \$907 million or about 2% of total Brazilian Exports. Brazilian exports to Canada are primarily aluminum, coffee, frozen orange juice, car radios and shoes. Total goods trade between the two countries totals approximately \$1.5. billion US.

Brazilian companies have little direct investment in Canada. Canadian companies have made some substantial investments in Brazil (primarily in natural resources, telecommunications and financial services) Brazil however, is, so far, a secondary location for Canadian FDI.

Canada has been a leading proponent of the Free Trade Agreement of the America's (FTAA) process, of which Brazil is also an important member. Brazil is widely perceived as reluctant to move forward aggressively in this process. Brazil is also the largest member of the South American

trading regime, Mercosur. Canada has moved aggressively to expand and enhance its relationships in Latin America over the past 10 years, both through multilateral processes like the FTAA, and through bilateral means such as foreign aid and the negotiation of a free trade agreement with Chile. Brazil has indicated a desire to play a leading role in South American international economic relations.

This simulation will focus on the period following the decision of the AB in the Article 21.5 cases. Canada and Brazil are meeting with the objective of forestalling Canadian retaliation and achieving a mutually acceptable solution to the issue of prohibited Brazilian export subsidies through "Proex". Canada alleges that:

"PROEX subsidies to Brazilian regional aircraft have resulted in serious distortions in the regional aircraft market -- the market for jet and turboprop aircraft that have between 20 and 90 seats. The significant reduction in the cost of Brazilian regional jet aircraft in a highly competitive market has resulted in a five-fold increase in the market share of exported Brazilian regional aircraft over the past two years and the displacement of not only other regional jet aircraft, but also turboprop aircraft in the market."

Brazil contends that Proex subsidies are essential to the viability of the Brazilian aircraft industry and respond to various subsidy programs of Canada and other countries. The Brazilian aircraft industry is considerably younger than its Canadian counterpart and the success of Embraer has important symbolic as well as practical advantages for the country. It therefore requires subsidies to counter barriers to entry to the global aircraft market from more developed countries such as Canada.

Officials from both countries have indicated that this dispute has done insignificant damage to the bilateral relationship.

Programa de Financiamento as Exportacoes (Proex)

"Proex" involves payments under the interest rate equalization component of the Programa de Financiamento as Exporta^çoes (PROEX), the export financing support program of Brazil, on exports of Brazilian regional aircraft. PROEX was created by the Government of Brazil on 1

June 1991 by Law No. 8187/91 and is maintained by provisional measures issued by the Brazilian government on a monthly basis. PROEX provides export credits to Brazilian exporters either through direct financing or interest rate equalization payments. These payments are generally result in an interest rate reduction of about 3.8 percentage points. Depending on the model of plane this can amount to a savings of about 15% or 2.5 to 4.5 million dollars per plane.

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

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

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

PROEX involvement in aircraft financing transactions begins when the manufacturer requests a letter of approval from the Committee prior to conclusion of a formal agreement with the buyer. This request sets forth the

terms and conditions of the proposed transaction. If the Committee approves, it issues a letter of commitment to the manufacturer. This letter commits PROEX to providing support as specified for the transaction provided that the contract is entered into according to the terms and conditions contained in the request for approval, and provided that it is entered into within a specified period of time, usually 90 days. If a contract is not entered into within the specified time, the commitment contained in the letter of approval expires.

PROEX interest equalization payments, pursuant to the commitment, begin after the aircraft is exported and paid for by the purchaser. PROEX payments are made to the lending financial institution in the form of non-interest bearing National Treasury Bonds (Notas do Tesouro Nacional ñ SÈrie I) referred to as NTN-I bonds. These are denominated in Brazilian Reais indexed to the United States dollar. The bonds are issued by the Brazilian National Treasury to its agent bank, Banco do Brasil, which then passes them on to the lending banks financing the transaction. The bonds are issued in the name of the lending bank which can decide to redeem them on a semi-annual basis for the duration of the financing or discount them for a lump sum in the market. PROEX resembles a series of zero coupon bonds which mature at six months intervals over the course of the financing period. The bonds can only be redeemed in Brazil and only in Brazilian currency at the exchange rate prevailing at the time of payment. If the lending bank is outside of Brazil, it may appoint a Brazilian bank as its agent to receive the semi-annual payments on its behalf. Brazil, under "Proex" has provided an increasing level of subsidies to its main regional aircraft manufacturer EMBRAER to a level of several hundred million U.S dollars in 1998 alone. Numerous (in fact, almost all) EMBRAER's international sales received "Proex" subsidies.

Embraer

Empresa Brasileira de Aeronautica S.A. - is Brazil's largest aircraft manufacturer. Embraer's headquarters is located in Sao Jose dos Campos, in the State of Sao Paulo. Embraer leads a group with widely diversified interests in the aerospace field. The group's activities entail the design, development, production and marketing of a range of turboprop and jet **aircraft** for

regional airline and military use, turboprop **aircraft** for general aviation, corporate and agricultural utilization, and aviation-related mechanical and hydraulic systems. Embraer is a major buyer of equipment and parts for its own production line, as well as a major international supplier for the aviation market. The United States is its largest customer, and largest supplier of parts. U.S. has a percentage of 65% on Embraer purchases.

Embraer has 650 units of Tucano **aircraft** in operation in 15 different Air Forces around the world. Following the success of the EMB-312 Embraer has designed the EMB-314 Super Tucano. Embraer has recently made several improvements to its production line to enhance the training and operational capabilities of its **aircraft**.

The EMB-120 Brasilia, another **aircraft** manufactured by Embraer has become a mainstay of short-haul routes worldwide. To date, it has logged over 5.5 million flight hours and carried more than eighty million passengers. Embraer has delivered more than 279 EMB-120 to 26 customers in 14 countries.

Embraer also entered the market for 30 to 70 passengers **aircraft**, with ranges from 800 to 1,700 nautical miles with the ERJ-135 and ERJ-145 models. Standing behind the **aircraft** are Embraer's modern managerial tools and partnerships with well-known manufactures of aerospace structures, electronic system and parts such as Rolls Royce/Allison Engines and C&D Interiors (U.S.), Gamesa (Spain), Sonaca (Belgium) and Enaer (Chile). Production of ERJ-135 and ERJ-145 relies on 800 suppliers providing more than 40,000 parts.

Early in 1999, Embraer announced the production of the ERJ-190 and ERJ-170. This represented their entrance into the market for 70 to 110 seat airplanes. They are still looking for partners for the production of these airplanes.

Embraer achieved profitability last year, with earnings of USDOLS 109.2 million. They also had a substantial increase in gross

revenue to USDOLS 1.3 billion, a backlog of firm orders of USDOLS 4.1 billions, and increase in shareholders' equity to USDOLS 345.7 millions. In 1998, Embraer created more than 2,000 new jobs and expect to create 3,000 more jobs with the launch of the new ERJ-170 and ERJ-190.

According to the company's administrators, Embraer profitability is expected to continue to grow in the next four years mainly because of the ERJ-170, ERJ-190 and also the ERJ-135 and ERJ-145. Embraer is among the most productive **aircraft** manufacturers in the world, with USDOLS 227,000 in revenue per employee.

At the 1999 Le Bourget Air Show in Paris, Embraer signed the largest contract for a **regional aircraft** in market history. Swiss Crossair ordered 200 jets, a market of around USDOLS 4.9 billions.

Recently a group composed of Dassault Aviation, Thomson CSF, Aerospatiale, Matra and Snecma paid about USDOLS 209 millions for 20 percent of the voting shares in Embraer. With the deal the French companies could gain an advantage in the bidding process for renovating Brazil's fleet of fighter jets. Embraer will gain access to the strong technological and commercial networks of the French, especially those of Dassault. They will also improve their position in Latin America's defense market, with the potential for USDOLS 8 billion in contracts in Brazil alone.

Bombardier

Since introducing the world's first regional jet in 1989, Bombardier has aggressively pursued the global market for regional aircraft and has established itself as the world's third largest aircraft manufacturer and the leading producer of regional aircraft. Bombardier, headquartered in Montreal, first entered this fast-growing sector with its 50 seat regional jet, which was followed with the introduction of the 70 seat CRJ Series 700 in 1987. Most recently, Bombardier announced that it will invest \$1

billion to build a new 90 seat version of its highly successful CRJ with the first deliveries expected to take place in 2003. Bombardier Inc. employs over 56,000 world-wide and 24,000 in Canada. Bombardier Aerospace, one of five divisions of the company, accounts for about two-thirds of revenue and employs nearly 7,000. The company projects total revenues of about \$13.6 billion Cdn. in 2000 and has an order backlog valued at over \$27 billion Cdn.

(1 Cdn. Dollar equaled about 67 cents US in October of 2000)

(b) Sources for Further Background Reading on the Issues

www.mre.gov.br (Foreign Ministry)

www.fazenda.gov.br (finance)

www.mdic.gov.br (industry)

www.conbrastoronto.org (Brazilian Consulate - Toronto. Also has useful links)

www.embraer.com

www.bombardier.com

www.strategis.gc.ca (Industry Canada - trade stats etc.)

www.dfait-maeci.gc.ca (Canadian Dept. of Foreign Affairs and Int'l Trade)

www.aia-aerospace.org (Aerospace Industry Association U.S.)

www.aiac.ca (Aerospace Industries Association of Canada)

www.tradeport.org/ts/countries/brazil/isa/isar0003.html (private sector site with ITA report on Brazilian Aerospace Industry)

www.theglobeandmail.com - (Canadian equivalent of New York Times/WSJ)

III General Format for Simulations

Parties to the Negotiations

Parties to these negotiations will include country teams and interest groups within country teams:

Brazil

- 1) Ministry of Foreign Affairs (Itamaraty)- Primary federal government Ministry representing Brazil in international negotiations;
- 2) Ministry of Finance (Fazenda)- Principal federal administrator of Proex program, primary financial agent of government;
- 3) Embraer- Brazil's largest aircraft manufacturer and fourth largest in the world. Direct competitor of Bombardier (see below).
- 4) Sindicato Nacional das Empresas Aerovias (SNEA)- Brazil's leading industry association representing the aerospace industry.

Canada

- 1) Department of Foreign Affairs and International Trade (DFAIT)- Primary federal government Ministry representing Canada in international negotiations;
- 2) Industry Canada (IC)- Primary federal government department responsible for Canadian industrial policy and Canadian industrial subsidy programs;
- 3) Bombardier- Canada's largest aircraft manufacturer and third largest in the world. Direct competitor of Embraer
- 4) Aerospace Industries Association of Canada (AIAC)- Canada's leading industry association representing the aerospace industry.

Negotiation Process

The parties to these negotiations will be provided with individual team instructions and facts common to each country team's interests.

Individual interest groups (eg. associations, government agencies, companies) will meet first to review facts develop team negotiating goals

and strategies, assign research and negotiating roles and to document all negotiating sessions. All interest groups will then meet with their country team members. (Country team members may or may not share common interests, goals etc.) Lead government agencies will seek to reconcile differences and to advance a unified voice in the bilateral sessions.

All teams will seek to advance specific negotiating goals and interests. To facilitate the process, certain assumptions can be made:

it can be assumed that Canada seeks to promote a positive climate for trading relations with Brazil;

It can also be assumed that the Canadian government sees promotion of its aerospace industry as an important component of increasing Canadian value added manufacturing, employment and research and development;

it can be assumed that Brazil seeks a positive relationship with Canada and the global trading community through the WTO;

It can also be assumed that Brazil seeks to promote international sales of regional aircraft by Embraer as an important means of economic development;

It can further be assumed that should Canada or Brazil seek direction from the WTO as to the amount of retaliation appropriate, the amount authorized by the WTO may or may not equal Canada's claim of \$700 million per year, but the WTO is likely to authorize an amount of one hundred million dollars at least;

As private companies Embraer and Bombardier are primarily interested in sales and profits;

All parties will also want to consider some or all of the following:

- 1) Documentation of the scope of the problem;
- 2) Specific agreements which may resolve the issues, including but not limited to, rules, regulations, monitoring, enforcement and legal remedies:

- 3) Timetables for implementation of agreements reached;
- 4) Appropriate criteria for subsidies and development policies
- 5) Use of alternative means such as continuing consultations and monitoring and committees of experts;

It will also be important to determine the interests of your counterparts. Building alliances within your country, with other countries and with other country interest groups may be appropriate.

Confidential Party Instructions

Each team or interest group will be provided with further confidential instructions issued from the perspective of a superior corporate or governmental officer. You are to design your negotiating strategy in accord with these instructions. Questions regarding instructions or the terms of agreements reached can be reviewed with one of the instructors.

Hypothetical versus Factual Information and Further Research

All information presented in the factual background and supplemental facts is based on actual figures.

Negotiating Skills and Techniques

- 1) Teams should engage in "brainstorming" sessions to identify and articulate your interests and those of your counterparts. This should include listing potential options for an agreement and the use of objective criteria for the structuring and implementation of agreements.
- 2) Teams should elect a lead negotiator for each negotiating session. It is important for team members to defer to a lead negotiator and to speak with one voice. Lead negotiators may invite the participation of team members on specific issues, areas of expertise, etc.

- 3) Teams should use caucuses (private team meetings) to review proposals. formulate counter-proposals or to review the status of the negotiations.
- 4) Remember to listen to your counterparts and ask questions to learn what their needs are. (eg. What do they want ? Can you fashion and agreement or provision that will meet some if not all of their needs ? Are your sessions confidential or open to the press and/or public ?)
- 5) Craft and utilize single text documents to introduce proposed language on agreements or to capture agreements on procedure and/or substance which can be added to the text of a final agreement.
- 6) Obtain signatures of counterparts on documents reflecting interim or final agreements.
- 7) Consider future meetings, working groups, investigative teams, etc. as a means to keep the process moving forward and to avoid stalemates.
- 8) Remember you are dealing with people. What are their needs within their organization, bureaucracy or company ? Can you help them to meet them ? If possible, establish a personal rapport. Be hard on the problem and soft on the people.
- 9) Consider a joint media release or conference to announce progress or a final agreement. Use the media to help solidify the parties' public commitment to the agreement.

Rules to Enhance the Learning Goals of the Simulation

Because time is extremely limited, the instructors request that students abide by the following rules which have proven effective in other negotiation simulations:

- 1) Limit caucus sessions and breaks during negotiations to no more than five (5) minutes;

- 2) Country teams will have to negotiate an internal consensus among all interest groups before the commencement of official bilateral negotiations;
- 3) The parties will not be authorized to "walk out" or otherwise boycott a negotiation session;
- 4) If negotiating teams reach an impasse or stalemate they should work on another issue and/or seek the instructor's intervention;
- 5) No name calling, personal attacks or insults will be permitted (This is not good style in real world negotiations and is usually the result of ego or loss of emotional control.);
- 6) Make use of charts, note-taking, printed exhibits and documents to facilitate the recording of interim and/or final agreements.

Location of the Negotiations

As negotiating sessions are established, a home country will be identified. The home country should serve as the hosts of the negotiation. Hosts should welcome guests to their country and to the negotiating session. Introductions should be made before the parties proceed to substantive matters.

General Format of the Simulations

Students will be divided into groups. Within each group there will be the following teams:

Canada:

DFAIT,
IC,
Bombardier,
Aerospace Industries Association of Canada

Brazil:

Ministry of Foreign Affairs (Itamaraty),

Ministry of Finance (Fazenda),
Embraer,
SNEA

Sequence of Meetings and Negotiations

Day I

Afternoon:

Individual interest groups meet to develop negotiation strategy

Country teams meet to negotiate and develop country team negotiation strategy.

(Country teams will not be able to begin bilateral negotiations with other national representatives UNTIL they have reached a consensus on negotiating goals within their country team, including all interest groups.)

Day II

Morning

Bilateral sessions: 1) Canada (DFAIT, IC) - Brazil (Itamaraty, Fazenda)

2) AIAC, SNEA, Bombardier, Embraer

Bilateral sessions continue until late morning break. Country teams will then caucus to determine progress, new options and procedures.

Afternoon

Resume bilateral sessions as in morning. Reach interim and/or final agreements

Break

Multilateral Working Group Session

Groups reconvene in lecture hall for reports and evaluation of agreements reached.
in Day II