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KOREA – MEASURES AFFECTING TRADE IN COMMERCIAL VESSELS (WT/DS273)

Report of the Panel

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Brazil – Aircraft (Article 21.5 – Canada)	Panel Report, *Brazil – Export Financing Programme for Aircraft, Recourse by Canada to Article 21.5 of the DSU* ("*Brazil – Aircraft (Article 21.5 – Canada)*"), WT/DS46/RW, adopted 4 August 2000, as modified by the Appellate Body Report, WT/DS46/AB/RW, DSR 2000:IX, 4093.
Brazil – Aircraft (Article 21.5 – Canada II	Panel Report, *Brazil – Export Financing Programme for Aircraft, Second Recourse by Canada to Article 21.5 of the DSU* ("*Brazil – Aircraft (Article 21.5 – Canada II)*"), WT/DS46/RW/2, adopted 23 August 2001, DSR 2001:XI, 5481.
Canada – Aircraft Credits and Guarantees	Panel Report, *Canada – Export Credits and Loan Guarantees for Regional Aircraft* ("*Canada – Aircraft Credits and Guarantees*"), WT/DS222/R and Corr.1, adopted 19 February 2002.
Canada – Aircraft (Article 21.5 – Brazil)	Appellate Body Report, *Canada – Measures Affecting the Export of Civilian Aircraft, Recourse by Brazil to Article 21.5 of the DSU* ("*Canada – Aircraft (Article 21.5 – Brazil)*"), WT/DS70/AB/RW, adopted 4 August 2000, DSR 2000:IX, 4299.
EC – Sugar Exports (Australia)	GATT Panel Report, *European Communities – Refunds on Exports of Sugar – Complaint by Australia*, adopted 6 November 1979, BISD 26S/290.
EC – Sugar Exports (Brazil)	GATT Panel Report, *European Communities – Refunds on Exports of Sugar – Complaint by Brazil*, adopted 10 November 1980, BISD 27S/69.
EEC – Wheat Flour Subsidies	GATT Panel Report, *European Economic Community – Subsidies on Export of Wheat Flour* ("*EEC – Wheat Flour Subsidies*"), 21 March 1983, unadopted, SCM/42.
Indonesia – Autos	Panel Report, *Indonesia – Certain Measures Affecting the Automobile Industry* ("*Indonesia – Autos*"), WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R and Corr.1, 2, 3, 4, adopted 23 July 1998, DSR 1998:VI, 2201.
Japan – Alcoholic Beverages II	Appellate Body Report, *Japan – Taxes on Alcoholic Beverages* ("*Japan – Alcoholic Beverages II*"), WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, adopted 1 November 1996, DSR 1996:I, 97.
US – Corrosion-Resistant Steel Sunset Review	Appellate Body Report, *United States – Sunset Review of Anti-Dumping Duties on Corrosion-Resistant Carbon Steel Flat Products from Japan* ("*US – Corrosion-Resistant Steel Sunset Review*"), WT/DS244/AB/R, adopted 9 January 2004.
US – Countervailing Measures on Certain EC Products	Appellate Body Report, *United States – Countervailing Measures Concerning Certain Products from the European Communities* ("*US – Countervailing Measures on Certain EC Products*"), WT/DS212/AB/R, adopted 8 January 2003.
US - Export Restraints	Panel Report, *United States – Measures Treating Exports Restraints as Subsidies* ("*US – Export Restraints*"), WT/DS194/R and Corr.2, adopted 23 August 2001, DSR 2001:XI, 5767.
US – FSC	Appellate Body Report, *United States – Tax Treatment for "Foreign Sales Corporations"* ("*US – FSC*"), WT/DS108/AB/R, adopted 20 March 2000, DSR 2000:III, 1619.
US – Norwegian Salmon CVD	GATT Panel Report, *Imposition of Countervailing Duties on Imports of Fresh and Chilled Atlantic Salmon from Norway* ("*US – Norwegian Salmon CVD*"), adopted 28 April 1994, BISD 41S/II/576.
US – Section 211 Appropriations Act	Appellate Body Report, *United States – Section 211 Omnibus Appropriations Act of 1998* ("*US – Section 211 Appropriations Act*"), WT/DS176/AB/R, adopted 1 February 2002.
US – Upland Cotton	Panel Report, *United States – Subsidies on Upland Cotton* ("*US – Upland Cotton*"), WT/DS267/R, and Corr.1, 8 September 2004.
US – Lead and Bismuth II	Panel Report, *United States – Imposition of Countervailing Duties on Certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom* ("*US – Lead and Bismuth II*"), WT/DS138/R and Corr.2, adopted 7 June 2000, as upheld by the Appellate Body Report, WT/DS138/AB/R, DSR 2000:VI, 2623.

Short Title	Full Case Title and Citation
US – Lead and Bismuth II	Appellate Body Report, *United States – Imposition of Countervailing Duties on Certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom* ("*US – Lead and Bismuth II*"), WT/DS138/AB/R, adopted 7 June 2000, DSR 2000:V, 2595.

I. INTRODUCTION

A. COMPLAINT OF THE EUROPEAN COMMUNITIES

1.1 On 21 October 2002, the European Communities requested consultations with Korea pursuant to Article 4 of the Dispute Settlement Understanding ("the *DSU*"), Article XXIII:1 of the General Agreement on Tariffs and Trade 1994 ("*GATT 1994*"), and Articles 4, 7 and 30 of the Agreement on Subsidies and Countervailing Measures ("the *SCM Agreement*"), with regard to measures affecting trade in commercial vessels.[1]

1.2 The European Communities and Korea held the requested consultations on 22 November and 13 December 2002, and 7 May 2003, but failed to reach a mutually satisfactory resolution of the matter.

1.3 On 11 June 2003, the European Communities requested the establishment of a panel to examine the matter.[2]

1.4 On 10 July 2003, the European Communities requested that the above request be placed on the agenda of the meeting of the Dispute Settlement Body ("the DSB") scheduled for 21 July 2003. The European Communities further requested that, at the same meeting, the DSB initiate the procedures provided for in Annex V of the *SCM Agreement* pursuant to paragraph 2 of that Annex.

B. ESTABLISHMENT AND COMPOSITION OF THE PANEL

1.5 At its meeting of 21 July 2003, the DSB established a panel in accordance with Article 6 of the DSU and pursuant to the request made by the European Communities in document WT/DS273/2.

1.6 At that meeting, the parties to the dispute also agreed that the Panel should have standard terms of reference. The terms of reference are, therefore, the following:

> "To examine, in the light of the relevant provisions of the covered agreements cited by the European Communities in document WT/DS273/2, the matter referred to the DSB by the European Communities in that document, 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 11 August 2003, the European Communities requested the Director-General to determine the composition of the Panel, pursuant to paragraph 7 of Article 8 of the *DSU*. This paragraph provides:

> "If there is no agreement on the panelists within 20 days after the date of the establishment of a Panel, at the request of either party, the Director-General, in consultation with the Chairman of the DSB and the Chairman of the relevant Council or Committee, shall determine the composition of the panel by appointing the panelists whom the Director-General considers most appropriate in accordance with any relevant special or additional rules or procedures of the covered agreement or covered agreements which are at issue in the dispute, after consulting with the parties to the dispute. The Chairman of the DSB shall inform the Members of the composition of the panel thus formed no later than 10 days after the date the Chairmen receives such a request."

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[1] WT/DS273/1.
[2] WT/DS273/2.

1.8 On 20 August 2003, the Director-General accordingly composed the Panel as follows:

Chairman: Mr. Said El-Naggar

Members: Mr. Gilles Gauthier
Ms. Ana Novik Assael

1.9 China, Japan, Mexico, Norway, Chinese Taipei and the United States reserved their third-party rights.[3]

1.10 On 11 April 2004, Mr. El-Naggar, Chairman of the Panel, passed away. On 6 May 2004, the parties jointly requested that the Director-General appoint a new Chairman to the Panel. On 11 May 2004, the Director-General appointed Mr. Julio Lacarte-Muró as the new Chairman of the Panel.[4]

C. INFORMATION GATHERING PROCEDURE UNDER ANNEX V OF THE *SCM AGREEMENT*

1.11 In its 10 July 2003 communication to the DSB requesting initiation of the information-gathering procedure under Annex V of the *SCM Agreement*, the European Communities stated that in order to facilitate the DSB's task of designating a representative pursuant to paragraph 4 of Annex V, it had proposed names and consulted with Korea. The European Communities indicated that it and Korea had not reached agreement in this respect, and thus requested that the DSB designate a representative to facilitate the information-gathering procedure.[5] At its meeting of 21 July 2003, the DSB designated Mr. András Szepesi as its representative for this purpose.

1.12 The date of 21 July 2003 was considered by the parties to be the date on which the matter was "referred to the DSB" in the sense of paragraph 5 of Annex V, such that the 60-day period established in that paragraph for completion of the information-gathering process would have ended on 19 September 2003. The parties agreed that the complaining party's first submission should be due six weeks after the end of the Annex V procedure, and the responding party's first submission six weeks after that, so that all information developed through the Annex V procedure could be used in the preparation of these submissions. The Panel established its timetable accordingly.

1.13 At a late stage in the 60-day period the 19 September 2003 date was modified, with the agreement of the parties, to allow the parties additional time to translate certain voluminous documentation into one of the three WTO working languages. The amended deadline for completion of the Annex V procedure was 10 November 2003. The Panel was immediately informed of these modifications and the causes thereof. The Panel revised its timetable accordingly.

1.14 On 10 November 2003, the Designated Representative submitted his report to the Panel. This report is set forth in Attachment 1.

D. ADDITIONAL PROCEDURES FOR THE PROTECTION OF BUSINESS CONFIDENTIAL INFORMATION

1.15 As indicated in the report of the Designated Representative the Panel, at the request of the parties, adopted additional procedures for the protection of business confidential information. These procedures ("the BCI procedures"), are set forth in Attachment 2.

[3] WT/DS274/6.
[4] WT/DS273/7.
[5] WT/DS273/3.

E. PANEL PROCEEDINGS

1.16 The Panel met with the parties on 9-10 March 2004, and 17-18 June 2004. The Panel met with third parties on 9 March 2004.

1.17 The Panel submitted its Interim Report to the parties on 24 November 2004. The Panel submitted its final report to the parties on 22 December 2004.

II. FACTUAL ASPECTS

2.1 This dispute concerns the following measures, alleged by the European Communities to constitute prohibited subsidies and/or actionable subsidies in the sense of Parts II and III of the *SCM Agreement*:

- The Act Establishing the Export-Import Bank of Korea ("KEXIM"), any implementing decrees and other regulations, alleged to specifically allow and enable KEXIM to provide Korean exporters of capital goods with financing at preferential rates.

- The pre-shipment loan ("PSL") and advance payment refund guarantee ("APRG") schemes established by KEXIM.

- The individual granting of pre-shipment loans and advance payment refund guarantees by KEXIM to Korean shipyards, including Samho Heavy Industries ("Samho-HI" or "SHI"), Daedong Shipbuilding Co. ("Daedong"), Daewoo Heavy Industry ("DHI"), Daewoo Shipbuilding and Marine Engineering ("Daewoo-SME", or "DSME"), Hyundai Heavy Industries ("Hyundai-HI", or "HHI"), Hyundai Mipo ("MIPO"), Samsung Heavy Industries ("Samsung") and Hanjin Heavy Industries & Construction Co ("Hanjin").

- Corporate restructuring measures including debt forgiveness, debt and interest relief and debt-to-equity swaps, affecting Daewoo-SME, Samho-HI, and Daedong)**.**

- The Special Tax Treatment Control Law ("STTCL"), in particular the special taxation on in-kind contribution (Article 38) and the special taxation on spin-off (Article 45-2) scheme.

III. PARTIES' REQUESTS FOR FINDINGS AND RECOMMENDATIONS

A. THE EUROPEAN COMMUNITIES

3.1 The European Communities asks the Panel to find that Korea has granted subsidies inconsistent with its obligations under the *SCM Agreement*, because:

- "Korea, through the KEXIM Act, KEXIM Decree and Interest Rate Guidelines provides prohibited subsidies, inconsistent with Article 3.1 and 3.2 of the SCM Agreement"*;*

- "Korea, through the establishment and maintenance of the APRG and preshipment loan programmes provides prohibited subsidies, inconsistent with Article 3.1 and 3.2 of the SCM Agreement"*;*

- "Korea, through individual grants of APRGs and preshipment loans provided prohibited subsidies, inconsistent with Article 3.1 and 3.2 of the SCM Agreement"*;*

- "Korea, by providing subsidies to Daewoo-SME/Daewoo-HI, Samho-HI/Halla-HI, and STX/Daedong through (i) workout plans and restructuring plans; (ii) tax concessions provided to Daewoo-HI/Daewoo-SME; and (iii) the grant of KEXIM APRGs and pre-shipment loans, has caused serious prejudice to the interests of the European Communities in violation of Articles 5(c) and 6.3(c) of the SCM Agreement."

3.2 The European Communities considers that the above violations of the *SCM Agreement* have nullified and impaired benefits accruing to it under the *Marrakesh Agreement Establishing the World Trade Organization* ("*WTO Agreement*") and accordingly asks the Panel to recommend that Korea withdraw these subsidies or remove the adverse effects of the actionable subsidies in accordance with Articles 4.7 and 7.8 of the *SCM Agreement*.

B. KOREA

3.3 Korea requested the Panel to issue a number of preliminary rulings. The Panel's reasoning and conclusions in respect of Korea's requests for preliminary rulings are set forth in section VII.A, infra.

3.4 Korea also requests the Panel to dismiss all of the claims of the European Communities.

IV. ARGUMENTS OF THE PARTIES

4.1 The arguments of the parties are set out in their submissions to the Panel. The parties' executive summaries of their submissions are attached as Annexes to this report (see List of Annexes, page viii), and constitute an integral part of this Report.

V. ARGUMENTS OF THE THIRD PARTIES

5.1 The arguments of third parties China, Japan, Norway, Chinese Taipei and the United States, are set out in their submissions to the Panel and are attached to this Report as Annexes (see List of Annexes, page viii), and constitute an integral part of this Report. Mexico made no submissions to the Panel.

VI. INTERIM REVIEW

6.1 On 24 November 2004, we submitted the interim report to the parties. Korea submitted a written request for interim review of certain aspects of the interim report. The EC did not request interim review. The EC also submitted written comments on Korea's request. Neither party requested an interim review meeting.

6.2 Korea's communication concerning interim review contained two parts, a cover letter containing general comments, and an annex containing specific comments on certain identified paragraphs of the interim report. We address these two parts of Korea's comments separately, in sections VI.A and VI.B, respectively.

6.3 We also have made certain technical revisions and corrections to the report.

A. KOREA'S GENERAL COMMENTS IN ITS COVER LETTER

6.4 The cover letter to Korea's submission requesting review of aspects of the Panel's interim report sets forth "some reservations regarding some procedural issues and certain aspects of the prohibited subsidies analysis of the Panel". We note at the outset, however, that these comments are quite general, lacking specific references to particular paragraphs or sections of the interim report, and

failing to indicate any changes that Korea requests the Panel make to the report. We therefore doubt whether these comments meet the requirement of Article 15.2 that a party's request for interim review identify "precise aspects" of the report. In any event, as discussed below, we see no need to make any changes to the report on the basis of the comments in Korea's cover letter.

6.5 Korea states that the Panel misallocated the burden of proof "in places", shifting the burden from the EC to Korea, but identifies no specific place in which this alleged misallocation of burden occurred. We believe that the appropriate burden of proof was maintained in respect of both parties throughout the dispute. Korea also argues that the EC was permitted to introduce new factual information at a late stage of the proceedings, not as rebuttals but to establish wholly new points. We disagree with Korea's implication that it lost due process rights, as we recall that at various stages of the proceedings, the Panel requested certain information from both parties, and the parties requested certain information from each other, and that after each of these submissions, each party was given full opportunity to comment on the new factual information submitted by the other party. Concerning Korea's general objection to the benchmarks offered by the EC for APRG transactions, and the Panel's analysis of country risk spread, we believe that our findings adequately explain our overall approach and reasoning.[6] As for Korea's general disagreement with our approach to defining a public body in the sense of Article 1.1(a)(1), as discussed in our findings, in our view Korea's approach confuses the concepts of financial contribution and benefit. Concerning actionable subsidies, Korea states that it disagrees with certain of our conclusions, but provides no specifics whatsoever. Finally, concerning Korea's statement that the EC "was permitted without remark to manifestly abuse the Annex V process", we recall that Korea originally raised this issue in its first written submission, and that we ruled on it on 12 March 2004.[7]

B. KOREA'S SPECIFIC COMMENTS ON CERTAIN IDENTIFIED PARAGRAPHS OF THE INTERIM REPORT

Footnote 75 (footnote 77 of the Final Report)

6.6 Korea requested that we change the reference to "Exhibit EC – 21" to refer to "Exhibit EC – 26". We have made the change requested by Korea.

Paragraphs 7.136 and 7.137

6.7 Korea argues that Exhibits KOREA – 58 and 59 were provided in response to Question 69 from the Panel, which sought "an example (with supporting documentation) of two instances in which different Korean shipyards were not able to select the APRG provider itself". Korea asserts that the Panel did not ask Korea to rebut the specific APRG benchmarks offered by the EC. Korea supposes that the Panel adopted this approach because it was looking at the issue from a systemic general point of view. Korea asserts that if it showed that there were questions about the choice of source of APRGs, it would be up to the EC to show who made that choice, and establish that the benchmarks proposed by the EC were appropriate. Korea asserts that had the Panel demanded that Korea rebut the specific instances offered by the EC, the Panel should not have asked for examples in a manner that indicated to Korea that the Panel was taking a general perspective. Korea submits that, by doing so, the Panel prohibited Korea from offering evidence that it might have been able to generate to rebut specific instances rather than just providing examples as the Panel requested.

6.8 Korea also disagrees with the Panel's statement that the examples in Exhibit KOREA – 83 "are APRGs provided to shipyards that fall outside the scope of the EC's prohibited export subsidies claims". Korea asserts that there were no limitations on the scope of the EC's claims. Korea submits

[6] In section VI.B, *infra*. we take up Korea's detailed, specific comments (in the Annex to part of its interim review submission) in relation to precise aspects of particular paragraphs of our report pertaining to certain benchmarks.

[7] The text of our ruling is reproduced in full at paragraph 7.5.

that the information in Exhibit KOREA – 83 is therefore relevant, probative and directly responsive to Question 69 from the Panel.

6.9 The EC submits that Korea's comment is based on the erroneous view that Korea needed only to rebut specific evidence advanced by the European Communities where specifically "demanded" to do so by the Panel and that, as a result, the Panel "prohibits Korea from offering evidence that it might have been able to generate to rebut specific instances rather than just providing examples as the Panel requested."

6.10 Regarding Exhibit KOREA – 83, the EC asserts that Korea misrepresents or misunderstands the Panel's reasoning. The EC argues that the Panel is dealing in this part of the Report with the EC's complaint that individual APRG transactions constituted export subsidies. The EC asserts that it is therefore irrelevant that the Panel accepted the admissibility of the EC's *per se* claim against KEXIM's export subsidy regimes. The EC suggests that the Panel could take account of Korea's point and avoid others misunderstanding the issue in the same way by amending the penultimate sentence to paragraph 7.137 to read:

> The evidence contained in Exhibit Korea-83 relates to APRGs provided to shipyards that fall outside the scope of ~~the EC's~~ **these** prohibited export subsidy claims.

6.11 First, we note that para. 213 of Korea's First Written Submission states that:

> Shipyards *do not always* select the APRG provider by itself. *Sometimes*, they are compelled to make use of the financial institutions, domestic or foreign, designated by the ship owners for issuing the APRGs regardless of whether the premium rates by such institutions are higher than those offered by other financial institutions. (emphasis supplied)

6.12 Korea's own submission therefore makes it clear that Korea was not approaching this issue from a "general perspective". Instead, Korea argued that APRG providers were "sometimes" designated by buyers. Korea's argument could not, therefore, have operated as a general defence, or response, to the benchmarks proposed by the EC. Rather, the onus was on Korea, as the party alleging a fact, to prove that the providers of the specific APRGs identified by the EC were designated by the relevant buyers of the ships in question.

6.13 Second, it was up to Korea to decide how it wished to respond to the claims, arguments and evidence of the EC. It was not up to the Panel to instruct Korea in this regard. Nor did the Panel "prohibit" Korea from offering any evidence that it chose. Korea had numerous opportunities to present whatever evidence it wished in response to the claims, arguments and evidence presented by the EC. The Panel addressed Question 69 to Korea in order to clarify Korea's argument regarding buyer designation. It did not do so in order to dictate how Korea should respond to the claims, arguments and evidence presented by the EC. The fact that the Panel phrased Question 69 in a particular manner did not prevent Korea from deciding for itself how it wished to respond to the claims, arguments and evidence presented by the EC.

6.14 Regarding Exhibit KOREA – 83, we note that our findings regarding individual APRG transactions were necessarily limited to those transactions specifically identified by the EC. We had no basis to make findings in respect of other individual APRG transactions for which no evidence had been submitted by the EC. We have made the change suggested by the EC in order to clarify this matter.

Paragraph 7.167

6.15 Korea asserts that the value of Yangdo Dambo is (at least) 50 per cent of the value of Physical Collateral such as government bonds. Korea submits that it clearly showed that differences existed as regards different types of collaterals and that the value of the Yangdo Dambo exceeds that of cash deposits for foreign APRGs which was 10 to 30 per cent of the amount covered by the APRGs in terms of collateral value.

6.16 The EC asserts that Korea's comment is addressed in para. 7.169 and footnote 95 of the Interim Report.

6.17 We maintain the view we expressed in footnote 95 that "at a certain point the value of a smaller portion of credit coverage by a stronger form of collateral will equal, or exceed, the value of a larger portion of credit coverage by a weaker form of collateral". We also recall our statement in para. 7.167 that, in order for Korea's argument to prevail, "Korea would need to demonstrate that the collateral value of the Yangdo Dambo exceeds that of the cash deposits". Korea has failed to show this, since Korea has failed to establish the collateral value of the cash deposits, i.e., it has failed to establish how much the credit spread was adjusted in order to reflect the value of the 10 – 30 per cent cash deposits.

Paragraph 7.234

6.18 Korea asserts that, contrary to the Panel's finding in para. 7.234, it did provide sufficient information to rebut the EC's argument regarding the **[BCI: Omitted from public version]** guarantee. Korea refers in this regard to its response to Question 17 from the EC, read in light of the information provided by the EC in Exhibit EC – 118.

6.19 The EC asserts that the evidence referred to by Korea is not sufficient to rebut the EC's argument.

6.20 Korea's reply to Question 17 from the EC refers to a "payment guarantee". It does not provide the value of that guarantee. Nor does it indicate the terms of that guarantee. Nor is this information to be found in Exhibit EC – 118. Accordingly, there is no basis for us to change our finding in para. 7.234.

Paragraph 7.237

6.21 Korea asserts that there is a difference in the value of the types of collateral referred to in para. 7.237 (i.e., factory and Yangdo Dambo). Korea asserts that the value of the factory is greater than the value of the Yangdo Dambo.

6.22 Korea's comment does not address the issue raised in para. 7.237 of the Interim Report. The fact that the different types of collateral may have different values is not denied in para. 7.237. Instead, we indicate that we have no information regarding what those values might be. Korea's comment does not address this issue, since it does not identify any evidence submitted during the Panel proceedings regarding the values of the types of collateral at issue. In any event, we note that para. 7.237 also provides additional reasons (unrelated to the value of the relevant collaterals) for rejecting the STX/Daedong corporate bond data submitted by Korea.

Paragraph 7.240

6.23 Korea asserts that it provided information regarding the interest rates for the Hyundai/Mipo corporate bonds at para. 238 of its First Written Submission.

6.24 We do not disagree with Korea. However, Korea's comment does not address the issues raised in para. 7.240 of the Interim Report. In particular, Korea's comment does not point to record evidence indicating whether or not the relevant bonds were guaranteed or collateralized.

Paragraph 7.243

6.25 Korea asserts that the reference to "collateral" in Exhibit KOREA – 22 was an error. Korea identifies record evidence indicating that the HHI corporate bonds were not collateralized.

6.26 The EC does not respond to Korea's comment. In the absence of any objection by the EC, and on the basis of the explanation provided by Korea, we shall amend para. 7.243 of the Report to remove references to the issue of collateralization. However, we note that para. 7.243 will still reflect the fact that the bond rates cannot be used as market benchmarks because of differences in maturity.

Footnote 154 (footnote 156 of the Final Report)

6.27 Korea asserts that the Panel failed to acknowledge that joint and several guarantees do have certain values. Korea asserts that the fact that joint and several guarantees have certain values is clear from paragraphs 15 and 16 of Exhibit KOREA – 90.

6.28 The Panel did not state that joint and several guarantees do not have any value. Rather, in footnote 154 the Panel quoted Korea's explicit statement that KEXIM treated such guarantees as if they had no value. Korea has not denied this. The Panel also stated that "[i]n any event, since Korea has failed to quantify the alleged value of such collateral, there is no basis for us to make any adjustment". This statement remains valid, since Korea has failed to identify any evidence regarding the value of the joint and several guarantees at issue. Paragraphs 15 and 16 of Exhibit KOREA – 90 do not indicate the value of such guarantees.

Footnote 174 (footnote 176 of the Final Report)

6.29 We have corrected a clerical error identified by Korea.

Paragraphs 7.290 and 7.291

6.30 Korea asserts that it did establish that the value of collateral was reflected in KEXIM's interest rate calculations. Korea also asserts that it identified Attachment 1 to the KEXIM Interest Rate Guidelines as the statutory basis for the application of different credit risk spreads depending on the types of security interests provided.

6.31 We note that Attachment 1 to the KEXIM Interest Rate Guidelines does not contain any reference to **[BCI: Omitted from public version]**. Nor was any other evidence presented by Korea regarding the amount of any interest rate adjustment made in respect of such collateral. Accordingly, there is no need for us to amend our statement (para. 7.292) that "[e]ven if an additional adjustment were necessary, therefore, there is no basis for the Panel to determine what exactly that adjustment should be".

Footnote 182 (footnote 184 of the Final Report)

6.32 Korea asserts that the references to "Samho" should be replaced by "STX/Daedong".

6.33 We disagree with Korea's comment, as the footnote is dealing with the EC's treatment of Samho PSLs in Figure 17 of the EC's first Written Submission. This is what Korea is referring to in para. 235 of its First Written Submission. We have slightly amended footnote 184 of the Final Report to clarify this point.

VII. FINDINGS

A. KOREAN REQUESTS FOR PRELIMINARY RULINGS

1. 29 August 2003 request for suspension of the Annex V information-gathering procedure

7.1 On 29 August 2003, Korea requested the suspension of the Annex V information-gathering procedure. On 3 September 2003, the Panel sent the following communication to the parties regarding this matter:

> I am writing to you in respect of Korea's request for preliminary rulings dated 29 August 2003. This letter concerns only Korea's request regarding the suspension or adaptation of the Annex V procedure pending issuance of the preliminary rulings sought by Korea. It does not address the substance of any of the requested preliminary rulings.
>
> In Section II.D of its request, Korea submits that the Annex V procedure should be immediately suspended until such time as the Panel has issued preliminary rulings on the issues raised by Korea in its request. In the alternative, Korea asks (Section I, para. 6) that replies to the Facilitator's questionnaires should only be submitted to the Panel (through the Facilitator), but not to the parties, until such time as the Panel has had the opportunity to make the preliminary rulings requested by Korea. In its comments dated 2 September 2003, the European Communities submits that there is no basis to suspend or otherwise interrupt the Annex V procedure.
>
> First, the Panel notes that, in accordance with paragraph 2 of Annex V, the Annex V procedure in the present case was initiated by the Dispute Settlement Body ("DSB"). There is no provision in Annex V which envisages the suspension of that procedure, either by the DSB itself or by any other body. In the absence of any provision explicitly authorising the Panel to suspend a procedure initiated by the DSB, the Panel has no authority to grant Korea's request for suspension of the Annex V procedure.
>
> Second, we understand paragraph 4 of Annex V to mean that the Annex V procedure is under the control of the Facilitator. In light of paragraph 4, we do not see any scope for intervention by the Panel in procedural issues relating to Annex V. We further note that Korea already asked the Facilitator to suspend or adapt the Annex V procedure in the third paragraph of a letter dated 8 August 2003, and that Korea's request was rejected by the Facilitator in a letter to the parties dated 11 August 2003.
>
> For the above reasons, we reject Korea's request that the Panel should suspend or adapt the Annex V procedure.

2. Other preliminary rulings requested by Korea on 29 August 2003

7.2 On 19 September 2003, the Panel addressed the following communication to the parties regarding other preliminary issues raised by Korea:

> 1. On 29 August 2003, Korea submitted a request for a number of preliminary rulings by the Panel. At the request of the Panel, the European Communities submitted comments on Korea's request, on 2 and 5 September 2003.
>
> 2. One of the preliminary rulings requested by Korea concerned the suspension of the Annex V information-gathering procedure. The Panel sent a communication to

the parties regarding that matter on 3 September 2003. The present communication addresses the remainder of the preliminary rulings requested by Korea, concerning the scope of the claims contained in the request for establishment, the conformity of that request with Article 6.2 of the DSU, and a number of issues characterized by Korea as substantive in nature.

A. THE SCOPE OF THE KEXIM CLAIMS INCLUDED IN THE REQUEST FOR ESTABLISHMENT

1. Arguments of Korea

3. Korea submits that the European Communities has sought to extend the scope of these dispute settlement proceedings beyond the measures specified in the request for consultations, and beyond the scope of the consultations held between the parties, contrary to Articles 4.2, 4.4, 7.2 and 7.4 of the SCM Agreement, and Articles 4 and 6.2 of the DSU.

4. First, Korea asserts that the scope of the European Communities' request for establishment of a panel is unduly broad since it includes the KEXIM Act itself, as applicable to all capital goods, and preferential financing at large outside the scope of the APRGs and pre-shipment financing for commercial vessels, which according to Korea had never been included in the "matter" referred to in the European Communities' request for consultations.

5. Second, Korea claims that the European Communities' request for establishment is unduly broad since it includes serious prejudice claims in respect of assistance provided by KEXIM under the APRG and PSL programmes. Korea asserts that no KEXIM assistance was included in the serious prejudice claim set forth in the request for consultations, and that APRG and PSL assistance was only cited in respect of the prohibited subsidy claim. Korea further submits that the European Communities' request for establishment is unduly broad since it cites as the legal basis both Articles 3 and 5 of the SCM Agreement for the same measures, i.e., the corporate restructuring packages, tax concessions and KEXIM programmes. Korea asserts that the request for establishment should only have challenged the KEXIM measures as prohibited subsidies under Article 3, and the corporate restructuring subsidies and tax programmes as actionable subsidies under Article 5. According to Korea, a challenge of the same measures as both prohibited and actionable subsidies is legally and factually impossible.

6. Third, Korea asserts that the KEXIM Act and implementing decrees and regulations referred to in the request for establishment do not constitute the basis for any claim in and of themselves, since they do not mandate the providing of export subsidies.

7. In respect of the above, Korea asks the Panel to issue preliminary rulings that:

- "un-specified KEXIM programs for capital goods at large are not legitimately in front of the Panel in accordance with Articles 4.2, 4.4, 7.2 and 7.4 of the SCM Agreement as well as Articles 4 and 6.2 of the DSU";

- "only the KEXIM APRGs and the pre-shipment loans for commercial vessels as prohibited subsidies and the corporate restructuring and tax subsidies as actionable subsidies are legitimately in front of the Panel"; and

- "the KEXIM Act and its implementing decrees and regulations do not mandate the adoption of prohibited and actionable subsidies and cannot be challenged as such; only the implementing measures specified for commercial vessels are the measures at issue."

2. Arguments of the European Communities

8. The European Communities submits that all of the KEXIM measures covered by its request for establishment were subject to consultations. The European Communities asserts that because the KEXIM Act "as such" is applicable to all capital goods, it consequently covers more than just commercial vessels. The European Communities asserts that the reference to capital goods other than commercial vessels only arises in respect of the *per se* challenge to the KEXIM Act as a prohibited subsidy. With regard to the scope of its serious prejudice claims, the European Communities submits that KEXIM subsidies were included in that claim during the course of consultations. The European Communities submits that Korea's objections regarding the mandatory nature of the KEXIM legal instruments, and the European Communities' reliance in the request for establishment on both Articles 3 and 5 of the SCM Agreement as concurrent or alternative legal bases, are substantive in nature, and should be addressed in the light of the submissions to the substantive meetings of the Panel.

3. Assessment by the Panel

9. We begin our consideration of these issues by noting that Articles 4.2, 4.4, 7.2 and 7.4 of the SCM Agreement are identified as "special or additional rules and procedures" in Appendix 2 of the DSU. If possible, these provisions should therefore be read so as to complement the relevant provisions of the DSU, including Article 4.2 – 4.7.[8] As regards the relationship between these SCM and DSU provisions, we agree with the finding by the panel in *Canada – Aircraft* that:

> "In our view, a panel's terms of reference would only fail to be determinative of a panel's jurisdiction if, in light of Article 4.1 - 4.4 of the SCM Agreement applied together with* Article 4.2 - 4.7 of the DSU, the complaining party's request for establishment were found to cover a "dispute" that had not been the subject of a request for consultations. Article 4.4 of the SCM Agreement permits a Member to refer a "matter" to the DSB if "no mutually agreed solution" is reached during consultations. In our view, this provision complements Article 4.7 of the DSU, which allows a Member to refer a "matter" to the DSB if "consultations fail to settle a dispute". Read together, these provisions prevent a Member from requesting the establishment of a panel with regard to a "dispute" on which no consultations were requested. In our view, this approach seeks to preserve due process while also recognising that the "matter" on which consultations are requested will not necessarily be identical to the "matter" identified in the request for establishment of a panel. The two "matters" may not be identical because, as noted by the Appellate Body in *India - Patents*, "the claims that are made and the facts that are established during consultations do much to shape the

[8] See Appellate Body Report, *Guatemala – Anti-Dumping Investigation Regarding Portland Cement from Mexico* ("*Guatemala – Cement I*"), WT/DS60/AB/R, adopted 25 November 1998, DSR 1998:IX, 3767, paras 64-66.

> substance and the scope of subsequent panel proceedings."*[9]
> (* footnotes omitted)

This principle was reaffirmed by the Appellate Body in *Brazil – Aircraft*.[10]

10. We do not consider that the scope of the request for establishment need be identical to the scope of the request for consultations. Rather, the scope of the request for establishment is governed by, and may not exceed, the scope of the consultations that actually took place between the parties. Provided the request for establishment concerns a dispute on which consultations had been requested, there is no need for the matter[11] identified in the request for establishment to be identical to the matter on which consultations were requested. Subject to our comments below regarding the European Communities' claims against the KEXIM legal instruments "as such", the request for establishment and the request for consultations clearly relate to the same dispute, namely whether or not Korean measures affecting trade in commercial vessels are prohibited by provisions of the SCM Agreement, and/or give rise to adverse effects thereunder. Thus, in order to address Korea's objections regarding the scope of the KEXIM claims included in the request for establishment, we must consider whether or not the scope of the request for establishment exceeded the scope of the consultations that actually took place between the parties.

11. In respect of the issue of whether or not the European Communities was entitled to include the entirety of the "Act Establishing the Export-Import Bank of Korea ("KEXIM"), any implementing decrees and other regulations" in its request for establishment, we note that the Statement of Available Evidence attached to the European Communities' request for consultations referred expressly to "the KEXIM Act and its Enforcement Decree". We further note that on 15 November 2002 the European Communities submitted a number of questions to Korea concerning the KEXIM Act and the implementation thereof.[12] This evidence alone is sufficient for us to conclude that the parties consulted on the entirety of the KEXIM Act, including any implementing decrees and other regulations, and that the European Communities was therefore entitled to include those measures in its request for establishment.

12. Turning to the question of whether the European Communities' request for establishment properly included the abovementioned measures insofar as they apply to Korean exporters of "capital goods" generally, rather than commercial vessels in particular, we note that the questions referred to in the preceding paragraph were not restricted to the KEXIM measures insofar as they applied to commercial vessels only. The questions referred to the KEXIM measures generally. Furthermore, we note the European Communities' argument that because the KEXIM Act "as such" is applicable to all capital goods, it consequently covers more than just commercial vessels. To the extent that a claim is brought against the KEXIM Act "as such", and to the extent that the KEXIM Act does not differentiate between assistance in respect of commercial vessels and assistance to capital goods more generally, the KEXIM

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[9] Panel Report, *Canada – Measures Affecting the Export of Civilian Aircraft* ("*Canada – Aircraft*"), WT/DS70/R, adopted 20 August 1999, as upheld by the Appellate Body Report, WT/DS70/AB/R, DSR 1999:IV, 1443, at para. 9.12.

[10] Appellate Body Report, *Brazil – Export Financing Programme for Aircraft* ("*Brazil – Aircraft*"), WT/DS46/AB/R, adopted 20 August 1999, DSR 1999:III, 1161, at para. 132.

[11] We recall that the term "matter" was defined by the Appellate Body in *Guatemala – Cement I* to mean the specific measures at issue and the legal basis of the complaint (WT/DS60/AB/R, para. 72). Accordingly, there is no need for the measures and legal claims identified in the request for establishment to be identical to the measures and legal claims identified in the request for consultations.

[12] See, for example, Questions 2, 3, 8, 9, 10, 11 and 12.

Act as a whole is under review. Thus, we see no basis at present to restrict our findings to the KEXIM Act "as such" only as applicable to commercial vessels.[13]

13. Regarding the inclusion in the European Communities' request for establishment of Article 5 / serious prejudice claims in respect of assistance provided under the KEXIM APRG and PSL programmes, and the inclusion of Article 3 / prohibited export subsidy claims in respect of restructuring assistance and tax programmes, we recall that provided the request for establishment concerns a dispute on which consultations had been requested, there is no need for the matter identified in the request for establishment to be identical to the matter on which consultations were requested. Since consultations took place in respect of all of the abovementioned measures, in the context of a dispute concerning the application to those measures of certain disciplines under the SCM Agreement, we consider that the European Communities was entitled to formulate its request for establishment on the basis of any combination of those measures and legal provisions. Furthermore, we note that in a letter to Korea dated 3 April 2003, the European Communities referred to the need to "clarify ... the effects of KEXIM financing and restructuring measures on the shipbuilding market". Attached to that letter were six questions under the title "Impact of KEXIM programmes on the market". In our view, this letter provides sufficient factual evidence to conclude that issues regarding serious prejudice allegedly caused by KEXIM programmes were consulted on, and were therefore properly included in the request for establishment.

14. The issue raised by Korea of whether or not the challenge of the KEXIM programmes and the corporate restructuring and tax subsidies under both Articles 3 and 5 of the SCM Agreement as prohibited and actionable subsidies is legally and factually impossible is substantive in nature. We will therefore only consider this issue in light of the submissions of the parties and third parties to the substantive meetings of the Panel.

15. We also consider that Korea's argument that the KEXIM legal instruments do not mandate the provision of export subsidies is similarly substantive in nature, since it brings into question the very substance of those legal instruments. Again, therefore, it is only appropriate for us to consider this issue in light of the submissions of the parties and third parties to the substantive meetings of the Panel.

16. For the above reasons, we are unable to grant Korea's request for preliminary rulings that (i) "un-specified KEXIM programs for capital goods at large are not legitimately in front of the Panel in accordance with Articles 4.2, 4.4, 7.2 and 7.4 of the SCM Agreement as well as Articles 4 and 6.2 of the DSU", and (ii) "only the KEXIM APRGs and the pre-shipment loans for commercial vessels as prohibited subsidies and the corporate restructuring and tax subsidies as actionable subsidies are legitimately in front of the Panel".

[13] By contrast, with respect to the European Communities' claims regarding the actual application of the KEXIM legislation and schemes thereunder, it is clear that the request for establishment relates only to financing under the APRG and PSL programmes, and only in respect of commercial vessels.

B. CONFORMITY OF THE REQUEST FOR ESTABLISHMENT WITH ARTICLE 6.2 OF THE DSU

1. Arguments of Korea

17. Korea submits that the European Communities' request for establishment fails to meet the requirements of Article 6.2 of the DSU by not defining sufficiently the specific measures at issue and by not providing a sufficient brief summary of the legal basis of the complaint so as to present the problem clearly.

18. First, Korea asserts that the request for establishment failed to meet the standard of clarity required by Article 6.2 of the DSU because it failed to choose between prohibited and actionable subsidy claims in respect of the same measures. According to Korea, the European Communities should not have claimed that one and the same measures are either prohibited or actionable subsidies.

19. Second, Korea asserts that the European Communities' claims are impermissibly vague and contradictory because the European Communities failed to specify (i) the product scope and geographical market of its serious prejudice and injury claims, and (ii) which of the circumstances indicating serious prejudice under Article 6.3 of the SCM Agreement it is alleging to exist as a result of Korean subsidies.

20. Korea submits that the European Communities' failure to specify the legal basis of its claims violates Korea's rights of defence.

21. Korea requests that the Panel issue preliminary rulings that:

- "the request for establishment of the Panel violates Articles 6.2 of the DSU and the corresponding provisions of the SCM Agreement in several (…) respects by not defining sufficiently the specific measures at issue and not providing a sufficient brief summary of the legal basis of the complaint so as to present the problem clearly, in particular, as regards the absence of the specific legal basis relied upon and the absence of clear indication of the geographical and product scope of the measures challenged"; and

- "by failing to specify the subparagraphs relied upon with respect to Article 6.3, the European Communities' panel request in this regard is inconsistent with the requirements of Article 6.2 of the DSU and hence these claims are inadmissible, or at least that Article 6.3(a), (b) and (d) are outside the terms of reference of the Panel."

2. Arguments of the European Communities

22. The European Communities submits that its request for establishment meets the requirements of Article 6.2 of the DSU because it clearly delineates the specific provisions and paragraphs that make up the legal basis of the complaint. The European Communities also asserts that Korea's argument that a subsidy cannot qualify simultaneously as both an actionable and prohibited subsidy, and its contention regarding the relationship between actionable and prohibited subsidies, is a question of substance and not subject to preliminary ruling.

23. Regarding the product scope of its claims, the European Communities submits that it has never demonstrated any interest in developing a serious prejudice

claim outside of the shipbuilding industry. As for Korea's argument that the panel request is vague with respect to the "market" at issue in this case, the European Communities asserts that it has made clear that its focus is on a world, or global market. By referring to SCM Article 6.5, and in listing the adverse effects referred to in Article 6.3(c), the European Communities asserts that its request for establishment has clearly identified which particular provision of Article 6.3 forms the basis of this claim. Moreover, through this reference to Article 6.3(c) of the SCM Agreement, and its reference, in turn, to the negative effects of a subsidy "in the same market", the European Communities asserts that its request for establishment clearly indicated that it was not concerned with any one geographic or national market in particular, but with the global market in which shipbuilders of the European Communities and Korea compete.

24. The European Communities denies that Korea's right to defend itself has been prejudiced.

3. Assessment by the Panel

25. Article 6.2 of the DSU provides in relevant part:

> The request for the establishment of a panel (…) shall (…) identify the specific measures at issue and provide a brief summary of the legal basis of the complaint sufficient to present the problem clearly.

26. In its request for establishment, the European Communities stated that the relevant measures:

> are in breach of Korea's obligations under the provisions of the *SCM Agreement*, in particular, but not necessarily exclusively of:
>
> – Articles 3.1(a) and 3.2 of the *SCM Agreement*, because, *inter alia*, the KEXIM Act, the advance payment refund guarantees and the pre-shipment loans provided by KEXIM and the corporate restructuring packages and tax concessions are specific subsidies within the meaning of Articles 1 and 2 of the *SCM Agreement* and are *de jure* or *de facto* export contingent.
>
> - Article 5(a) of the *SCM Agreement*, because, *inter alia*, the above-mentioned KEXIM subsidies, the corporate restructuring packages and tax concessions are specific subsidies within the meaning of Articles 1 and 2 of the *SCM Agreement* and are causing injury to the Community industry.
>
> – Article 5(c) of the *SCM Agreement*, because, *inter alia*, the above-mentioned KEXIM subsidies, the corporate restructuring packages and tax concessions are specific subsidies within the meaning of Articles 1 and 2 of the *SCM Agreement* and cause serious prejudice to the interests of the European Communities, in particular through significant price undercutting, price suppression, price depression or lost sales within the meaning of Articles 6.3 and 6.5 of the *SCM Agreement*.

27. We note the finding of the Appellate Body in *Korea – Dairy Products* that:

> "There may be situations where the simple listing of the articles of the agreement or agreements involved may, in the light of attendant circumstances, suffice to meet the standard of clarity in the statement of the legal basis of the complaint. However, there may also be situations in which the circumstances are such that the mere listing of treaty articles would not satisfy the standard of Article 6.2. This may be the case, for instance, where the articles listed establish not one single, distinct obligation, but rather multiple obligations. In such a situation, the listing of articles of an agreement, in and of itself, may fall short of the standard of Article 6.2." [14]

28. We first consider Korea's assertion that the European Communities failed to satisfy the requirements of Article 6.2 of the DSU because it failed to choose between prohibited and actionable subsidy claims in respect of the measures at issue. Given its view that it is "legally and factually impossible" for a given measure to be at the same time both a prohibited and an actionable subsidy, Korea apparently believes that the European Communities is identifying the provisions at issue as alternative claims. Korea then seems to suggest that it is impermissible to raise alternative claims in a WTO dispute. In our view, the question of whether it is permissible to raise alternative claims is substantive, and it is neither necessary nor appropriate to address it at this time. We would note as a factual matter, however, that citing multiple provisions in respect of a given measure, both as complementary and as alternative claims, is very common in WTO dispute settlement.[15]

29. Leaving aside the substantive question, and returning to the requirements of Article 6.2 of the DSU, we can only conclude that if a complaining party wishes to pursue claims in respect of a given measure under multiple provisions, whether complementarily or alternatively, not only is it *permitted* by Article 6.2 of the DSU to refer to all of those provisions in its request for establishment, but it is *required* to do so. In this respect, we find that the European Communities' request for establishment meets this requirement, as it identifies quite clearly which provisions are at issue, namely Articles 3.1(a), 3.2, 5(a) and 5(c) of the SCM Agreement, and it explicitly states the European Communities' view that, pursuant to these provisions, the relevant measures are specific subsidies that are export contingent, and that cause serious prejudice to the interests of the European Communities. There is thus no doubt as to which provisions are cited by the European Communities in respect of which measures, and on what basis. As for the substantive issues, including whether it is possible to demonstrate that the relevant measures could constitute at one and the same time both prohibited and actionable subsidies, these should only be addressed in light of the submissions of the parties and third parties to the substantive meetings of the Panel.

30. Concerning the question of which subparagraph of Article 6.3 forms the basis of the European Communities' claim of serious prejudice, Korea asks the Panel to rule "at least that Article 6.3(a), (b) and (d) are outside the terms of reference of the Panel". In this regard, the European Communities has asserted that "the focus of the

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[14] Appellate Body Report, *Korea – Definitive Safeguard Measure on Imports of Certain Dairy Products* ("*Korea – Dairy*"), WT/DS98/AB/R, adopted 12 January 2000, DSR 2000:I, 3, at para. 124.

[15] See, e.g., the *Canada – Dairy* dispute (WT/DS103/R-WT/DS113/R), in which alternative claims were raised in respect of the measures at issue, and the *Indonesia – Autos* dispute (WT/DS54/R-WT/DS55/R-WT/DS59/R-WT/DS64/R), in which complementary claims were raised in respect of the measures at issue.

claim is, in fact, on Article 6.3(c) of the *SCM Agreement*, as demonstrated by the inclusion of Article 6.5 (which specifically refers to Article 6.3(c)) in the panel request, [and] in the reference to 'significant price undercutting, price suppression, price depression, or lost sales within the meaning of Articles 6.3 and 6.5 of the *SCM Agreement*'."[16] On the basis of this statement, and the language in the request for establishment that it cites, we see no need to issue, at this stage, the ruling sought by Korea on this point.

31. In respect of product scope, we understand Korea to argue that the European Communities' request for establishment is not sufficiently clear for the purpose of Article 6.2 of the DSU because it fails to specify that the actionable subsidy (serious prejudice and injury) claims relate only to commercial vessels, and further, that in any event such a reference is overly broad. In this regard, we first note the European Communities' assertion that "its actionable subsidy claim relates to commercial vessels".[17] Since the European Communities used the heading "Korea – Measures Affecting Trade in Commercial Vessels" in its request for establishment, we are in no doubt that the request for establishment was sufficiently specific for the purpose of Article 6.2 of the DSU insofar as it applies to measures affecting trade in "commercial vessels". Since the European Communities has indicated that there will be no actionable subsidy claims in respect of products other than commercial vessels, there is simply no need for us to consider whether or not the request for establishment was sufficiently specific in respect of other products. Furthermore, we find the reference to "commercial vessels" as used in the request for establishment to be a sufficiently precise specification of the product scope of these claims to satisfy the standard of Article 6.2 of the DSU.[18]

32. Korea also asserts that the European Communities' failure to specify a geographic market in its serious prejudice and injury claims is inconsistent with Article 6.2 of the DSU. With respect to the serious prejudice claims, we note that the request for the establishment of a panel explicitly refers to "price undercutting, price suppression or lost sales within the meaning of Article 6.3 and Article 6.5 of the SCM Agreement". As discussed above, it is readily apparent to the Panel, as it should be to the parties, that the specific provision at issue is Article 6.3(c), which refers to "the same market", that is, a market where Korean and European Communities producers of commercial vessels compete and where the alleged adverse effects of the subsidies on prices or sales will need to be substantiated. Given this, we do not consider that a further elaboration as to geographic market is necessary in the request for establishment, in respect of the serious prejudice claims. As for the injury claims, it is clear from the text of Article 5(a), the cited provision, that the alleged injury is to the "domestic industry" of the complaining party, coupled with which the request for establishment explicitly refers to injury to the "Community industry". Given this, we find a simple citation to the provision to be sufficient. In sum, we recall that the requirement under Article 6.2 of the DSU is to "provide a brief summary of the legal basis of the complaint", and we believe that this requirement does not extend to a further elaboration, beyond that implicit or explicit in the provisions cited in this case, of the geographical locus of the alleged adverse effects.

[16] European Communities' submission of 5 September 2003, para. 41.

[17] *Id.*, para. 42. See also para. 33.

[18] Here, in any case, we note that the European Communities has clarified, in its 5 September 2003 submission, at para. 43, that its actionable subsidy claims relate to only certain kinds of commercial vessels. Thus we would not expect to receive arguments from the European Communities regarding other kinds of vessels in the context of these claims.

> 33. For the above reasons, we decline to rule that "the request for establishment of the Panel violates Articles 6.2 of the DSU and the corresponding provisions of the SCM Agreement in several [] respects by not defining sufficiently the specific measures at issue and not providing a sufficient brief summary of the legal basis of the complaint so as to present the problem clearly, in particular, as regards the absence of the specific legal basis relied upon and the absence of clear indication of the geographical and product scope of the measures challenged."
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> 34. Korea has asserted that the European Communities' failure to specify the legal basis of its claims violates Korea's right of defence. Since we do not find that the European Communities' request for establishment fails to meet the requirements of Article 6.2 of the DSU, there is no need for us to consider whether or not the alleged violation of that provision prejudiced Korea's right of defence.
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> C. OBJECTIONS CHARACTERIZED BY KOREA AS SUBSTANTIVE IN NATURE
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> 35. In its request for preliminary rulings, Korea has also raised a number of issues which it expressly characterizes as "substantive" objections. In particular, Korea submits that in the context of ships and trade in commercial vessels a claim of serious prejudice cannot be entertained in the context of a "world market" under the SCM Agreement, and that the European Communities cannot be permitted in the context of this case and the EC's request for the establishment of a Panel, to rely on both Article 3 and Article 5 of the SCM Agreement as concurrent or alternative legal bases for its claims against the same Korean measures. As already noted, the Panel does not deem it appropriate to consider substantive issues before receiving the submissions of the parties and third parties to the substantive meetings of the Panel. We therefore decline to make any preliminary rulings in respect of those issues characterized by Korea as substantive in nature.

3. Exclusion of certain Annex V information

7.3 At para. 68 of its first written submission, Korea asserts that the EC abused the Annex V procedure, by using that procedure to obtain information for (Part II) claims in respect of which the Annex V procedure does not apply. In particular, Korea asserts that the EC used the Annex V procedure (reserved for Part III claims) to obtain information regarding non-shipbuilding sectors, even though its Part III claims were limited to the shipbuilding sector. Korea asserts that the EC did so in order to obtain information to support its Part II claims, which do extend beyond the shipbuilding sector, but which fall outside the scope of the Annex V process.

7.4 Korea submits that the Panel should exclude from its consideration under Part II of the *SCM Agreement* any evidence or information obtained under the Annex V procedure. Korea also submits that the Panel could decide to exclude any and all evidence obtained in the context of the Annex V process from the evidence considered by the Panel in reaching its decision as to the EC's claims under both Part II and Part III of the *SCM Agreement*.[19]

7.5 On 12 March 2004, the Panel issued the following ruling regarding this matter:

> 1. Korea asserts that the EC abused the Annex V procedure by using it to obtain information for (Part II) claims in respect of which the Annex V procedure does not

[19] Korea also asserts (at para. 74 of its first written submission) that the EC's alleged lack of prima facie evidence before bringing its case may be inconsistent with Article 3.7 of the *DSU*. Since Korea does not request a ruling from the Panel regarding this matter, we need not consider it further.

apply. In particular, Korea asserts that the EC used the Annex V procedure (which it claims is reserved for Part III claims) to obtain information regarding non-shipbuilding sectors, even though its Part III claims were limited to the shipbuilding sector. Korea asserts that the EC did so in order to obtain information to support its Part II claims, which do extend beyond the shipbuilding sector, but which in Korea's opinion fall outside the scope of the Annex V process.

2. Korea submits that the Panel should exclude from its consideration under Part II of the *SCM Agreement* any evidence or information obtained under the Annex V procedure. Korea also submits that the Panel could decide to exclude any and all evidence obtained in the context of the Annex V process from the evidence considered by the Panel in reaching its decision as to the EC's claims under both Part II and Part III of the *SCM Agreement*.

3. We note that the information at the heart of Korea's preliminary objection relates to the individual APRG and PSL transactions identified in paragraphs 170 and 172 of the EC's first written submission. In requesting transaction-specific APRG and PSL information from Korea, the Facilitator carefully limited the scope of the request to APRG and PSL transactions relating to "companies (involved (directly or indirectly) in trade in commercial vessels)". In conformity with that request, the transaction-specific information provided by Korea did not extend beyond the commercial vessels sector. As a result, the transaction-specific information at issue does not extend beyond the commercial vessel sector. Furthermore, the relevant information concerns the existence of subsidization, and was relied on by the EC in respect of its Part III claims. We note that paragraph 2 of Annex V envisages the gathering of such information as necessary "to establish the existence and amount of subsidization". In addition, paragraph 5 of Annex V states that the designated representative's report to the Panel should include "data concerning the amount of the subsidy in question". In our view, therefore, the information relied on by the EC in support of its Part III claims regarding the existence of subsidization was properly gathered under the Annex V procedure. The EC therefore did not abuse the Annex V procedure in seeking that information.

4. We must now consider whether or not the EC was entitled to use that information for the additional purpose of supporting its Part II claims. In particular, the question is whether information properly gathered under the Annex V mechanism regarding the existence of alleged subsidization, which was properly relied on by the EC in support of its Part III serious prejudice claims against certain alleged subsidies, could also be used in the context of Part II claims concerning the same alleged subsidies.

5. In the context of the EC's Part III claims, we must determine whether or not the relevant APRG and PSL transactions constitute subsidies. In doing so, we are bound by the provisions of Article 1 of the *SCM Agreement*. At paragraphs 170 and 172 of the EC's first written submission, the EC is requesting us to perform the same analysis of subsidization[20] in respect of the same measures in the context of its Part II claims. We see nothing in Annex V that would require us to ignore our Part III analysis of subsidization when reviewing the EC's Part II claims which concern allegations of the same subsidization in respect of the same measures. Nor indeed do

[20]Article 3.1(a) claims necessarily involve an additional analysis of export contingency. We note that the EC's allegation of export contingency is not based on the Annex V information set forth in paragraphs 170 and 172 of the EC's first written submission.

we see any requirement in the *SCM Agreement* to perform this analysis more than once for any given measure alleged to be a subsidy.

6. In any event, even if we were precluded from relying on the relevant Annex V information when determining the existence of subsidization in the context of the EC's Part II claims, at the very least any finding of the existence of subsidization in respect of the EC's Part III claims would compel us to "seek" that very same information (i.e., regarding the same alleged subsidies) from Korea under Article 13.1 of the *DSU*. In other words, the very same information would in any event be brought before the Panel, but only much later in the proceedings, after the Panel had made findings regarding the existence of subsidization in respect of the EC's Part III claims. We recall that there is no textual basis for requiring us to rule that the relevant Annex V information is not directly admissible in respect of the EC's Part II claims. We therefore see no basis for ruling that the relevant information should only enter the record indirectly, and much later in the proceedings, via Article 13.1 of the *DSU*.

7. For the above reasons, we decline to rule that the EC was precluded from using information that was properly gathered under the Annex V mechanism regarding the existence of alleged subsidization, and properly relied on by the EC in respect of its Part III serious prejudice claims against certain alleged subsidies, in support of additional Part II claims concerning the same alleged subsidies.

4. Prejudice to Korea's earlier preliminary ruling request

7.6 At para. 76 of its first written submission, Korea submits that "it would appear reasonable for the Panel to reconsider" its 19 September 2003 preliminary ruling concerning the alleged impermissible ambiguity of the EC's serious prejudice claims. Korea suggests that reconsideration of the ruling would be necessary subject to two conditions: (1) that the EC's statement (in its 5 September 2003 submission) that it had "never" intended its serious prejudice claims to cover a wider product scope than commercial vessels is inaccurate; and (2) that this may have had a bearing on the Panel's decision to decline Korea's preliminary ruling request on this point.

7.7 Although Korea does not explicitly say so, we understand that Korea is referring to the Panel's preliminary ruling regarding the conformity of the EC's request for establishment with Article 6.2 of the *DSU*. The relevant ruling is found at para. 31 of the abovementioned communication dated 19 September 2003. It is apparent from the text of that communication that the Panel's ruling was not based on the EC's statement that it had "never" intended its serious prejudice claims to cover a wider product scope than commercial vessels. The Panel only took into account the EC's assertion that "its actionable subsidy claim relates to commercial vessels". In other words, the Panel focused on what was included in the EC's serious prejudice claim, and not whether or not the EC had ever demonstrated an interest in developing a serious prejudice claim outside of the shipbuilding industry. Since the second condition identified by Korea is not fulfilled, there is no need for the Panel to reconsider its earlier ruling.

5. Withdrawal of Article 5(a) claim

7.8 Korea asserts that the EC has failed to pursue its claim under Article 5(a) of the *SCM Agreement*, and that it has not presented a *prima facie* case of any alleged injury in its first submission. Korea therefore requests that the Panel formally find that this claim has been effectively withdrawn.

7.9 This issue is addressed by the Panel at para. 7.521 *infra*.

6. Price suppression and price depression / Article 6.3(c)

(a) Exclusion of price undercutting claim

7.10 Korea notes that the EC's Article 6.3(c) claim rests solely on price suppression and price depression, and not price undercutting. Korea submits that the EC has failed to pursue its claim on price undercutting, and that it has not presented a *prima facie* case of any such price undercutting in its first submission. Korea therefore requests that the Panel formally find that this claim has been effectively withdrawn.

7.11 This issue is addressed by the Panel at para. 7.521 *infra*.

(b) Scope of serious prejudice claim

7.12 Korea asserts that the product scope of the EC's serious prejudice claims must be restricted to commercial vessels pursuant to the EC's latest assertion of 5 September.

7.13 We understand that Korea's assertion regarding the scope of the EC's serious prejudice claim relates to Korea's original request for a preliminary ruling in respect of Article 6.2 of the *DSU*. Korea appears to be asking the Panel (although there is no explicit request) to rule that the scope of the EC's serious prejudice claims be restricted to commercial vessels.

7.14 At para. 31 of the abovementioned 19 September 2003 communication, the Panel stated *inter alia*:

> Since the European Communities has indicated that there will be no actionable subsidy claims in respect of products other than commercial vessels, there is simply no need for us to consider whether or not the request for establishment was sufficiently specific in respect of other products.

7.15 It is clear, therefore, that the Panel already indicated its understanding that the scope of the EC's serious prejudice claim is limited to commercial vessels.

7. The extent of the record

7.16 At para. 82 of its first written submission, Korea disputes the EC's argument that the responses provided in the context of the Annex V process should be considered the "record" on the basis of which the panel should reach its conclusions in this case.

7.17 Since Korea has not requested a preliminary ruling on this issue, there is no need for the Panel to consider this matter further.

8. Continued relevance of Korea's 29 August 2003 request for preliminary rulings

7.18 At para. 84 of its first written submission, Korea submits that a number of issues raised in its 29 August 2003 request for preliminary rulings remain applicable. In our view, these issues have already been addressed in our communications dated 19 September 2003 and 12 March 2004. We therefore do not consider it necessary to revisit the issues raised in Korea's submission of 29 August 2003.

B. ALLEGED PROHIBITED EXPORT SUBSIDIES

7.19 The EC claims that Korea has provided and continues to provide its shipbuilding industry prohibited export subsidies, contrary to Articles 3.1(a) and 3.2 of the *SCM Agreement*.

7.20 First, the EC claims that such subsidies were and are provided pursuant to the Export-Import Bank of Korea ("KEXIM") Act, the KEXIM Decree, and the KEXIM Interest Rate Guidelines (the "KEXIM legal regime", or "KLR"). The EC asserts that these measures "as such" (i.e., by their very existence, irrespective of their application in a given case) violate Articles 3.1(a) and 3.2 of the *SCM Agreement*.

7.21 Second, the EC claims that Korea provides and has provided prohibited export subsidies pursuant to the KEXIM Advance Payment Refund Guarantee ("APRG") and Pre-shipment Loan ("PSL") programmes. Again, the EC claims that these measures "as such" violate Articles 3.1(a) and 3.2 of the *SCM Agreement*.

7.22 Third, the EC claims that individual APRGs and PSLs (i.e., the application of the APRG and PSL programmes in individual cases) violate Articles 3.1(a) and 3.2 of the *SCM Agreement*.

1. Kexim Legal Regime

7.23 Before turning to the substance of the EC's claims, we observe that a measure is generally to be treated as a prohibited export subsidy if it is a subsidy (as defined by Article 1 of the *SCM* Agreement) that is "contingent … upon export performance" (in the meaning of Article 3.1(a) of the *SCM Agreement*). While the EC's claims do not raise many issues regarding the notion of export contingency, the parties have made extensive arguments on the question of whether or not the measures at issue constitute subsidies. A subsidy exists if there is a "financial contribution" by a government or public body (or a private body entrusted or directed by the government) that confers a "benefit".

7.24 We shall begin our analysis of the EC's claim against the KLR by determining whether measures taken under the KLR constitute financial contributions, and whether KEXIM is a public body. If so, we shall then determine whether or not the KLR confers a benefit. We shall then consider whether or not measures taken under the KLR are contingent on export performance.

(a) Does the KLR Provide for Financial Contributions?

(i) Arguments of the parties

7.25 The EC submits that the KEXIM Act provides for direct transfers of funds within the meaning of Article 1.1(a)(1)(i) of the *SCM Agreement*. The EC asserts that Article 18 of the KEXIM Act provides for loans and loan guarantees, among other types of financing. The EC states that loans and loan guarantees are identified as types of direct transfer of funds in Article 1.1(a)(1)(i) of the *SCM* Agreement.

7.26 Korea submits that the KLR does not provide for "financial contributions" in the meaning of Article 1.1(a)(1)(i) of the *SCM Agreement* because KEXIM does not engage in "government practice". Korea asserts that even if a body is a public body, it does not make a financial contribution if it is not involved in a "government practice". Korea states that the term "government practice" means the exercise of government authority, e.g., regulatory powers and taxation authority. According to Korea, this is confirmed by the context of Article 1.1(a)(1)(iv) of the *SCM Agreement*, which provides that there is a "government practice" only when a body carries out a function "which would normally be vested in the government" and "the practice, in no real sense, differs from practices normally followed by governments". Korea argues that the panel in *US – Export Restraints* looked at the negotiating history of the term "normally vested in the government" in Article 1.1(a)(1)(iv) of the *SCM Agreement* and concluded that the term "was a general reference to the delegation to private

parties of the particular government functions of taxation and expenditure of revenue and not a reference to government market intervention in the general sense, or the effects thereof."[21]

7.27 Korea asserts that KEXIM is set up for the specific purpose of meeting needs of an industrial or commercial nature, i.e., activities involving the extension of financing facilities on markets where it competes with other public or private operators based on market-oriented principles. Korea argues that in extending financing facilities such as APRGs or PSLs, KEXIM operates in a traditional banking capacity, performing functions normally performed by banks – not by governments.

(ii) Evaluation by the Panel

7.28 We do not accept Korea's argument that there is only a "financial contribution" in the meaning of Article 1.1(a)(1(i) if the relevant government or public body is engaged in "government practice" such as regulation or taxation. Article 1.1(a)(1) states in relevant part that the term "government" refers to both "government" and "public body". Since the phrase "government practice" in Article 1.1(a)(1)(i) therefore refers to the practice of both governments and public bodies, the practice at issue need not necessarily be purely "governmental" in the narrow sense advocated by Korea. In this regard, we consider that the concept of "financial contribution" is writ broadly to cover government and public body actions that might involve subsidization. Whether the government or public body action in fact gives rise to subsidization will depend on whether it gives rise to a "benefit". Since the concept of "benefit" acts as a screen to filter out commercial conduct, it is not necessary to introduce such a screen into the concept of "financial contribution".

7.29 In our view, the phrase "government practice" in Article 1.1(a)(1)(i) is simply a grammatical construction, or series of words, chosen because sub-paragraph (i) of Article 1.1(a)(1) could not have been drafted in the direct form.[22] As such, it refers to cases ("practice") where governments or public bodies provide direct or potential direct transfers of funds. The phrase "government practice" is therefore used to denote the author of the action, rather than the nature of the action. "Government practice" therefore covers all acts of governments or public bodies, irrespective of whether or not they involve the exercise of regulatory powers or taxation authority. If the phrase "government practice" fulfils the filtering role advocated by Korea, this phrase would presumably also have been included in sub-paragraphs (ii) and (iii) of Article 1.1(a)(1). In particular, we would have expected it to be included in sub-paragraph (iii), such that only the provision of goods and services pursuant to the exercise of regulatory powers or taxation authority would be covered by that provision.[23] However, sub-paragraph (iii) is not drafted in this way.

7.30 We note Korea's argument that Article 1.1(a)(1)(iv) of the *SCM Agreement* refers to functions "normally (...) vested in the government" and "practice [that] in no real sense, differs from practices normally followed by governments". We note that this language was addressed by the panel in *US – Export Restraints*. That panel referred to the report of the Group of Experts on the Calculation of the Amount of a Subsidy, which in turn referred to a 1960 panel report.[24] Like that panel, we too "find very significant the Group of Experts' interpretation that the 1960 Panel's reference to 'practice . . . in no real sense different from those normally followed by governments' was a general reference to the *delegation* to private parties of the particular government functions of taxation and expenditure of

[21] Panel Report, *US – Export Restraints*, para. 8.72.

[22] It is grammatically inconceivable that sub-paragraph (i) could have been drafted as "a government provides a direct transfer of funds or a potential direct transfer of funds", since it makes no sense to refer to a government concretely providing a potential, or hypothetical, direct transfer of funds.

[23] We also note that there has never been any suggestion in any previous panel or Appellate Body reports addressing Article 1.1(a)(1) of the *SCM Agreement* that the scope of that provision (or parts thereof) is confined to government or public body measures taken pursuant to the exercise of regulatory powers or taxation authority.

[24] See MTN.GNG/NG10/W/4, "Subsidies and Countervailing Measures – Note by the Secretariat", 28 April 1987, Section 4.1.A.

revenue, ...".[25] The Panel notes that the reference to functions "normally vested in the government" textually mirrors the reference to "practices normally followed by governments". Accordingly, the Panel considers that the reference to functions "normally vested in the government" should also be understood to mean functions of taxation and revenue expenditure. Thus, a function may be said to be "normally vested in the government" if that function involves the levy of taxation or the expenditure of revenue. Accordingly, since loans and loan guarantees involve revenue expenditure, they may be treated as functions "normally vested in the government", whether or not they are provided pursuant to the exercise of regulatory powers or taxation authority.[26]

7.31 In light of the above, and since Korea does not dispute the EC's assertion that loans and loan guarantees fall within the scope of Article 1.1(a)(1)(i), we find that the KLR provides for "financial contributions" in the meaning of Article 1.1(a)(1) of the *SCM Agreement*.

(b) Is KEXIM a Public Body?

(i) Arguments of the parties

7.32 The EC submits that KEXIM is a public body because (i) it is created and operates on the basis of a public statute giving the Government of Korea ("GOK") control over its decision-making, (ii) it pursues a public policy objective, and (iii) it benefits from access to state resources.

7.33 Concerning governmental control over decision-making, the EC submits that as of December 2002 KEXIM was owned 51.6 per cent by the GOK, 42.8 per cent by the Bank of Korea, and 5.6 per cent by the Korea Development Bank ("KDB"), both of which latter are wholly subscribed by the Government of Korea. The EC further asserts that KEXIM's key management is appointed and dismissed by the GOK, and its operations and budget are subject to the approval and control of the GOK. The EC also submits that KEXIM's annual Operation Plans are formulated under the control of the GOK.

7.34 Concerning public policy objective, the EC asserts that pursuant to Article 1 of the KEXIM Act, KEXIM was created to fulfil the public purpose of promoting "the sound development of the national economy and economic cooperation with foreign countries."[27] According to the EC, KEXIM itself acknowledges that it is a public body that acts in the interests of the country by serving as "an official export credit agency providing comprehensive export credit and project finance to support Korean exporters and investors" and facilitating "the development of the national economy and enhanc[ing] economic cooperation with foreign companies as a financial catalyst."[28] The EC further notes that KEXIM's annual reports specifically refer to KEXIM as "a special governmental financial institution",[29] and as "an agent of the Government".[30] Similarly, the EC asserts that KEXIM's website describes KEXIM as a "special government financial institution under the guardian authority

[25] *US – Export Restraints*, para. 8.72.

[26] We also note that Korea agrees (see Korea's First Written Submission, para. 163) with the statement by the US – Export Restraints panel that "the difference between subparagraphs (i) – (iii) on the one hand and subparagraph (iv) on the other has to do with the identity of the actor and not the nature of the action". Since we have already concluded that the text of subparagraph (i) is not limited to the exercise of regulatory powers or taxation authority, the above statement suggests that the same must also be true of subparagraph (iv) (because the only difference between sub-paragraphs (i) – (iii) and (iv) is the author, not the nature, of the action). Subparagraph (iv) cannot therefore be relied on by Korea to limit the scope of actions covered by subparagraph (i).

[27] See Exhibit EC – 10.

[28] *See* KEXIM 2002 Annual Report, at "Profile" (Exhibit EC-14).

[29] KEXIM Annual Report 2000, at "Profile" (Exhibit EC-15).

[30] KEXIM 2002 Annual Report, p. 35 (Exhibit EC-14); KEXIM 2000 Annual Report, p. 31 (Exhibit EC-15); KEXIM 2001 Annual Report, p. 32 (Exhibit EC-16).

of MOFE [*i.e.*, the Ministry of Finance and Economy]"[31], and as "a government institution [that] supports the Government's policies on international trade and overseas investment."[32] According to the EC, other KEXIM materials confirm that KEXIM "is a special government financial institution whose purpose is to promote the development of the Korean economy and economic cooperation with foreign countries ... [and] expand appropriate financing activities to conform with government policies."[33]

7.35 Concerning access to state resources, the EC submits that the GOK is required to guarantee any net loss incurred by KEXIM. In this regard, the EC asserts that GOK, and government-owned banks, injected over 1.6 trillion Korean Won ("KRW") between 1998 and 1999 into KEXIM, and at least an additional KRW 270 billion since January 2000. The EC asserts that an unlimited guarantee for losses and massive capital injection provide evidence of government influence and control over KEXIM.

7.36 In the alternative, the EC submits that KEXIM is a private body "entrusted" or "directed" by the Korean Government within the meaning of Article 1.1(a)(1)(iv) of the *SCM Agreement*.

7.37 Korea asserts that KEXIM is not a public body, as it is a body that carries on a business equivalent to that of a private operator. Korea submits that an organization is a public body only when it acts in an official capacity, or is engaged in governmental functions. Korea submits that the term "public" in Article 1.1(a)(1) of the *SCM Agreement* should be defined as "[a]cting in an official capacity on behalf of the people as a whole; as a public prosecutor".[34]

7.38 According to Korea, the pursuit of a public policy objective does not confer on a body the status of a public body when such body is set up for the specific purpose of meeting needs of an industrial or commercial nature through the supply of goods or services on markets which are open to other public or private operators under fully competitive conditions. Korea submits that a general public policy purpose reflected in sectoral focuses is characteristic of many privately owned companies, particularly in the financial sector. By way of example, Korea asserts that investment trusts are limited in their activities in many countries, home mortgage lending is often a separate specialty, and often it is required that merchant banking be legally separate from retail banking. Korea asserts that it is a matter of focusing expertise, protecting consumers (corporate as well as natural), and protecting the integrity of the overall financial markets from errors caused by financial institutions venturing into substantive areas where they have insufficient expertise.

7.39 Korea refers to the International Law Commission's Articles on State Responsibility in support of its position. According to Korea, Article 5 of the Articles on State Responsibility[35] provides for a two-step analysis that helps clarify whether an entity is a public body. First, Korea submits that, pursuant to Article 5, the entity will be a public body if it "is empowered by the law of the State to exercise elements of the governmental authority." Korea asserts that this is a simple and logical test, based on the substance of what an entity is required to do rather than on questions of form

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[31] KEXIM "On-line Road Show" <http://www.koreaexim.go.kr/web/eng/index.jsp>, p. 2 (Exhibit EC-17).

[32] *See* "The Bank in Outline" <http://www.koreaexim.go.kr/web/eng/about/M01/m1_01.html> (visited 21 November 2002) (Exhibit EC-18).

[33] *See* Brief Guide to Korea Eximbank (March 2000), p. 1 (Exhibit EC-19).

[34] Webster's New Twentieth Century Dictionary, unabridged second edition at page 1456.

[35] Article 5 of the Articles on State Responsibility provides:

> "The conduct of a person or entity which is not an organ of the State under article 4 but which is empowered by the law of that State to exercise elements of governmental authority shall be considered an act of the State under international law, provided the person or entity is acting in that capacity in the particular instance."

such as whether a statute is a "public statute" or not. Regarding the second step, Korea submits that the acts in question will be considered acts of State only if such entities are acting pursuant to such authority in the particular instance. Thus, Korea asserts that it is not the case that an entity is a public body for all purposes simply because it might have been given authority to act for the State in some matters. Korea asserts that one must still determine that the acts in question were undertaken pursuant to the specific grant of governmental authority. According to Korea, if financing is offered as part of a commercial program by a para-statal entity, it is presumptively non-governmental and therefore should not be considered a financial contribution.

7.40 Korea submits that in extending financing facilities, KEXIM is not acting in an official or governmental capacity. Korea asserts that KEXIM has no authority to regulate, and manufacturers and borrowers are free to seek financing from other financial institutions. According to Korea, the role played by KEXIM in its financing activities is the same as that of other financial institutions offering private financing. Korea argues that, even though KEXIM may have been established in the general interest of the public for the promotion of the growth of the national economy,[36] it supplies financial services in markets that are open to other public or private operators under full competitive conditions in accordance with Article 18 of the KEXIM Act.

7.41 In addition, Korea asserts that Article 26 of the KEXIM Act provides that KEXIM must operate to cover its expenses and fees so as to include a profit element. As regards guarantees such as the APRGs, Korea argues that this means that the premium rates must cover the long-term operating costs and losses of the programmes.[37] According to Korea, even if a body disposes of governmental resources, it does not necessarily mean that the receiving body is a public body. Instead, Korea asserts that it could well be that the provision of governmental resources simply constitutes a subsidy to that body which still is a private body. Korea asserts that GOK injected capital into KEXIM not to cover KEXIM's losses, but to avoid negative credit ratings and maintain a sound Bank of International Settlements ("BIS") adequacy ratio. Korea rejects the EC's argument that KEXIM is not required to repay capital contributions made by the GOK, even during years in which KEXIM achieves a profit, since Article 36(2) of the KEXIM Act provides for the payment of dividends to the KEXIM shareholders, including the GOK, even if part of the profits will first be paid out to (non-GOK) preferential shareholders. Korea asserts that this preferential treatment was intended to help persuade commercial financial institutions and other entities to participate in capital contributions into KEXIM.

7.42 Regarding government control, Korea argues that the daily operations of KEXIM are under the ultimate responsibility of, and thus decided by, the Board of Directors, without any form of control by the Government. Korea asserts that although KEXIM is to submit for approval by the Ministry of Finance and Economy the annual Operation Plans, which include the schedules/plans in broad perspectives as to administering loan provisions as well funding requirements therefor, the annual Operation Plan does not pertain to any terms or conditions prescribed for APRGs, nor does the Government require such terms or conditions for APRGs to be included.

7.43 Korea also refers to paragraph 5(c)(i) of the *GATS Annex on Financial Services*, which provides that the term "public entity" does not include "an entity principally engaged in supplying financial services on commercial terms". Korea argues that this definition is context for the interpretation of "public body" under Article 1.1 of the *SCM Agreement* in the present case, since

[36] Korea asserts that, among other things, KEXIM was set up to provide extra liquidity. According to Korea, this was very common in developing countries (which Korea was when KEXIM was set up), as capital markets are undeveloped and funding for commercial enterprises may be limited in a manner not always familiar to those Members with highly developed and liquid capital markets.

[37] Korea asserts that Article 26 has never been applied in practice. According to Korea, it was set forth with the concept of "matching" in the OECD Arrangement on Guidelines for Officially Supported Export Credits in mind and, in any event, it is normal commercial behavior to occasionally sell goods or services below cost in order to meet competition so as to strengthen the firm's competitive position and, therefore, overall to strengthen profitability.

KEXIM is engaged in the provision of financial services. According to Korea, since KEXIM is demonstrated to be an entity principally engaged in supplying financial services on commercial terms, the GATS *Annex on Financial Services* indicates that KEXIM should not be treated as a "public body".

(ii) Evaluation by the Panel

7.44 By asserting that an entity will not constitute a "public body" if it engages in market (non-official) activities on commercial terms, Korea is essentially arguing that we should apply the "benefit" test (whereby a "financial contribution" only confers a "benefit" if it was made available on terms more favourable than the recipient could have obtained on the market).[38] The Appellate Body ruled in *Brazil – Aircraft* that "the issues – and the respective definitions – of a 'financial contribution' and a 'benefit' [are] ... two separate legal elements".[39] Likewise, we consider that the concepts of "public body" and "benefit" should also be treated as separate legal elements. Thus, the question whether an entity is a public body should not depend on an examination of whether that entity acts pursuant to commercial principles. Rather, it is the fact that a financial contribution is provided by a public body (or pursuant to entrustment or direction by a public body) that gives rise to the possibility that the financial contribution might be provided on below-market terms in order to advance public policy goals.

7.45 We cannot accept Korea's approach because it would mean that at different times, the same financial entity could be both a public and a private body, depending on how that entity were conducting itself in the market. Thus, on one day the entity could provide financing on market terms and constitute a "private" entity, whereas on the next day it could make cash grants and then constitute a "public" body. This would make the "private"/"public" body determination entirely dependent on the existence of benefit, despite Article 1.1 of the *SCM Agreement* clearly referring to "public body" and "benefit" as separate concepts.

7.46 Korea denies that its argument fails to properly distinguish between the concepts of public body and benefit. Korea asserts that the issue of lending on a commercial basis is, at the outset, a general one. According to Korea, therefore, if there is a general practice of lending on a commercial basis, then the entity is not a public body. We understand Korea to mean that one would assess whether or not an entity were lending on a commercial basis generally, rather than conducting the type of transaction-specific analysis that might be required for a "benefit" determination. We are not convinced by this argument, since it immediately raises the issue of how one would determine whether or not an entity were engaging in a "general practice of lending on a commercial basis".[40] Would this only be the case if 100 per cent of total lending were on a commercial basis, or would 80 per cent suffice? And how would one determine that the lending is on a "commercial basis" without looking at the sort of factors envisaged in a "benefit" analysis? In our view, it is precisely because of the uncertainty surrounding such issues that it is important to maintain a clear distinction between the concepts of benefit and financial contribution / public body.

7.47 We have the same concerns regarding Korea's reliance on paragraph 5(c)(i) of the *GATS Annex on Financial Services*.[41] That is to say, Korea again fails to distinguish between the concepts

[38] Korea also argues that KEXIM is not a public body because it supplies financial services in markets that are open to other public or private operators under full competitive conditions. We are unable to accept this argument, however, because it is tantamount to asserting that the *SCM Agreement* only applies when the government or public bodies are monopoly suppliers.

[39] Appellate Body report, *Brazil – Aircraft*, para. 157.

[40] See Korea's oral statement at the second substantive meeting with the parties, para. 45.

[41] Paragraph 5(c) provides in relevant part:

> "'Public entity' means:

of "public body" and "benefit". By defining "public body" on the basis of whether or not an entity operates on commercial terms, Korea is introducing considerations of benefit into the analysis of the private / public status of an entity. Furthermore, we question the relevance of the *GATS Annex on Financial Services* to an interpretation of Article 1.1(a)(1) of the *SCM Agreement*.[42]

7.48 Korea also relies on part of a dictionary definition that assimilates "public body" with an entity that acts in an "official capacity". However, it is not clear to us that an entity will cease to act in an official capacity simply because it intervenes in the market on commercial principles if that intervention is ultimately governed by that entity's obligation to pursue a public policy objective. For example, a police officer patrolling a football match as part of his/her police work does not cease to act in an official capacity simply because the home football club is required to pay a market rate for that service.

7.49 The *SCM Agreement* envisages a more straightforward approach, based on a clear distinction between public and private bodies. On the basis of this clear distinction, one may establish with relative certainty whether or not an entity is a public body whose financial contributions fall within the scope of the *SCM Agreement*. Only then need one address the more complex issue of whether or not a benefit is conferred (on the basis of a market benchmark). Korea's approach would blur the clear distinction between public and private bodies, and introduce complex considerations of benefit into the initial filtering process.

7.50 In our view, an entity will constitute a "public body" if it is controlled by the government (or other public bodies). If an entity is controlled by the government (or other public bodies), then any action by that entity is attributable to the government,[43] and should therefore fall within the scope of Article 1.1(a)(1) of the *SCM Agreement*. We consider that KEXIM is a "public body" because it is controlled by GOK. This is evidenced primarily by the fact that KEXIM is 100 per cent owned by GOK or other public bodies.[44] Evidence suggesting governmental control over KEXIM also lies in the fact that the operations of KEXIM are presided over by a President (Article 9(1) of the KEXIM Act) appointed and dismissed by the President of the Republic of Korea (Article 11(1) of the KEXIM Act), and that the KEXIM President shall be assisted by a Deputy President and Executive Directors (Article 9(2) and (3) of the KEXIM Act) to be appointed and dismissed by the Minister of Finance and Economy upon the recommendation of the President of KEXIM (Article 11(2) of the KEXIM Act). Government control is also exercised through the Ministerial approval of the annual KEXIM Operation Programs (Article 21 of the KEXIM Act).

7.51 Although there is some flexibility for the KEXIM President to change the Operation Program pursuant to resolutions passed by the Board of Directors, the circumstances in which the KEXIM President may do so are exhaustively set forth in the Operation Program, and therefore subject to Government control. In addition, we recall that the KEXIM President is a Government appointee.

(i) a government, a central bank or a monetary authority, of a Member, or an entity owned or controlled by a Member, that is principally engaged in carrying out governmental functions or activities for governmental purposes, not including an entity principally engaged in supplying financial services on commercial terms".

[42] In any event, this provision seems to indicate that "an entity principally engaged in supplying financial services on commercial terms" might be treated as a "public entity" absent this clarification in the last phrase of that provision ("not including ..."). Were this not possible, there would be no need for such clarification. This could undermine Korea's argument that a public entity acting on commercial terms could not be treated as a "public body".

[43] This approach is consistent with the fact that Article 1.1(a)(1) provides that both governments and public bodies shall be referred to as "government".

[44] The relevant public bodies are KDB and BOK. We find below (para. 7.172 *infra*) that KDB is a public body. Korea acknowledged in response to Question 76 from the Panel that BOK is a public body.

7.52 The Operation Programs provide detailed direction on the allocation of KEXIM financing between different financing activities and, thereafter, between different sectors. Thus, the Operation Programs generally identify three types of "financing supply" to be provided by KEXIM, and state the proportion of total financing for which each type of "financing supply" should account. Furthermore, the Operation Programs go so far as to stipulate how much of one specific type of "financing supply" should be directed towards specifically identified activities and industrial sectors.

7.53 Korea asserts that the Operation Program does not pertain to any terms or conditions prescribed for APRGs and PSLs. While this may be true, GOK nevertheless enjoys extensive control over the parameters within which KEXIM must operate. Thus, if the Operation Program were to require KEXIM to cease providing financing in the shipbuilding sector, it would appear that KEXIM would be required to do so, even if that sector were the most profitable one in which KEXIM operated. The ability of the Government to issue such instructions is established by virtue of certain "basic directions" set forth in the Operation Programs.[45] For example, the "basic directions" of the 1999 Operation Program required KEXIM to "support the export of capital goods such as ships, industrial plant, machinery, etc., which creates high net export earnings and industrial backward-forward effect".[46] Such "basic directions" necessarily have an impact on the day-to-day operations of KEXIM, since they stipulate the areas in which KEXIM should focus its day-to-day operations (irrespective of purely commercial considerations).

7.54 We consider that the "public" nature of KEXIM is further confirmed by KEXIM's own perception of itself as a "special governmental financial institution". In addition, we note that Korea describes KEXIM as an "export credit agency" (see Korea's reply to Question 52 from the Panel). This phrase is generally reserved for official export credit agencies, and not for private providers of export financing or insurance. Since the term "agency" suggests a relationship of agent and principal, one could reasonably assume that the relevant principal on whose behalf KEXIM acts as agent is the Government of Korea.

7.55 The EC also refers to KEXIM's public policy objective in support of its argument that KEXIM is a public body. Although a public policy objective or creation through public statute might also be indicative of the public nature of an entity, this may not always be the case. For example, the fact that a private philanthropist may pursue public policy objectives should probably not cause that person to be treated as a "public body". In addition, the privatization of a company might be finalized through a public statute. In all cases, though, we consider that public status can be determined on the basis of government (or other public body) control.

7.56 Since we find that KEXIM is a "public body", there is no need to consider the EC's alternative argument that KEXIM is a private body entrusted or directed by the government.

(c) Subsidization

7.57 The EC's claim that the KLR confers a benefit is based on a number of provisions of the KLR. We shall examine the parties' arguments concerning these provisions below. Before doing so, however, we must first decide whether or not to apply what is known as the traditional mandatory / discretionary distinction in reviewing the KLR provisions at issue.

[45] Earlier Operation Programs provided that KEXIM "shall make efforts to accomplish" specified "basic directions". The requirement on KEXIM to "make efforts" to accomplish the specified "basic directions" was strengthened further in the 2003 Operation Program, which provided that KEXIM "shall do the Operation Program 2003 in accordance with the following basic directions" (see Exhibit EC – 95).

[46] KEXIM 1999 Operation Program, Exhibit EC – 95.

(i) Application of the Traditional Mandatory/Discretionary Distinction

Arguments of the parties

7.58 According to the traditional mandatory / discretionary distinction, only measures mandating WTO-inconsistent conduct could be condemned as such (i.e., on their face, rather than as applied in particular cases). Under this traditional distinction, therefore, the KLR could only be challenged as such if it mandated *inter alia* subsidization. The EC considers that this traditional distinction is no longer applicable, and claims that its application was excluded by the Appellate Body in *US – Corrosion Resistant Steel Sunset Review*. According to the EC, therefore, it is no longer necessary that legislation must mandate export subsidization in order for it to be condemned under Article 3.1(a) of the *SCM Agreement*. The EC asserts that it is enough that legislation specifically envisages export subsidization in order for it to be condemned. The EC also argues that Article 3.2 of the *SCM Agreement* confirms that Members may not maintain the discretionary power to provide export subsidies. The EC relies on the panel report in *Brazil – Aircraft* to support an argument that a legal framework that provides for the provision of future export subsidies may be subject to an "as such" attack.

7.59 Korea argues that the traditional mandatory / discretionary distinction remains applicable, and has not been overruled by the Appellate Body.

Evaluation by the Panel

7.60 There is no dispute between the parties regarding the fact that the traditional mandatory / discretionary distinction has been applied by both GATT and WTO dispute settlement panels. The only dispute is whether or not that distinction continues to apply. Since the starting point for the EC's analysis is that "[t]he Appellate Body has recently laid to rest the notion that non-mandatory measures cannot be the subject of dispute settlement in *US – Sunset Review (Japan)"*,[47] we shall focus principally on whether or not the Appellate Body in that case really did rule against the continued application of the traditional mandatory / discretionary distinction.

7.61 In order to do so, we shall first consider the Appellate Body's treatment of this issue in the earlier *US – Section 211 Appropriations Act* case. The Appellate Body analysed the panel's application of the traditional mandatory / discretionary distinction in the following terms:

> 259. ... the Panel relied on previous rulings addressing the issue of legislation that gives discretionary authority to the executive branch of a Member's government. As the Panel rightly noted, in *US – 1916 Act*, we stated that a distinction should be made between legislation that mandates WTO-inconsistent behaviour, and legislation that gives rise to executive authority that can be exercised with discretion. We quoted with approval there the following statement of the panel in *US – Tobacco*:
>
> > … panels had consistently ruled that legislation which mandated action inconsistent with the General Agreement could be challenged as such, whereas legislation which merely gave the discretion to the *executive authority* of a contracting party to act inconsistently with the General Agreement could not be challenged as such; only the actual application of such legislation inconsistent with the General Agreement could be subject to challenge.
>
> Thus, where discretionary authority is vested in the executive branch of a WTO Member, it cannot be assumed that the WTO Member will fail to implement its

[47] EC first written submission, para. 73.

> obligations under the *WTO Agreement* in good faith. Relying on these rulings, and interpreting them correctly, the Panel concluded that it could not assume that OFAC would exercise its discretionary executive authority inconsistently with the obligations of the United States under the *WTO Agreement*. Here, too, we agree.[48]

7.62 Although the Appellate Body went on to reverse the panel's application of the traditional mandatory / discretionary distinction to the facts of that case, the above extract indicates clearly to us that the Appellate Body was not rejecting the use of the traditional mandatory / discretionary distinction *per se*. To the contrary, the Appellate Body explicitly found that "where discretionary authority is vested in the executive branch of a WTO Member, it cannot be assumed that the WTO Member will fail to implement its obligations under the *WTO Agreement* in good faith." This is generally understood to be the very rationale behind the traditional mandatory/discretionary distinction.

7.63 In *US – Corrosion-Resistant Steel Sunset Review*, the Appellate Body examined two issues. First, it considered whether certain types of measures could not, as such, be subject to dispute settlement proceedings. Second, the Appellate Body considered whether the measure at issue in that case could be inconsistent with the *AD Agreement*. The Appellate Body treated the first issue as a jurisdictional matter. Thus, having found that there was "no reason for concluding that, in principle, non-mandatory measures cannot be challenged 'as such'",[49] the Appellate Body stated that panels are not "obliged, as a preliminary jurisdictional matter, to examine whether the challenged measure is mandatory".[50] However, this does not mean that the Appellate Body was excluding the application of the traditional mandatory / discretionary distinction, since it went on to acknowledge that the distinction might be relevant as part of the second issue, i.e., the panel's assessment of whether the measure at issue was inconsistent with particular obligations.[51] In addressing that second issue, the Appellate Body "caution[ed] against the application of [the traditional mandatory / discretionary] distinction in a mechanistic fashion".[52] In particular, the Appellate Body condemned the panel for having taken a "narrow approach", and failing to consider other indications as to whether or not the measure at issue was "binding"[53] or of a "normative nature".[54] The use of such phrases suggests to us that the Appellate Body ultimately resolved the case on the basis of whether or not the measure at issue was mandatory (i.e., "binding", or "normative" in nature). Furthermore, we note that the Appellate Body stated that it was not "undertak[ing] a comprehensive examination of this distinction". Having explicitly applied the traditional mandatory / discretionary distinction in *US – Section 211 Appropriations Act*, we fail to see how the Appellate Body could be understood to have excluded the continued application of that distinction in a subsequent case in which it was not even conducting a "comprehensive examination" of the distinction.

7.64 The EC also argues that *SCM* Article 3.1(a) prevents a Member from maintaining the discretion to provide export subsidies. We note, however, that such an approach would be inconsistent with the principle – confirmed by the Appellate Body in *US – Section 211 Appropriations Act*, that "where discretionary authority is vested in the executive branch of a WTO Member, it cannot be assumed that the WTO Member will fail to implement its obligations under the *WTO Agreement* in good faith".[55]

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[48] See Appellate Body Report, *US – Section 211 Appropriations Act*, para. 259 (footnotes omitted).
[49] *US – Corrosion-Resistant Steel Sunset* Review, para. 88
[50] *Ibid*, para. 89
[51] *Ibid*, para. 89.
[52] *Ibid*, para. 93.
[53] *Ibid*, para. 97.
[54] *Ibid*, para. 98.
[55] See Appellate Body Report, *US – Section 211 Appropriations Act*, para. 259.

7.65 The EC has also relied on the following statement by the *Brazil – Aircraft* panel to argue that measures that provide for the provision of future export subsidies may be subject to an "as such" attack:

> the effective operation of the SCM Agreement requires that a party be able in some manner to obtain prospective discipline on the provision of subsidies in cases where it can be established in advance, *based upon the legal framework governing the provision of those subsidies*, that they would be inconsistent with Article 3 of the SCM Agreement.[56] (Emphasis added)

7.66 We consider that, contrary to the EC's argument, this statement actually supports the application of the traditional mandatory / discretionary distinction, since it relates to circumstances in which one can establish in advance that a provision or measure "would" be inconsistent with Article 3 of the *SCM Agreement*. The word "would" (as opposed to "could") suggests to us a degree of certitude that is only be found in mandatory (as opposed to discretionary) provisions.

7.67 For the above reasons, we reject the EC's argument that the Appellate Body ruled against the application of the traditional mandatory / discretionary distinction in *US – Corrosion-Resistant Steel Sunset Review*. We shall therefore resolve the EC's "as such" claims on the basis of whether or not the measure at issue mandates the provision of (export) subsidies.

(ii) Benefit

7.68 The relevant arguments of the parties in respect of whether the KEXIM legal regime mandates (export) subsidies concern the KEXIM Act non-competition clause, the alleged absence of any obligation on KEXIM to take market conditions into account, the availability of government funding, the Market Adjustment Rate, the KEXIM Act provision concerning international competitiveness, and KEXIM documentation.

Non-competition clause

7.69 Article 24 of the KEXIM Act provides:

> [KEXIM] shall not compete with other financial institutions in performing the operations provided for in Article 18.

7.70 Article 25(2) of the KEXIM Act provides in relevant part:

> [KEXIM] may lend funds, discount drafts or notes, or guarantee obligations under paragraph (1) of Article 18 only when the term of repayment, payment or discharge is six (6) months or more but twenty five (25) years or less.

- Arguments of the parties

7.71 The EC asserts that the non-competition clause means that KEXIM is specifically directed to perform functions and provide financing in situations in which no commercial bank would act, and therefore to make available loans and guarantees in financial circumstances that the market would not support.

7.72 Korea states that in fact KEXIM is permitted to compete with commercial financial institutions, as confirmed by an earlier amendment of Article 18 of the KEXIM Act, whereby an obligation on KEXIM not to engage in operations "normally conductible by other financial

[56] Panel Report, *Brazil – Aircraft*, para. 7.2 n. 187.

institutions" was removed. Korea asserts that KEXIM is currently "in competition with commercial banks in all areas of financial services, except the long-term export credits with deferred payment terms that are regulated by the OECD Arrangement".[57] Korea argues that this is consistent with Article 25(2) of the KEXIM Act, whereby the maturity of KEXIM loans should be between six months and 25 years, and therefore of a maturity offered by commercial institutions. Korea argues that Article 24 "must be read together"[58] with Article 25(2) to appreciate the limited scope of this prohibition. Korea further states that Article 24 should have been repealed, and that in fact "KEXIM has been contemplating proposing the repeal or amendment of Article 24".[59]

- Evaluation of the Panel

7.73 We are not persuaded by Korea's arguments regarding the alleged interaction between Articles 24 and 25(2) of the KEXIM Act. First, we note that there are no cross-references between these provisions. Second, the fact that the limits under Article 25(2) on the maturity of KEXIM financing coincide with the maturity of commercial financing does not necessarily mean that KEXIM competes with commercial institutions, since it is still possible for KEXIM to comply with both provisions and offer financing with a maturity of between six months and 25 years in respect of which there is no competition from commercial financial institutions.

7.74 Furthermore, even if Korea may be correct in stating that KEXIM does compete with private financial institutions in practice, we note that the EC's argument regarding Article 24 is made in the context of an "as such" claim against the KEXIM Act. Thus, because Article 24 continues to impose a legal obligation on KEXIM not to compete with other financial institutions, the fact that Article 24 may not be respected in practice is not relevant. The EC's "as such" claim concerns the KEXIM legal regime on its face, and not as applied in practice.

7.75 That being said, we are not persuaded that the language of Article 24 of the KEXIM Act is sufficiently clear to conclude that it necessarily requires KEXIM to confer a benefit, i.e., offer terms that are more favourable than those available to the recipient on the market. In particular, does the non-competition clause mean that KEXIM is only required to provide financing when market operators are unable to do so? Or does it mean that KEXIM is not permitted to take business away from market operators? We consider that the terms of Article 24 are far too imprecise to draw the specific conclusion that it requires KEXIM to act in a below-market manner.

<u>No obligation to take market conditions into account</u>

- Arguments of the parties

7.76 The EC claims that the KEXIM legal regime confers a "benefit" as such because the KEXIM Act imposes no obligation on KEXIM to take market conditions into account when disbursing funds.

7.77 Korea submits that KEXIM is required to operate on a market-oriented basis. In particular, Korea asserts that the KEXIM legal regime requires KEXIM to appropriately assess the credit risks of the borrower, to apply interest rates or guarantee premia commensurate to the credit rating of the borrower/applicant, to take into account market situations when setting up interest rates/premium, to properly manage risks associated with the KEXIM business, and to ensure soundness of management.[60]

[57] See Korea's Second Written Submission, para. 99.
[58] See Korea's First Written Submission, para. 120.
[59] See Korea's response to Question 53 from the Panel.
[60] See Korea's reply to Question 103 from the Panel.

- Evaluation by the Panel

7.78 We do not consider that a legal instrument may be found to mandate subsidization simply because it neither prohibits subsidization nor requires market conditions to be taken into account. The fact that a legal instrument is silent on subsidization should not lead to a conclusion that the resultant discretion will of necessity be exercised in a manner that results in subsidization. As stated by the Appellate Body in *US – Section 211 Appropriations Act*, "where discretionary authority is vested in the executive branch of a WTO Member, it cannot be assumed that the WTO Member will fail to implement its obligations under the WTO Agreement in good faith".[61]

Government funding

- Arguments of the parties

7.79 The EC asserts that KEXIM need not act on market terms or with proper regard to risk, as the Government of Korea provides virtually unlimited funds to KEXIM. In this regard, the EC notes that Article 19 of the KEXIM Act provides that KEXIM "may borrow funds from the Government [and] the Bank of Korea . . . ". The EC also argues that Article 36(2) of the KEXIM Act indicates that KEXIM is not required to pay . . . capital contributions made by the Government of Korea, even during years in which KEXIM achieves a profit. In this regard, the EC notes that Article 36(2) provides that KEXIM shall distribute its profits "on a preferential basis" "to capital contributors other than the Government." According to the EC, this provides further support for the understanding that KEXIM need not act in the same manner as a commercial bank, as it has access to funds of an important shareholder that does not demand to be treated in the same manner as shareholders operating pursuant to market considerations. The EC submits that KEXIM therefore receives a subsidy that it can pass on to its customers.

7.80 The EC further asserts that Article 37 of the KEXIM Act provides that any net loss incurred by KEXIM that cannot be covered by its reserves shall be covered by funds from the Government of Korea. The EC argues that KEXIM need not therefore act in the same manner as a commercial bank, as it has no risk of insolvency. According to the EC, combining (a) the guarantee by Article 37 that the Government "shall provide funds to cover such net loss" and (b) the specific exclusion of the Government in Article 36(2) from the capital contributors that shall benefit from KEXIM's net profit, underscores the fact that KEXIM need not act on market terms. The EC acknowledges that KEXIM must first attempt to cover net losses with its reserves, but argues that the ultimate guarantee of losses by the Government reduces the incentive for KEXIM to maintain a sufficient reserve and allows KEXIM to act otherwise than would a body subject to market forces.

7.81 Korea asserts that there is no logical inference from Articles 19, 36(2) and 37 of the KEXIM Act that KEXIM need not act on market terms or with proper regard to risk. Korea argues that although these provisions indicate that the Government may provide funds, this is not the same as stating that KEXIM's financing facilities need not be market-oriented. According to Korea, KEXIM is explicitly required by law to operate on a market-oriented basis.

7.82 Korea asserts that the Government's capital contributions into KEXIM were necessary to allow KEXIM to maintain a good credit rating as well as a sound Bank of International Settlements ("*BIS*") adequacy ratio. Korea also asserts that Article 36 of the KEXIM Act was intended to encourage other entities to participate in capital contributions into KEXIM. Korea asserts that it is not uncommon in private corporations that the major shareholders receive less dividends and take more risks than other minor shareholders.

[61] Appellate Body Report, *US – Section 211 Appropriations Act*, para. 259.

7.83 Korea submits that the source of KEXIM's funds is not legally relevant, as the legal standard for subsidization is "benefit" to the recipient, rather than cost to the government. Korea submits that whatever the source of KEXIM's funds, there is no indication in particular that any of these funds are used in loans or guarantees which bestow a benefit onto their recipient or were envisaged as such.

- Evaluation by the Panel

7.84 Given that it is now well established that the legal standard for "benefit" is benefit to the recipient, and not cost to the government, the source of KEXIM's funds is irrelevant to the issue of whether or not the KEXIM legal regime mandates (export) subsidization. The fact that KEXIM may receive subsidized government funding does not mean that it will inevitably provide subsidized financing to its customers. It is possible that KEXIM might charge market rates and increase its profit margin instead.

7.85 Furthermore, Articles 19, 36(2) and 37 of the KEXIM Act are relied on by the EC in support of an argument that KEXIM "need not" act on market principles. However, the EC has neither argued nor demonstrated that these provisions prevent KEXIM from acting on market principles. In other words, the EC has not argued that these provisions mandate subsidization.

Market Adjustment Rate

- Arguments of the parties

7.86 According to the EC, the KEXIM Interest Rate Guidelines clarify that market conditions are not taken into account even in situations where KEXIM has specifically determined that its rates would be better than those available in the market. According to the EC, Articles 17(2) and 25(6) of the KEXIM Interest Rate Guidelines explicitly prevent, under certain situations, full market-based adjustments of KEXIM's interest rates even when it has been determined that the rates are below those available in the market. According to the EC, the KEXIM Guidelines establish an explicit cap on the "Market Adjustment Rate" that would otherwise be applied to bring KEXIM's rates into accord with the market's rates.

7.87 The EC notes that a new translation of Articles 17(2) and 25(6) of the KEXIM Interest Rate Guidelines recently submitted by Korea reads **[BCI: Omitted from public version]**.[62] According to the EC, Korea's modified translation indicates that the Market Adjustment Rate is only a downward adjustment. The EC argues that if the Market Adjustment Rate can only be used to adjust the cost-based rate downwards, this provision will often lead to interest rates that are below the market rate. The EC asserts that in any event, these provisions do not, by their terms, ensure that KEXIM provides loans at market rates, since the Market Adjustment Rate is an adjustment to the cost based rate that takes account not only of lower offers by other banks but also of the "business relationship with the borrower and the distinctive features of the transactions, etc."[63]

7.88 Korea submits that the Market Adjustment Rate in Articles 17(2) and 25(6) of the Interest Rate Guidelines operates on a market-oriented basis to take into account the PSL interest rates and the APRG premia offered by other financial institutions, the track record and relationship of the applicant with KEXIM and other considerations including the particulars of the project concerned.

7.89 Korea asserts that a "market rate" exists in the form of "range" or "band", not a single rate. Korea explains that the Market Adjustment Rate is one of the spreads (discounts or premia) that are to be applied upward or downward to the base rate in addition to other spreads such as "credit risk

[62] Responses to Questions from the Panel by Korea, 22 March 2004, Question 57, citing Exhibit Korea-56.

[63] Article 17(2) of the KEXIM Interest Rate Guidelines, Exhibit EC – 13.

spread" and "target margin". According to Korea, this Market Adjustment Rate may be applied by the KEXIM loan managers when determining the rates for a specific applicant in a specific individual transaction. Korea asserts that the following factors are to be taken into account when determining whether and to what extent to apply this Market Adjustment Rate: the APRG premia offered by other financial institutions; the track record and relationship of the applicant with KEXIM; and other considerations including particulars of the project concerned.

7.90 Korea also submits that while the Market Adjustment Rate allows the KEXIM loan managers to react to the market, the loan manager is nevertheless prohibited, when he applies the Market Adjustment Rate for 'downward' adjustment of an ARPG fee, from applying it beyond a certain limit **[BCI: Omitted from public version]**. In contrast, there is no limitation when the loan manager applies it for upward adjustment. Korea asserts that in this sense, the Market Adjustment Rate is a "floor", not a "cap". Korea submits that the Market Adjustment Rate does not cause the final fee rate to be set below the market rates.

- Evaluation by the Panel

7.91 According to Korea, Article 17 of the KEXIM Guidelines for Interest Rates and Fees Amended provides:

[BCI: Omitted from public version.]

7.92 According to Korea, Article 25 of the KEXIM Guidelines for Interest Rates and Fees Amended provides:

[BCI: Omitted from public version.]

[...]

[BCI: Omitted from public version.]

7.93 The above translation of Articles 17 and 25 was attached to Korea's reply to Question 57 from the Panel, and amends the translation initially provided by Korea during these proceedings. The EC has not contested the accuracy of the amended translation.

7.94 We do not consider that the EC's argument that Articles 17(2) (Market Adjustment Rate in respect of loan interest rates) and 25(6) (Market Adjustment Rate in respect of guarantee premia) only allow a downward adjustment is correct. In our view, the fact that these provisions do not explicitly refer to upward adjustments does not mean that they should be interpreted to mean that upward adjustments are precluded. Indeed, we note that Korea has provided evidence of situations in which upward adjustments have been made in practice (see Korea's reply to Question 58 from the Panel). Furthermore, we note that Articles 17(2) and 25(6) do not impose limits on the amount of upward adjustment. The possibility of upward adjustment, and the absence of any limit on the amount of such upward adjustment, means that KEXIM is not automatically locked into providing below-market financing.

7.95 In addition, we note the EC's argument that the above Market Adjustment provisions do not "ensure" that KEXIM provides services at market rates. As noted above, we do not consider that the absence of an obligation on KEXIM to apply market rates permits a finding that the KEXIM legal regime mandates below-market rates, and therefore subsidization. We also recall that in *Canada – Aircraft – Article 21.5* the Appellate Body expressed reservations regarding the application of an "ensure" standard, noting that such a standard could "be very difficult, if not impossible, to satisfy".[64]

[64] See Appellate Body Report, *Canada – Aircraft – Article 21.*5, para. 38.

We further recall that the panel only applied an "ensure" standard because it was proposed by the parties in that case.[65]

7.96 For the above reasons, we reject the EC's arguments concerning Articles 17(2) and 25(6) of the KEXIM Interest Rate Guidelines.

KEXIM On-Line Road Show

- Arguments of the parties

7.97 The EC submits that KEXIM has itself acknowledged its role as providing financial contributions to Korean exporters in cases and on terms that would not be provided by commercial banks. In this regard, the EC notes that KEXIM's 2003 "On-Line Road Show" stated that one of the core missions of KEXIM's business was to serve "a complementary but pioneering role and function for the national economy, which would be hard for commercial banks to shoulder."[66] The EC asserts that KEXIM has therefore acknowledged its role as providing financial contributions to Korean exporters in cases and on terms that would not be provided by commercial banks.

7.98 Korea asserts that the "On-Line Road Show" contains a description of the specialized role and function being performed by KEXIM as an export credit agency. Korea submits that export credit agencies, such as KEXIM, generally provide specialized trade-related financing involving longer-term project-related loans (e.g., mid- and long-term export loans), special payment terms (e.g., deferred or specially structured payments) or specialized collateralization methods. Korea submits that it is important to remember the context of the establishment of KEXIM, i.e., the fact that Korea was a developing country with inadequately formed capital markets, among other things. According to Korea, it is quite typical in such situations for specialist banks to be set up to provide such pioneering expertise. Korea submits that the "On-Line Road Show" is irrelevant to the question of below-market financing by KEXIM.

- Evaluation by the Panel

7.99 We note that the EC refers to the On-Line Road Show as evidence that "KEXIM has acknowledged its role as providing financial contributions to Korean exporters in cases and on terms that would not be provided by commercial banks".[67] The On-Line Road Show describes KEXIM's alleged practice, rather than its legal obligations under the KEXIM legal regime. Since the On-Line Road Show relates to practice, rather than the KEXIM legal regime *per se*, it has no bearing on our findings regarding the EC's claim against the KEXIM legal regime "as such".

Maintenance of international competitiveness

- Arguments of the parties

7.100 The EC asserts that Article 26 of the KEXIM Act demonstrates that KEXIM values the "international competitiveness" of Korean export-oriented industries over its own financial condition, a situation that increases KEXIM's ability to provide support on terms better than those available in the market.

[65] See Panel Report, *Canada – Aircraft – Article 21.5*, para. 5.66.
[66] Exhibit EC – 17.
[67] EC first written submission, para. 128.

7.101 Article 26 provides:

> Except where inevitable for maintaining the international competitiveness to facilitate the export, or for promoting the overseas investment or overseas exploitation of natural resources, the interest rates, discount rates and fee rates applicable to loans, discounts and guarantees ... shall be so set as to cover the operating expenses, commissions for undertaking of delegated operations, interest on borrowed funds, and depreciation of assets which [KEXIM] incurs.

7.102 The EC asserts that although Article 26 of the KEXIM Act states that interest rates and fees imposed with respect to loans and guarantees are to be set so as to cover the operating costs of KEXIM, there is no requirement that KEXIM establish rates that comport with market rates. The EC notes that Article 26 permits KEXIM to avoid the requirement to cover its operating costs where "inevitable for maintaining the international competitiveness to facilitate . . . export . . . .".

7.103 Korea submits that Article 26 has no purpose other than to provide that all fees and rates must cover "at least" the costs when KEXIM provides financing. Korea asserts that Article 26 does not prohibit KEXIM from earning profits and, instead, effectively requires it to carry on profitable operations. Korea argues that other relevant provisions of the KEXIM Decree, such as Articles 17-3 through 17-13 (providing parameters for sound and profitable management of KEXIM), also effectively require KEXIM to carry on its business for profit. Korea further asserts that the Interest Rate Guidelines of KEXIM provide that KEXIM interest rates and fees are always aligned with market rates.

7.104 Korea submits that the phrase "inevitable for maintaining the international competitiveness to facilitate ... export" was included in Article 26 of the KEXIM Act in order to allow KEXIM the option to provide financing at below-cost levels in exceptional situations when KEXIM faces severe 'rates' competition from foreign financial institutions, as in the context of "matching" under the *OECD Arrangement*. Korea submits that because "matching" would be exceptional, Article 26 uses the term "inevitable", which means that under normal or ordinary circumstances this exception must not be applied. Korea notes that this "exception" under Article 26 has never been applied in practice thus far. Further, Korea asserts that KEXIM has interpreted this matching mechanism in such a restrictive manner that it can be applied only for matching of "country risk premium", not the total interest rate applied by the competing export credit agencies. Korea also submits that even if KEXIM's interest rates had in exceptional circumstances gone below its operating expenses (which Korea claims they have never done), this has nothing to do with the finding of a benefit or a subsidy. According to Korea, as long as Article 26 permits KEXIM to match the low interest rates applied by other competing export credit agencies, KEXIM will always end up applying the market benchmark (i.e., the prevailing conditions in the market), whether or not the KEXIM rate is below or above its operating expenses.

7.105 The EC notes Korea's argument that this provision allows KEXIM to finance at below-cost when "matching" under the *OECD Arrangement*. However, the EC considers that this explanation does not justify the provision. First, the EC asserts that there is absolutely no mention of either the *OECD Arrangement* or "matching" in this provision. Although Article 43 of the KEXIM Interest Rate Guidelines does refer to matching, the EC submits that there is nothing in these Guidelines that indicates that this Article should be read together with Article 26 of the KEXIM Act. Second, the EC notes that the panel in *Canada –Aircraft Credits and Guarantees* concluded that "matching" under the *OECD Arrangement* does not provide a valid affirmative defence for measures that violate the terms of the *SCM Agreement*.[68]

[68] The EC refers in this regard to Panel Report, *Canada – Aircraft Credits and Guarantees*, para. 7.180.

- Evaluation by the Panel

7.106 Leaving aside the question of whether or not "matching" under the *OECD Arrangement* is in conformity with the *SCM Agreement*, we would simply note that the EC again applies the incorrect legal standard in pursuing its arguments regarding Article 26 of the KEXIM Act. First, the EC states that there is no requirement that KEXIM rates comport with market rates. As noted above, however, the fact that there is no requirement to act on market terms does not mean *ipso facto* that KEXIM is required, or mandated, to provide below-market terms. Second, the EC asserts that Article 26 permits KEXIM to avoid the requirement to cover its operating costs in certain circumstances, and increases KEXIM's ability to provide support on terms better than those available in the market. Again, however, the EC does not argue that Article 26 requires KEXIM to provide below-market financing. Providing a public body with the legal and financial ability to subsidize is not the same as requiring it to do so.

Conclusion

7.107 For the above reasons, the EC has failed to establish a *prima facie* case that the KEXIM legal regime mandates subsidization. Although certain provisions of the KLR might indicate that it was intended as a means of providing subsidies, a conclusion that the KLR *could* be applied in a manner that confers a benefit would not be a sufficient basis to conclude that the KLR as such is mandatory legislation susceptible of inconsistency with Article 3.1(a) of the *SCM Agreement*.[69]

(d) Export contingency

(i) Arguments of the parties

7.108 The EC submits that, pursuant to Article 18 of the KEXIM Act, financial contributions by KEXIM are "[f]or the purpose of facilitating exports of products" and, therefore, contingent on export within the meaning of Article 3.1(a) of the *SCM Agreement*.

7.109 Korea has not taken a position on whether or not the KLR is export contingent.

(ii) Evaluation by the Panel

7.110 In light of our finding that the EC has failed to establish a prima facie case that the KLR mandates subsidization, we do not consider it necessary to determine whether or not then KLR is "contingent ... upon export performance" within the meaning of Article 3.1(a) of the *SCM Agreement*.

(e) Conclusion

7.111 Given our finding that the EC failed to establish a *prima facie* case that the KEXIM legal regime mandates subsidization, we reject the EC's claim that the KEXIM legal regime "as such" is inconsistent with Articles 3.1(a) and 3.2 of the *SCM Agreement*.

2. APRG programme

7.112 An APRG provides foreign buyers with a guarantee that they will be refunded any advance payments made to an exporter, including any accrued interest on the advance payments, in case the Korean company defaults under the relevant export contract. In exchange, the Korean exporter pays a premium consisting of (1) a minimum base rate, and (2) additional spreads (*e.g.*, credit and market risk spreads).

[69] We note that a similar approach was adopted by the panel in *Brazil –Aircraft, Second Recourse by Canada to Article 21.5 of the DSU*, WT/DS46/RW/2, adopted 23 August 2001, para. 5.43, DSR 2001:XI, 5481.

(a) Arguments of the Parties

7.113 The EC asserts that the KEXIM APRG programme "as such" provides for the grant of subsidies that are contingent on export, contrary to Articles 3.1(a) and 3.2 of the *SCM Agreement*. The EC submits that the APRG programme provides for financial contributions because (i) KEXIM is a public body, and (ii) APRGs constitute a "potential direct transfer of funds" pursuant to Article 1.1(a)(1)(i) of the *SCM Agreement*. The EC submits that the APRG programme confers a benefit because, although KEXIM levies a premium when granting APRGs, the premium fails to reflect the degree of creditworthiness, or lack thereof, of the Korean exporters. According to the EC, KEXIM issues guarantees without proper consideration of the risk involved in the transaction – in many cases, granting guarantees to financially troubled companies that would not have been able to obtain a guarantee from a commercial bank. The EC submits that the APRG programme is *de jure* export contingent because KEXIM APRGs are provided for the specific purpose of guaranteeing the down payments for Korean goods intended for export.

7.114 Korea asserts that the EC's description of the measure is incomplete and inadequate to support its claim regarding the KEXIM APRG programme. According to Korea, whilst a definition is given of what the guarantees denominated as APRGs entail for the manufacturers of the capital goods and their purchasers, the EC fails to identify what precisely constitutes the so-called "APRG programme". Korea submits that the measure at issue is therefore un-defined and cannot as such be the subject of a detailed factual or legal analysis.

7.115 Korea also denies that the APRG programme constitutes a prohibited export subsidy. Korea asserts that the APRG programme does not constitute a financial contribution covered by the *SCM Agreement* because KEXIM is not a "public body". Korea also denies that the APRG programme confers a "benefit". Korea asserts that the EC must provide a benchmark to define whether the APRG program "as such" yields premium rates that confer a benefit. Korea considers that the EC has failed to meet this burden, since it only refers to certain individual APRGs extended to shipyards alone rather than to the basic conditions of the program as such irrespective of the sector of industry. In the alternative, Korea submits that the APRG programme benefits from a safe haven pursuant to item (j) of the *Illustrative List of Export Subsidies*.

(b) Evaluation by the Panel

7.116 We shall first address Korea's arguments regarding the identification of the measure. We shall then turn to the substance of the EC's claim against the APRG programme.

7.117 Regarding the identification of the measure at issue, the Panel sought clarification from the EC regarding the extent to which its claim against the APRG programme differed from its claim against the KEXIM legal regime. In response to Question 138 from the Panel, the EC stated that the APRG and PSL programmes are linked to the KEXIM legal regime, in the sense that they are a consequence of the KEXIM legal regime. According to the EC, the APRG and PSL programmes are also distinguishable from the KEXIM legal regime since, although the KEXIM legal regime envisages the provision by KEXIM of financial services, these financial services do not necessarily need to be the APRG and PSL programmes, as KEXIM could provide financial assistance to exporters in other forms.

7.118 Furthermore, in its first written submission, the EC stated that the APRG programme was introduced immediately after the establishment of KEXIM, and has been administered since that time pursuant to Article 18 of the KEXIM Act.[70] The EC also submits that KEXIM is authorised to issue

[70] See Responses to Annex V Questions (Non-confidential Version), Answer 1.2(26), pp. 14-15 (Exhibit EC-39).

"performance guarantees related to contracts for export" pursuant to Article 23(1) of the KEXIM Operating Manual.[71]

7.119 In our view, the EC has done enough to identify an APRG programme "as such". We consider that the legal basis for that programme is set forth in Article 18 of the KEXIM Act and Article 23(1) of the KEXIM Operating Manual. We shall conduct our analysis of subsidization and export contingency on the basis of those provisions.

7.120 We recall that a measure is only a subsidy covered by the *SCM Agreement* if it is a "financial contribution" by a government or public body that confers a "benefit". We have already found that KEXIM is a "public body" in the meaning of Article 1.1(a)(1) of the *SCM Agreement*.[72] Regarding the "financial contribution" element, we accept the EC's argument that the APRG programme, pursuant to Article 23(1) of the KEXIM Operating Manual, provides for a "potential direct transfer of funds" within the meaning of Article 1.1(a)(1)(i) of the *SCM Agreement*. We therefore find that the APRG programme constitutes a "financial contribution" covered by the *SCM Agreement*.

7.121 As to whether the APRG programme "as such" confers a "benefit", however, we recall that we are applying the traditional mandatory / discretionary approach. The issue before us, therefore, is whether or not the APRG programme mandates the conferral of a benefit by requiring the provision of APRGs on terms more favourable than Korean shipyards could obtain on the market. We do not consider that the EC has established a *prima facie* case to this effect.[73] Neither Article 18 of the KEXIM Act nor Article 23(1) of the KEXIM Operating Manual even refer to the terms on which KEXIM shall offer APRGs, let alone require below-market guarantees. The EC has not identified any other provisions regulating the terms of APRGs.[74] Accordingly, we reject the EC's claim that the APRG programme "as such" constitutes a subsidy. For this reason, there is no need for us to examine the EC's claim that the APRG programme is *de jure* export contingent, nor Korea's reliance on item (j) of the *Illustrative List*.

3. PSL programme

7.122 PSLs are loans made to Korean companies in connection with export contracts for the purpose of assisting Korean exporters to finance production.

(a) Arguments of the Parties

7.123 The EC asserts that the KEXIM PSL programme "as such" provides for the grant of subsidies that are contingent on export, contrary to Articles 3.1(a) and 3.2 of the *SCM Agreement*. The EC submits that the PSL programme provides for financial contributions covered by the *SCM Agreement* because (i) KEXIM is a public body, and (ii) PSLs constitute a "direct transfer of funds" pursuant to Article 1.1(a)(1)(i) of the *SCM Agreement*. The EC submits that the PSL programme confers a

[71] See KEXIM Operating Manual, Responses to Annex V Questions, Attachment 1.1(9) (Exhibit EC-58).

[72] See para. 7.50 *supra*.

[73] We note that the EC has argued that KEXIM failed to apply any credit risk spread before 12 March 1998. Since credit risk provisions were introduced after that date, the absence of any obligation to impose credit risk spreads in the pre-12 March 1998 APRG programme is not relevant to our analysis of the EC's claims against the (current version of the) APRG programme "as such".

[74] Although the EC has adduced evidence regarding KEXIM's practice of providing APRG guarantees (see paras 146-148 of the EC's first written submission), such evidence of practice is not relevant to our analysis of the EC's claim against the APRG programme "as such". Although the Panel was initially unclear whether the EC adduced this evidence of practice under the APRG programme in support of its claim against that programme "as such", the EC confirmed in response to Question 8 from the Panel that, in its view, the practices "are ... separate violations in their own right". Furthermore, in reply to Question 138 from the Panel, the EC stated that "the individual export subsidy transactions are ... separate, even if linked, violations".

benefit because PSLs are provided at preferential interest rates that place the Korean exporters in a more advantageous position than if they were to obtain such financing on market terms. The EC submits that KEXIM's website describes the PSL programme as designed "to encourage the export of capital goods such as . . . ships . . . involving larger credits and longer repayment terms than what suppliers or commercial banks would provide."[75] According to the EC, this shows that the very purpose of KEXIM's pre-shipment loans is to provide financing to shipbuilders on better terms than they could receive in the market. The EC submits that the PSL programme is *de jure* export contingent because KEXIM PSLs are provided for the specific purpose of guaranteeing the down payments for Korean goods intended for export.

7.124 Korea submits that the EC has failed to identify what precisely constitutes the so-called "KEXIM pre-shipment loan program". Korea therefore considers that the measure at issue is un-defined and cannot "as such" be the subject of a detailed factual or legal analysis. Korea further asserts that the EC fails to give any support other than by way of general statements -- without evidentiary support or, in some cases, outright inaccurately -- as regards the benchmark on the basis of which it claims that the pre-shipment loan program confers a benefit. For Korea, the EC fails to make a *prima facie* case that the PSL program "as such" constitutes a subsidy. According to Korea, as the interest rates for the pre-shipment loans under the KEXIM program are determined taking into account base rates reflecting market rates, the credit rating of the manufacturer of the capital goods covered by the pre-shipment loan and the collateral provided by the pre-shipment loan beneficiary, the pre-shipment loan program "as such" does not confer a benefit. Regarding the abovementioned extract from the KEXIM website, Korea considers that providing a longer term than is generally available does not mean that the rates are below market, since it depends on how those rates are adjusted to reflect the different terms. According to Korea, the size of a credit may or may not require different rates; it depends on factors extraneous to size alone. In the alternative, Korea submits that the PSL programme benefits from a safe haven pursuant to the first paragraph of item (k) of the *Illustrative List*.

(b) Evaluation by the Panel

7.125 We recall that the EC replied to Question 138 from the Panel regarding the identification of the PSL programme, as set forth at para. 7.117 above. We also note that the EC stated that the PSL programme was introduced immediately after the establishment of KEXIM, and has been administered since that time pursuant to Article 18 of the KEXIM Act.[76] The EC further argued that KEXIM is authorised to provide "Pre-delivery Export Loans, which are extended until the delivery date of the export goods and/or services concerned" pursuant to Article 11(4) of the KEXIM Operating Manual.[77] In light of these considerations, we find that the EC has done enough to identify a PSL programme "as such". We consider that the legal basis for that programme is set forth in Article 18 of the KEXIM Act and Article 11(4) of the KEXIM Operating Manual. We shall conduct our analysis on the basis of those provisions.

7.126 Regarding the existence of a "financial contribution" covered by the *SCM Agreement*, we have already found that KEXIM is a "public body" in the meaning of Article 1.1(a)(1) of the *SCM Agreement*. We further accept the EC's argument that the PSL programme, pursuant to Article 11 of the KEXIM Operating Manual, provides for a "direct transfer of funds" within the meaning of Article 1.1(a)(1)(i) of the *SCM Agreement*. We therefore find that the PSL programme constitutes a "financial contribution" covered by *SCM* Article 1.1(a)(1).

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[75] See Description of Services and Products, "Project Related Guarantees" <http://www.koreaexim.go.kr/web/eng/products/M03/s3_02.html> (Exhibit EC-26).

[76] See Responses to Annex V Questions (Non-Confidential Version), Answer 1.2(26), at 14-15 (Exhibit EC-39).

[77] See KEXIM Operating Manual, Exhibit EC-58.

7.127 As to whether the PSL programme confers a "benefit" and therefore constitutes a subsidy, the issue before us is whether or not the PSL programme mandates the conferral of a benefit by requiring the provision of PSLs on terms more favourable than Korean shipyards could obtain on the market. We do not consider that the EC has established a prima facie case to this effect.[78] Neither Article 18 of the KEXIM Act nor Article 11(4) of the KEXIM Operating Manual even refer to the terms on which KEXIM shall offer PSLs, let alone require below-market loans. The EC has not identified any other provision regulating the terms of PSLs.[79]

7.128 Regarding the KEXIM website material, we note that it was submitted by the EC in support of an argument regarding the "purpose"[80] of the PSL programme. We recall, however, that the question we must answer is whether or not the PSL programme requires KEXIM to provide prohibited export subsidies. The intent behind the PSL programme is not relevant to this issue. In this respect, we agree with the following statement by the panel in *Brazil – Aircraft (Article 21.5 – Canada II)*:

> In our view, a conclusion that PROEX III *could* be applied in a manner which confers a benefit, or even that it was intended to be and *most likely would* be applied in such a manner, would not be a sufficient basis to conclude that PROEX III as such is mandatory legislation susceptible of inconsistency with Article 3.1(a) of the *SCM Agreement*.[81]

7.129 In light of the above, we reject the EC's claim that the PSL programme constitutes a subsidy. For this reason, there is no need for us to examine the EC's claim that the PSL programme "as such" is *de jure* export contingent, nor Korea's reliance on the first paragraph of item (k) of the *Illustrative List*.

4. Individual APRG transactions

7.130 The EC has identified a number of KEXIM APRGs which it claims are prohibited export subsidies. The EC argues that these APRGs were provided on terms more favourable than the recipients could have obtained on the market. This argument is based on a comparison of the terms of the KEXIM APRGs with those of APRGs provided by certain other domestic banks and foreign banks.

7.131 Korea denies that the APRGs identified by the EC constitute prohibited export subsidies. In the alternative, Korea asserts that KEXIM APRGs benefit from a safe haven provided for through an *a contrario* reading of item (j) of the *Illustrative List*. The EC submits that an item (j) defence is not available to Korea.

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[78] We note that the EC has argued in respect of both the APRG and PSL programmes that KEXIM failed to apply any credit risk spread before 12 March 1998. Since credit risk provisions were introduced after that date, the absence of any obligation to impose credit risk spreads in the pre-12 March 1998 programmes is not relevant to our analysis of the EC's claims against the APRG and PSL programmes "as such".

[79] Although the EC has adduced evidence regarding KEXIM's practice of providing PSLs (see para 161 of the EC's first written submission), such evidence of practice is not relevant to our analysis of the EC's claim against the PSL programme "as such". Although the Panel was initially unclear whether the EC adduced evidence of practice under the PSL programme in support of its claim against that programme "as such", the EC confirmed in response to Question 8 from the Panel that, in its view, the practices "are ... separate violations in their own right". Furthermore, in reply to Question 138 from the Panel, the EC stated that "the individual export subsidy transactions are ... separate, even if linked, violations".

[80] See EC First Written Submission, para. 159.

[81] *Brazil – Aircraft, Second Recourse by Canada to Article 21.5 of the DSU*, para. 5.43 (emphasis in original).

7.132 The arguments of the parties raise a number of horizontal issues, mostly concerned with the market benchmarks proposed by the EC. We shall consider these horizontal issues before turning to the parties' transaction-specific arguments. In the event that we find any of the relevant APRG transactions inconsistent with Articles 3.1(a) and 3.2 of the *SCM Agreement*, we shall consider the availability of a defence under item (j) of the *Illustrative List*.

(a) Horizontal issues

7.133 The parties have made arguments regarding the following horizontal issues: designation by the ship purchaser of a specific foreign APRG provider, use of foreign benchmarks, country risk spreads, use of domestic benchmarks, credit risk spread, past subsidies, and adverse inferences.

(i) Buyer's designation of foreign APRG-provider

7.134 Korea asserts that certain shipyards are not always able to choose which financial institution would provide the APRG for its customers, since certain buyers require Korean shipyards to procure APRGs from designated foreign banks. Korea submitted evidence of a number of such designations. The EC has not responded to Korea's argument.

7.135 In our view, the fact that a buyer designates the source from which a shipyard is to procure an APRG establishes a prima facie case that such APRG should not be treated as a market benchmark. In such cases, the designation of the APRG-provider by the buyer means that there is a risk that the APRG is not negotiated at arm's length, since the shipyard is a captive buyer. The rate paid by the shipyard might therefore be higher than it would if the shipyard were able to shop around and compare offers from alternative suppliers.

7.136 Korea has submitted evidence pertaining to one transaction (Exhibit Korea-59) demonstrating that the buyer, **[BCI: Omitted from public version]** designated **[BCI: Omitted from public version]** as the provider of two APRGs proposed by the EC as market benchmarks against which to assess the terms of KEXIM APRGs provided in respect of Daedong. For the reasons set forth in the preceding paragraph, and given the absence of any rebuttal by the EC, we reject the use of these two APRGs, dated 7 July 1999, as market benchmarks. That being said, we note that this nevertheless leaves one **[BCI: Omitted from public version]** APRG (provided on the same terms, and about which Korea has not adduced any evidence of buyer designation) for use as a market benchmark.

7.137 Korea also submitted further evidence in Exhibits KOREA-58 and KOREA-83, concerning foreign APRG providers. This evidence is less probative, however. Exhibit KOREA-58 relates to an APRG transaction that is not proposed as a market benchmark by the EC. The evidence contained in Exhibit Korea-83 relates to APRGs provided to shipyards that fall outside the scope of these prohibited export subsidy claims. The evidence in these Exhibits is therefore of no direct relevance to our findings.

(ii) Foreign market benchmark

7.138 Early in the proceedings, the Panel was under the impression that Korea was arguing that, as a matter of law, APRGs provided by foreign banks could not form part of the "market" against which to compare APRGs provided by KEXIM. During the second substantive meeting, however, Korea stated that:

> "the Panel may wish to do as the EC requests and make a ruling that foreign lenders can be part of the market, but such a ruling would be completely beside the issue of choosing an appropriate benchmark. The EC cites the Appellate Body report in

> *US -- Lumber CVD Final* as support for its position, but that only serves as an illustration of the "straw man" argument the EC is using."[82]

7.139 In light of this statement, we do not consider that Korea disputes that foreign market benchmarks could be used as a matter of law.[83] Rather, we understand Korea to argue that, as a matter of fact, the foreign market benchmarks relied on by the EC are not representative of APRG activities in the Korean market since the foreign APRG providers only participated in the APRG business on an exceptional basis, and were less familiar with that business.[84]

7.140 In response, the EC submits that there is no reason to believe that foreign institutions are less capable of evaluating the creditworthiness of a shipyard or its technical capability to carry out the construction project until delivery. In response to Question 10 from the EC, Korea stated that its argument "is based on discussions with the shipyards and KEXIM. Korea has asked the shipyards and KEXIM for any further documentation and it will be submitted when provided to the Government of Korea".

7.141 We do not consider that a vague reference to shipyard and KEXIM perceptions is sufficient to reject the foreign market benchmarks proposed by the EC. We also note that, despite Korea's response to Question 10 from the EC, no documentation supporting the alleged perception of the shipyards and KEXIM was submitted in the subsequent stages of the Panel proceedings. In the absence of more substantial arguments by Korea regarding alleged shortcomings in foreign banks' evaluation of the creditworthiness of shipyards, we are not persuaded by Korea's argument that foreign benchmarks are not appropriate as a result of their lack of familiarity with the APRG business. In our view, provided the terms of an APRG are negotiated at arm's length for fair market value, the fact that the provider engages in only a limited number of transactions should not be conclusive, and should not preclude the use of such transactions as market benchmarks.

(iii) Country risk spreads

7.142 Korea has submitted evidence to the effect that at least one foreign bank proposed by the EC as a market benchmark included a 0.6 per cent country risk spread in its APRG rates for Korean shipyards. Korea submits that all other foreign banks would have done likewise. Korea submits that this means that foreign market APRG rates cannot be compared with KEXIM APRG rates without adjusting for country risk.

7.143 The EC does not contest that a country risk spread would have been included by foreign APRG providers. However, the EC submits that the same spread should also have been included by Korean banks, since the APRGs were provided in a foreign currency (i.e., US dollars). The EC argues that the risk of providing an APRG to a Korean company in a foreign currency, as it is the case for most of the APRGs, is the same regardless of where the bank is based. The EC notes in this regard that the *Comptroller's Handbook on Country Risk Management* prepared by the US Comptroller of the Currency provides that "[c]ountry risk is not necessarily limited to a bank's exposures to foreign-domiciled counterparties".[85]

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[82] Korea's second oral statement, para. 77.

[83] We therefore consider that any potential argument by Korea that APRGs provided by foreign banks could not form part of the "market" against which to compare KEXIM APRGs is a "straw man" that we need not consider.

[84] In light of para. 79 of Korea's second oral statement, Korea could also be understood to argue that all foreign benchmarks are unreliable because foreign banks only provided APRGs when designated by the buyer. However, since Korea argued these two issues separately in its earlier submission, we shall continue to treat them separately in these findings. The buyer designation issue is addressed at paras 7.134- 7.137 *supra*.

[85] Exhibit EC – 148, page 9.

7.144 The EC asserts that a Korean country premium has to be taken into account whenever a currency exposure is generated, regardless of whether a domestic or foreign bank issues the APRGs. The EC asserts that KEXIM quoted below-market rates because it failed to take such currency exposure into account. According to the EC, the country risk of Korea needs to be taken into account in the price as an add-on to cover the transfer risk resulting from the company needing to find foreign currency in the case where a government wants to keep the "strong" foreign currencies, and as an add-on resulting from the bank's needs to obtain refinancing in the foreign currency (in the case of default by the shipyard).

7.145 Korea submits that Korean domestic banks, by definition, cannot face the risk of their own country. Korea asserts that, for Korean banks, risks from events in their own country are no longer "country risk." Korea asserts that the *Comptroller's Handbook* does not imply that country risk can be applied to "every" domestic counterparty that is involved in "an export transaction". Rather, the handbook itself establishes that the country risk may be exceptionally applied to transactions with domestic counter parties under very limited circumstances, e.g., where the business of a domestic borrower is heavily relying on the businesses associated with that particular foreign country with respect to which the country risk is assessed. Korea asserts that this explanation is understandable because, in the situations where the business of a borrower (or guarantor) is heavily relying on transactions associated with a specific foreign country, events in such a foreign country will directly and significantly affect the general credit risks of the borrower (or guarantor) which in turn will significantly and directly affect the creditworthiness of the borrower (or guarantor). According to Korea, only in such specific circumstances would it make sense to take into account the country risk of such specific foreign country when assessing the creditworthiness of such borrower (or guarantor).

7.146 Korea submits that no Korean shipyards deal exclusively with a specific foreign country such that the events in that foreign country would significantly and directly affect the creditworthiness of the Korean shipyards. Korea also asserts that among the buyers of Korean ships, the absolute majority of buyers come from high income *OECD* countries, such as the EC, Norway, USA and Japan. Korea submits that no foreign financial institution would apply country risk with respect to counterparties from such countries as they do not bear any country risks.

7.147 Korea submits that, moreover, even if a Korean shipyard were exposed to the country risk of a particular foreign country by retaining significant "export receivables" from the buyers in that foreign country, the country risk it bears is the country risk of that particular "foreign" country, and not the country risk of "Korea". In other words, in such case, any Korean banks issuing APRGs to such Korean shipyard would apply the country risk of the said "foreign" country, not the "Korean" country risk.

7.148 Korea also asserts that Korean country risk relates to Korea's ability to honor its "external" financial commitments. Korea therefore asserts that Korean domestic banks cannot face similar "Korea risks" to those faced by foreign banks. Korea also submits that, in light of the definition of country risk, country risk factors such as the risk of expropriation of assets and the risk of currency manipulations must be understood to mean those that are of such nature that rather directly affect external financial obligations of Korea. Korea asserts that, by nature, these risks could not be the same as those risks faced by Korean domestic banks.

7.149 Korea acknowledges that, during the period of the financial crisis, the Korean banks were facing credit risks that were generally increased throughout the country, but states that such risks were different from the "country risk factors" as faced by foreign banks. Korea submits that such increased risks during the crisis were taken into account by the Korean banks (as by foreign banks) as the "general credit risk" of the Korean shipyards.

7.150 While Korea has provided evidence to the effect that foreign banks included country risk spreads when providing APRGs to Korean shipyards,[86] we consider that the EC has established that at least something equivalent to a country risk spread would also have been included by domestic APRG providers. A country risk spread is generally applied whenever a financial institution incurs international exposure. This will occur when a currency exposure is incurred. A currency exposure is incurred by both domestic and foreign providers of APRGs to Korean shipyards, because APRGs are provided to Korean shipyards in a foreign currency, i.e., US dollars.

7.151 In addition, we note that an APRG guarantees the repayment of pre-payments in the event of default by the shipyard. The risk of default by the shipyard is related to the general economic conditions in Korea, and would therefore form part of the country risk assessment. This risk applies to both domestic and foreign banks.

7.152 For these reasons, we proceed on the basis that APRG rates offered by Korean banks also reflect a country risk spread, or something equivalent thereto.

(iv) Domestic market benchmark

7.153 Korea also rejects the use of certain Korean domestic banks as a market benchmark. Korea asserts that domestic rates should only be taken into account (in fixing an appropriate market benchmark) if they represent a statistically representative number of transactions. Thus, rates charged by domestic entities that only provided APRGs rarely or exceptionally should not be taken into account.

7.154 The EC asserts that such domestic banks only provided APRGs exceptionally because they could not compete with the beneficial terms offered by KEXIM.

7.155 In our view, the exceptional nature of any market APRG (be it domestic or foreign) should not preclude its use as an appropriate market benchmark for the purpose of determining the existence of "benefit". Provided it is negotiated on a commercial basis by a market operator, and is comparable in terms of duration etc., any APRG should be admissible as a market benchmark. Korea has submitted no evidence demonstrating that this was not the case for the domestic APRGs relied upon by the EC as market benchmarks.

(v) Credit risk spread

7.156 The EC claims that APRGs issued by KEXIM before 12 March 1998 conferred a benefit because the terms did not include any credit risk spread.

7.157 In Attachment 6 to its first written submission, Korea states that "[u]ntil March 1998, KEXIM did not take credit risks into account for its APRG transactions". There is therefore no disagreement between the parties regarding the factual element of the EC's claim. Regarding the legal issue of whether or not the absence of credit risk spreads confers a "benefit", we consider that market operators of necessity would take account of credit risk, and that the failure by KEXIM to include a credit risk spread would result in APRGs being offered on terms that are more favourable than those offered on the market. In this regard, we note that at page 62 of its first written submission, Korea stated (in respect of PSLs, but the same principle would apply in respect of APRGs) that "Chapter 2 of the Interest Rate Guidelines provides detailed standards for determining the interest rates including the base rates and spreads requiring in particular to take a credit risk spread into account in the same way as a private financial institution would." (emphasis supplied, footnote omitted) This would suggest that Korea accepts that failure to apply a credit risk spread is inconsistent with market behaviour (i.e., the behaviour of a private financial institution). In light of the above, we find that the

[86] See Exhibits KOREA - 86a and b.

following pre-12 March 1998 APRGs confer a "benefit" by virtue of KEXIM's failure to include a spread for credit risk:

[BCI: Omitted from public version.]

(vi) Past subsidies

7.158 Korea submits that an alleged subsidy may only be challenged if it is conferring a benefit at the time that the dispute settlement proceeding is initiated. According to Korea, Article 1.1(a)(1) and (2), Article 3 and Article 4 do not apply to subsidies that were granted in the past, and that are not currently being maintained.

7.159 The EC submits that there is no rule in the WTO that a violation is forgiven once it is in the past. According to the EC, Korea confuses the issue of whether a subsidy has been granted with countervailing duty principles, which only allow current benefit to be offset.

7.160 Despite Korea's abovementioned argument, Korea stated in response to Question 108 from the Panel that it was "not making a general argument that the EC cannot challenge alleged past subsidies as a matter of principle". In light of Korea's reply, we see no need to rule on whether or not the EC is entitled to challenge "past" subsidies.[87]

(vii) Adverse inferences

7.161 The EC requests adverse inferences on the basis of Korea's alleged failure to provide information regarding APRGs issued by independent entities after 28 May 2001. The EC requests the Panel to find in accordance with paragraph 7 of Annex V of the *SCM Agreement* that these banks either stopped issuing APRGs because they determined that they could not compete with KEXIM's low premia, or that they continued issuing APRGs at comparatively higher premia than KEXIM.

7.162 We note that the EC has requested an adverse inference on the basis of paragraph 7 of Annex V of the *SCM Agreement*. Korea argues that adverse inferences cannot be drawn on the basis of that provision in the context of claims brought under Part II of the *SCM Agreement*. We do not consider it necessary to resolve this legal issue, since in any event it is well established that WTO dispute settlement panels retain a residual authority[88] to draw adverse inferences outside of the circumstances set forth in Annex V. Thus, even if that provision does not apply in respect of Part II claims, our residual authority to draw adverse inferences remains.

7.163 As a factual matter, however, we consider that the EC has failed to establish that an adverse inference would be warranted. The EC request is based on Korea's alleged failure to provide information regarding APRGs issued by private banks to Daewoo-SME/Daewoo-HI after 28 May 2001, to Samho-HI/Halla-HI after 1 December 2000, and to STX/Daedong after 14 September 1999. The EC asks the Panel to infer (because of Korea's failure to provide the relevant information) that such APRGs were issued at rates higher than those charged by KEXIM. However, the EC has failed to provide any evidence that such APRGs were actually provided to the shipyards concerned after the dates specified by the EC, whereas Korea submits that it has provided all information regarding APRGs in its responses to the Annex V questions. In the absence of any

[87] We note that Korea raised concerns regarding the probative value of "past" subsidies. To the extent this issue is relevant in respect of the EC's Part III claims, it is addressed in section VII.D *infra*.

[88] See Appellate Body Report, *Canada –Aircraft*, para. 198.

evidence regarding the existence of the alleged APRGs, there is no basis for us to draw any inference regarding the terms on which such alleged APRGs were issued. [89]

(b) Transaction-specific issues

(i) Daewoo

7.164 The EC has proposed a number of market benchmarks to argue that certain APRGs[90] provided by KEXIM to DHI or DSME were below market rates. In particular, the EC has compared certain APRGs provided by KEXIM in 1998, 2000 and 2001 with a number of APRGs provided by **[BCI: Omitted from public version]** during that period.

7.165 Korea rejects the market benchmarks proposed by the EC, and submits that the rates of KEXIM's APRGs should be compared with APRGs provided to those companies by KDB. Korea rejects the use of the EC's **[BCI: Omitted from public version]** benchmarks APRGs because, in Korea's view, those APRGs did not involve collateral of the same value as that provided in respect of the relevant KEXIM APRGs, i.e., Yangdo Dambo.[91]

7.166 In response, the EC submits (on the basis of information provided by Korea in its reply to Question 14 from the EC) that the APRGs issued by **[BCI: Omitted from public version]** were guaranteed by cash deposits, which the EC claims is a stronger form of collateral than Yangdo Dambo.

7.167 Information provided by Korea confirms the EC argument that the **[BCI: Omitted from public version]** APRGs were collateralized by cash deposits.[92] The EC has provided a convincing explanation in support of its argument that cash deposits are a stronger form of collateral than Yangdo Dambo. The EC asserts that Yangdo Dambo "presents [] a wide spread depending on the financial situation of the shipyard, the quality of the shipyard work, its on-time delivery record, the evolution of the construction of the vessel, the sales price versus production cost of the ship, the technological requirements of the buyer and the ease with which these will be met".[93] The EC also states that "[i]t is not unusual for instance that the final price paid by the purchaser of the ship be dependent upon a certain number of technical characteristics of the ship such as its speed for instance. In such a case, the final value of the ship will only be known at the end of the production process. The value of such a collateral is therefore highly dependent upon the quality of the shipyard."[94] The value of Yangdo Dambo is therefore dependent on a number of variables, whereas the value of a cash deposit is self-evident. Korea has failed to rebut the EC's arguments. Instead, Korea asserts that the cash deposits provided in respect of the **[BCI: Omitted from public version]** APRGs covered only a small portion of the guarantee, compared with the 100 per cent coverage of the Yangdo Dambo provided in respect of the KEXIM APRGs. In order for this argument to prevail, Korea would need to demonstrate that

[89] We note that the EC also acknowledged the possibility that subsequent APRGs did not exist, but nevertheless asked the Panel to infer that the APRGs ceased because market providers were not able to compete with the terms offered by KEXIM. If the APRGs did not exist, however, there is no basis for any adverse inference. In particular, there is no basis for us to find that Korea failed to provide information concerning APRGs that did not exist.

[90] See Figure 11 of the EC's first written submission.

[91] Korea describes Yangdo Dambo as "a security interest (including on the hull and the materials used by the shipyards) created by way of transfer of the title /ownership of a property to the creditor. Such transfer takes place based on an agreement providing that the creditor can either cover his claims through the sale or the assumption of the definitive ownership to the property upon the default of the debtor or return of the title / ownership to the property to the debtor when the latter fully settles the claim of the creditor" (see para. 215 of Korea's first written submission).

[92] See, for example, Korea's reply to Question 14 from the EC.

[93] See Exhibit EC – 118, page 16.

[94] See Exhibit EC – 118, page 4.

the collateral value of the Yangdo Dambo exceeds that of the cash deposits. We consider that Korea has failed to do so, since Korea has made no attempt to do so.[95] We consider such a demonstration to be particularly necessary since Korea has not challenged the EC's assertion that "cash deposits [] are one of the strongest forms of collateral compared to Yangdo Dambo".[96]

7.168 We do not consider that the EC could have done more to prove its argument that the **[BCI: Omitted from public version]** collateral matched that of the KEXIM Yangdo Dambo. The EC was dependent on Korea for information regarding the value of the **[BCI: Omitted from public version]** cash deposits. The EC was also dependent on Korea for information regarding the value of the Yangdo Dambo required by KEXIM. However, in its reply to Question 67 from the Panel (concerning one of the **[BCI: Omitted from public version]** transactions), Korea indicated that it could not provide worksheets or other documentation regarding KEXIM's consideration of collateral. Korea was only able to provide very basic information regarding the Yangdo Dambo at issue.[97] Given the number of variables that determine the collateral value of Yangdo Dambo, this limited information is not sufficient to conclude that the value of the Yangdo Dambo exceeds that of the relevant cash deposits.

7.169 Furthermore, even though Korea seeks to rely on the limited value of the cash deposits provided in respect of the **[BCI: Omitted from public version]** APRGs, Korea has failed to establish the precise scope of those cash deposits. Thus, at note 155 to its first written submission, Korea reported the collateral for the **[BCI: Omitted from public version]** APRGs as "a pledge against bank deposits amount[ing] to 20 to 30% of the advance payments". Then, in reply to Question 14 from the EC, Korea stated that the cash deposits for the four **[BCI: Omitted from public version]** APRGs amounted to 10, 12, 20 and 20 per cent respectively, whereas the cash deposit for the **[BCI: Omitted from public version]** APRG was 30 per cent. As the party seeking to rely on the allegedly limited coverage of the relevant cash deposits, Korea should at least have stated clearly what that allegedly limited coverage was. Furthermore, Korea has failed to provide any evidence in support of its reporting of the coverage of the **[BCI: Omitted from public version]** cash deposits. Such evidentiary support is particularly necessary in this case, given the differences in Korea's reporting of the cash deposits at issue.

7.170 In light of the above, there is no basis for us to accept Korea's argument that the **[BCI: Omitted from public version]** market benchmarks proposed by the EC should be rejected because the relevant collaterals were not comparable. In the absence of additional argumentation by Korea, we consider that the 1998, 2000 and 2001 KEXIM APRGs identified at Figure 11 of the EC's first written submission should be compared with those benchmarks in order to determine whether or not they were provided on terms more favourable than those available on the market. Since the KEXIM premia rates were less than the market benchmarks proposed by the EC, we find that the 1998, 2000 and 2001 KEXIM APRGs identified at Figure 11 of the EC's first written submission conferred a benefit and therefore constitute subsidies.

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[95] At para. 81 of its second oral statement, Korea stated that "[t]he strength of a type of collateral is relevant, but is not particularly useful as a basis for comparison if it only covers a small portion of the credit". We do not consider that this statement rebuts the EC's claim, since at a certain point the value of a smaller portion of credit coverage by a stronger form of collateral will equal, or exceed, the value of a larger portion of credit coverage by a weaker form of collateral.

[96] EC second written submission, para. 100.

[97] In Exhibit KOREA-57, "Security interests" are reported as:

"[on-Credit: 100%]

- Yangdo Dambo as for shipbuilding materials & ships being built
- Yangdo Dambo as for ship price payment claim
- Procuring insurance against loss as to ships being built on behalf of KEXIM as beneficiary."

This was the only information submitted by Korea regarding the value of the collateral at issue.

7.171 The EC has also proposed APRGs offered by **[BCI: Omitted from public version]** and **[BCI: Omitted from public version]** as market benchmarks against which to compare KEXIM APRGs provided to Daewoo in 1997. It is not necessary for us to review the EC's argument, since we have already found that KEXIM's pre-March 1998 APRGs constituted subsidies because the terms did not include any credit risk spread.[98]

7.172 We recall that Korea proposed the use of certain APRGs provided by KDB to Daewoo as market benchmarks. Korea's proposal was based on its argument that KDB is not a public body. We disagree with this argument, however. In our view, KDB is a public body because it is subject to government control. Government control derives from the fact that it is 100 per cent owned by the GOK.[99] Further evidence of government control is found in the fact that GOK "appoints the Governor, Vice Governor, Directors and Auditors of the KDB…, approves its annual operation plan…, and has an oversight role with respect to its operations….".[100] Since the KDB is a public body, there is a risk that its APRG rates are based on public policy, rather than commercial, principles.[101] The KDB APRG rates therefore do not constitute an appropriate market benchmark.

(ii) Samho/Halla

7.173 The EC has proposed a number of market benchmarks to argue that certain APRGs provided by KEXIM to Samho / Halla in 2000 were below market rates. The relevant KEXIM APRGs are set forth at Figure 12 of the EC's first written submission. Korea asserts that the KEXIM APRGs are not comparable with the EC's proposed market benchmarks, since the latter were not collateralized whereas the former were provided on the basis of Yangdo Dambo. Korea submits that the KEXIM APRGs should instead be compared with a number of APRGs provided by KDB.[102] Korea also asserts that the KEXIM APRGs identified by the EC were not provided to Samho / Halla.

7.174 Regarding Korea's reliance on KDB APRGs, we recall our finding that KDB is a public body. KDB rates therefore cannot be used as a market benchmark.

7.175 Regarding Korea's argument on collateralization, the EC refers to its translation of a document submitted by Korea in the Annex V procedure, and asserts that the KEXIM APRGs were issued "on credit", and therefore without collateral.[103] In its first written submission, however, Korea stated that KEXIM APRGs were always provided against "real property (land, buildings, factories as a whole), personal property, securities (i.e., 'Yangdo Dambo' [...] on significant items such as the hull of a vessel) and guarantees."[104] In response to Question 67 from the Panel, Korea has demonstrated that KEXIM APRG transactions reported by Korea as being "on credit" actually involved the

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[98] For the sake of completeness, however, we note that Korea's reply to Question 14 indicated that no collateral had been required in respect of the **[BCI: Omitted from public version]** and **[BCI: Omitted from public version]** APRGs relied on by the EC. Korea asserts that those APRGs therefore cannot be properly compared with KEXIM APRGs, which were collateralized. In the absence of any argument by the EC that the **[BCI: Omitted from public version]** and [**BCI: Omitted from public version**] APRGs were collateralized, or that the KEXIM APRGs were not, there is no basis for us to find that the **[BCI: Omitted from public version]** and **[BCI: Omitted from public version]** APRGs may be properly compared with the relevant KEXIM APRGs.

[99] See Attachment 3 to the EC's replies to the Panel's questions after the first substantive meeting.

[100] See Responses to Annex V Questions (Non-Confidential Version), Answer 2.4(29), at 45 (citing Articles 12, 21, and 47 of Korea Development Act) (citations omitted) (Exhibit EC-50).

[101] Otherwise, the rates of one public body could be used to show that the rates of another public body do not confer a "benefit", even though there is a risk that the rates of both entities are below market. This, of course, is the reason that Article 1 of the *SCM Agreement* brings financial contributions by public bodies into the scope of the disciplines of the *SCM Agreement*.

[102] See Korea's reply to Question 71 from the Panel.

[103] See para. 100 of the EC's second written submission, note 117.

[104] See Korea's first written submission, para. 188. See also para. 215 of that submission.

provision of collateral such as Yangdo Dambo.[105] There is therefore no basis to doubt that the KEXIM APRGs provided to Samho / Halla and reported as being "on credit" were actually collateralized. Since the EC has failed to demonstrate that its proposed market benchmarks were also collateralized, we are unable to accept the use of those proposed market benchmarks for comparing with collateralized KEXIM APRGs. We therefore reject the EC's claim against the KEXIM APRGs identified in Figure 12 of its first written submission.

7.176 In response to a Korean argument that some of the KEXIM APRGs included in Figure 12 of the EC's first written submission did not relate to Samho, the EC performed an additional benefit analysis in respect of other KEXIM APRGs provided to Samho / Halla.[106] However, the EC's modified analysis is based on the same proposed market benchmarks, which (as described above) we are unable to compare with collateralized KEXIM APRGs. Since the EC has given us no reason to doubt Korea's assertion that all KEXIM APRGs were collateralized, we reject the EC's modified analysis in respect of the additional[107] KEXIM APRGs identified by the EC. We therefore reject the EC's claim against those additional KEXIM APRGs provided to Samho / Halla.

(iii) STX/Daedong

7.177 The EC submits that two KEXIM APRGs issued to STX/Daedong in 1999 (see Figure 13 of the EC's first written submission) constitute prohibited export subsidies. The EC claims that the terms of the KEXIM APRGs were more favourable than those of three APRGs provided to STX / Daedong by **[BCI: Omitted from public version]** in 1999. Korea opposes any comparison with APRGs provided by **[BCI: Omitted from public version]**. Korea asserts that those APRGs were not collateralized, whereas KEXIM's APRGs were. Korea submits that the KEXIM APRGs should instead be compared with APRGs provided by the Korea Exchange Bank ("KEB") in 2001 and KDB in 2002.

7.178 We recall that we have already rejected the use of two of the three **[BCI: Omitted from public version]** APRGs.[108] We shall therefore examine the EC's claim in light of the terms and conditions of the one remaining **[BCI: Omitted from public version]** APRG. Regarding comparability on the basis of collateralization, we recall Korea's argument that all KEXIM APRGs were collateralized. KEXIM APRGs should therefore be compared with collateralized market benchmarks. In this regard, we note that the remaining **[BCI: Omitted from public version]** APRG was collateralized "with cash deposits amounting to 5% of the advance payment amount and an export guarantee insurance".[109] Since Korea has failed to argue that such collateral is not comparable with any collateral required in respect of the relevant KEXIM APRGs, we consider that it is appropriate to compare the two 1999 KEXIM APRGs with the single **[BCI: Omitted from public version]** APRG provided to STX / Daedong in 1999. On the basis of such comparison, we find that the KEXIM APRGs were below market, and therefore conferred a benefit.

7.179 We recall that Korea has argued that the terms of the KEXIM APRGs should be compared with the terms of certain APRGs provided by KDB and KEB. In this regard, we recall our finding that KDB is a public body. Accordingly, KDB APRGs do not constitute a reliable market benchmark with which to asses the existence of benefit. As for KEB, we note that Korea has sought to rely on APRG rates offered by KEB in 2001, whereas the KEXIM APRGs at issue date from 1999. Given the absence of any temporal correlation between the KEXIM APRGs challenged by the EC and the KEB APRGs identified by Korea, and our preference for rates charged by entities without government

[105] See Exhibit KOREA – 57, under the heading "II. Items relating to the resolution", where various security interests are reported in respect of a transaction described as being "On-Credit: 100%".
[106] See para. 36 of the EC's second oral statement.
[107] As set forth at para. 36 of the EC's second oral statement.
[108] See para. 7.136 *supra*.
[109] See Korea's reply to Question 14 from the EC.

ownership, we do not consider it appropriate to use KEB APRGs as a market benchmark for determining whether or not the KEXIM APRGs conferred a benefit. We also note the EC argument that KEB is not a reliable market benchmark as a result of government entrustment or direction[110] and government ownership.[111] We are not persuaded by the EC's argument concerning government entrustment or direction, since the only evidence provided by the EC of the government's alleged role is in relation to KEB's participation in the Daewoo workout, and has nothing to do with KEB's provision of APRGs to Samho / Halla. Regarding government ownership, the EC asserts that GOK has a minority shareholding in KEB. In choosing an appropriate market benchmark, we consider it preferable to choose when possible entities without any government ownership. The absence of government ownership generally removes the possibility that rates have been fixed on the basis of public policy, rather than commercial principles.

7.180 In light of the above, we uphold the EC's claim against the KEXIM APRGs identified in Figure 13 of the EC's first written submission.

(iv) Hanjin

7.181 The EC claims that two APRGs provided by KEXIM to Hanjin in 2002 constitute subsidies because they were provided on terms more favourable than those of two APRGs provided by **[BCI: Omitted from public version]** to Hanjin in the same year. The relevant APRGs are set forth at Figure 14 of the EC's first written submission.

7.182 Korea opposes the comparison proposed by the EC because of differences in collateralization. Korea submits that the relevant KEXIM APRGs should instead be compared with certain APRGs provided by **[BCI: Omitted from public version]**, KEB, KDB and **[BCI: Omitted from public version]** in 1997.[112]

7.183 In its reply to Question 71, Korea submits that no security was deposited for the **[BCI: Omitted from public version]** APRGs, whereas Yangdo Dambo was provided for the relevant KEXIM APRGs. Korea submits that such differences in collateralization preclude any comparison between the **[BCI: Omitted from public version]** and KEXIM APRGs at issue. The EC submits that Korea's argument that the two APRGs issued by **[BCI: Omitted from public version]** were not collateralized is inconsistent with Korea's statement in the Annex V process[113] that "[a]ll APRGs" reported by Korea, including therefore those from **[BCI: Omitted from public version]**, "were issued with the collaterals of *Yangdo Dambo*".

7.184 Despite Korea's contradictory statement in the Annex V process, Korea provided documentary evidence[114] during these proceedings demonstrating that the two **[BCI: Omitted from public version]** APRGs at issue were not collateralized. The EC has not disputed that the KEXIM APRGs at issue were, by contrast, collateralized. Given these differences in collateralization, and the fact that the EC has not provided us with any basis for making adjustments to reflect such differences, we are unable to determine benefit on the basis of a comparison of the **[BCI: Omitted from public version]** APRGs with the KEXIM APRGs. We are therefore unable to accept the use of the **[BCI: Omitted from public version]** APRGs as a market benchmark, and reject the EC's claim against the Hanjin APRGs accordingly.

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[110] See EC reply to Question 171 from the Panel.

[111] See para. 103 of the EC's second written submission.

[112] See para. 223 of Korea's first written submission, which refers to other domestic, non-KEXIM APRGs set forth in Exhibit Korea – 16.

[113] See Annex V information submitted as Exhibit EC-24.

[114] See Exhibit Korea – 88, which clearly states that no securities were provided in respect of APRG projects N-120 and N-121.

7.185 In light of the above finding, it is not strictly necessary for us to consider the **[BCI: Omitted from public version]**, KEB, KDB and **[BCI: Omitted from public version]** benchmarks proposed by Korea. We shall do so, however, for the sake of completeness. We have already indicated that KDB APRGs would not constitute an appropriate market benchmark, since KDB is a "public body". Although the EC does not argue that **[BCI: Omitted from public version]**, KEB and **[BCI: Omitted from public version]** are public bodies, it asserts that they are entrusted or directed by the government.[115] We must reject this argument, since the EC has not provided any evidence that these entities were entrusted or directed to provide APRGs to Hanjin. The only evidence of alleged government entrustment or direction of these entities relates to their participation in some of the restructurings at issue in these proceedings. Nevertheless, we note that the alternative APRGs proposed by Korea as market benchmarks all relate to 1997, whereas the KEXIM APRGs challenged by the EC relate to 2002. Given the lack of temporal correlation between these APRGs, the **[BCI: Omitted from public version]**, KDB, KEB and **[BCI: Omitted from public version]** APRGs do not constitute appropriate market benchmarks for the purpose of assessing the KEXIM APRGs at issue.

(v) Samsung

7.186 In respect of Samsung, the EC challenges four KEXIM APRGs, all of which were issued in 1997. The EC claims that these APRGs conferred a benefit because they were issued on terms more favourable than 1997 APRGs provided by **[BCI: Omitted from public version]** and **[BCI: Omitted from public version]**. The relevant APRGs are set forth at Figure 15 of the EC's first written submission.

7.187 We recall that we have already found that KEXIM's pre-March 1998 APRGs to Samsung constitute subsidies because their terms did not include any credit risk spread. For this reason, there is no need for us to consider additional arguments by the parties regarding the comparability of these APRGs with the market benchmark APRGs proposed by the EC.

7.188 For the sake of completeness, we note Korea's argument regarding the use of KDB APRGs as a market benchmark. We recall that KDB is a public body.[116] As a public body, KDB does not constitute a market benchmark for the purpose of assessing whether or no the relevant KEXIM APRGs conferred a benefit.

(c) Export contingency

(i) Arguments of the Parties

7.189 The EC submits that APRGs are provided for the specific purpose of guaranteeing the down payments for Korean goods intended for export. The EC asserts that any transaction financed through KEXIM's APRG programme must, by definition, be an export transaction, and that APRGs provided pursuant to the programme are expressly contingent on export within the meaning of Article 3.1(a) of the *SCM Agreement*.

7.190 When asked by the Panel (Question 48) whether Korea contests the EC's claim that PSLs and APRGs under the KEXIM legal regime are contingent on export performance, Korea responded that it "has not taken any position as to whether [PSLs and APRGs] are contingent on export performance". In response to an oral question from the Panel at the second substantive meeting, Korea stated that it was not contesting the EC's claim of export contingency.

[115] See EC reply to Question 171 from the Panel.
[116] See para. 7.172 *supra*.

(ii) Evaluation by the Panel

7.191 We find that the EC has established a *prima facie* case that KEXIM APRGs are contingent on export performance. In light of Korea's decision no to contest the EC's arguments regarding this matter, we find that KEXIM APRGs are "contingent ... upon export performance" within the meaning of Article 3.1(a) of the *SCM Agreement*.

(d) Specificity

7.192 Pursuant to Article 1.2, the disciplines of the *SCM Agreement* only apply to subsidies that are "specific" within the meaning of Article 2 thereof. Article 2.3 of the *SCM Agreement* provides that "[a]ny subsidy falling under the provisions of Article 3 shall be deemed to be specific". Since export contingent subsidies fall under the provisions of Article 3 (paragraph 1(a)), they are "specific". Pursuant to Article 2.3, therefore, we conclude that those APRGs that we have found to be export subsidies are "specific".

(e) Item (j) defence

7.193 In light of our findings that certain APRGs constitute subsidies, and that such subsidies are contingent on export performance, we will be required to find that such APRGs are inconsistent with Articles 3.1(a) and 3.2 of the *SCM Agreement* unless we uphold Korea's claim that they benefit from a safe haven pursuant to item (j) of the *Illustrative List*.

7.194 Korea submits that item (j) should be interpreted such that export credit guarantee programmes, or guarantee programmes against increases in the cost of exported products, that are provided at premium rates that cover the long-term operating costs and losses of the programmes should be found not to constitute export subsidies. In other words, Korea relies on an *a contrario* interpretation of item (j). Korea's reliance on item (j) raises a number of issues. First, is an *a contrario* interpretation of item (j) permissible? Second, if so, what are the relevant conditions to be fulfilled? Third, have those conditions been fulfilled in this case?

(i) Is an a contrario interpretation permissible?

7.195 We note that the panel in *Brazil – Aircraft – Article 21.5* was required to consider whether or not one of the items of the *Illustrative List* could be interpreted in an *a contrario* manner. In doing so, that panel observed that footnote 5[117] to the *SCM Agreement* provides an explicit textual basis for determining whether and under what conditions the *Illustrative List* may be used to demonstrate that a measure is not a prohibited export subsidy.[118] The panel noted that footnote 5 provides that "[m]easures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement." The panel observed that, in its ordinary meaning, footnote 5 relates to situations where a measure is referred to as *not* constituting an export subsidy. The panel therefore considered whether or not the *Illustrative List* provision at issue contained any affirmative statement that a measure is *not* an export subsidy, or that a measure not satisfying the

[117] The *SCM Agreement* also includes a provision governing the relationship between certain elements of the *Illustrative List* and Article 1 of the Agreement. Footnote 1 to the *Agreement* provides that, "[i]n 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 and taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy." Footnote 1 therefore indicates when certain measures will not constitute a subsidy, whereas footnote 5 addresses situations where certain measures will not constitute prohibited export subsidies. Footnote 1 is not applicable to the situation at hand, as Korea has not alleged that APRGs (or PSLs) are related to the exemption of an exported product from duties or taxes.

[118] See Panel Report, *Brazil – Aircraft – Article 21.5*, paras. 6.33-6.34.

conditions of that provision is *not* prohibited, and thus falls within the scope of footnote 5.[119] Finally, the panel noted that a broad reading of footnote 5 could place developing country Members at a permanent, structural disadvantage in the field of export credit terms, a result that it considered to be inconsistent with one of the objects and purposes of the *WTO Agreement*.[120]

7.196 We find the reasoning[121] expressed by the *Brazil – Aircraft-Article 21.5* panel to be convincing, and consider it appropriate for us to be guided by it in these proceedings. We are of course aware that the *Brazil – Aircraft-Article 21.5* panel was considering whether or not the first paragraph of item (k) of the *Illustrative List* could be interpreted *a contrario*. However, the panel's reasoning was based in the first instance on an interpretation of footnote 5 of the *SCM Agreement*, and was not confined to the text of item (k) in isolation. Furthermore, the panel's concerns regarding structural discrimination against developing country Members were based explicitly on considerations regarding item (j). Accordingly, there is no reason why the panel's reasoning should not also be applied in respect of the remaining provisions of the *Illustrative List*, including item (j).

7.197 Korea argues that we should not follow the reasoning of the *Brazil – Aircraft – Article 21*.5 panel because it was invalidated by the Appellate Body. In particular, Korea relies on the statement by the Appellate Body in those proceedings that "[i]f Brazil had demonstrated that the payments made under the revised PROEX were not 'used to secure a material advantage in the field of export credit terms', and that such payments were 'payments' by Brazil of 'all or part of the costs incurred by exporters or financial institutions in obtaining credits', then we would have been prepared to find that the payments made under the revised PROEX are justified under item (k) of the *Illustrative List*."[122] However, we do not accept that this amounts to a reversal of the panel's findings, nor a legal finding by the Appellate Body that an *a contrario* interpretation of the first paragraph of item (k) is permissible. This is because the Appellate Body explicitly stated that "[i]n making this observation, we wish to emphasize that we are not interpreting footnote 5 of the *SCM Agreement*, and we do not opine on the scope of footnote 5, or on the meaning of any other items in the Illustrative List." In light of this clarification by the Appellate Body, we consider that there is nothing in the Appellate Body statement that would cause us not to be guided by the abovementioned reasoning of the *Brazil – Aircraft – Article 21.5* panel.

7.198 Thus, in order to determine whether or not item (j) of the *Illustrative List* may be interpreted *a contrario*, we shall consider whether or not item (j) falls within the scope of footnote 5 of the *SCM Agreement*. That is to say, we shall consider whether item (j) contains any affirmative statement that a measure is *not* an export subsidy, or that a measure not satisfying the conditions of that paragraph is *not* prohibited. Item (j) contains no such affirmative statement. Item (j) merely describes certain circumstances in which particular programmes shall constitute export subsidies. Since item (j) therefore falls outside the scope of footnote 5, item (j) does not provide a basis on which to find that measures do not constitute prohibited export subsidies.

7.199 Although the EC rejects the application of item (j) on the basis of the facts of this case, the EC submits that in law item (j) could be read to include a proviso, and thereby "refer" to export credit guarantees as not constituting export subsidies to the extent that the premium rates cover the long-term operating costs and losses of the programmes. As indicated above, however, we consider that item (j) does not refer to measures as not constituting export subsidies. The terms of item (j) merely refer to export credit guarantees etc. at premium rates which are inadequate to cover long-term operating costs and losses. It contains no explicit reference to export credit guarantees etc. that are

[119] See *ibid.*, paras. 6.36-6.37.
[120] See *ibid.*, paras. 6.46-6.66.
[121] We therefore incorporate the reasoning set forth in paragraphs 6.33 – 6.41 of that panel's report into our findings.
[122] See Appellate Body Report, *Brazil – Aircraft – Article 21*.5, para. 80.

adequate to cover long-term operating costs and losses. There is therefore no basis for claiming that item (j) somehow incorporates a proviso that brings it within the scope of footnote 5.

7.200 Korea objects to the *Brazil – Aircraft – Article 21.5* panel's interpretation and application of footnote 5, which we apply here. Korea considers that such an application is overly narrow. Korea argues that the negotiating history of footnote 5 shows that the drafters intended to expand, rather than restrict, the scope of footnote 5. In this regard, Korea makes the same argument as was advanced by the United States in *Brazil – Aircraft – Article 21.5*. The *Brazil – Aircraft – Article 21.5* panel described and rejected this argument in the following terms:

> The United States advances arguments based on the negotiating history of footnote 5 in support of its broad interpretation of that footnote to apply to the first paragraph of item (k). In this respect, it points out that in a Chairman's text of the *SCM Agreement* known as *Cartland III*, footnote 5 provided as follows:
>
> "Measures *expressly* referred to as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement." (emphasis added).
>
> As the United States correctly observes, a new Chairman's text (known as "Cartland IV") was released just a few days later. In that new text, the word "expressly" was dropped from the footnote, which took its present form. In the view of the United States, this change demonstrates that the drafters "intended to expand, rather than restrict" the scope of footnote 5, and that "they did not intend the sort of narrow construction of footnote 5 advanced by Canada and the EC."
>
> We agree with the United States that the deletion of the term "expressly" appears to have broadened the scope of footnote 5 in *Cartland IV* beyond its scope in *Cartland III*. We do not agree, however, that it served to broaden footnote 5 to the extent suggested by the United States. As we discussed above, the Illustrative List contains – and already contained at the time of *Cartland III* and *IV* – a number of provisions that include affirmative statements that arguably represent authorizations to use certain measures. The language of *Cartland III* ("expressly referred to") could have precluded asserting that footnote 5 applied to any of these provisions, and it may be that the purpose of the modification was to rectify this situation. If on the other hand the intention of the drafters in changing footnote 5 had been to extend the scope of that footnote to cover situations where the Illustrative List merely referred to things that *were* export subsidies, they might have been expected to modify the structure of the second part of the footnote, and not merely delete the word "expressly". At the very least, we conclude that the implications of the negotiating history referred to by the United States are inconclusive and cannot lead us to disregard the ordinary meaning of the footnote.
>
> Of course, it could be argued that, based on an *a contrario* argument, the Illustrative List permits admitted export subsidies *even where those subsidies do not fall within the scope of footnote 5*. As we have already indicated, however, the drafters have provided us with a specific textual provision that addresses the issue when the Illustrative List can be used to demonstrate that a measure is not a prohibited export subsidy. The fact that this footnote was adjusted on at least one occasion suggests that the drafters gave this issue consideration and provided the answer to this question. If we were to conclude that the Illustrative List by implication gave rise to

> "permitted" measures beyond those allowed by footnote, we would be calling into serious question the *raison d'être* of footnote 5.[123]

7.201 We find the panel's reasoning to be convincing. For this reason, and in light of the fact that Korea has not attempted to rebut it, we see no reason not to be guided by that reasoning in the present case. Although Korea notes that the Appellate Body has not opined on the *Brazil – Aircraft – Article 21.5* panel's reasoning,[124] this fact does not make the panel's reasoning any less convincing to us. On the basis of that reasoning, we reject Korea's argument concerning the negotiating history of footnote 5.

7.202 Korea also argues that the only purpose of item (j) is to indicate when export subsidies do not exist.[125] Korea submits that failure to permit an *a contrario* reading of item (j) and the first paragraph of item (k) would render those provisions meaningless, since a complaining party would never rely on them to demonstrate the existence of an export subsidy. According to Korea, this is because reliance on these provisions would require a complaining party to demonstrate more facts than the basic legal provision in Article 3. In particular, Korea argues that since one could establish a violation of Article 3.1(a) simply by showing export contingency, a complainant would never have recourse to item (j) to demonstrate export subsidization, because that would require the complainant to also demonstrate that premium rates are inadequate to cover the long-term operating costs of the relevant programme (i.e., that the conditions of item (j) are met).

7.203 We cannot accept Korea's argument that the only purpose of item (j) is to indicate when export subsidies do not exist. To accept this argument would require reading item (j) in a sense exactly opposite that of its plain language: on its face, item (j) defines certain circumstances in which export credit guarantee programmes are export subsidies. Item (j) simply does not address export guarantee programmes that do cover their long-term operating costs and losses. Indeed, what is the point of footnotes 1 and 5 being included in the *SCM Agreement* to clarify the relationship between Articles 1 and 3 of the *SCM Agreement* on the one hand, and the *Illustrative List* on the other, if footnotes 1 and 5 can ultimately be ignored and the *Illustrative List* read in a sense exactly the opposite of its plain language?

7.204 As for Korea's argument that item (j) would never be used by a complaining party to establish the existence of a prohibited export subsidy, we disagree. As item (j) provides, if a complaining party establishes that another Member's export guarantee programme fails overall to cover its long-term operating costs and losses, that is sufficient for a finding that the programme as a whole constitutes a prohibited export subsidy. Given the *per se* nature of the items set forth in the *Illustrative List*, no further separate analysis of the programme under Articles 1 and 3 would be necessary.[126] Furthermore, in arguing that all a party would need to do to pursue a claim under Article 3.1(a) is establish export contingency, Korea overlooks the need under Article 3.1(a) to demonstrate the existence of subsidization. Thus, a complainant cannot establish a violation of Article 3.1(a) simply by showing export contingency; the complainant must also demonstrate subsidization, and therefore benefit, on the basis of Article 1.1 of the *SCM* Agreement.

7.205 Furthermore, we recall that the *Brazil – Aircraft –Article 21.5* panel's reasoning was based explicitly on the structural disadvantages for developing country Members that would result from an *a contrario* interpretation of item (j). The panel found:

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[123] Panel Report, *Brazil – Aircraft – Article 21.5*, paras 6.39 – 6.41 (footnotes omitted).
[124] Korea's first written submission, para. 253.
[125] Korea's rebuttal submission, para. 103.
[126] This perhaps reflects the historical context of the *Illustrative List*, in the sense that it was first drafted before the definition of "subsidy" set forth in the *SCM Agreement* was introduced.

> 6.59 The same situation exists in respect of item (j) of the Illustrative List. Brazil argues that its interpretation of the first paragraph of item (k) is necessary to allow it to meet export credit terms provided by developed country Members through export credit guarantees. If footnote 5 is interpreted broadly to encompass the first paragraph of item (k), however, it presumably would also apply to item (j) and thus "permit" export credit guarantees at premium rates adequate to cover long-term operating costs and losses, even where the guarantees constituted a subsidy contingent upon export performance within the meaning of Article 3.1(a). As Canada points out, however, in the case of a government guarantee, a lending bank establishes financing terms in light of the risk of the guarantor government, not the borrower. Developed countries generally present a lower risk of default than developing countries, and a developing country may often be perceived as posing a higher risk than even the borrower to whom a guarantee might be extended. As a result, while developing countries in theory could utilise any "safe harbour" under item (j) to provide loan guarantees at the same premium rates as developed countries, the effect of guarantees by developing country Members on the interest rate of the guaranteed export credits would be minimal or non-existent in most cases. In other words, a broad reading of footnote 5 would, in respect of item (j), allow developed countries to support export credits at interest rates that would be consistently lower than those of export credits supported by developing countries.
>
> 6.60 If, on the other hand, we interpret footnote 5 in accordance with its ordinary meaning, and conclude that it does not apply to items such as the first paragraph of item (k) and item (j), then all WTO Members are faced with a common set of rules in respect of export credit practices. *First*, they can ensure that those practices do not confer a benefit within the meaning of Article 1 and are therefore not subsidies. Because the existence of benefit is determined based on the existence of a benefit to a recipient, and without regard to whether there is a cost to the government, all Members compete on a level playing field in respect of this assessment, *i.e.*, a measure which constitutes an export subsidy when provided by Brazil *ipso facto* will also constitute a subsidy when provided by Canada, and vice versa.[127]

7.206 We share that panel's concerns regarding the structural disadvantages that would result for developing country Members from an *a contrario* interpretation of item (j). As noted by that panel, an interpretation leading to such structural disadvantages "would be at odds with one of the objects and purposes of the *WTO Agreement* generally and the *SCM Agreement* specifically".[128]

7.207 In light of the above, we find that an *a contrario* interpretation of item (j) is not permissible. Strictly speaking, therefore, it is not necessary for us to continue with our analysis of the two remaining issues outlined above. For the sake of completeness, however, we shall do so.

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[127] See Panel Report, *Brazil – Aircraft – Article 21.5*, paras 6.59 – 6.60 (footnotes omitted).

[128] *Ibid*, para. 6.47. That panel noted that the preamble to the *WTO Agreement* recognises "that there is need for positive efforts designed to ensure that developing countries, and especially the least-developed among them, secure a share in the growth in international trade commensurate with the needs of their economic development." That panel also noted that "[t]his overarching concern of the *WTO Agreement* finds ample reflection in the *SCM Agreement*. Article 27 of that Agreement recognizes that 'subsidies may play an important role in economic development programmes of developing country Members' and provides substantial special and differential treatment for developing countries, including in respect of export subsidies" (*ibid*, note 49).

(ii) If an a contrario interpretation of item (j) were permissible, what conditions would need to be fulfilled?

7.208 Assuming *arguendo* that item (j) could operate as an affirmative defence (with which, as noted, we disagree), it would need to be demonstrated that the APRG programme constitutes an export credit guarantee or insurance programme, or an insurance or guarantee programme against increases in the cost of exported products or of exchange risk, that operates at premium rates which are adequate to cover the long-term operating costs and losses of that programme.

(iii) Are the relevant conditions for the application of item (j) as an affirmative defence fulfilled?

7.209 As the party seeking to rely on item (j) as an affirmative defence, the burden of proof is on Korea to establish that the relevant conditions have been fulfilled. Korea submits that KEXIM APRGs are export credit guarantees or, at least, guarantees against increases in the costs of exported products. Korea further submits that the APRG programme covers its long-term operating costs, as evidenced by the profitability of that programme from 1997 to 2002.

7.210 The EC contests Korea's assertion that APRGs are export credit guarantees, or guarantees against increases in the cost of exported products. The EC asserts that export credit guarantees are provided to banks or exporters in respect of credits they have provided to foreign customers, whereas APRGs involve guarantees provided to the foreign customers in respect of payments they have made to shipbuilders. The EC also asserts that APRGs guard against the overall expenses of the exporter or credit risks taken by the purchaser, not against increases in the cost of the exported product. The EC argues that Korea's broad interpretation would allow any subsidy to an exporter or to exported products that is formulated as a "guarantee programme" to be covered by item (j) since any such subsidy would tend to reduce the cost of manufacturing the exported goods for the exporter or of buying the exported goods for the purchaser.

7.211 The EC further asserts that, in making APRGs and preshipment loans, KEXIM assumes a risk that relates to the creditworthiness of the domestic exporters. The EC submits that the export credit financing referred to in item (j) concerns foreign risk. According to the EC, the underlying rationale of these provisions is that domestic banks typically do not have the means of assessing overseas risks of a potential buyer of an export product (or of recovering money abroad).

7.212 The EC does not challenge Korea's assertion regarding the long-term profitability of the APRG programme.

Do APRGs constitute export credit guarantees?

7.213 From a purely textual perspective, based entirely on the plain meaning of the words, we consider that an instrument may only be designated as an "export credit guarantee" if it guarantees an export credit. An instrument will guarantee an export credit if it covers default by a borrower in respect of an export credit provided to that borrower.

7.214 Korea has not explicitly argued that APRGs guarantee export credits. Rather, Korea has sought to establish a link between the APRGs and export credits by arguing that "APRGs are issued to protect the shipowner against a contractual default by the shipbuilder. It is not disputed that Korean exporters who export capital goods which qualify for loans under KEXIM policies on export loans are also eligible for APRGs. There is, therefore, a close connection between the export loan / credit financing and the APRGs even though there is no complete concurrence."[129] Thus, although Korea does not argue that APRGs guarantee export credits (Korea asserts, instead, that APRGs guarantee against contractual default by the shipbuilder), it argues that there is a sufficiently close connection

[129] Korea's first written submission, para. 263.

between credits to exporters[130] and APRGs for the latter to be treated as export credit guarantees. We note, however, that there is no direct connection between APRGs and loans to exporters, since there may well be cases in which APRGs are issued but no KEXIM loans (or, in theory at least, any loans at all) are provided to the exporters.

7.215 In reply to Question 59 from the Panel, Korea stated that "[t]he fact that APRGs may be granted when export credits in the narrow sense are not does not prevent APRGs from being qualified as export credit guarantees because it still is a guarantee accessory to an export transaction similar to a loan guarantee which covers a default by the borrower." If we understand Korea correctly, it is seeking to demonstrate a closer link between APRGs and loans to exporters by treating advance payments by the buyers as loans to exporters, and the APRGs as guarantees of those loans. We are unable to accept this argument. First, we see no basis for treating the advance payment as a loan to the shipbuilder. Receiving and making pre-payment is not the same as accepting and offering a loan. A loan is to be repaid, whereas a pre-payment is a payment for a good or service to be provided. Indeed, the fact that Korea merely argues that the APRG is "similar to" a loan guarantee suggests that Korea itself is not of the view that the advance payment constitutes a loan.[131] Second, even if the advance payment were treated as a loan, the mere fact that a guarantee is issued in respect of a loan in the context of (or "accessory to") an export transaction does not necessarily make that guarantee an export credit guarantee. An instrument will only constitute an export credit guarantee if it guarantees an "export credit". Korea has neither argued nor demonstrated that advance payments guaranteed by APRGs constitute "export credits".[132]

7.216 Korea submits that other Members' export credit agencies also provide APRGs. We understand Korea to argue that, because APRGs are offered by other Members' export credit agencies, they should be treated as export credit guarantees. Korea also asserts at note 34 to its replies to questions from the Panel after the second meeting that "if the EC's narrow and simplistic construct is correct, then a number of EC Member States are *prima facie* in violation of Part II of the *SCM Agreement* as their programs would be outside of the parameters of the *OECD Arrangement* and not protected by any safe harbors." The conformity of the practices of other Members with Part II of the *SCM Agreement* is not an issue in these proceedings. In resolving the present dispute, therefore, we take no account of the practices of other Members, nor of the potential implications of our findings for the practices of such Members.

7.217 For the above reasons, we find that KEXIM APRGs do not constitute export credit guarantees within the meaning of item (j) of the *Illustrative List*.

Do APRGs constitute guarantees against increases in the cost of the exported product?

7.218 Regarding the issue of guarantee against increases in cost, Korea asserts (response to Question 60 from the Panel) that an APRG guarantees against an increase in the cost associated with the working capital necessary to produce the ship, because the fact that the shipowner makes an advance payment (guaranteed by the APRG) reduces the amount of money that the shipyard needs to borrow to finance the cost of producing the vessel (i.e., the pre-payment serves as interest-free working capital).

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[130] For present purposes, we do not consider it necessary to determine whether or not a loan to an exporter constitutes an export credit.

[131] As noted below, Korea actually treats the advance payment covered by the APRG as interest-free working capital for the shipyard, and therefore not as a loan.

[132] Korea makes an argument at para. 262 of its first written submission that only applies "[i]f a credit to the shipyard qualifies as an export credit". We do not treat this hypothetical assertion as an argument that advance payments do constitute export credits. In any event, even if this could be interpreted as an argument by Korea that advance payments constitute "export credits", we find below that loans to exporters do not constitute export credits. Thus, even if advance payments could be treated as loans to exporters, they would not be "export credits".

7.219 The EC submits that item (j) does not apply to guarantees against increases in exporters' costs generally, but only to guarantees against increases in "the cost of exported products".

7.220 We note that item (j) applies to guarantee programmes against increases in the cost of "exported products". The fact that a shipyard has access to interest-free working capital (in the amount of the advance payments guaranteed by APRGs) has no bearing on whether or not the (total) cost of the vessel will increase. It provides neither a guarantee for the shipbuilder that the cost of production of the vessel will not increase, nor a guarantee to the buyer that the price of the vessel will not increase.[133] Irrespective of the pre-payment, the cost of the vessel could still increase. APRGs provide no guarantee that other costs, and therefore the (total) cost of the exported product, will not increase. Accordingly, there is no basis for us to find that APRGs constitute "guarantee programmes against increases in the cost of exported products" within the meaning of item (j) of the *Illustrative List*.

7.221 Although the above findings indicate that item (j) could not operate as an affirmative defence in the present case, for the sake of completeness we shall address the issue of the adequacy of APRG premium rates. In this regard, we note that the EC has not disputed Korea's assertion that the APRG premia are adequate to cover the long-term operating costs and losses of the programme. We therefore consider that Korea has established prima facie that this condition is fulfilled.

7.222 In light of our findings that item (j) may not be interpreted *a contrario,* and that APRGs are neither export credit guarantees nor guarantees against increases in the cost of exported products, we find that Korea has failed to demonstrate that item (j) is applicable as an affirmative defence for those individual APRGs found to be in violation of Article 3.1(a) of the *SCM* Agreement.[134]

(f) Conclusion

7.223 To conclude on the individual APRG transactions challenged by the EC, we find that the following KEXIM APRGS constitute prohibited export subsidies contrary to Articles 3.1(a) and 3.2 of the *SCM Agreement*:

[BCI: Omitted from public version.]

5. Individual PSL transactions

7.224 The EC claims that a number of individual KEXIM PSLs constitute prohibited export subsidies, contrary to Articles 3.1(a) and 3.2 of the *SCM Agreement*. The EC's claim is based on a comparison of the terms of individual PSLs with a market benchmark constructed primarily on the basis of an index of corporate bond prices.

7.225 Korea has made a number of arguments concerning the EC's proposed market benchmark. Korea has also proposed alternative market benchmarks of its own. In particular, Korea submits that the terms of KEXIM PSLs should be compared with the terms of other financing instruments used by the relevant shipyards, including corporate bonds issued by those shipyards. In the alternative, Korea submits that the individual PSL transactions benefit from a safe haven provided for in the first paragraph of item (k) of the *Illustrative List*. We shall examine the parties' arguments regarding the alternative market benchmarks proposed by Korea before addressing issues concerning the market benchmark proposed by the EC. Only then will we examine the individual transactions identified by

[133] The parties have made a number of arguments as to whether "the cost of the exported products" refers to cost of production or price. We do not consider it necessary to resolve this issue in order to decide whether APRGs constitute guarantees against increases in the cost of exported products.

[134] In light of this finding, it is not necessary for us to consider the EC's argument that any safe haven under item (j) of the *Illustrative List* could only operate as a defence for the APRG programme *per se*, but not the individual APRG transactions under that programme (see EC reply to Question 169 from the Panel).

the EC in its claim. In the event that we uphold any of the EC's claims against individual transactions, we shall then consider Korea's reliance on the first paragraph of item (k) of the *Illustrative List*.

(a) Alternative benchmarks proposed by Korea

(i) Corporate bonds issued by shipyards

7.226 Korea notes that the EC has proposed a market benchmark constructed on the basis of an index of corporate bond rates. Korea submits that, if a market benchmark is to be based on corporate bonds, it should at least be based on corporate bonds issued by the individual shipyards at issue. Accordingly, Korea has submitted data concerning corporate bonds issued by DHI/DSME, Samho, STX/Daedong, Hyundai Mipo and HHI.

7.227 The EC asserts that the bonds actually issued by the shipyards are not appropriate market benchmarks. The EC submits that many of the bonds issued were guaranteed, and that Korea failed to submit details regarding the terms of the guarantees. The EC also complains that Korea often failed to report the identity of the guarantor.[135]

7.228 In determining whether or not it is appropriate to use the corporate bond data submitted by Korea as a market benchmark, we shall examine the evidence provided by Korea for each shipyard separately.

DHI/DSME

7.229 In response to Question 17 from the EC, Korea provided a table containing information in respect of six corporate bonds issued by DHI/DSME in 1997 and 1998.[136] The table reports "N/A" in the "collateral / guarantee" column. It is unclear whether Korea intended to report "not applicable" or "not available". The EC argues that at least three of those bonds were guaranteed.[137] Although Korea has not disputed this, it has not provided information regarding the terms on which such guarantees were offered. Without this information, we are unable to use the bond data provided by Korea as a market benchmark. In particular, there is no means for us to ensure that the Korean corporate bond data and the PSL rates are directly comparable. Nor is there any means for us to make adjustments for any differences in guarantee / collateralization that may exist. In addition, information submitted by the EC also indicates that the guarantor for at least one of those bonds was KDB, which we have already found to be a public body.[138] This confirms our decision not to establish a market benchmark on the basis of this data, since there is a risk that corporate bonds guaranteed by public bodies are not a reliable indicator of market rates.

7.230 Korea also submitted corporate bond data for 1999 and 2000.[139] The data comprise quarterly balances, with average interest rates. The parties disagree as to whether or not such information constitutes a proper basis for a market benchmark.[140] We consider that we do not need to address this

[135] The EC also argued that Korea failed to provide information regarding yield rates in respect of bonds issued below par value. However, some such information was ultimately provided by Korea (see, for example, Exhibit KOREA – 68). The EC also argued that, because the data submitted by Korea reflects a quarterly summary of outstanding borrowings, they do not reflect interest rates at any given date, and may reflect bonds issued months or years before the quarter in which they were reported. In view of our decision to reject the data for other reasons, we do not consider it necessary to address this argument.

[136] See Exhibit KOREA-68.

[137] See Exhibit EC-129.

[138] See para. 7.172 *supra*.

[139] See Exhibit KOREA – 18.

[140] The EC also claims that such bonds were affected by the restructuring, and also for that reason should not be used as a market benchmark (para. 132, EC second written submission). Korea has not disputed this argument.

issue, however, as Korea has in any event failed to report details of any collateral or guarantees provided in respect of these bonds, even though Exhibit EC – 129 demonstrates that many DHI/DSME bonds were issued against guarantees. Again, the absence of such information precludes us from using such data as a market benchmark.

7.231 In light of the above, we are unable to use the data submitted by Korea in respect of corporate bonds issued by DHI/DSME as a reliable market benchmark.

Samho

7.232 Korea provided information regarding corporate bonds issued by Samho at para. 233 of its first written submission, and in response to question 17 from the EC.

7.233 The EC claims that the bonds cannot be used as a reliable market benchmark because they were guaranteed by **[BCI: Omitted from public version]**, thus reflecting the credit rating of **[BCI: Omitted from public version]** rather than Samho.

7.234 Korea has not rebutted the EC's argument regarding the **[BCI: Omitted from public version]** guarantee, nor has it provided any information regarding the terms of that guarantee. We are therefore unable to determine what the rate for the bonds would have been without the guarantee. Furthermore, Korea has reported two-year bond data, which cannot be readily compared with six-month PSL rates. In these circumstances, we are unable to use the Samho corporate bond data submitted by Korea as a basis for establishing a market benchmark against which to judge the KEXIM PSLs.

STX/Daedong

7.235 Korea provided information regarding corporate bonds issued by STX/Daedong at para. 236 of its first written submission, and in response to question 17 from the EC. Korea asserts that the STX/Daedong bonds constitute particularly appropriate market benchmarks, since they were collateralized, and could therefore be readily compared with the collateralized PSLs.

7.236 The EC notes that, according to the information provided by Korea, the STX/Daedong bonds were issued in Japanese yen. The EC submits that it is improper to compare the corporate bond interest rates quoted in Japanese yen with the PSL rates quoted in Korean won, as interest rates may differ greatly based on the underlying currency. The EC also asserts that the collateral backing the STX/Daedong bonds was the factory as a whole, whereas the factory was not used as collateral for PSLs.

7.237 We note that Korea has not rebutted the EC's arguments against the use of the STX/Daedong bond data as a market benchmark. We agree with the EC that yen rates for corporate bonds cannot be compared directly with won rates for PSLs. Furthermore, in the absence of additional information from Korea regarding the value of the collateral underlying the STX/Daedong bonds (i.e., factory) and PSLs (i.e., Yangdo Dambo) respectively, we are unable to ensure that any comparison of the corporate bond and PSL rates is not affected by differences in the value of the relevant collateral. In addition, we note that Korea has reported three-year bond data, which cannot be readily compared with six-month PSL rates. For these reasons, we are unable to use the STX/Daedong corporate bond data submitted by Korea as a basis for establishing a market benchmark against which to judge the STX/Daedong PSLs.

Hyundai / Mipo

7.238 Korea provided information regarding corporate bonds issued by Hyundai Mipo at para. 238 of its first written submission.

7.239 The EC submits that Korea's data should not be used as a market benchmark because Korea failed to provide any supporting evidence in the form of exhibits, or otherwise. The EC also argues that, even if the Panel considers Korea's proposed benchmark as relevant, the corporate bond rates proposed by Korea are generally higher than the rates of the KEXIM pre-shipment loans to Hyundai-MIPO.

7.240 First, we note that Korea failed to provide any detailed information regarding the Mipo bond rates. For example, it failed to provide any of the more detailed information (concerning quarterly average rates) that it had provided for other shipyards in the form of Exhibits KOREA 18 – 21. In addition, we note that Korea failed to inform the Panel whether any of the Mipo bonds were guaranteed or collateralized. For these reasons, we do not consider it appropriate to establish a market benchmark on the basis of the corporate bond information submitted by Korea.

HHI

7.241 Korea provided information regarding corporate bonds issued by HHI at para. 240 of its first written submission.

7.242 The EC asserts that the HHI PSL rates are lower than the HHI corporate bond rates submitted by Korea.

7.243 We note that Korea has reported three-year bond data, which it would be inappropriate to compare with six-month PSL rates (without further adjustment). For this reason, we are unable to establish a market benchmark on the basis of the HHI corporate bond data submitted by Korea.

Conclusion

7.244 For the above reasons, we are unable to establish a market benchmark on the basis of the data submitted by Korea regarding corporate bonds issued by the shipyards at issue.

(ii) Other benchmarks proposed by Korea

7.245 Korea submits that individual PSL transactions can be reviewed in light of usance letters of credit, overdraft loans, corporate bonds, commercial papers, facility loans and short-term borrowings taken / issued by the individual shipyards at issue.

7.246 The EC asserts that the other sources of financing mentioned by Korea should not be used as a market benchmark, as the EC is unaware of the conditions and collateral with which such financing was provided.

7.247 In our view, Korea has failed to provide enough information for us to use the abovementioned alternative instruments as a reliable market benchmark. With the exception of facility loans, the only information submitted by Korea regarding collateral requirements is that it "depend[s] on the financial strength of the borrower".[141] For facility loans, Korea reports a need for collateral in the form of "real properties, factory as a whole",[142] but provides no indication of the impact of such collateral on the facility loan spreads. Thus, there is not enough information for us to be sure that facility loans and KEXIM PSLs are comparable on the basis of collateralization (nor is there sufficient information for us to make any adjustments that might be required). The information provided in respect of the terms / maturity of these various instruments is similarly insufficient. The only concrete term information relates to usance letters of credit.[143] For the other instruments, Korea merely reports what terms

[141] See para. 226 of Korea's first written submission.
[142] See Korea's First Written Submission, para. 226.
[143] *Ibid.*

"normally" or approximately ("about") are applicable.[144] There is therefore no means for us to ensure that these other instruments and KEXIM PSLs are directly comparable in terms of maturity (nor is there sufficient information for us to make any adjustments that may be required). In addition, because Korea has not reported the identity of the providers of the abovementioned instruments, we are unable to establish whether or not they represent market (as opposed to public body) rates. Furthermore, we note that Korea has reported data in respect of usance letters of credit issued in US dollars for Hanjin.[145] We do not consider it appropriate to compare the terms of instruments issued in different currencies.

(iii) Conclusion

7.248 For the above reasons, we are unable to establish a market benchmark on the basis of the abovementioned alternative instruments.

(b) The EC's proposed market benchmark

7.249 The EC's claim is based on a comparison of the terms of individual PSLs with a market benchmark constructed primarily on the basis of an index of corporate bond prices.[146] For shipyards with a credit rating agency rating of BBB or higher (i.e., investment grade), the EC generally compares the actual KEXIM PSL rates with a market benchmark constructed on the basis of the Korea Stock Dealers Association ("KSDA") general index of six-month corporate bond prices, with certain adjustments for differences in maturity and collateral. For each investment grade shipyard, the EC identifies a credit rating agency rating, and applies KSDA index prices for corporate bonds with the same rating. For non-investment grade shipyards, having agency ratings lower than BBB, the EC compares the actual PSL rates with rates constructed on the basis of KEXIM's own Interest Rate Guidelines (generally using the KEXIM spreads for the relevant KEXIM rating), again with certain adjustments for differences in maturity and collateral.

7.250 Korea objects to the market benchmark proposed by the EC. Korea's objections concern alleged differences in the rating practices of KEXIM / private banks and corporate bond credit rating agencies, the use of indexed bond pricing, the choice of maturity of the KSDA index data, risk management under the PSL disbursement process, and the admissibility of certain EC arguments / data.

(i) Alleged differences in rating practices

7.251 Korea submits that the EC's methodology for investment grade transactions is flawed, as the credit rating assigned by KEXIM to a particular shipbuilder cannot be systematically matched to the credit ratings assigned to the same shipbuilder by corporate bond rating agencies. Korea asserts that corporate bond ratings and KEXIM's credit ratings are based on different levels of underlying credit risk.[147] In particular, Korea argues that the basic credit rating for an unsecured bond is the same as the credit rating for the issuing company, whereas the credit rating by KEXIM is based on a "facility rating", which includes not only the credit risk of the borrowing company, but also risk-reducing factors reflecting the structure of the facility concerned, including collateral. As a result of facility rating, Korea argues that the default rate for a bank credit rating (such as KEXIM's PSLs) is lower than that for the corresponding corporate bond rating. According to Korea, for the same corporate entity, the corporate bond rating must be higher than the bank credit rating in order to have equivalent risk. Korea submits that banks analyse three elements when assigning credit ratings: the probability of default, loss given (i.e., in the event of) default, and expected loss. Korea states, on the basis of a

[144] *Ibid*.
[145] See Exhibit KOREA-21.
[146] The latest version of the EC's analysis is set forth in Attachment EC-10.
[147] See Exhibit KOREA – 91.

KEXIM document,[148] that loss given default "is the critical element that distinguishes corporate bonds from bank loans, since corporate bond rating in Korea, which is generally targeting for unsecured senior bonds with long-term maturity, does not take into account [loss given default]". Korea asserts that there is therefore a significant difference in expected loss between bank loan rating and corporate bond rating, with the result that yields on corporate bonds should be higher than those of bank loans for the same entity.

7.252 Korea also argues that there is a fundamental difference between the rating practices of banks and those of credit rating agencies. Korea submits that banks generally employ a "point in time" approach, under which the time period for validity of a risk assessment is generally one year from the date of assessment. Korea states that private banks therefore analyse the risk in the "current situation". Korea asserts that credit rating agencies, on the other hand, rate corporate bonds on a "through the cycle" approach, covering the whole period of maturity, and taking into account the projected condition of the bond issuer in the projected worse part of the economic or industry cycle within that period. Korea therefore submits that the rating by credit ratings would be worse than that of banks.

7.253 The EC submits that the credit ratings by corporate bond credit rating agencies are comparable to credit ratings by KEXIM. With regard to DSME, the EC notes that most of the DSME bonds issued between 1997 and 1999 were guaranteed / collateralized. The EC argues that the rating of the bonds reflected the guarantee, just as KEXIM's ratings reflected the collateral for the PSL.

7.254 The EC also asserts that credit exposure from investment grade and BB rated private placement loans are comparable to credit exposure from public debt with the same rating. The EC argues that, in case of discrepancy, the more pessimistic rating is usually the one with the most predictive power. The EC argues that there should at least be correlation between corporate bond ratings and KEXIM ratings for ratings better than or equal to BB. The EC asserts that a credit rating assesses exposure risk in terms of the repayment capacity of the obligor, taking into account all possible collateral. The EC therefore submits that a private loan (such as a PSL) and a bond having the same ratings will present the same obligor repayment capacity and the same credit exposure risk, and should therefore be remunerated with the same interest rate.

7.255 Regarding rating practices, the EC asserts that Standard & Poor's definition of a rating does not refer to worst-case scenario projections. Instead, it refers to the creditworthiness of the obligor and guarantees. In addition, the EC states that KEXIM's rating must analyse more than the "current situation", otherwise it would not have continued issuing PSLs for DSME when it was bankrupt.

7.256 Regarding the relevance of guarantees in determining credit risk exposure, Korea states that most of the bonds issued in Korea are non-collateralized, and that the KSDA bond rates quoted by the EC are also non-collateralized. Korea also notes that the EC stated that the DSME corporate bonds were collateralized, just like the KEXIM PSLs, and queries why the DSME corporate bonds could not have been used as a benchmark.

7.257 With regard to the EC's argument that the credit exposure from investment grade and BB-rated private loans and public debt is comparable, Korea notes that the source relied on by the EC actually refers to the "worse incidence or default rates" for public placements, and "better loss severities on private placements". Korea also notes that the source further provides that private placement "offer superior experience with respect to all of incidence, severity and economic loss" than publicly issued bonds. Korea asserts that the EC's source therefore confirms Korea's position regarding the lower risk exposure of private placements *vis-à-vis* public placements with the same credit rating.

[148] Incompatibility of Bank Rating Systems and Agency Rating systems, KEXIM, July 2004, page 3 Exhibit KOREA-143.

7.258 In reviewing Korea's argument, we are struck by KEXIM's statement that loss given default "is the critical element that distinguishes corporate bonds from bank loans, since corporate bond rating in Korea, which is generally targeting for **unsecured senior bonds with long-term maturity**, does not take into account [loss given default]".[149] KEXIM states that loss given default depends in part on the conditions of the facility and protection measures, including "**collateral**, collateral margin requirements, ... and other support measures including **guarantees and insurances**".[150]

7.259 We also note Korea's reliance on a Moody's document which states:

> Moody's typically rates bank loans anywhere from on a par with a given borrower's senior implied rating to three refined categories above senior implied. The rating differential between a firm's bank loans and other debt obligations is not a reflection of a greater or lesser probability of default. Rather it is a consideration of higher expected recovery values for bank loans over the same borrower's bonds **as a result of loan structure and security**."[151]

7.260 To the extent that there are discrepancies between the rating practices of private banks and credit rating agencies, the above extracts from the KEXIM and Moody's documentation submitted by Korea indicates that such discrepancies are largely caused by differences in collateral / guarantee (in the sense that bank loans such as KEXIM PSLs are normally guaranteed / collateralized, whereas corporate bonds are not) and maturity (in the sense that corporate bonds generally have a longer maturity than private bank loans such as KEXIM PSLs).[152][153] We shall therefore examine to what extent differences in collateralization and maturity are addressed in the EC's proposed market benchmark.

7.261 Although the KSDA bond index is based on unsecured bonds, whereas KEXIM PSLs are collateralized, the EC's proposed market benchmark includes the same adjustment for collateral / guarantees as made by KEXIM in respect of PSLs (i.e., **[BCI: Omitted from public version]** per cent reduction in credit risk spread).[154] For the most part, therefore, we consider that any rating

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[149] Incompatibility of Bank Rating Systems and Agency Rating systems, KEXIM, July 2004, page 3, Exhibit KOREA-143, emphasis supplied.

[150] *Ibid*, page 3, emphasis supplied

[151] A Sense of Security, Moody's Investors Service, October 1997, Exhibit KOREA– 143, emphasis supplied.

[152] Our understanding that Korea's concern essentially relates to issues of collateral and maturity is confirmed by para. 236 of Korea's first written submission, where Korea stated that corporate bonds and PSLs are not directly comparable "due to, particularly, the difference in collaterals and maturity". Although this statement was made early in the Panel proceedings, it was never retracted by Korea, and should therefore inform Korea's subsequent arguments.

[153] The fact that the EC's proposed market benchmark may require adjustments for differences in collateral and maturity does not render that benchmark *ipso facto* unusable. Indeed, even the alternative benchmarks proposed by Korea would have required similar adjustments. As stated at para. 230 of Korea's first written submission, DSME "has used various types of financing and due to the difference in terms, direct comparison between the pre-shipment loan interest rate and the interest rates of other financing facilities is difficult." Of course, the fact that a comparison is difficult does not mean that it should not be made.

[154] During the Panel proceedings, Korea contested the manner in which the EC had adjusted the KSDA interest rate data to reflect the value of Yangdo Dambo provided as collateral for KEXIM PSLs (see Exhibit KOREA – 90, paras 6-9). The EC claimed to address Korea's concern in the recalculations set forth in Attachment EC 10 (see paras 40 and 41 of the EC's replies to the Panel's questions after the second substantive meeting.) Since there was no further reference to the EC's treatment of this adjustment in Korea's comments on Attachment EC- 10 (see page 20 of Korea's 9 July 2004 replies to the Panel's supplemental questions), we consider that there is no longer any dispute between the parties concerning this issue. Korea also complained that the EC failed to take account of the collateral value of joint and several personal liability guarantees. Since Korea stated in Exhibit KOREA – 90 that **[BCI: Omitted from public version]**, we see no reason why the EC

discrepancy caused by differences in collateralization between corporate bonds and KEXIM PSLs is appropriately addressed.

7.262 Regarding maturity, we note that the EC has incorporated six-month bond pricing data into its proposed benchmark. Since Korea claims that "the maturity of PSLs in general is not less than 6 months",[155] the alleged discrepancies in rating practices caused by differences in maturity should not arise when comparing the terms of those KEXIM PSLs with the KSDA bond index rates.

7.263 In any event, we note Moody's statement that bank loans may sometimes be rated on a par with other debt obligations.[156] This would suggest that, in certain cases, credit ratings for bank loans and other debt obligations can be compared directly, without any need for collateral or maturity adjustments. Given that adjustments may not be necessary in all cases, and given the approach to collateralization and maturity taken in the EC's proposed market benchmark, we consider that any discrepancies in the rating practices of credit rating agencies and private banks are adequately addressed in the EC's proposed market benchmark.

7.264 Korea has also argued that there is a fundamental difference between the rating practices of banks and those of credit rating agencies. Korea submits that banks generally employ a "point in time" approach, whereas credit rating agencies use a "through the cycle" / worst case scenario approach. Korea has submitted an extract from the abovementioned Moody's article, which compares point-in-time to through-the-cycle gradings. Although Korea relies on this article to argue that there is a fundamental difference between the rating practices of banks and credit rating agencies, we note that the article also states that "[a]gencies and banks both consider similar risk factors".[157] In addition, we note that the Standard & Poor's rating definition submitted by the EC contains no reference to either "through the cycle" or worst case scenario rating methodologies. Instead, that definition states that a rating "is a **current opinion** of the creditworthiness of an obligor".[158] We consider this to be consistent with KEXIM's point-in-time approach, which (according to Korea) "mainly focus[es] on the '**current condition**' of the borrower".[159] On the basis of the evidence before us, therefore, we are not persuaded by Korea's argument that there are fundamental differences between the rating practices of banks and those of credit rating agencies.

7.265 Furthermore, we note that KEXIM introduced its credit rating system in April 2001.[160] Between March 1998 and April 2001, KEXIM applied the ratings of credit rating agencies. This causes us to make two observations. First, many of the individual PSLs challenged by the EC were provided under KEXIM's pre-April 2001 corporate bond rating regime. Thus, the abovementioned issues raised by Korea do not apply in respect of those transactions. Second, the fact that KEXIM itself was using agency ratings up until April 2001 suggests to us that the rating practices of rating agencies and private banks are not incompatible (especially when adjustments are made for any differences in collateralization and maturity).

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should not do likewise in constructing its market benchmark. In any event, since Korea has failed to quantify the alleged value of such collateral, there is no basis for us to make any adjustment.

[155] See Korea's reply to Question 12 from the EC. The table included in para. 226 of Korea's first written submission states that the tem of PSLs is "about 6 months (average)".

[156] See para. 7.259 *supra*.

[157] A Sense of Security, Moody's Investors Service, October 1997, Exhibit KOREA– 143, page 911.

[158] *Ibid*, page 13, emphasis supplied.

[159] Incompatibility of Bank Rating Systems and Agency Rating systems, KEXIM, July 2004, Exhibit KOREA-143, page 5, emphasis supplied.

[160] See Attachment 6 to Korea's first written submission. Although this attachment refers to credit ratings in respect of APRGs, Korea argues that the same applies to PSLs (see para. 196 of Korea's first written submission).

7.266 For the above reasons, we do not accept Korea's arguments that alleged fundamental differences between the rating practices of banks and those of credit rating agencies preclude the use of the market benchmark proposed by the EC.

(ii) The use of indexed bond pricing

7.267 In its response to Question 73 from the Panel, Korea submits that the KSDA corporate bond data submitted by the EC does not constitute an appropriate market benchmark because it is a hypothetical index of bond prices. According to Korea, the corporate bond rates offered by the EC are the rates which the KSDA announces for the purposes of general indices. Korea asserts that, in order for KSDA to post corporate bond yield rates daily, the securities dealers of 10 securities houses designated by KSDA provide KSDA with the daily yield rates that are not based on the statistics of actual yield rates, but based on their own projections taking into account the market situations on that date. Korea asserts that KSDA simply averages those projected rates and posts it, so that the KSDA rates must also be projected / hypothetical ones. Korea also submits that the KSDA rates are general indices that do not reflect differences between industry sectors, nor the different financial strengths of individual issuers (e.g., whether the company is an affiliate of a Chaebol) of the actual corporate bonds being traded in the market. Korea asserts that, when looking at the individual companies even having the same credit ratings, the companies may be perceived and treated differently in the market considering various factors. According to Korea, therefore, the actual yield rates of the corporate bonds of the issuers with the same credit rating may be substantially different. Korea submits that there must therefore be differences or gaps between the KSDA rates and the actual corporate bond rates of individual companies. According to Korea, therefore, the KSDA Bond Matrix is only an index which indicates the market situations on a specific date. Korea submits that it does not reflect specific situations of the industry sector, the issuers, and the preferences in the market, and can in no event be a "price" at which a specific bond can be purchased.

7.268 The EC submits that the KSDA Bond Matrix is not a hypothetical or projected rated, but a reliable market benchmark to assess interest rates for loans. The EC asserts that, based on the definition provided by Bloomberg on KSDA Corporate Bond, "KSDA collects daily pricing for each sector from 10 major investment banks for tenors ranging from three months to five years. The indices are calculated daily and re-balanced weekly. All such changes are updated weekly in the Index Constituents so you can see the new underlying securities for each sector. Credit rating changes are updated monthly by the KSDA. […] The KSDA Bond Matrix is the accepted mark-to-market price for the domestic market".[161] The EC submits that, in short, the KSDA bond matrix is the accepted mark to market price, i.e. that it reflects the current market price of bonds, since bond prices and yields are updated daily based on data collected from a wide number of representative local securities houses.

7.269 We are required to establish a market benchmark in order to resolve the claims before us. We recall that Korea has failed to provide sufficient information to allow us to use any of the alternative market benchmarks that it has proposed. In these circumstances, and given the absence of any acceptable benchmark based on shipyard-specific data, we are prepared to use the KSDA index data, provided it does not give rise to manifestly inaccurate results. In this regard, we note that the KSDA index is based on input from a number of market operators, and is updated on a daily basis. We further note that Korea itself has acknowledged that the KSDA index "may be a preliminary indicator that an investor may use as a first reference before studying the market further".[162] As such, we do not consider that the use of the KSDA index would give rise to manifestly inaccurate results. Furthermore, since appropriate adjustments are made for factors such as collateralization, we consider that the KSDA index necessarily constitutes more than merely a "preliminary indicator", and becomes a reliable indicator of the terms on which the market would have offered PSLs to the shipyards.

[161] See Exhibit EC – 118, page 9.
[162] Korea's 9 July 2004 comment on Exhibit EC-148 regarding KSDA Bond Matrix, see Annex G-5.

(iii) The choice of maturity of the KSDA index data

7.270 Initially, the EC constructed its market benchmark on the basis of three-year KSDA corporate bond data. In response to arguments by Korea that PSLs had a maturity of six months, the EC then used one-year KSDA index data, adjusted to six-month levels. In response to additional comments by Korea, the EC constructed its proposed market benchmark primarily on the basis of six-month KSDA index data.[163] In Attachment EC – 10, however, the EC stated that it had continued to use one-year KSDA index data in cases "when the base rate applied by Kexim is superior to 6 months"[164] i.e., in cases where KEXIM had used one year, or one year six months, prime rates.

7.271 In its comments on Attachment EC – 10, Korea complained that:

> the EC now abruptly starts to allege that a benchmark with a 1-year duration should be used in certain cases. In support, the EC alleges that the base rates for certain instances of PSLs are **[BCI: Omitted from public version].** This is non-sensical. As has been established and thus far alleged by the EC itself, a proper benchmark must be a facility conferred with similar terms and conditions. The term must be assessed based on its duration, not the name of base rates.[165]

7.272 In the absence of any explanation by Korea why KEXIM chose to use one-year (or longer) base rates for certain PSLs, but six-month base rates for others, we consider it appropriate to construct a market benchmark using six-month KSDA data when reviewing PSLs issued on the basis of six-month base rates, and using one-year KSDA data when reviewing PSLs issued on the basis of one-year (or more) base rates. In this way, the data underlying the market benchmark is aligned with the data underlying the KEXIM PSLs. Furthermore, we note that, even though the EC adopted the same approach in respect of its earlier proposed market benchmark based on one-year KSDA data,[166] Korea did not object to this approach at that earlier stage of the Panel proceedings.[167] Korea's objection therefore lacks conviction. For all these reasons, we consider that the EC was entitled to use one-year KSDA index data in cases where the KEXIM base rate exceeded six months.

(iv) Risk management under the PSL disbursement process

7.273 Korea submits that KEXIM enjoys greater scope for risk management than corporate bond-holders. In particular, Korea asserts that, because PSLs are disbursed in instalments corresponding to the progress of the shipbuilding work, KEXIM is able to continuously monitor and review the development of any management and financial conditions of shipyards. Korea asserts that KEXIM is also able to immediately stop disbursing additional instalments, and take actions to promptly recover outstanding loans by disposing of collaterals or otherwise.

7.274 The EC concedes that Korea's risk management argument is to a certain extent valid but only if Kexim effectively adjusts the credit spread following the downgrading of a shipyard's financial situation. The EC submits that this is not the case, as evidenced by KEXIM's failure to adjust its credit risk spreads despite changes in certain shipyard credit ratings. The EC further asserts that even if KEXIM were really monitoring and managing this situation, the impact on the credit spread at issuance of the credit would be very limited.

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[163] Korea made a number of arguments concerning the EC's earlier reliance on data pertaining to corporate bonds with a maturity in excess of six months. Since the EC ultimately used a benchmark constructed primarily on six-month data, we do not consider it necessary to review all of these arguments in our findings.

[164] Attachment EC – 10, page 1.

[165] Korea's 9 July comment on Attachment EC-10, see Annex G-5.

[166] See Exhibit EC – 125, column (8), "AD duration".

[167] In particular, there is no reference to this issue in Exhibits KOREA 90 – 102.

7.275 Regarding the possible cessation of disbursements, the EC asserts that Korea has presented no evidence that KEXIM ever stopped disbursing additional instalments when the credit situations degraded. The EC also submits that because KEXIM's credit spreads already took into account the existence of collaterals by adjusting downward the (no collateral) credit spread, there is no reason why the above disbursement mechanism for PSLs should further mitigate KEXIM's risk. The EC also asserts that Korea's argument is flawed since, in the case of Yangdo Dambo, the collateral is supposed to increase in value as the total amount disbursed increases. However, the EC states that stopping disbursements will not increase the value of what will be recovered. The EC argues that the opposite will occur, as the ship will not be finished and will be more difficult to sell.

7.276 We consider that the EC has effectively rebutted Korea's argument that KEXIM has a greater capacity for risk management under the PSL disbursement process. Furthermore, we note Korea's failure to quantify the impact of KEXIM's allegedly greater capacity for risk management. We consider this to be especially important given the EC's assertion that any impact on the credit spread upon issuance of the credit would be very limited.[168] In the absence of any quantification by Korea, there is no basis for us to reject the EC's assertion that the impact would be very limited. For these reasons, we do not consider this to be an appropriate basis for rejecting the EC's proposed market benchmark.

(v) Admissibility of certain EC arguments and data

7.277 At para. 88 of its second oral statement, Korea claims that paragraphs 113-121 of the EC's second written submission should be disregarded and dismissed by the Panel. Korea argues that this part of the EC's submission is material purporting to support a *prima facie* case, rather than rebuttal evidence.

7.278 We assume that Korea's comment is based on paragraph 12 of the Panel's Working Procedures, whereby:

> Parties shall submit all factual evidence to the Panel no later than during the first substantive meeting, except with respect to evidence necessary for purposes of rebuttals, answers to questions or comments made for purposes of rebutting answers provided by others. Exceptions to this procedure will be granted upon a showing of good cause. In such cases, the other party shall be accorded a period of time for comment, as appropriate.

7.279 In paragraphs 113 to 121 of its second written submission, the EC is responding to arguments made by Korea (in its first written submission and during the Panel's first substantive meeting with the parties) concerning the market benchmark proposed in the EC's first written submission. As such, we consider that the factual information contained in those paragraphs constitutes "evidence necessary for purposes of rebuttals" within the meaning of paragraph 12 of our Working Procedures. For this reason, we decline Korea's request to dismiss or disregard this evidence.

(vi) Conclusion

7.280 In light of the above, we reject Korea's objections to the market benchmark proposed by the EC. We therefore consider it appropriate to apply that benchmark in order to determine whether the individual PSL transactions at issue confer a "benefit" and therefore constitute subsidies.

[168] See para. 7.274 *supra*.

(c) The application of the EC's market benchmark to individual KEXIM PSL transactions

7.281 The EC has compared a number of KEXIM PSLs with its market benchmark. The PSLs were provided by KEXIM to DSME, Samho/Halla, STX/Daedong, Hyundai/MIPO, HHI. The EC claims that the majority of these PSLs conferred a benefit on the relevant shipyard. Korea has raised a number of issues regarding the shipbuilder-specific comparison undertaken by the EC. We examine these issues below.[169]

(i) DSME

7.282 On the basis of Attachment EC-10, the EC submits that a number of KEXIM PSLs to DSME conferred a benefit and therefore constitute subsidies. In applying its market benchmark, however, the EC did not use KEXIM's credit rating for DSME **[BCI: Omitted from public version]** when determining the KEXIM credit risk spread for certain PSLs provided in 2000 and 2001.[170] It used a KEXIM SM rating instead. The EC noted that credit rating agencies had rated DSME "C" during this period. The EC asserts that a credit rating agency's C rating equates to a KEXIM rating of SM (instead of the **[BCI: Omitted from public version]** used by KEXIM). The EC argues that credit rating agency ratings constitute a more appropriate benchmark than KEXIM's ratings. According to the EC, any discrepancy in credit ratings shows an unexplained difference between the credit rating of KEXIM and the private credit agencies.

7.283 Korea submits that the EC should have applied the KEXIM credit risk spread for KEXIM **[BCI: Omitted from public version]** ratings. In addition to arguing that credit rating agency ratings cannot be compared directly with KEXIM ratings, Korea denies that a credit rating agency "C" is equivalent to a KEXIM "SM" rating.

7.284 We note that, according to Exhibit KOREA – 92, KEXIM rated DHI/DSME **[BCI: Omitted from public version]** as of April 2001 (when KEXIM introduced its own credit rating system). In Exhibit KOREA – 99, Korea proposes to apply this **[BCI: Omitted from public version]** rating in respect of all PSLs issued as of June 1999. According to Exhibit KOREA - 92, however, credit rating agencies rated DHI/DSME BB+ in May 1999, but reduced their rating to C in August 1999.[171] This would reflect the fact that DHI/DSME's financial condition deteriorated during the course of 1999. By contrast, Korea purports to apply the same KEXIM credit rating as of June 1999, through August 1999, and into 2000. Given DHI's deteriorating financial position, we are unable to accept that a market-based approach to credit rating would have applied the same credit rating to DHI/DSME throughout this period.[172] For this reason, we have serious doubts as to the reliability (in terms of market consistency) of KEXIM's **[BCI: Omitted from public version]** rating of DHI/DSME during this period. In these circumstances, we consider that the starting point for the credit risk spread adjustment in the EC's market benchmark should be the C rating applied by the credit rating agencies.

7.285 In terms of establishing the KEXIM equivalent of a credit rating agency C rating, we note that Table 1 of Exhibit EC – 148[173] indicates that a KEXIM **[BCI: Omitted from public version]** credit risk spread equates to a BBB or BB credit risk agency credit spread. It does not equate to a C spread.

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[169] At this point, our findings are confined to the parties' arguments regarding the existence of benefit. They do not include issues regarding the amount of alleged benefit (such as, for example, Korea's argument regarding the actual duration of certain PSLs (see *inter alia* para. 283 of Korea's second written submission)).

[170] We note that the EC used actual KEXIM credit risk spreads when a shipyard's rating was below investment grade, as KSDA index data was not available for such ratings (see para. 7.249 *supra*).

[171] This is confirmed by para. 338 of Korea's first written submission, which states that "starting in 1999, the international credit rating of Daewoo group companies including DHI began to weaken".

[172] In response to Question 114 from the Panel, Korea notes that KEXIM improved DHI/DSME's rating after the workout. While this is true, it does not mean that KEXIM's P5 rating during the workout was accurate, or reflected market principles.

[173] See page 7.

Although Korea submits that Table 1 of Exhibit EC – 148 only refers to the chronology of the changes implemented by KEXIM in its credit rating system,[174] we nevertheless consider that it indicates that KEXIM itself considered that a **[BCI: Omitted from public version]** rating was broadly equivalent to a credit rating agency BBB or BB rating, as opposed to a C rating. This is confirmed by KEXIM's own definition of a **[BCI: Omitted from public version]** rating, which applies where **[BCI: Omitted from public version]**.[175] By contrast, a C-rated obligor has "no capacity for redemption",[176] i.e., no capacity to redeem its financial obligations. There is therefore a fundamental difference between a KEXIM **[BCI: Omitted from public version]** rating and a credit rating agency C rating (in terms of capacity to redeem obligations). In our view, a comparison of the relevant definitions indicates that an agency C rating is more appropriately compared with a KEXIM SM rating, since an SM obligor is similarly "vulnerable to non payment".[177]

7.286 In light of the above considerations, we find that KEXIM's **[BCI: Omitted from public version]** credit risk spread should not be used in the market benchmark in respect of DHI/DSME PSLs issued during the period that credit rating agencies applied a C rating for DHI/DSME. Instead, we consider it appropriate to apply KEXIM's SM credit risk spread to these transactions.

7.287 For these reasons, we uphold the comparison undertaken by the EC in Attachment EC-10 concerning KEXIM PSLs to DSME. Since that comparison demonstrates that these PSLs are made on terms more favourable than those available to DSME on the market, we find that those KEXIM PSLs confer a benefit, and therefore constitute subsidies.

(ii) Samho/Halla

7.288 On the basis of the comparison set forth in Attachment EC-10, the EC submits that a number of KEXIM PSLs to Samho/Halla conferred a benefit and therefore constitute subsidies. Korea submits that the EC failed to adjust its analysis of those PSLs to reflect the fact that they were **[BCI: Omitted from public version]**.

7.289 The EC submits that Korea never provided substantiated evidence of the existence and monitoring of collaterals and replied to the Panel[178] that it is not "Kexim's policy to keep and maintain any worksheet or similar documents"[179] necessary for the consideration of collaterals. According to the EC, there is, therefore, no justified reason to consider **[BCI: Omitted from public version]**. The EC asserts that, on the basis of best information available, the EC applied the same rule as for the Yangdo Dambo adjustment, i.e. a **[BCI: Omitted from public version]** per cent of the credit risk spread.

7.290 In addressing this issue, we consider that the onus should be on Korea, as the party seeking to establish a fact, to prove that KEXIM applied a lower credit risk spread in respect of transactions reported as being **[BCI: Omitted from public version]** than for transactions reported as being **[BCI: Omitted from public version]**. We do not consider that Korea has discharged this burden.

7.291 First, Korea has failed to cite to any provision of the KEXIM Interest Rate Guidelines concerning this matter. Second, there is nothing on the face of any other document submitted by Korea to indicate that an additional adjustment of the credit risk spread is made in respect of transactions reported as being **[BCI: Omitted from public version]** compared to transactions reported as being **[BCI: Omitted from public version]**.

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[174] See Korea's 9 July 2004 comment on the EC's reply to Supplemental Question 136 from the Panel.
[175] Responses to Annex V Questions, Answer 1.1(24)-2, Exhibit EC – 131.
[176] Moody's affiliate, Korea Investor Services, Bond ratings definitions, Exhibit EC – 9.
[177] Responses to Annex V Questions, Answer 1.1(24)-2, Exhibit EC – 131.
[178] See Reply by Korea to Panel Question 72 following the first substantive meeting.
[179] See Korea's reply to Question 67 from the Panel.

7.292 Korea asserts that "Exhibit Korea – 60 clearly show[s] that as to **[BCI: Omitted from public version]**. However, while it may be correct that **[BCI: Omitted from public version]**, Exhibit KOREA – 60 does not indicate how, if at all,[180] KEXIM reflected the value of **[BCI: Omitted from public version]** in its interest rate calculation. Indeed, Korea's reply to Question 72 from the Panel[181] – in the context of which Exhibit KOREA – 60 was provided – stated that "it is not KEXIM's policy to keep and maintain worksheets and other similar documents." Even if an additional adjustment were necessary, therefore, there is no basis for the Panel to determine what exactly that adjustment should be.

7.293 For the above reasons, we consider that the EC was entitled to make the same credit risk spread adjustment for transactions reported as being **[BCI: Omitted from public version]** as for transactions reported as being **[BCI: Omitted from public version]**.

7.294 We therefore uphold that part of the analysis set forth in Attachment EC-10 concerning KEXIM PSLs to Samho / Halla. Since that comparison demonstrates that these PSLs are made on terms more favourable than those available to Samho / Halla on the market, we find that those KEXIM PSLs conferred a benefit and therefore constitute subsidies.

(iii) STX/Daedong

7.295 On the basis of the comparison set forth in Attachment EC-10, the EC submits that a number of KEXIM PSLs to STX/Daedong conferred a benefit and therefore constitute subsidies.

7.296 Korea criticises the EC for having applied KSDA index data from BBB- rated companies. Korea notes that KEXIM rated STX **[BCI: Omitted from public version]** during the relevant period, and argues that a KEXIM P3 rating equates to an agency A- rating. Korea therefore asserts that the EC should have included KSDA index data from A- rated companies in its benchmark.

7.297 The EC submits that the BBB- rating it used for its analysis regarding STX/Daedong is the rating provided by private credit rating companies. The EC asserts that such ratings are more accurate than KEXIM's internal rating.

7.298 Consistent with its methodology for investment grade shipyards, the EC based its analysis of STX/Daedong PSLs on rating agency ratings and relevant KSDA index prices. Given our rejection of Korea's arguments against the use of rating agency ratings, and in the absence of any further arguments from Korea concerning the agency ratings of STX/Daedong in particular, we see no reason why those ratings should not be relied on by the EC.[182]

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[180] We note in this regard that KEXIM does not make an additional adjustment of the credit risk spread in respect of transactions reported as being **[BCI: Omitted from public version]** (Korea stated in Exhibit KOREA – 90 that **[BCI: Omitted from public version]**). There is no evidence to suggest that KEXIM applies a different approach in respect of **[BCI: Omitted from public version]**.

[181] Requesting, *inter alia*, "worksheets and other documentation showing calculations of the interest rate and other terms, including consideration of collateral" related to KEXIM's review / authorization of a particular Samho PSL.

[182] While we note (in relation to para. 235 of Korea's first written submission, which refers to the EC's treatment of Samho PSLs) that an A- agency rating was applied by the EC in respect of Samho, when that yard was rated **[BCI: Omitted from public version]** by KEXIM, this does not necessarily mean that the EC equates a KEXIM P3 rating with an agency A- rating. It simply means that Samho was rated A- by agencies and **[BCI: Omitted from public version]** by KEXIM at that time. Under the EC methodology, it would have applied a BBB+ rating if that is how the agencies had rated Samho at that time, even if the KEXIM **[BCI: Omitted from public version]** rating remained unchanged. There is, therefore, no methodological connection between the agency rating and the KEXIM rating in that particular case.

7.299 We therefore uphold that part of the analysis set forth in Attachment EC-10 concerning KEXIM PSLs to STX/Daedong. Since that comparison demonstrates that these PSLs are made on terms more favourable than those available to STX/Daedong on the market, we find that those KEXIM PSLs conferred a benefit and therefore constitute subsidies.

(iv) Hyundai/MIPO

7.300 Korea has not raised any transaction-specific objections regarding the EC's analysis of KEXIM PSLs to Hyundai / Mipo. We therefore uphold the EC's analysis of these PSLs in Attachment EC-10, and find that these PSLs - other than projects 000056P and 000116P[183] - are made on terms more favourable than those available to MIPO on the market. Those PSLs (other than projects 000056P and 000116P) therefore conferred a benefit, and constitute subsidies.

(v) Hanjin

7.301 Korea has not raised any transaction-specific objections regarding the EC's analysis of KEXIM PSLs to Hanjin. We therefore uphold the EC's analysis of these PSLs in Attachment EC-10, and find that projects 000108P, 000109P, 000130P, 000131P, 000132P, 010005P and 010073P conferred a benefit and therefore constitute subsidies.

(vi) Hyundai Heavy Industries

7.302 During the Panel proceedings, Korea complained that the EC had failed to apply the correct credit risk spreads in respect of certain KEXIM PSLs for HHI. Korea asserted that the credit risk spreads presented in the EC's first written submission for HHI were temporary non-collateral rates that were subsequently reduced upon the provision of collateral by Hyundai.

7.303 Since the EC confirmed in response to Question 137 that it had applied the reduced credit risk spread for the relevant HHI PSLs, we do not consider it necessary to address this issue further.

7.304 In the absence of any additional transaction-specific objections by Korea, we uphold the EC's analysis of KEXIM PSLs to HHI set forth in Attachment EC-10. We therefore find that projects 010019P, 010020P, 010021P, 010022P, 010023P, 010080P, 010081P, 010082P, 010083P, 010084P, 010154P, 010152P, 010153P, 010155P, 010157P, 010156P, 024838P, 024840P, 024842P, 024849P and 024852P conferred a benefit and therefore constitute subsidies.

(d) Export contingency

(i) Arguments of the parties

7.305 The EC submits that PSLs are provided for the specific purpose of assisting Korean companies with production of goods intended for export. The EC asserts that KEXIM PSLs are therefore contingent on export within the meaning of Article 3.1(a) of the *SCM Agreement*.

7.306 When asked by the Panel (Question 48) whether Korea contests the EC's claim that PSLs and APRGs under the KEXIM legal regime are contingent on export performance, Korea responded that it "has not taken any position as to whether [PSLs and APRGs] are contingent on export performance". In response to an oral question from the Panel at the second substantive meeting, Korea stated that it was not contesting the EC's claim of export contingency.

[183] The EC calculated negative benefit margins in respect of these transactions.

(ii) Evaluation by the Panel

7.307 We find that the EC has established a *prima facie* case that KEXIM PSLs are contingent on export performance. In light of Korea's decision not to contest the EC's arguments regarding this matter, we find that KEXIM PSLs are "contingent ... upon export performance" within the meaning of Article 3.1(a) of the *SCM Agreement*.

(e) Specificity

7.308 Pursuant to Article 1.2, the disciplines of the *SCM Agreement* only apply to subsidies that are "specific" within the meaning of Article 2 thereof. Article 2.3 of the *SCM Agreement* provides that "[a]ny subsidy falling under the provisions of Article 3 shall be deemed to be specific". Since export contingent subsidies fall under the provisions of Article 3 (paragraph 1(a)), they are "specific". Pursuant to Article 2.3, therefore, we conclude that those PSLs that we have found to be export subsidies are "specific".

(f) Defence under the first paragraph of item (k) of the *Illustrative List*

7.309 In light of our findings that certain PSLs constitute subsidies, and that such subsidies are contingent on export performance, we will be required to find that such PSLs are inconsistent with Articles 3.1(a) and 3.2 of the *SCM Agreement* unless we uphold Korea's claim that they benefit from a safe haven provided for in the first paragraph of item (k) of the *Illustrative List*. As with Korea's earlier reliance on item (j) of the *Illustrative List* as a defence in respect of certain individual APRG transactions, Korea's defence raises the issue of whether or not the first paragraph of item (k) may be interpreted *a contrario* and, if so, whether or not the relevant conditions are fulfilled in the present case.

(i) Is an a contrario interpretation of the first paragraph of item (k) permissible?

7.310 We have already determined that an *a contrario* interpretation of item (j) is not permissible. We see no reason why we should not reach the same conclusion in respect of the first paragraph of item (k). Since the first paragraph of item (k) does not contain any affirmative statement that a measure is not an export subsidy, nor that a measure not satisfying the conditions of that paragraph is not prohibited, we consider that it does not fall within the scope of footnote 5 of the *SCM Agreement*. We note that this finding is consistent with the report of the *Brazil – Aircraft – Article 21.5* panel, with which we agree. In light of the above, we find that the first paragraph of item (k) may not be interpreted *a contrario*.

7.311 For the most part, Korea makes the same arguments concerning the *a contrario* interpretation of item (k), first para., as for item (j).[184] There is therefore no need for us to repeat our analysis of those arguments at this juncture. Korea also argued that a failure to permit an *a contrario* reading of the first paragraph of item (k) would render the "material advantage" clause ineffective. This argument was made by Brazil and the United States in the *Brazil – Aircraft – Article 21.5* case. The *Brazil – Aircraft – Article 21.5* panel described and rejected that argument in the following terms:

> Brazil, and the United States as third party, contend that a finding that the first paragraph of item (k) cannot be used *a contrario* to permit export credits and payments that are *not* used to secure a material advantage would render the "material advantage" clause ineffective. We do not agree. In our view, the primary role of the Illustrative List is not to provide guidance as to when measures are *not* prohibited export subsidies – although footnote 5 allows it to be used for this purpose in certain

[184] The EC submits that the first paragraph of item (k) – unlike item (j) (see para. 7.199 *supra*) - may not be interpreted *a contrario.*

> cases – but rather to provide clarity that certain measures *are* prohibited export subsidies. Thus, it would be possible to demonstrate that a measure falls within the scope of an item of the Illustrative List and was thus prohibited without being required to demonstrate that Article 3, and thus Article 1, was satisfied. To borrow a concept from the field of competition law, the Illustrative List could be seen as analogous to a list of *per se* violations. Seen in this light, the material advantage clause is not "ineffective", in the sense that it is reduced to redundancy or inutility, by a finding that the first paragraph of item (k) cannot be used *a contrario* to establish that a measure is permitted. To the contrary, the material advantage nevertheless continues to serve an important role by narrowing the range of measures that would otherwise be subject to the "*per se*" violation set forth in the first paragraph of item (k), as discussed below.
>
> Let us consider the first situation envisioned by the first paragraph of item (k), the grant by governments of export credits at rates below their cost of funds. It may generally be assumed that in such circumstances there will be a benefit to the recipient and thus a subsidy. This is however not always the case. Whenever a government's cost of funds is higher than that of the borrower, a loan at below the government's cost of funds may nevertheless fail to confer a benefit on the recipient. For example, Brazil argues in this dispute that its cost of funds is in excess of 13 per cent. By contrast, it is likely that many purchasers of Brazilian exports could obtain private export credit financing, not benefiting from government intervention of any kind, at an interest rate significantly lower than 13 per cent. Thus, direct financing by Brazil in these circumstances could well entail a cost to the government but provide no advantage, material or otherwise, to the recipient. Under these circumstances, and in the absence of the material advantage clause, Brazil would be prohibited from providing export credits at an interest rate lower than 13 per cent, even if the export credits provided no advantage whatsoever. The role of the material advantage clause in this situation is to narrow the scope of the *per se* prohibition in such cases.
>
> A similar situation could arise in cases of payments under the first paragraph of item (k). Without the material advantage clause, a complainant could demonstrate the existence of a prohibited subsidy merely by demonstrating the existence of a payment within the meaning of item (k). However, a financial institution in a developing country may have a higher cost of funds than financial institutions in developed countries, and thus be unable to provide export credits on terms competitive with those of foreign financial institutions. A payment by Brazil that allowed a Brazilian financial institution to provide export credits to an overseas customer on precisely the same terms as that customer could have obtained in international financial markets could, absent the material advantage clause, constitute a prohibited export subsidy, even though the borrower – and hence the exporter – was no better off than it would have been but for the payment. The material advantage clause narrows the scope of the "*per se*" violation in the first paragraph of item (k) and precludes this result.
>
> In light of the foregoing, we consider that the "material advantage" clause would not be rendered "ineffective" by a finding that the first paragraph of item (k) cannot serve as a basis to establish that a measure is "permitted".[185]

7.312 We find this reasoning to be convincing. We also note that Korea has not attempted to rebut it. In these circumstances, we shall be guided by this reasoning and on that basis reject Korea's

[185] Panel Report, *Brazil – Aircraft – Article 21.5*, paras 6.42 – 6.45 (footnotes omitted).

argument that a failure to permit an *a contrario* interpretation of the first paragraph of item (k) would render the material advantage clause of that provision meaningless.

7.313 Having found that an *a contrario* interpretation of the first paragraph of item (k) is not permissible, there is strictly speaking no need for us to consider the additional issues identified above. For the sake of completeness, however, we shall do so.

(ii) If an a contrario interpretation of the first paragraph of item (k) were permissible, what conditions would need to be fulfilled?

7.314 Assuming *arguendo* that the first paragraph of item (k) could operate as an affirmative defence in the present case (with which, as discussed, we disagree), it would need to be demonstrated that PSLs constitute "export credits", and are provided at rates above those which the government in question actually has to pay for the funds or, if the rates are below cost, at rates that nevertheless do not secure a material advantage in the field of export credit terms.

(iii) Are the relevant conditions fulfilled?

7.315 As the party seeking to rely on the first paragraph of item (k) as an affirmative defence, the burden of proof is on Korea to establish that the relevant conditions have been fulfilled. Korea submits that the PSLs constitute export credits, and that PSLs "are made at rates far higher than those the government has to pay for the funds so employed".[186] Korea also submits that the PSLs do not confer a material advantage.

7.316 The EC submits that PSLs are not export credits, since they are not extended to the foreign buyer. The EC bases its argument on the following definition set forth in the *Organization for Economic Cooperation and Development* ("*OECD*") Handbook on Export Credits:

> Broadly defined, an export credit is an insurance, guarantee or financing arrangement which enables a foreign buyer of exported goods and/or services to defer payment over a period of time. … Export credits may take the form of "supplier credits" extended by the exporter or of "buyer credits" where the exporter's bank or other financial institution lends to the buyer (or his bank).

7.317 Given the EC's argument that PSLs are not export credits in the meaning of the first paragraph of item (k), the EC does not address Korea's assertions that PSLs "are made at rates far higher than those the government has to pay for the funds so employed",[187] and that the PSLs do not confer a material advantage.

7.318 Korea asserts that the EC's definition of "export credit" is overly narrow. Korea relies on a broad interpretation of the concept of "export credit". Korea submits that a basis for such a broad interpretation is provided by the following *OECD* website definition:

> Broadly defined, an export credit arises whenever a foreign buyer of exported goods or services is allowed to defer payment. Export credits are generally classified as short-term (repayment terms of usually under two years), medium term (usually two to five years) and long-term (over five years). Export credits may take the form of "supplier credits" or "buyer credits". "Supplier credits" are extended by an exporter directly to an overseas buyer. "Buyer credits" are extended by an exporter's bank or other financial institution as loans to the buyer (or his bank). OECD Member countries may give official support to both types of transactions through their export

[186] Korea's First Written Submission, para. 277.
[187] *Ibid*, para. 277.

> credit agencies, provided that such support is in accordance with the Arrangement on Guidelines for Officially Supported Export Credits.[188]

7.319 Korea also relies on Section 3 of the *OECD Sector Understanding on Export Credits for Ships*, whereby:

> The minimum interest rate will also apply to the credit granted with support by governments participating in the Understanding, in the shipbuilder's country to the shipbuilder or to any other party, to enable credit to be given to the shipowner or to any other party in the shipowner's country, whether this official support is given for the whole amount of the credit or only part of it.

7.320 Korea asserts that the EC's approach gives primacy to the *OECD* over the WTO.[189] The EC considers that the definition of "export credits" given by the *OECD* reflects the generally accepted meaning of term in the relevant circles, that the term "export credit" used in the second paragraph of item (k) has the meaning given to it in the *OECD Arrangement on Guidelines for Officially Supported Export Credits* (*"OECD Arrangement*") and that in view of the close parallels between the first and second paragraph it must be assumed, in the absence of any indication to the contrary, that the term has the same meaning in both the first and second paragraphs.

7.321 We do not consider that the reference to "export credits" in the first paragraph of item (k) should necessarily be defined in the same way as the reference to "official export credits" in the second paragraph thereof. However, we note that both parties have referred to *OECD* sources in supporting their respective definitions of the term "export credit". Accordingly, we will have regard to *OECD* sources for the purpose of assessing the meaning of the term "export credit" in the first paragraph of item (k).

7.322 The basic issue raised by the parties' arguments is whether a loan will only constitute an "export credit" if it is conferred on the foreign buyer, or whether the term "export credit" also includes loans provided to exporters. The EC submits that loans to exporters are not "export credits". Korea relies on Section 3 of the Sector Understanding to argue that loans to shipbuilders may also be treated as "export credits". Failing that, Korea asserts that PSLs are "export credits" because they are "intricately linked" to supplier credits extended by the shipyard to its customer. The relevant "supplier credit" is the amount of money that the shipbuilder allows the foreign buyer to "defer" until the end of the contract. Korea establishes a link between the PSL and the "deferred" payment by arguing that the larger the payment at the end of the contract, the more credit the shipyard needs in terms of pre-shipment loans.

7.323 In addressing this issue, we note that both parties have relied on *OECD* definitions that indicate that the *OECD* only treats loans to foreign buyers (and not to exporters) as "export credits". Even the *OECD* website definition relied on by Korea states that "[e]xport credits may take the form of "supplier credits" or "buyer credits". "Supplier credits" are extended by an exporter directly **to an overseas buyer**. "Buyer credits" are extended by an exporter's bank or other financial institution as loans **to the buyer** (or his bank)" (emphasis supplied). Although Korea relies on Section 3 of the Sector Understanding, we first note that Section 2 thereof also indicates that "export credits" are loans to the foreign buyer. Thus, Section 2 refers to credits "granted with official support by the shipbuilder **to the buyer** (in a supplier-credit transaction) or by a bank or any other party in the shipbuilder's country **to the buyer** or any other party in the buyer's country" (emphasis supplied). The *OECD* materials submitted by both parties therefore indicate that the term "export credits" relates to credits provided to foreign buyers.

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[188] *Ibid*, para. 272.
[189] Korea's reply to Question 168 from the Panel.

7.324 Although Section 3 of the Sector Understanding indicates that the *OECD Arrangement*'s minimum interest rate shall also apply to official credits granted "to the shipbuilder", this is only to the extent that such credit to the shipbuilder "enable[s] credit to be given to the shipowner or to any other party in the shipowner's country". Thus, a stand-alone credit to the shipbuilder would not be treated as an "export credit" even under Section 3 of the Sector Understanding. Section 3 therefore supports the view that credits to shipyards in and of themselves do not constitute "export credits".

7.325 Korea submits that, even if loans to exporters do not constitute "export credits", PSLs constitute "export credits" because they are "intricately linked" to supplier credits extended to the foreign buyer in the form of tail-heavy contracts. In this regard, we understand Korea to argue that the amount of money payable at the end of the contract is effectively an export credit from the shipyard/supplier to the foreign buyer. We further understand Korea to argue that PSLs are also therefore export credits because they are "intricately linked" to that export credit because the greater the amount of the PSL, the greater the amount of payment that can be delayed until the end of the contract, and therefore the greater the amount of the "export credit".[190]

7.326 We do not find Korea's argument convincing. First, we do not consider that a shipyard's agreement that certain money should only be paid upon termination of the contract should be treated as a loan, or credit, to the buyer, since nothing is lent or credited to the foreign buyer in the period leading up to termination of the contract. Second, there is no direct connection between the PSL and the payment terms, particularly as different parties are involved in each respective transaction. Third, even if the "delay" of payment until completion of the contract did operate as a loan, it does not provide for the deferral of payment. As noted above, the *OECD* definitions of export credits relied on by the parties refer to an arrangement that enables the foreign buyer to "defer payment" over time. In our view, this reference to deferral means post-shipment deferral of payment, whereas any delay in payment resulting from the availability of a PSL does not extend beyond termination of the contract.

7.327 According to Korea, the largest *OECD* member, the United States, has suggested interpreting the definitions in a more economically coherent manner to include guarantees to both the seller and the buyer. In this regard, Korea argues that the United States has proposed that the export credit disciplines envisaged by Article 10.2 of the *Agreement on Agriculture* should apply to "any other form of involvement, direct or indirect, by providers of official support".[191] We do not share Korea's interpretation of the US position. First, the United States refers to the involvement of "providers of official support". In response to a question from the Panel, the United States noted that the definition of "official support" in the *OECD Arrangement* is limited to support provided "for export", and would therefore "preclude pre-export financing to the *exporter*, such as the PSL program".[192] Second, the United States has explicitly argued before the Panel that APRGs are not export credit guarantees. Accordingly, we reject Korea's argument regarding the US proposal concerning Article 10.2 of the *Agreement on Agriculture*.

7.328 In light of the above, and having regard in particular to the fact that PSLs are credits to shipbuilders, rather than foreign buyers, we find that PSLs are not "export credits" in the sense of the first paragraph of item (k) of the *Illustrative List*. Thus, even though the EC has not contested Korea's

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[190] As with APRGs, Korea also argues that a number of export credit agencies offer instruments similar to PSLs (see Korea's reply to Question 168 from the Panel). We remain of the view that our findings should be based on our interpretation of the relevant provisions of the *SCM Agreement*, and not the practices of other Members (se para. 7.216 *supra*).

[191] Korea refers to the "US Position on Disciplines for Export Credits", allegedly submitted in early February 2003 to the WTO in relation to Article 10.2 of the WTO *Agreement on Agriculture* (see Korea's First Written Submission, para. 275).

[192] US response to question from the Panel following the second substantive meeting, para. 5, emphasis in original.

assertion that PSLs cover costs and do not confer a material advantage, PSLs would not fulfil the conditions for any *a contrario* application of the first paragraph of item (k).

7.329 For these reasons, we find that the abovementioned PSLs do not benefit from any safe haven provided for in the first paragraph of item (k) of the *Illustrative List*. First, we find that an *a contrario* reading of this provision is not permissible. Second, we find that, even if such a reading were permissible, some of the relevant conditions would not have been fulfilled by the PSLs at issue. Accordingly, we find that the abovementioned PSLs constitute prohibited export subsidies, in violation of Articles 3.1(a) and 3.2 of the *SCM Agreement*.

(g) Conclusion

7.330 To conclude on the individual PSL transactions challenged by the EC, we find that the DSME, Samho/Halla, STX/Daedong and Hyundai/MIPO (except projects 000056P and 000116P) PSLs identified in Attachment EC-10, as well as PSLs 000108P, 000109P, 000130P, 000131P, 000132P, 010005P and 010073P provided to Hanjin, and PSLs 010019P, 010020P, 010021P, 010022P, 010023P, 010080P, 010081P, 010082P, 010083P, 010084P, 010154P, 010152P, 010153P, 010155P, 010157P, 010156P, 024838P, 024840P, 024842P, 024849P and 024852P provided to HHI, constitute prohibited export subsidies, contrary to Articles 3.1(a) and 3.2 of the *SCM Agreement*.

6. Conclusion

7.331 For the above reasons, we reject the EC's claim that the KLR, the APRG programme, and the PSL programme, "as such" violates Articles 3.1(a) and 3.2 of the *SCM Agreement*. We uphold the EC's claim that the individual KEXIM APRGs identified at para. 7.223 *supra* constitute prohibited export subsidies, contrary to Articles 3.1(a) and 3.2 of the *SCM Agreement*. We further find that the KEXIM PSLs identified at para. 7.330 supra constitute prohibited export subsidies, contrary to Articles 3.1(a) and 3.2 of the *SCM Agreement*.

C. ALLEGED ACTIONABLE SUBSIDIES

7.332 The EC has challenged a number of alleged actionable subsidies under Article 5 of the *SCM Agreement.* In order for a complaint under Article 5 to prevail, it must be demonstrated that the measure is a subsidy, that it is specific, and that it causes adverse effects to the interests of another Member.

7.333 For the most part, these claims of the EC are concerned with the restructurings of Daewoo, Halla and Daedong. These claims also include an alleged tax concession to DSME and DHIM, and the individual APRG and PSL transactions addressed above.

7.334 In respect of the EC's Article 5 claims concerning these transactions, we recall that Korea has argued that it is "legally and factually impossible" for a given measure to be at the same time both a prohibited and an actionable subsidy. We do not accept Korea's legal argument, since nothing in the *SCM Agreement* precludes claims being brought under both Parts II and III in respect of the same measures. Thus, to the extent that a complaining Member is able to demonstrate that a measure is a prohibited export subsidy that causes adverse effects to the interests of other Member, we see no reason why simultaneous findings could not be made under both Articles 3 and 5 of the *SCM Agreement* in respect of that measure. In respect of the present dispute, we take up in section VII.D, *infra*, the factual analysis of whether the individual APRG and PSL transactions that we have found to be prohibited export subsidies cause serious prejudice to the interests of the EC.

7.335 We shall first provide a factual review of the three debt restructurings at issue in these proceedings. We shall then address the parties' arguments on whether or not these restructurings constitute "financial contributions" "by a government or public body" that confer a "benefit" in the

mean ing of Article 1.1 of the *SCM Agreement*. We shall next consider the parties' arguments regarding the alleged tax concession to DSME and DHIM. In the event that we find that any of these measures are subsidies, we shall consider whether or not they are "specific". If any of these measures are specific subsidies, we shall then consider whether they have caused adverse effects to the interests of the EC. We shall perform the same analysis in respect of the APRG and PSL transactions identified at para. 7.331 *supra*, which we have already found to be specific subsidies.

1. Debt restructurings

(a) Factual Review

(i) Daewoo workout

7.336 Daewoo Heavy Industry, or DHI, was restructured in 1999 under the workout procedure set forth in the Corporate Restructuring Agreement ("CRA"), after a failed attempt at a voluntary workout in 1998. As discussed in more detail *infra*, the CRA, which was signed by more than 200 private banks, established certain terms and procedures pertaining to corporate restructuring. The parties have differing views as to whether the CRA compelled banks to participate in such restructurings. Daewoo's creditors adopted a workout plan after Anjin, an accounting firm, reported that the going concern value of Daewoo exceeded its liquidation value. The workout plan comprised three elements: the spin-off from DHI of two new companies, DSME (shipbuilding) and DHIM (machinery); debt-for-equity swaps; and debt rescheduling.

7.337 DSME and DHIM were spun off from DHI on 23 October 2000. Each of the new companies received a portion of DHI's assets and capital stock, whereas much of the company's debt was left behind in DHI. The assets, liabilities, and capital stock of the new operating companies were determined based on their debt payment capability.

7.338 On 14 December 2000, a major portion of the debt still held by DSME was swapped by the creditors for equity in the newly established company. The terms of the debt-for-equity swaps varied according to the division of the company and the type of debt at issue (*i.e.*, secured or non-secured).

7.339 Daewoo-SME's debt obligations were also rescheduled. The debt rescheduling took three forms: extension of principal repayment due date; reduction of interest rates; and conversion of short-term loans into medium- and long-term loans.

(ii) Halla reorganization

7.340 The SHI/Halla corporate reorganization plan was crafted by creditors under the Corporate Reorganization Act, after a court confirmed the report by Rothschild, a consulting firm retained by Halla, that the going concern value of Halla exceeded its liquidation value. The reorganization plan (based on a proposal from Rothschild) comprised four elements: (i) debt forgiveness; (ii) a debt-for-equity swap; (iii) interest forgiveness; (iv) a conversion of short-term debt.

7.341 Under the reorganization plan, the assets of Halla were transferred to a new company, RHHI. Halla's debts were partly paid off using the proceeds from this sale, and Halla's remaining debts were assumed by RHHI. All of RHHI's shares were held by a single individual, although these shares were subsequently cancelled.[193]

[193] Korea asserts that, under Article 221(4) of the Corporate Reorganization Act, at least two-thirds of the shares held by the shareholder who influenced the directors in the mismanagement of a bankrupt company shall be written off. In the event, the court-appointed receiver proposed that all of the individual's shares should be written off (see Korea's reply to Question 38 from the EC after the first substantive meeting).

7.342 RHHI then issued 20,000,000 new shares to its creditors under a debt-for-equity swap of KRW 100 billion. At the same time, RHHI changed its name to Samho Heavy Industries ("Samho"). Samho received interest relief on its remaining debt (accrued interest was written off).

7.343 Samho then entered into a trusteeship agreement with Hyundai-HI, under which Hyundai-HI was entrusted with the management of Samho. When Hyundai-HI entered into the trusteeship agreement, it also executed a call option agreement with the shareholders of Samho, whereby Hyundai-HI received an option to purchase the shares of Samho at a specified price within the next five years. The call-price was the par value of the subject shares (*i.e.*, **[BCI: Omitted from public version]**). However, if the net asset value per share of Samho, as of the date of exercise of the call option, exceeded the par value of the subject shares, then **[BCI: Omitted from public version]** per cent of the difference would be added to the purchase price. Pursuant to the agreement, Hyundai-HI exercised its call option on 30 April 2002. Because the net asset value per share on that date was **[BCI: Omitted from public version]**, Hyundai exercised its call option at the price of **[BCI: Omitted from public version]**, as per the terms of the agreement. Hyundai then held **[BCI: Omitted from public version]** per cent of the shares in Samho, which changed its name to Hyundai Samho Heavy Industries, or Samho-HI. Samho then increased its capital by **[BCI: Omitted from public version]**, reducing Hyundai's shareholding to **[BCI: Omitted from public version**] per cent.

(iii) Daedong

7.344 Daedong was reorganized under the Corporate Reorganization Act, after the court established that the going concern value of Daedong exceeded its liquidation value. The reorganization plan comprised three elements: (i) debt restructuring / exemption from interest; (ii) a capital infusion; and (iii) the issuance of corporate bonds.

7.345 In August 2000, in accordance with the corporate reorganization plan, all shares owned by the then controlling shareholder were extinguished[194] and shares held by the remaining shareholders were consolidated at the rate of **[BCI: Omitted from public version]**. Daedong then began searching for an outside investor with the help of KPMG Financial Services Inc. ("KPMG"), its financial advisor. KMPG received final offers from five investors. KPMG determined that the offer from STX was most beneficial for Daedong and recommended that STX be granted the right of first negotiation on 22 August 2001. Accordingly, on 27 August 2001, the Seoul District Court selected STX Co. as the first negotiation party based on KPMG's recommendation.

7.346 STX submitted a preliminary proposal on 22 August 2001, with the key terms that (i) it would subscribe for and acquire common shares (new shares) corresponding to approximately **[BCI: Omitted from public version]**, (ii) subscribe for and acquire bonds with warrants corresponding to KRW 20 billion and immediately exercise these warrants to acquire new shares, and (iii) purchase additional bonds with warrants after amending the reorganization plan.

7.347 On 24 September 2001, STX submitted a definitive proposal on almost identical terms to those in the first proposal. Daedong accepted STX's proposal. On 28 September 2001, Daedong and STX executed a subscription agreement for the acquisition of new shares and bonds with warrants. On 24 October 2001, STX paid **[BCI: Omitted from public version]** and immediately thereafter exercised its warrants, resulting in a shareholding of **[BCI: Omitted from public version]** per cent in Daedong.

7.348 After it had acquired the Daedong shares as described above, STX acquired additional bonds issued by Daedong in the amount of **[BCI: Omitted from public version]**. This means that STX injected a total of **[BCI: Omitted from public version]** into Daedong's capital. With such funds, Daedong made an early repayment of **[BCI: Omitted from public version]** per cent of its liabilities

[194] *Ibid*.

(i.e., **[BCI: Omitted from public version]**), leaving only **[BCI: Omitted from public version]** outstanding (consisting of **[BCI: Omitted from public version]** for secured loans and **[BCI: Omitted from public version]** for unsecured loans). On 1 January 2002, Daedong changed its corporate name to STX Shipbuilding Co., Ltd.(the "STX Shipbuilding"), its current corporate name.

7.349 STX made partial sell-off of its shares in STX Shipbuilding on two occasions (one for public offering and the other for private placement), leaving it with **[BCI: Omitted from public version]** per cent of the shares in STX Shipbuilding. Further, STX Shipbuilding listed its shares at the Korea Stock Exchange in September 2003.

(b) Financial Contribution Issues

7.350 The EC submits that the restructurings constitute "financial contributions" by public body creditors and private body creditors entrusted or directed by GOK. Korea denies that any of the creditors participating in the restructurings are public bodies.[195] Korea also denies that (private body) creditors were entrusted or directed by GOK to participate in the workout. In addition, Korea submits that the restructurings did not provide for any transfer of pecuniary value, and that in any event the creditors could not properly be found to have made "financial contributions" to companies in which they acquire ownership rights. Korea also submits that any "financial contributions" were not made "by" public bodies, in the sense that decisions were made pursuant to the authority of the creditors' council or courts under the relevant legislative provisions.

(i) Public Bodies

7.351 The EC claims that the following creditors participating in the relevant restructurings and workout are "public bodies" in the sense of Article 1.1(a)(1) of the *SCM Agreement*: Korea Asset Management Corporation ("KAMCO"), Korea Depository Insurance Company ("KDIC"), Bank of Korea ("BOK"), KDB, Industrial Bank of Korea ("IBK"), and KEXIM.

7.352 We recall[196] that we consider that an entity is a "public body" if it is controlled by the government.

KAMCO

7.353 We find that KAMCO is a public body. First, KAMCO is 100 per cent government-owned, a situation that is highly relevant to and often determinative of government control. We find further evidence of government control of KAMCO in the fact that government-appointed officials on the Management Committee are responsible *inter alia* for formulating KAMCO's operational policy and service plan, and assuming non-performing assets (Article 14 of the KAMCO Act).

7.354 Although we therefore find that KAMCO is a "public body", we note Korea's argument that KAMCO only became a Daewoo creditor (by virtue of its acquisition of the NPLs of other creditors) toward the middle of the workout process, after the workout plan had already been adopted by prior creditor financial institutions. We understand Korea to argue that KAMCO therefore did not actually participate in the workout. In its reply to Question 25 in the Annex V process, however, Korea stated that creditors "agreed to allow the holders of the 19 July Loan (including KAMCO which purchased

[195] Korea also repeats its argument (made above in the context of the KEXIM legal regime) that a transfer of funds by a public body or private body entrusted or directed by a government will only constitute a "financial contribution" if it involves a "government practice" or a function that would "normally be vested in the government" and "the practice, in no real sense, differs from practices normally followed by governments". Since we have already rejected that argument (see paras 7.28 - 7.31 *supra*, there is no need for us to consider it further at this juncture.

[196] See para. 7.50 *supra*. Since we have already reviewed the parties' arguments on this issue, there is no need for us to revisit these arguments at this juncture.

loans from other creditor financial institutions) to participate in the debt for equity swap". In light of Korea's statement that KAMCO participated in the debt-for-equity swap provided for under the Daewoo workout, we see no basis for finding that KAMCO did not participate in that workout.

KDB

7.355 We have already found, at para. 7.172 *supra*, that the KDB is a public body.

IBK

7.356 We find that the IBK is a "public body". Here, we give particular weight to the fact that the IBK is almost fully (95 per cent) government owned,[197] a highly relevant and arguably determinative fact for the question of government control of the IBK. In addition, we note that, pursuant to Article 35 of the IBK Act, both the IBK Business Plan and Operations Manual must be approved by a GOK minister, and the Operations Manual itself must contain detailed provisions regarding the operations of the IBK, including "the lending method, interest rates, loan terms, means of collection of loan principal and interest, and the maximum loan amount and payment guarantees to any one person".[198]

BOK and KDIC

7.357 Korea submits that BOK and KDIC did not participate in any of the three restructurings at issue in these proceedings. The EC has not responded to this argument. With regard to the Daewoo workout, we note that Attachment 3 to Annex 1 of the EC's replies to Panel questions after the first substantive meeting includes a list of DHI's creditors. This would appear to confirm Korea's argument that BOK and KDIC did not participate in the Daewoo workout. Bearing this in mind, and in the absence of any rebuttal of Korea's argument that BOK and KDIC did not participate in the two remaining restructurings, we find that BOK and KDIC did not participate in any of the restructurings at issue in these proceedings. For this reason, it is not necessary for us to determine whether BOK and KDIC constitute "public bodies".

(ii) Entrustment or Direction of Private Bodies?

Arguments of the parties

7.358 The EC submits that a number of private financial institutions involved as creditors in the restructuring of shipbuilders were subject to such a high degree of government influence that they were "entrust[ed] or direct[ed]" by the Korean Government in the sense of Article 1.1(a)(1)(iv). The EC asserts that their participation in the restructuring process should therefore be treated as a financial contribution by the Korean Government.

7.359 The EC argues that the Korean Government and its public bodies took advantage of their multiple roles as decision-maker/strategist, legislator, executive, regulator, shareholder/owner, capital injector, guarantor, and lender to ensure that commercial financial institutions acted to support the Korean shipbuilding industry pursuant to the entrustment and direction of the Government of Korea. The EC submits that, at the time that the commercial financial institutions were called upon to make restructuring decisions, they were themselves financially weak (as a result, in part, of their exposure to the shipbuilding industry) and in the process of being restructured, essentially dependent on the Government of Korea and its agencies and associated public bodies for their future liquidity.

[197] As of 2003, 51 per cent of IBK was owned by the GOK, 15.2 per cent by KEXIM, 15.6 by KIS (itself owned 12.08 per cent by the GOK and 86.61 per cent by KDIC), and 12.53 per cent by KDB (See Responses to Annex V Questions (BCI), Answer 2.1(1), at 23, Exhibit EC-39).

[198] Exhibit EC – 52.

According to the EC, the injection by the Korean Government and the six public bodies acting pursuant to the Government's policies of substantial sums into the private financial institutions (at a time that these institutions were themselves facing considerable financial difficulties) persuaded these institutions to participate in the corporate restructuring programmes of the shipbuilding industry.

7.360 Korea submits that the EC has failed to provide *prima facie* evidence of the existence of any direction or entrustment, since it has not even identified which commercial financial institutions are concerned. Korea asserts that the demonstration of direction or entrustment is a determination that must be made for each private body separately. Korea also asserts that the EC must prove government entrustment and direction in respect of each of the three restructuring procedures challenged by the EC, rather than making allegations regarding the general structure of the financial market.

7.361 Korea also submits that there cannot be direction or entrustment by the GOK for private banks to extend a financial contribution without an explicit and affirmative mandate to do so. Korea notes in this regard that the panel in *US - Export Restraints* concluded that "the ordinary meanings of the words 'entrusts' and 'directs' require an explicit and affirmative action of delegation or command."[199] Although the EC asserts that there is no basis for requiring "an explicit and affirmative action of delegation or command", Korea argues that such a requirement is needed to preserve the balance of rights and obligations arising under the *SCM Agreement*. According to Korea, allowing challenges to be made based on vague circumstantial evidence that does not amount to an explicit and affirmative action would likely impair the interests of the Member which is alleged to have provided subsidies.

7.362 Korea submits that the GOK simply intervened in the market, in consultation with the IMF, in order to stabilize the overall financial market. Korea relies on the following findings of the abovementioned panel to argue that there is a difference between government intervention and government entrustment or direction:

> Government entrustment or direction is thus very different from the situation in which the government intervenes in the market in some way, which may or may not have a particular result simply based on the given factual circumstances and the exercise of free choice by the actors in that market.[200]

7.363 Korea notes that a part of its agreement with the IMF was that it would abstain from government direction.[201] Korea submits that private financial institutions participated in the restructuring process in their own commercial interest, especially as they would only receive capital injections from the government on the condition that they meet certain financial soundness targets.

7.364 According to the EC, there is no basis in the *SCM Agreement* for the *US – Export Restraints* panel having required that the "*element* of an explicit and affirmative action, be it delegation or command"[202] must be a formal action by the government. The EC asserts that if the panel were to interpret these terms as requiring a showing that a government made a formal or official command to the private entity, this would create a loophole because governments can use less formal—but no less effective—forms of influence to grant their subsidies. According to the EC, the analysis whether a

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[199] Panel Report, *US - Export Restraints*, para. 8.44.

[200] Panel Report, *US - Export Restraints*, para 8.31.

[201] In this regard, Korea notes that Letters of Intent ("LOIs") signed with the IMF required that specific workout procedures as applied to particular corporations should be carried out on a "voluntary (i.e., not government directed)" basis as well as on a "market oriented" basis. Attachment to the LOI of May 2, 1998, Attachment "Corporate Governance and Restructuring" section), Exhibit Korea - 23. The Panel notes that the LOI submitted as Exhibit EC – 102 also stated that Korea would "ensure that corporate debt restructuring takes place in a market-based manner, through voluntary workouts between corporations and their creditors".

[202] Panel Report, *US - Export Restraints*, para 8.29 (emphasis supplied).

financial contribution granted by a private body can be imputed to the government has to be made on a case by case basis, taking account of all the relevant elements influencing the decision-making of the private body that point towards government involvement.

Evaluation by the Panel

7.365 The parties disagree as to the circumstances under which an investigating authority could properly determine that a government has entrusted or directed a private body in the sense of Article 1.1(a)(1)(iv). Korea submits that an authority must demonstrate an explicit and affirmative government action addressed to a particular party to perform a particular task or duty. The EC considers that there is no need to have express proof of private body-by-private body, transaction-by-transaction, entrustment or direction, arguing that entrustment or direction can be established on the basis of broader evidence.

7.366 We recall that Article 3.2 of the *DSU* recognizes that interpretative issues arising in WTO dispute settlement are to be resolved through the application of customary rules of interpretation of public international law. It is well settled that the principles codified in Articles 31 and 32 of the *Vienna Convention on the Law of Treaties* (the "*Vienna Convention*") are such customary rules.[203] Thus, the task of interpreting Article 1.1(a)(1)(iv) a treaty provision must begin with its specific terms. Article 1.1(a)(1)(iv) provides that a financial contribution by a private body is covered by the *SCM Agreement* when:

> a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments.

7.367 We note that the text of Article 1.1(a)(1)(iv) was interpreted by the *US – Export Restraints* panel. That panel found:

> 8.28 The dictionary meaning of the word "entrust" is, *inter alia*, to "give (a person, etc.) the responsibility for a task . . . Commit the . . . execution of (a task) *to* a person . . . ". The word "direct" is defined, *inter alia*, as to "[g]ive authoritative instructions to; order (a person) *to do* . . . order the performance of". In this regard, we consider significant the fact that, for "direct" when followed by "to" plus an infinitive (i. e., a verb), the dictionary gives as a meaning to "give a formal order or command to", as this is precisely the construction used in subparagraph (iv) (". . . entrusts or directs a private body *to carry out* . . .").
>
> 8.29 It follows from the ordinary meanings of the two words "entrust" and "direct" that the action of the government must contain a notion of delegation (in the case of entrustment) or command (in the case of direction). To our minds, both the act of entrusting and that of directing therefore necessarily carry with them the following three elements: (i) an explicit and affirmative action, be it delegation or command; (ii) addressed to a particular party; and (iii) the object of which action is a particular task or duty. In other words, the ordinary meanings of the verbs "entrust" and "direct" comprise these elements – *something* is necessarily delegated, and it is necessarily delegated *to someone*; and, by the same token, *someone* is necessarily commanded, and he is necessarily commanded *to do something*. We therefore do not

[203] Article 31(1) of the *Vienna Convention* provides in relevant part that: "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."

> believe that either entrustment or direction could be said to have occurred until all of these three elements are present.
>
> 8.30 Having said that, it is clearly the first element – an explicit and affirmative action of delegation or command – that is determinative. The second and third elements – addressed to a particular party and of a particular task – are *aspects* of the first. Any assessment of whether delegation or command has occurred would necessarily be in reference to that which has been delegated or commanded and in reference to the one to whom it has been delegated or commanded. As aspects of and flowing from the first element of the definition, the second and third elements provide further support for our view that the action must be an explicit and affirmative act of delegation or command. We note, in this regard, that the "entrusts or directs" language in subparagraph (iv) is followed by the language "a private body to carry out . . . ", which is similar to that which we have used to describe the second and third elements of the definition of entrustment or direction. Thus, the subsequent language in subparagraph (iv) confirms our view of the requirement of an explicit and affirmative action.[204]

7.368 As noted by the panel in *US – Export Restraints*, the dictionary meaning of the word "entrust" is, *inter alia*, to "give (a person, etc.) the responsibility for a task . . . Commit the . . . execution of (a task) *to* a person . . . ".[205] The word "direct" is defined, *inter alia*, as to "[g]ive authoritative instructions to; order (a person) *to do* . . . order the performance of".[206] We agree with the *US – Export Restraints* panel that "[i]t follows from the ordinary meanings of the two words 'entrust' and 'direct' that the action of the government must contain a notion of delegation (in the case of entrustment) or command (in the case of direction)".

7.369 The *US – Export Restraints* panel also found that "both the act of entrusting and that of directing therefore necessarily carry with them the following three elements: (i) an explicit and affirmative action, be it delegation or command; (ii) addressed to a particular party; and (iii) the object of which action is a particular task or duty".[207] The parties disagree on this aspect of the panel's findings. Korea relies on this finding to argue that there can be no finding of entrustment or direction in the absence of an explicit act whereby a particular task or duty is delegated to a specific person, or whereby a specific person is commanded to perform a particular task or duty. The EC denies that the act of delegation or command need be explicit, or addressed to a specific person.

7.370 Regarding the first element identified by the *US – Export Restraints* panel, we agree that the delegation or command inferred by the terms "entrustment" and "direction" must take the form of an affirmative act. The object of a Member's responsibility should be its acts, as such, rather than the reactions to or consequences of those acts, as alleged reactions and consequences may simply be the result of happenstance or chance.[208] That being said, we see nothing in the text of Article 1.1(a)(1)(iv) that would require the act of delegation or command to be "explicit". Although the particular facts of the *US – Export Restraints* case may have caused that panel to employ the term "explicit", no such qualification is included in the terms of Article 1.1(a)(1)(iv). In our view, the affirmative act of delegation or command could be explicit or implicit, formal or informal. [209]

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[204] Panel Report, *US – Export Restraints*, paras 8.28 – 8.30 (footnotes omitted).

[205] *The New Shorter Oxford English Dictionary*, Volume 1, 1993, Clarendon Press, Oxford.

[206] *Id.*

[207] Panel Report, *US – Export Restraints*, para. 8.29.

[208] Like the *US – Export Restraints* panel, "we do not see how the reaction of private entities to a given governmental measure can be the basis on which the Member's compliance with its treaty obligations under the WTO is established" (see *US – Export Restraints*, para. 8.34).

[209] Indeed, the utility of Article 1.1(a)(1)(iv) would be undermined if an "explicit and affirmative action of delegation or command" were required. That provision operates as a catch-all, so that indirect government

7.371 As to the issue of whether or not the act of delegation or command must be addressed to a specific individual, we agree with the *US – Export Restraints* panel that, of the three elements it identified in the extract cited above, the first element, i.e. the affirmative action of delegation or command, is determinative. As the panel noted, the second and third elements – addressed to a particular party and of a particular task – are aspects of the first, in the sense that the assessment of whether delegation or command has taken place would of necessity involve an examination of both who allegedly has been entrusted or directed to act, and what the action or task in question is.

7.372 Since the second and third elements identified by the *US – Export Restraints* panel are aspects of the first element, we consider that the manner, or degree of detail, in which the addressee and object of the act of delegation or command is specified will depend on the form that the act of delegation or command may take. Thus, while a greater degree of specificity may be expected in respect of explicit or formal acts of delegation or command,[210] this will not necessarily be the case in respect of implicit or informal acts. In our view, the fact that the addressee and object of the act of delegation or command is described in less detail does not preclude a finding of entrustment or direction, as a matter of law. Rather, it raises evidentiary issues. While the fact that an act of delegation or command is specifically addressed to a particular private body may make it easier, in terms of evidence, for a Member or investigating authority to establish the existence of entrustment or direction, the fact that an act of delegation or command is not specifically addressed to a particular private body does not necessarily mean that a finding of entrustment or direction in respect of that private body is precluded. It simply means that, as an evidentiary matter, it will be more difficult for a Member or investigating authority to properly demonstrate that such private party was entrusted or directed. Similarly, the fact that an act of delegation or command does not specify in great detail what must be done does not necessarily preclude a finding of entrustment or direction. It simply makes it more difficult for a complainant or investigating authority to properly demonstrate that a transaction undertaken by a private body was the object of governmental entrustment or direction. Thus, although the plain meaning of entrustment and direction requires that something must be delegated to someone, or that someone must be commanded to do something, the plain meaning of those terms does not require that such someone or something must necessarily be specified in great detail. That being said, the evidence of entrustment or direction must in all cases be probative and compelling. Thus, whatever the nature or form of the affirmative acts of delegation or command at issue, the evidence must demonstrate that each entity allegedly providing, or participating in, a financial contribution was entrusted or directed by the government to do so.[211]

7.373 For the most part, the EC does not rely on any explicit affirmative act of government delegation or command in respect of the three restructurings at issue in these proceedings. Instead, its arguments are largely based on alleged implicit and informal acts of delegation or command. For this reason, most of the evidence relied on by the EC is circumstantial in nature. There is no reason why a case of government entrustment or direction should not be premised on circumstantial evidence, provided that such evidence is probative and compelling, in the sense that it demonstrates that each of the private creditors participating in the restructurings was entrusted or directed to do so. Thus, the EC purports to build its claim on the following factors:

- GOK compelled commercial financial institutions to participate in the restructuring process by ruling that no public funds would be made available to banks which "are not certified by

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action does not fall outside the scope of the *SCM Agreement*. We are not prepared to read into Article 1.1(a)(1)(iv) terms that would allow such indirect government action to circumvent the WTO's subsidy disciplines.

[210] Of course, explicit and formal acts of delegation or command could also be drafted in very general terms, and addressed to a broadly defined group.

[211] Whatever the nature or form of the affirmative acts of delegation or command, and whatever the type of evidence relied upon, there must always be a determination to the effect that each of the private entities at issue was entrusted or directed by the government.

the FSC to be performing their role in the corporate restructuring process",[212] or "making adequate progress on implementation of sound corporate debt restructuring";[213]

- GOK controlled the workout of DHI/DSME at the level of the CRA;
- the enactment of Prime Ministerial Decree No. 408;
- one of Daewoo's creditors, Kookmin Bank, acknowledged that its commercial policy had been affected by government intervention;
- GOK guaranteed creditors against losses incurred in the restructurings at issue;
- the very fact that capital-deficient creditors restructured, rather than liquidated, the companies at issue; and
- many of the domestic creditors were partially or wholly owned by GOK.

7.374 Although reliance on such circumstantial evidence may make it more difficult for the EC to establish a *prima facie* case of entrustment or direction as a matter of fact, it does not exclude the EC's claim as a matter of law. In reviewing the EC's evidence, however, we would agree with the *US – Export Restraints* panel that:

> Government entrustment or direction is thus very different from the situation in which the government intervenes in the market in some way, which may or may not have a particular result simply based on the given factual circumstances and the exercise of free choice by the actors in that market.[214]

7.375 Since the EC's Article 1.1(a)(1)(iv) claims are based on circumstantial evidence, we consider that it is particularly important not to confuse the concepts of government entrustment or direction on the one hand, and the government intervention in the market on the other. With this in mind, we shall now consider the circumstantial evidence relied on by the EC.

- Access to public funds

7.376 The EC submits that GOK was able to entrust or direct Korean private banks to participate in restructurings because they were financially weak and essentially dependent on government capital. The EC claims that GOK was able to compel financial institutions to participate in corporate restructurings by imposing conditions on their access to public funds. In particular, the EC submits that, in accordance with LOIs submitted to the IMF, no public funds would be made available to banks which were "not certified by the FSC to be performing their role in the corporate restructuring process",[215] or "making adequate progress on implementation of sound corporate debt restructuring".[216] The EC also asserts that banks that received public funds were limited in the way they could exercise their independence in participating in a restructuring. According to the EC, Article 18 of the Special Act on the Management of Public Funds obliges banks to enter into written agreements with the companies they wish to support the details of which are set out in a Presidential Decree. The EC further argues that banks are prohibited from providing funds if the agreements are not implemented or are not likely to be implemented.

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[212] Exhibit EC – 36.
[213] Exhibit EC – 102.
[214] Panel Report, *US - Export Restraints*, para 8.31.
[215] Exhibit EC – 36.
[216] Exhibit EC – 102.

7.377 The EC also submits that it would have been unthinkable for Daehan Investment Trust and Seoul Guarantee Insurance Co. not to participate in the Daewoo restructuring having been informed that they were eligible to receive substantial amounts of public funds. In support, the EC relies on a MOFE press release which, it claims, "announc[es] that Daehan Investment Trust Co. would receive KRW 1 trillion in public funds and that Seoul Guarantee Insurance Co. would receive public funds to guarantee Daewoo bond".[217]

7.378 According to Korea, the certification by the FSC referred to in the LOI was never implemented. Korea also submits that the EC's description of the *Special Act on the Management of Public Funds* is misleading. In response to Question 118 from the Panel, Korea submits that Article 18 does not apply in the context of the restructurings at issue in the present proceedings. According to Korea, Article 18 applies to a publicly-funded bank's individual lending activity. Thus, the restriction applies only when a publicly-funded financial institution decides to extend a new loan to an unsound company in an individual transaction between that particular bank and the unsound company as a borrower. According to Korea, therefore, the "restructuring agreement" referred to in Article 18 means an agreement between the lending bank and borrowing company (normally called a "Memorandum of Understanding", or "MOU") whereby the unsound borrower agrees to implement self-initiated actions, such as disposing of unnecessary assets or businesses or reducing labor costs, in order to make itself more accountable for the new borrowing. Korea asserts that Article 18 does not apply to the cases where the publicly-funded banks participate in a workout or court-receivership proceeding as a member of the creditors' council or other interested parties' meeting.

7.379 First, we note that the EC has not disputed Korea's argument that the FSC certification referred to in the LOI was never implemented. In addition, we note that the LOIs required that specific workout procedures as applied to particular corporations should be carried out on a "voluntary (i.e., not government directed)" basis as well as on a "market oriented" basis.[218] For these reasons, we are unable to accept the LOIs as evidence that GOK compelled banks to participate in corporate restructurings.[219]

7.380 Second, we are not persuaded that the Special Act on the Management of Public Funds is relevant to these proceedings. On the basis of the explanation provided by Korea, and in the absence of rebuttal by the EC, we do not consider that the restructurings under review are "restructuring[s]" referred to in Article 18 of the Special Act on the Management of Public Funds.[220]

7.381 Third, we note that the MOFE press release relied on by the EC in respect of the Korea Investment Trust Co. and Daehan Investment Trust Co. also contains a statement by the FSC chairperson that "the fiscal injection to these two ITCs is not directly related to Daewoo papers, rather it is an inevitable step needed to resolve financial problems aggravated over the years at these two companies".[221] Since the same document therefore both makes and refutes the EC's argument

[217] MOFE Press Release, "Financial Market Stabilization Package Related to Daewoo Group Workout Plan", 4 November 1999, Exhibit EC – 60.

[218] Attachment to the LOI of May 2, 1998, Attachment "Corporate Governance and Restructuring" section), Exhibit Korea - 23. The LOI submitted as Exhibit EC – 102 also states that Korea would "ensure that corporate debt restructuring takes place in a market-based manner, through voluntary workouts between corporations and their creditors".

[219] We note that Korea has not sought to rely on its various agreements with the IMF as a general defence in these proceedings (see para. 46 of Korea's first written submission).

[220] Article 18(1) of the Special Act on the Management of Public Funds provides "[i]f a Financial Institution which received Public Funds pursuant to the provision of Article 17(1) intends to provide new funds to an unsound company as prescribed by the Presidential Decree, it shall enter into a written agreement with such unsound company, which shall include consents from the persons concerned with the restructuring of that company and other matters as prescribed by the Presidential Decree".

[221] MOFE Press Release, "Financial Market Stabilization Package Related to Daewoo Group Workout Plan", 4 November 1999, Exhibit EC – 60.

regarding these companies' access to public funds, we are unable to draw any conclusions on the basis of that document regarding the conditions on which those companies obtained access to public funds.

7.382 In light of the above, we are not persuaded by the EC's argument that restrictions on creditors' access to public funds provided GOK with sufficient leverage to entrust or direct creditors to participate in the Daewoo workout.

- Corporate Restructuring Agreement

7.383 The EC asserts that GOK controlled the Daewoo workout at the level of the CRA. According to the EC, the Government of Korea in mid-1998 forced all banks and financial institutions sign the CRA, under which these institutions explicitly committed themselves to such things as corporate restructuring (as opposed to liquidation) through debt-for-equity swaps and other measures, and subjected themselves to penalties for breach of the CRA. The EC asserts that banks essentially waived their rights to act as fully independent entities when signing the CRA.

7.384 Korea submits that the CRA is merely a framework agreement that did not in itself pose any substantive controversial issues. According to Korea, the CRA was a voluntary agreement and, in no event, mandated the banks to agree to a particular restructuring plan against market principles. Rather, the CRA provided a structure for workout once the creditor financial institutions had decided that workout of a given company was preferable to liquidation. Korea rejects the EC's argument that the CRA was government-mandated because it was implemented quickly. According to Korea, the speed of action, particularly in a financial crisis where everything moves quickly, is proof of nothing at all regarding independence.

7.385 The EC states that Korea’s contention that the CRA was negotiated and signed voluntarily is doubtful. The EC asserts that the CRA was explained to only 28 financial institutions in June 1998, and was signed by 210 financial institutions only 6 days later. According to the EC, it is hard to believe that 210 institutions voluntarily negotiated and agreed to such an important document in less than one week without any governmental interference. Korea disputes the EC contention that the CRA was created over so short a period, stating that a task force had been at work on this question since April 1998.

7.386 We understand that the EC's argument concerns the structure and basic provisions of the CRA *per se*, rather than the application of the CRA in respect of the Daewoo workout in particular. The EC relies on Articles 1, 2 and 20 of the CRA in support of its argument. Turning to Article 1, we note that it states that the objective of the CRA is "to propel workout programs of companies ... and improve financial integrity of creditor financial institutions through an effective and activated propulsion of workout programs". We do not interpret this provision as an obligation on signatories to participate in restructurings. For example, in the event of a determination by creditors that the liquidation value of a company exceeds its going-concern value, nothing in Article 1 of the CRA requires those creditors to nevertheless restructure (rather than liquidate) the company. The CRA simply means that if restructuring is to take place, the provisions of the CRA shall apply. Article 2 merely contains definitions, and therefore imposes no substantive obligation on signatories to participate in restructurings. Article 20 provides for the imposition of penalties when financial institutions breach restructuring arrangements that have been negotiated under the CRA. Article 20 does not impose penalties on creditors that oppose a restructuring. Nor are penalties imposed if creditors collectively decide to liquidate rather than restructure a company. Accordingly, we do not consider that Articles 1, 2 and 20 of the CRA support a finding that the CRA *per se* obliges creditors

to participate in restructurings, or otherwise constitutes evidence of government entrustment or direction in respect of the Daewoo workout.[222]

7.387 Regarding the speed with which banks signed up to the CRA, we note[223] that work on the CRA commenced in April 1998, and that the basic concept and structure of the CRA as the framework agreement for workout was explained to 28 banks and financial institutions. Furthermore, a process of commenting and negotiations took place among the financial institutions through their trade associations between 19 June and 24 June 1998. We also note that, although the CRA was to take effect on 25 June 1998, it remained open for signature after that date. In these circumstances, and especially given the involvement of banks in the preparation of the CRA, we see nothing untoward in a large number of banks being in a position to sign the CRA within one week after it took effect.

7.388 In light of the above, we reject the EC's argument that the CRA constitutes evidence of entrustment or direction.

- Prime Ministerial Decree No. 408

7.389 The EC submits that GOK's control over private banks is demonstrated by Prime Ministerial Decree No. 408. The EC asserts that, while Article 6 of this Decree seems to guarantee the independence of banks in which the Government of Korea has a shareholding interest, Article 5 specifically requires these banks to co-operate with the Government of Korea "for the purpose of stability of the financial market" and "to attain the goals of financial policies." The EC states that it is even specified that instructions can be given orally or by telephone.

7.390 Korea submits that it is a duty of the government in any jurisdiction to adopt and implement financial policies and to ensure stability of the financial market. Korea asserts that financial institutions are typically subject to statutory obligations to comply with legitimate governmental orders or requests to implement such financial policies to stabilize the financial market. Korea submits that Article 5 of the Prime Minister's Decree only provides for procedures that the Government of Korea can follow to implement such legitimate governmental policies. Korea submits that the Prime Minister's Decree proves the opposite to what the EC purports to prove by referring to it, since the Decree was intended to guarantee the independence of banks in which the Government of Korea has a shareholding interest. Korea asserts that the Prime Minister's Decree in fact implemented the commitment of the Government of Korea to the IMF that:

> In the interim [i.e., pending re-privatization of government-owned commercial banks], banks will be operated on a fully commercial basis and the government will not be involved in the day-to-day management of the banks.[224]

7.391 We understand the EC's argument in respect of Prime Ministerial Decree No. 408 to be that the Decree gives the GOK "control" over private banks, i.e., that by virtue of the Decree, the GOK has the power to entrust or direct the banks to engage in corporate restructuring. We do not see anything in the Decree, however, to suggest that it has anything to do with any such power of the government to compel banks to participate in corporate restructuring. Rather, the Decree appears to be focused on measures to ensure the stability of the financial market as such.[225] We note that Article 1 of Prime Ministerial Decree No. 408 provides that its purpose is to "procure that the Government shall go

[222] Our conclusion is further supported by Article 10 of the CRA, which provides that dissatisfied creditors may resort to mediation.

[223] See Korea's reply to Question 120 from the Panel. The EC did not comment on the new factual information submitted by Korea in response to this question.

[224] Annex to Korea's 13 November 1998 Letter of Intent to the IMF, Exhibit EC – 117.

[225] We find it difficult to conceive of any country that does not have a legislative or regulatory framework enabling the government to intervene in the market for the purpose of maintaining financial stability.

through objective and transparent formalities in *establishing financial policies or conducting supervision over financial institutions*, and to exclude unfair outside intervention in management of financial institutions, etc. so that financial institutions, etc. can operate their businesses more independently, taking more responsibility" (emphasis added). We further note that Article 5.1 of the Decree provides that "[i]f the Financial Supervisory Agencies request cooperation or assistance of Financial Institutions, etc. *for the purpose of stability of the financial market*, etc. (excluding the request for data in relation to routine management activities), such request shall be made in writing or through a meeting" (emphasis added). Whereas Article 5.2 provides that in cases of urgency such request may be made orally or by telephone, it further provides that "[i]n this case, the Financial Supervisory Agencies shall notify such request to the relevant Financial Institutions, etc. in writing without delay". Pursuant to the Decree, therefore, the GOK does appear to have the power, in certain circumstances, to compel private banks to undertake certain actions related to maintaining stability in the financial markets. The EC has provided no evidence, however, that "stability in the financial markets" encompasses or is related to corporate restructuring.

7.392 In any event, we emphasize that the issue of entrustment or direction does not have to do with a government's power, in the abstract, to order economic actors to perform certain tasks or functions. It has instead to do with whether the government in question has *exercised* such power in a given situation subject to a dispute. In this regard, we note that the EC has provided no evidence that the Prime Ministerial Decree No. 408 was ever invoked or relied on by the GOK in the context of any restructuring.

7.393 For these reasons, we are not persuaded by the EC's reliance on Prime Ministerial Decree No. 408 as evidence of GOK entrustment or direction of private creditors in respect of the restructurings at issue in these proceedings.

- Kookmin Bank Statement

7.394 The EC submits that one of the creditors participating in the Daewoo workout, the Kookmin Bank, publicly stated that the Korean Government has indeed compelled banks to agree to restructuring measures that were not in accordance with their own credit review policies. In support, the EC refers to the following statement by Kookmin on 18 June 2002 in connection with a planned offering of shares on the New York Stock Exchange:

> The Korean government promotes lending to certain types of borrowers as a matter of policy, which we may feel compelled to follow. The Korean government has promoted, and, as a matter of policy, may continue to attempt to promote lending to certain types of borrowers. It generally has done this by requesting banks to participate in remedial programs for troubled corporate borrowers and by identifying sectors of the economy it wishes to promote and making low interest loans available to banks and financial institutions who lend to borrowers in these sectors. … government policy may influence us to lend to certain sectors or in a manner in which we otherwise would not in the absence of the government policy.[226]

7.395 Korea submits that the EC omitted the following extract from the abovementioned Kookmin statement:

> The government has in this manner promoted low-income mortgage lending and lending to technology companies. We expect that all loans made pursuant to government policies will be reviewed in accordance with our credit review policies.

[226] Kookmin Bank brochure, p. 22, (Exhibit EC-100).

7.396 According to Korea, the omitted text makes it clear that Kookmin's statement was actually made in respect of GOK promotion of low-income mortgages and lending to technology companies, rather than the shipbuilding sector. Korea also submitted a letter from Kookmin's lawyers explaining that the above statement "does not state, nor was it intended to imply, that the Korean government exercises control over the banking sector generally or over bank lending decisions either generally or with respect to particular borrowers such as Hynix".

7.397 Taking into account that part of the Kookmin statement omitted by the EC, we accept Korea's argument that it was actually made in respect of GOK promotion of low-income mortgages and lending to technology companies, rather than the shipbuilding sector. The statement therefore provides no evidence that Kookmin was entrusted or directed to participate in the restructuring of shipyards. In any event, we note that the statement refers to GOK "requesting" banks to participate in remedial programs for troubled corporate borrowers. In the absence of any other probative material, we do not consider that a government "request" should be treated as evidence of entrustment or direction, since it does not imply the requisite elements of delegation or command. Since we do not consider that the Kookmin statement constitutes evidence of government entrustment or direction in respect of the restructurings at issue in these proceedings, there is no need for us to consider the explanatory letter prepared by Kookmin's lawyers.

- 1998 December Agreement / Guarantee Against Loss

7.398 The EC submits that GOK further established its ability to entrust and direct the financial institutions' participation in the corporate restructuring by guaranteeing against losses arising from these workouts. The EC notes in this regard that the 1998 December Agreement for the Restructuring of the Top Five *Chaebols* ("December 1998 Agreement") stipulates that the Government "will monitor implementation of the agreed restructuring plan from the viewpoint of upholding soundness of financial institutions" and "support the restructuring efforts of corporate sector and financial institutions."[227]

7.399 Korea submits that the relevant Agreement did not apply to the restructurings at issue in these proceedings, and that it is unrelated to the CRA.

7.400 We do not consider that the December 1998 Agreement has any bearing on allegations of government entrustment or direction in respect of the restructurings at issue in these proceedings, since it did not apply to them. The December Agreement envisaged self-restructuring by the top five chaebols – including Daewoo – through *inter alia* Capital Structure Improvement Plans,[228] while they were still solvent. There are no such self-restructurings before us in these proceedings. Instead, these proceedings concerns restructurings required by creditors under the CRA and corporate reorganization procedures. Accordingly, the December 1998 Agreement is of no relevance to the question of whether or not GOK entrusted or directed creditors to participate in the restructurings of Daewoo, Halla and Daedong.

7.401 The EC submits that a precursor to the December 1998 Agreement was concluded between the top five chaebols and the President of Korea in January 1998. The EC requests an adverse inference under Annex V.7 of the *SCM Agreement,* on the basis that Korea failed to provide a copy of the January 1998 Agreement under the Annex V procedure. Korea submits that it did not provide a copy of the January 1998 Agreement because it has nothing to do with the corporate restructuring of insolvent companies. Korea asserts that the January 1998 Agreement ceased to apply to Daewoo after it became insolvent and entered the workout procedure. The EC alleges that the January 1998 Agreement was concluded between the top five chaebols and the President of Korea. The only restructuring at issue in these proceedings involving a chaebol is the Daewoo workout, dating from

[227] December 1998 Agreement, Articles 18, 20 (Exhibit EC-40).
[228] See Section 2(10) of the December 1998 Agreement, Exhibit EC-40.

2000. As the December 1998 Agreement is not relevant to our examination of the Daewoo workout, we fail to see how an earlier version of that agreement could be of greater probative value, especially as it was concluded over two years before the Daewoo workout. Furthermore, we note that the EC asserts that the January 1998 Agreement "shows the degree of intervention of the [GOK] in the corporate sector".[229] However, government intervention in the corporate sector does not necessarily amount to government entrustment or direction in respect of a particular restructuring. For these reasons, we decline to treat Korea's failure to provide the January 1998 Agreement in the context of the Annex V procedure as "non-cooperation" in the meaning of Annex V.7 of the *SCM Agreement*. We therefore reject the EC's request for an adverse inference under that provision.

- Liquidation as a source of capital

7.402 The EC asserts that proof of entrustment or direction lies in the fact that, under normal market conditions, the financial institutions' need for capital would have led them to pursue all means to increase cash inflows by *inter alia* liquidating – rather than restructuring - troubled borrowers. Thus, the EC submits that the very fact that these financial institutions engaged in restructuring is evidence of government entrustment or direction.

7.403 We are unable to accept this argument, since the question of whether or not market considerations would have caused creditors to liquidate, rather than restructure, Daewoo, Halla or Daedong relates more directly to the issue of "benefit".[230]

- Government ownership

7.404 The EC claims that further evidence of entrustment or direction lies in the fact that many of the domestic creditors participating in restructurings were partially or wholly owned by GOK.

7.405 Korea submits that government ownership is not the same as government entrustment or direction.

7.406 We are not prepared to accept that some degree of government ownership, by itself, constitutes proof of government entrustment or direction.[231] Although a government ownership share in an entity may increase the ability of a government to entrust or direct that entity, there must still be evidence of an affirmative act of delegation or command before a finding of entrustment or direction may be made.[232]

- Conclusion

7.407 In light of the above, we reject the EC's claim that private creditors were entrusted or directed to participate in the three restructurings at issue in these proceedings. Although the EC may have provided evidence of general GOK intervention in the financial services market, we do not consider

[229] See EC First Written Submission, note 31.

[230] Since we find below that the EC fails to establish that market considerations would have required liquidation rather than restructuring, there would be no factual basis to the EC's argument even if it were considered as potential evidence of government entrustment or direction.

[231] We note that government ownership would seem to be more directly relevant, in the first instance, to the application of Article 1.1(a)(1) of the *SCM Agreement*, i.e., to whether or not the entity in question is or is not a "public body", rather than to entrustment or direction. That is, would the extent of government ownership be sufficient to confer government control, such that the relevant entity was a public body? Here, we recall that the EC has not alleged that any of the domestic creditors other than KAMCO, KDIC, BOK, KDB, IBK, AND KEXIM are public bodies.

[232] In addition, we note that, according to Attachment 3 to the EC's replies to the Panel's questions after the first substantive meeting, many of the private creditors participating in the restructurings at issue were not owned to any extent by GOK. The factual basis of the EC's argument is to some extent, therefore, undermined.

that the circumstantial evidence relied on by the EC indicates any affirmative act of delegation or command in respect of the three restructurings at issue. Similarly, even if the GOK had the authority and potential to entrust or direct private creditors to participate in the restructurings, the EC has not demonstrated that the GOK exercised such power.

(iii) Transfer of Pecuniary Value

Arguments of the parties

7.408 Korea submits that the debt-for-equity swaps, interest rate reductions, interest forgiveness and interest deferral at issue in these proceedings did not constitute "financial contributions" because there was no transfer of pecuniary value to the companies under workout or corporate reorganization, but rather an increase in the value of recovery by the financial institutions engaging in those transactions. Korea asserts that at the time of commencement of the workout or corporate reorganization procedures, Halla and Daedong went bankrupt and Daewoo was also insolvent, thereby reducing the actual value of the credits extended by the financial institutions to the level of the liquidation values of these distressed companies. Korea considers that, in this context, the creditor financial institutions did not forego anything of value, but undertook the debt-for-equity swaps and other debt restructuring as a means of preserving the going concern value which was determined to be higher than the liquidation value.

7.409 The EC asserts that, from the perspective of both the grantor and the grantee, a debt-for-equity swap is a financial contribution. First, it includes the element of debt forgiveness, as the creditor no longer can demand interest payments or repayment of debt principal after a debt-for-equity swap. Second, it also requires the purchase of equity in the company by the former creditor. These are both, independently, financial contributions to the recipient.

7.410 The EC also submits that Korea confuses financial contribution and benefit when it argues that the debt-for-equity swaps and other debt restructuring cannot constitute a financial contribution because the creditors agreed to these measures "as a means of preserving the going concern value which was determined to be higher than the liquidation value."[233] According to the EC, the question of whether the creditors received something in exchange for their financial contribution, such as the preservation of going concern value, is a question of benefit, not of financial contribution.

Evaluation by the Panel

7.411 We are not persuaded by Korea's arguments that debt-for-equity swaps and interest reductions and deferrals are not financial contributions. In the first place, we recall that there is a financial contribution in the sense of Article 1.1(a)(1)(i) of the *SCM Agreement* if there is a "direct transfer of funds", and that grants, loans and equity infusions are listed only as three possible examples of such transfers. Thus, we view Article 1.1(a)(1) as identifying in its respective subparagraphs the kinds of instruments or transactions that could be considered to be "financial contributions". Of course these instruments would only be covered by the Agreement if they were made "by a government or public body", and they would only be subsidies covered by the Agreement if they both conferred a benefit and were specific. Thus, the concept of financial contribution is but one in a set of cumulative, and independent, elements all of which must be present for a measure to be regulated by the *SCM Agreement.*

7.412 We find the examples listed in Article 1.1(a)(1)(i) to be illuminating in respect of the scope of the term "direct transfer of funds". Most importantly, considering the "medium of exchange" in the listed examples, we note that all of the examples involve transfers of money ("funds"), as opposed to in-kind transfers (of goods or services, in the sense of Article 1.1(a)(1)(iii)). The fact that the listed

[233] First Written Submission by Korea, 2 February 2004, para. 318.

kinds of direct transfers of funds (grants, loans and equity infusions) are identified as only examples clearly indicates that there may well be other types of instruments that would equally constitute direct transfers of funds in the sense of Article 1.1(a)(1)(i).

7.413 Turning to the particular cases of the transactions involved in the restructuring, we find that all of them are of the same nature as those explicitly listed in Article 1.1(a)(1)(i). First we note that interest reductions and deferrals are similar to new loans, as they involve a renegotiation / extension of the terms of the original loan. We see no reason why loans would constitute financial contributions while interest reductions and deferrals would not. Further, we consider that interest / debt forgiveness is comparable to a cash grant, as funds that were previously provided as a loan, against interest, are now provided for free, given the removal of the repayment obligation. All of these transactions therefore constitute direct transfers of funds in the sense of Article 1.1(a)(1)(i) of the *SCM Agreement*. Regarding debt-for-equity swaps, we note that equity infusions are explicitly listed as a type of direct transfer of funds in Article 1.1(a)(1)(i). Since we have also found that debt forgiveness constitutes a direct transfer of funds, we see no reason why a combination of equity infusion and debt forgiveness should fall outside the scope of that provision. The reason why creditors agree to such transactions (i.e., whether or not it is in order to preserve going concern value) is not relevant to the issue of whether or not the transactions constitute financial contributions. Rather, it relates to the issue of benefit (in the sense of whether or not creditors operating on market principles would have undertaken such transactions on the same terms).

(iv) Financial Contribution to Oneself

Arguments of the parties

7.414 Korea submits that the various debt restructurings challenged by the EC are not "financial contributions" since they involve transactions between companies and the owners of those companies. Korea submits that one cannot make a "financial contribution" to oneself. Korea argues that, in order for a "financial contribution" to exist, there must be at least two separate identifiable entities. According to Korea, the EC has failed to identify which party received the alleged financial contribution, because when the creditor financial institutions of the three Korean shipyards undertook a debt forgiveness or other debt rescheduling, they had already taken, or at least simultaneously took, the ownership or control of the subject companies. Thus, they have forgiven the debt of the companies which they owned or controlled and the beneficiaries of this debt forgiveness were the financial institutions themselves.

7.415 Korea asserts that its argument is based on the WTO case-law indicating that "any analysis of whether a benefit exists should be on 'legal or natural persons' instead of productive operations."[234] Korea submits that such case-law regarding the existence of benefit also has consequences regarding the definition and recipient of "financial contribution", in the sense that if one looks through the assets to the actual owners to determine if there is a benefit, one should also do so to determine if there is a financial contribution. According to Korea, this means that if the owner and the contributor are the same "person", the issue arises as to whether there has actually been a financial contribution at all.

7.416 The EC (and US) submit that Korea's argument is incorrect, because if the drafters of the *SCM Agreement* had contemplated having ownership of a company operate as an exemption from subsidies disciplines, they would not have listed equity infusions as an example of a form of financial contribution in Article 1.1(a)(1)(i). According to the EC and US, Korea's argument is therefore at odds with the text of the *SCM Agreement*.

7.417 The EC also argues that Article 14(a) of the *SCM Agreement* provides relevant context, as it permits an authority investigating the potential for imposing countervailing duties to find a benefit to

[234] Appellate Body Report, *US – Countervailing Measures on Certain EC Products*, para. 110.

recipients based on "government provision of equity capital." According to the EC, if the simultaneous action of the transfer of funds and the creation of equity interest in a company prevents a finding of financial contribution, then Article 14(a) would not have been included in the *SCM Agreement*.

7.418 Korea counters these arguments by distinguishing debt / equity swaps from equity infusions / government provision of equity capital. Thus, in response to the EC and US arguments that equity infusions by public entities can constitute financial contributions, Korea asserts[235] that "equity infusions are legally distinct from debt-for-equity swaps", and that "there is no logical relationship of debt-equity swaps to the term equity infusion". In particular, Korea asserts[236] that equity infusions are often covers for direct subsidies to cover operating losses, in the sense that the purported capital calls generally were mere shams reflected by the unwillingness of minority shareholders to respond. According to Korea, the issue in a debt-for-equity swap made in an insolvency situation is different. In such cases, where the company is insolvent and, therefore, in the hands of the creditors, the swap reflects a change in form of financial instrument. Korea asserts that in the present case, the creditor financial institutions were not holding cash which they could invest in a range of financial instruments; they were holding debt and the issue was what they could do with the debt in order to maximize their return.

Evaluation by the Panel

7.419 We do not agree with Korea's argument that a debt-for-equity swap should be treated as a transaction with oneself. Clearly, creditors and the debtor company are separate legal entities. In an insolvency situation, the creditors may decide to acquire ownership of the company in order to maximize the return on their debt-holding (or minimize their losses). One way of doing so is through a debt-for-equity swap. Such a transaction between separate legal entities results in a change in ownership of the debtor company, and the issue before the Panel is whether the changes in ownership of certain Korean shipyards conferred subsidies. Korea relies on WTO case-law[237] concerning the changes in ownership in the context of privatizations to argue that a financial contribution, like benefit, must be conferred on a legal or natural person, rather than on productive operations / assets. We are not persuaded that such case-law is relevant, however, since this is not a case involving privatization. In those privatization cases, the alleged subsidy took place prior to privatization, and the question was whether the benefit from those earlier subsidies was extinguished upon the change-in-ownership. The change in ownership in those cases was undertaken at arm's length, and for fair market value. In the present case, however, the change in ownership is the alleged subsidy. In any event, even the Appellate Body privatization case-law relied on by Korea has clarified that a distinction may be made between a company and its owners in certain cases, such that the owners of a company may be found to confer a benefit on that company.[238] That being the case, we see no reason why the owners of a company could not also provide a "financial contribution" to that company.[239]

7.420 Furthermore, we consider that the EC and US arguments regarding Articles 1.1(a)(1)(i) and 14(a) of the *SCM Agreement* are both compelling. In particular, the fact that equity infusions are explicitly designated as "financial contributions" suggests to us that the *SCM Agreement* does not preclude the owner of a company making a "financial contribution" to that company. Equity infusions and debt-for-equity swaps have the same effect, in the sense that equity changes hands

[235] See Korea's response to Question 22 from the EC.
[236] See Korea's response to Question 46 from the Panel.
[237] See, for example, Panel and Appellate Body Reports in *US – Lead and Bismuth I,US – Lead and Bismuth II, and US – Countervailing Measures on Certain EC Products.*
[238] See *US – Countervailing Measures on Certain EC Products*, para. 118.
[239] For instance, a government injecting equity into a government-owned enterprise, or a holding company injecting new capital into one of its subsidiaries, are examples of cases where the owner of a company provides a financial contribution to that company.

against consideration in both cases (and subsidization arises if the amount of consideration is less than the market would have provided). Also, a debt/equity swap comprises an element of equity infusion. Accordingly, we consider that the references to equity infusions in Articles 1.1(a)(1)(i) and 14(a) of the *SCM Agreement* provide a strong contextual basis for rejecting Korea's argument that there is no financial contribution because one cannot make a financial contribution to oneself.

7.421 Korea responds by seeking to distinguish equity infusions from debt-for-equity swaps. Korea's distinction, however, is premised on an assumption that "equity infusions" are necessarily subsidies, and that debt/equity swaps necessarily are not (since, according to Korea, they involve the maximization of return). Such an approach, however, prejudges the substantive issue before the Panel (i.e., was there subsidization?), and overlooks the fact that an equity infusion may be undertaken by a market operator on market terms (in which case there would be no subsidy).

7.422 Furthermore, Korea's argument would mean that a cash grant by a government to a government-owned company would not constitute a financial contribution (and therefore could never be a subsidy). Such an outcome would be absurd. Indeed, when this issue was put to Korea in Question 46 from the Panel, Korea did not actually answer the question. Instead of addressing the issue of government cash grants (which the Panel's question was about), Korea again reverted to the alleged distinction between equity infusions and debt/equity swaps. However, if there is truth in the statement that one cannot make a financial contribution to oneself, it should apply in all cases, including to cash grants.

7.423 In light of the above, we reject Korea's argument that the owners of a company are unable, in law, to make a financial contribution to that company.

(v) Financial contributions "by" public bodies

7.424 In respect of the Daewoo workout, Korea asserts that there were no financial contributions "by" individual public bodies or private bodies allegedly entrusted/directed by GOK because financial contributions were effected pursuant to the authority of the creditors' councils or meetings of interested parties. In respect of the reorganizations of Halla and Daedong, Korea submits that there were no financial contributions "by" public bodies or private bodies allegedly entrusted/directed by GOK since the reorganization of Halla was legally effected by the court's decision approving the corporate reorganization plan and not by the approval of individual creditors.

7.425 We are unable to accept Korea's argument, since entities participating in a financial contribution must assume responsibility for that participation. Thus, to the extent that a public body participates in a loan agreed by a creditors' council, that part of the loan attributable to the public body may be treated as an individual financial contribution by that public body falling within the scope of Article 1.1(a) of the *SCM Agreement*. Otherwise the disciplines of the *SCM Agreement* could be easily circumvented by groups of public bodies deciding collectively, or under court approval, to provide financial contributions.

(vi) Conclusion

7.426 For the above reasons, we conclude that KAMCO, KDIC, BOK, KDB, IBK, and KEXIM are "public bodies", and that their participation in the Daewoo, Halla and Daedong restructurings constitutes a "financial contribution" covered by the *SCM Agreement*. We further find that the private creditors participating in the restructurings were not entrusted or directed to do so, such that their participation does not constitute a "financial contribution" covered by the *SCM Agreement*.

(c) Benefit Issues

7.427 We recall that a "financial contribution" only constitutes a subsidy if it confers a "benefit". It is now well established that the existence of "benefit" is determined by reference to the market. Thus, there will be a "benefit" if a financial contribution is made available on terms more favourable than those that the recipient could obtain on the market. The parties' arguments on "benefit" are primarily concerned with the identification of appropriate market benchmarks against which to judge the conduct of the creditors engaging in the restructurings. Thereafter, the parties make specific arguments relating to each of the restructurings at issue.

7.428 Our approach to the issue of benefit in the context of the restructurings is to ask whether the EC has demonstrated that each of the restructurings was commercially unreasonable. In this context, the parties have advanced general horizontal arguments as to the participation of domestic versus foreign creditors in the restructurings, as well as company-specific arguments as to the decisions to restructure each of the companies and as to the terms of the restructurings as implemented. We consider all of this evidence in its totality in respect of each restructuring, taking up first the general, horizontal question of the creditors' participation, followed by the company specific arguments and evidence pertaining to the individual restructurings.

(i) The creditors' participation in the restructurings

7.429 The EC asserts that the assessment of the commercial reasonability of the restructurings should be based on the behaviour of foreign creditors / investors, because these were the only creditors / investors operating outside the influence of the GOK. The EC asserts that the decision by foreign creditors / investors not to participate in the relevant restructurings demonstrates that these restructurings were not conducted pursuant to market considerations.

7.430 Korea submits that foreign creditors' non-participation in the restructurings does not constitute an appropriate benchmark, because the alleged subsidy was provided by domestic Korean financial institutions. Korea asserts that the market-conformity of the restructurings was assured by determinations in each case that the going concern value of the restructured company exceeded its liquidation value.

7.431 We understand the EC to argue in the first instance that private domestic creditors / investors participated in the restructurings as a result of government entrustment or direction, rather than commercial principles. However, as discussed above, we have rejected the EC's claim of government entrustment or direction in respect of the private domestic creditors' participation in the restructurings.

7.432 We pursued this issue with the EC, in our Question 149:

> If the Panel were to reject the EC's claim of government entrustment / direction of private creditors, would this mean that those private creditors provide a reliable market benchmark for determining whether or not the restructurings at issue conferred a benefit? Please explain. Did the EC address this issue in its previous written and oral submissions to the Panel. If yes, please indicate precisely where it did so.

7.433 In response, the EC stated:

> The tremendous government influence over the actions of private creditors (even if the Panel were to find that it does not rise to the level of entrustment/direction), certainly raises strong doubts as to their ability to act according to market considerations (as is required for a valid benchmark). Thus, the Panel would still be

> required to look elsewhere for a market benchmark -- either to foreign investors, outside investors, or another reliable source.

7.434 We note that of course there could be circumstances in which a government influences the market to such an extent that it becomes distorted, so that private entities no longer operate pursuant to purely commercial principles.[240] In the case before us, however, the evidence on the reasons for and significance of the differing behaviour of domestic versus foreign creditors is mixed. We note that certain creditors did participate in the restructuring while others opted not to. We note that there was a certain generalized flight of foreign capital from Korea during the financial crisis, reflecting investors' wariness of the overall situation, and neither party has provided information as to whether the foreign creditors' decisions not to invest in the restructured shipbuilding companies were purely a reflection of this general wariness, or also reflected more specific concerns of these creditors over the prospects of the individual companies.

7.435 We next turn to the evidence and arguments on each of the individual restructurings at issue.

(ii) The Daewoo workout

The Anjin report

7.436 In response to the EC's argument that Daewoo's creditors failed to act pursuant to market considerations, Korea submits that Daewoo's creditors acted on the basis of a report by Anjin to the effect that the going concern value of Daewoo exceeded its liquidation value. Although the EC accepts that a proper going concern analysis might have provided a basis for establishing that the decision to restructure Daewoo was market-based,[241] the EC questions whether the report did constitute such a proper analysis, and further asserts that the 1999 Anjin report does not demonstrate whether or not the individual components of the workout were based on market principles.

7.437 We consider that the evidence and arguments concerning the Anjin report are very relevant to the commercial reasonableness of the decision to restructure Daewoo. In this respect, we first take up the Anjin report's conclusion that the going-concern value of Daewoo exceeded its liquidation value, and we then take up the individual elements of the workout. On the report, we consider the question whether a reasonable commercial actor could have use the report as the basis to decide that restructuring made better economic sense than liquidation. Here, our initial reaction is that the report on its face appears credible and *bona fide*. It was prepared at the time and in the context of the decision on whether to restructure Daewoo, and even the EC's expert consultant, Price Waterhouse Coopers ("PWC")[242] stated as a general observation that the report was good given the timeframe that Anjin had had to prepare it.[243]

7.438 Korea initially presented detailed argumentation in respect of the Anjin report in response to the EC's argument that independent commercial investors would not have restructured Daewoo, but instead would have opted for liquidation. According to Korea, the 1999 Anjin report was a thorough and comprehensive report based on in-depth analysis that gave the creditors reliable information in deciding to restructure DHI. Korea asserts that the Anjin report shows that when Anjin made its assessment, it considered carefully all of the relevant data and circumstances relating to the Korean economy, shipbuilding industry and individual shipbuilders, as well as the business plans of DHI, in order to provide an objective and independent assessment of the real situation of DHI and of the

[240] Indeed, a similar consideration influenced the findings of the Appellate Body in *US – Softwood Lumber IV*, para. 103.

[241] See, in particular, the EC's reply to Question 23 from the Panel.

[242] Price Waterhouse Coopers was engaged by the EC as an expert consultant for purposes of this dispute. The EC submitted a number of critiques prepared by PWC of various aspects of the Anjin report. (Exhibits EC-112, 118, 133, 145 and 148).

[243] Exhibit EC-112 at 3.

various options available to the creditor financial institutions. Korea submits that creditor banks therefore acted prudently when they decided on the DHI restructuring taking into account the findings and recommendations contained in the report.

7.439 The EC challenges the integrity and substantive accuracy of Anjin's conclusion that the going concern value of Daewoo exceeded its liquidation value. The EC submits that the Anjin report (1) was commissioned by Daewoo-HI and its main creditor, KDB, a public body; (2) could not have been thoroughly reviewed before creditors voted on the workout plan for the first time; and (3) in any event did not properly demonstrate that the going concern value of DHI exceeded its liquidation value. The EC asserts that the Anjin report was "pre-cooked",[244] and that prudent creditors would not have agreed to any solution other than liquidation without requiring a much more in-depth analysis. Referring to a series of alleged errors / shortcomings identified by PWC in the context of this dispute, the EC asserts that the Anjin report was not a proper basis for market-driven creditors to decide to restructure DHI because the report did not make an adjustment for existing shareholders, and therefore assumed that all benefits from the restructuring would accrue to the creditors; the report double counted tax shield benefits; the report did not provide for sufficient investment to maintain residual value; the report used an excessively high EBIT margin of earnings before interest and taxes ("EBIT") for Daewoo in the going-concern projections; the report assumed an overly optimistic perpetual growth rate in the going-concerning projections; the report used incorrect interest coverage ratios; the report did not account for unbooked liabilities; and the report made no adjustment for payables and receivables from five affiliated companies. The EC submits that, if the Anjin report had not contained these errors, and if it had applied a perpetual growth rate of less than 2 per cent and a discount rate above 12 per cent, liquidation value would have been found to exceed going concern value. We shall examine each of the issues raised by the EC.[245]

- Commissioned by DHI and KDB

7.440 We understand the EC to argue that the Anjin report should not have been relied on by DHI's creditors since the report was commissioned by DHI and KDB, a public body, both of which had an interest in seeing DHI restructured rather than liquidated.

7.441 Korea submits that Anjin was retained by the KDB, on behalf of all creditors. Korea asserts that, although DHI was mentioned in the retainer agreement, this was only because DHI was responsible for paying Anjin's fees.

7.442 **[BCI: Omitted from public version.]** [246]

7.443 The EC has not challenged these statements by Anjin. In particular, the EC has not disputed that it is standard practice for companies under receivership / workout to pay the fees of professional advisors. Nor has the EC disputed that DHI "was not in a position to receive reports and/or updates thereof from Anjin". We also note that the cover letter accompanying Anjin's report was addressed exclusively to KDB, and not to DHI.[247] Since we have no reason to believe that DHI was in a position to influence the substance of Anjin's report, there is no reason to discredit the Anjin report merely because Anjin's fees were paid by DHI.

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[244] EC oral statement at first substantive meeting, para. 83.

[245] Korea submits that, since the EC's critique of the Anjin report is a central part of the EC's affirmative case, the Working Procedures and basic considerations of due process require that it should have been submitted earlier in the proceedings. We note, however, that the EC's critique of the Anjin report only became necessary after Korea sought to defend itself on the basis of that report, which it did in its first written submission. We have no objection, therefore, to the EC presenting a critique of the Anjin report in its second written submission.

[246] See Exhibit KOREA – 78.

[247] See English translation of Attachment 3.1(17) provided by Korea under the Annex V procedure.

7.444 Similarly, we do not believe that the integrity of the report is *ipso facto* impaired by the fact that it was commissioned by a public body. This is particularly so given that the KDB was the lead creditor, who was responsible for commissioning a report on behalf of all creditors. Since the EC has not disputed Korea's assertion that the KDB commissioned the report on behalf of all other creditors, and in the absence of any allegations of improper influence by the KDB over Anjin, we are not prepared to reject the integrity of the Anjin report merely on the basis that it was commissioned by the KDB (acting on behalf of all other creditors). In short, while the issue raised by the EC is not irrelevant, we do not find that the evidence before us on this point reaches the level of undermining the credibility of the report's conclusions.

- Amount of time for review

7.445 The EC submits that the Anjin report was not made available to creditors in sufficient time to allow for a thorough review before voting on the workout plan for the first time. In particular, the EC submits that the Anjin report was made available to creditors on the same day that they voted on it for the first time, and that all major decisions regarding the restructuring were taken only two days later.

7.446 Korea submits that Anjin actually began the due diligence of DHI on **[BCI: Omitted from public version]** when the initiation of the DHI workout procedure was announced by the creditor financial institutions. Anjin submitted its due diligence report concerning DHI and its foreign subsidiaries on 23 October 1999[248] and submitted a workout report in summary form to creditor financial institutions on 30 October 1999 (Exhibit Korea – 64). Korea asserts that these reports confirmed that the going concern value of Daewoo was higher than the liquidation value, and recommended that the creditor financial institutions proceed with a workout rather than liquidation. Korea states that, based on these reports, KDB as the lead bank prepared a workout plan and submitted it to the third Council of Creditor Financial Institutions ("CCFI") meeting held on 24 November 1999. Korea asserts that the fully-compiled workout report by Anjin was submitted to the KDB on 24 November 1999. According to Korea, therefore, the creditors were well briefed in advance of the third and fourth CCFI meetings on 24 and 26 November 1999 respectively.

7.447 The EC claims that there are inconsistencies regarding the timing of this newly presented report. The EC asserts that the Anjin report was assigned on 7 October 1999,[249] allowing only three weeks to perform the enormous task of evaluating Daewoo's financial affairs. Considering that Anjin was also assigned to prepare a due diligence report on Daewoo-HI's assets that needed to be completed before a workout analysis could begin, and that this report was submitted on 23 October 1999,[250] the EC asserts that the time remaining for the preparation of the summary workout report was effectively only one week (from 23 to 30 October). Furthermore, the EC asserts that Korea referred to an earlier KDB report provided to creditors. The EC asks the Panel to draw adverse inferences against Korea, given that Korea had failed to reveal the existence of that KDB report earlier in the proceedings. The EC also asserts that Korea stated that Anjin began work on the due diligence and workout reports on **[BCI: Omitted from public version]**, the day after the Daewoo group requested a workout,[251] although Anjin was not appointed as the financial advisor until 8 September 1999.[252] The EC also notes Korea's reference to Anjin's 30 October 1999 summary workout report. The EC requests the Panel to draw adverse inferences for Korea's failure to make an English version of that summary report available to the EC by the deadline for responses to the Panel's questions after the first substantive meeting.

[248] *See* Korea Annex V Response Attachments 3.1(17)-2 &3.
[249] Exhibit Korea-64, p. 110.
[250] Responses to Questions from the Panel by Korea, 22 March 2004, Question 78.
[251] Responses to Questions from the Panel by Korea, 22 March 2004, Question 78, n. 4.
[252] First Written Submission by Korea, 2 February 2004, para 341.

7.448 Korea refers to the EC's request for adverse inferences against Korea for not providing the "KDB report" to the Panel. Korea asserts that there was no "KDB report", and denies having mentioned that there was one. Korea asserts that it merely stated that KDB proposed a DHI workout plan, and that this DHI workout proposal was based on the Anjin report. Korea submits that it disclosed to the EC the relevant information on KDB's proposed workout plan in the course of an earlier EC Trade Barriers Regulation proceeding.

7.449 In terms of timing, we do not consider that the fact that the KDB's proposed workout plan was presented to creditors at the fourth CCFI meeting (on 26 November 1999) means that creditors did not have a reasonable opportunity to review that plan (before adopting it at that same meeting), since KDB's proposed workout plan was based on the Anjin workout plan presented to creditors at the third CCFI meeting (on 24 November 1999).[253] Indeed, the KDB prepared its workout plan in response to creditors' opposition to the Anjin workout plan. Nor do we consider that creditors had not had sufficient time to review Anjin's (earlier) proposed workout plan, since although it was presented by Anjin at the third CCFI meeting on 24 November 1999, Anjin's due diligence report (concluding that the going concern value of DHI exceeded its liquidation value) was submitted to creditors on 23 October 1999,[254] and a workout report in summary form was presented to creditors on 30 October 1999. In cases involving the proposed restructuring of insolvent companies, it is to be expected that decisions will need to be made expeditiously. In such circumstances, parties may need to act with greater speed than they would otherwise want to do. As noted by the banking expert relied on by Korea, "[i]t is essential in circumstances such as these that reorganising and restructuring decisions are made as quickly as possible. This not only maintains direction, management confidence, morale and motivation within a company, but also quickly recreates confidence amongst the company's customers."[255] We also note that Anjin itself was acting under the "principle of promptness".[256] In light of these considerations, although DHI's creditors may have felt hard-pressed to review the Anjin report and various proposed workout plans in the time available to them, we do not consider that the time was so short that they could not have had sufficient time to conduct an adequate, market-based review of the relevant documents.[257]

7.450 We consider that the EC's request for adverse inferences regarding the "KDB report" is unfounded, since there is nothing on the record to suggest that any such report ever existed. In particular, Korea has never referred to any such report. Korea has merely referred to a workout plan proposed by the KDB (on 26 November 1999) on the basis of a workout report prepared by Anjin (submitted in final form on 24 November 1999).

7.451 Regarding the EC's request for adverse inferences concerning the 30 October 1999 summary workout earlier in these proceedings, we see no reason why, having submitted an English version of the full Anjin workout report under the Annex V procedure,[258] Korea should also have submitted an English version of the summary report. We note that Annex V question 3.1.3(17) merely requested a

[253] We acknowledge that Korea's description of the facts may cause some confusion, especially as Korea submits that the KDB presented its proposed workout plan at the third CCFI meeting. On the basis of Korea's first written submission, however, we understand that the KDB only presented its proposed workout plan at the fourth CCFI meeting, and that Anjin was the author of the proposed workout plan submitted at the third CCFI meeting.

[254] See Korea Annex V Response Attachments 3.1(17)-2 &3.

[255] See Exhibit KOREA – 105, page 3.

[256] See page 89 of the Anjin report, section 2.2.1.

[257] The EC asserts that there is an anomaly between the fact that Korea reports that Anjin commenced its due diligence work on 26 August 1999, whereas the retainer agreement was only concluded on 7 October 1999. Since there is no basis for us to doubt Korea's assertion that such procedure is normal practice, we do not consider this situation anomalous. Rather, it suggests that Anjin was conscious of the need to complete its work as early as possible.

[258] See Attachment 3.1(17) of Korea's Annex V response. That Attachment also includes a cover letter from Anjin to the KDB dated 24 November 1999.

copy of the "full report with all annexes", so we do not consider that Korea was required to provide a copy of the summary report under the Annex V procedure. As for whether or not Korea should in any event have submitted an English version of Anjin's summary report earlier in the Panel proceedings, we consider it appropriate that Korea only submitted the summary report when it sought to rely on it in response to a question from the Panel (which in turn was prompted by arguments from the EC). Since the report had not already been translated into English, we consider it reasonable that Korea would not be able to make an English version of that report available to the Panel until some time after the deadline for the reply to the Panel's question. For these reasons, we reject the EC's request for adverse inferences.

- Existing shareholder adjustment

7.452 The EC submits that, when comparing the present value of the cash flows generated on a going-concern basis with the liquidation value, Anjin's analysis should have taken into account the fact that the present value of the going concern cash flows should be shared with the shareholders, and that the financial lenders would only obtain approximately **[BCI: Omitted from public version]** per cent of these cash flows.

7.453 Korea submits that the EC confuses two distinct phases in Anjin's report. In Phase 1, Anjin estimated the liquidation value and going concern values of DHI, and compared the two to determine which one was greater. Then, having confirmed that the going concern value exceeded the liquidation value, Anjin undertook Phase 2, which involved an analysis of three alternative restructuring scenarios. According to Korea, Anjin therefore only considered the effects or implications of restructuring in the context of Phase 2. Korea submits that the EC is seeking to introduce (Phase 2) issues relating to the effects of restructuring into the analysis of Phase 1 of Anjin's report. In particular, Korea argues that, because DHI was insolvent in 1999, the adjusted equity value of DHI as of 31 July 1999 was **[BCI: Omitted from public version]**. Accordingly, creditor financial institutions had priority claims on DHI over the shareholders in both liquidation and going concern scenarios. Since this analysis was performed under Phase 1, there was no need for Anjin to consider what value may have accrued to shareholders under any of the three restructuring scenarios. Thus, there was no error in attributing **[BCI: Omitted from public version]** per cent of DHI's value to financial creditors prior to any restructuring scenario. Korea asserts that a partial allocation of value **[BCI: Omitted from public version]** to shareholders was, however, made under Phase 2.

7.454 The EC does not reply to this argument by Korea, and to us it appears that a value of zero could plausibly be attributed to shareholders in the context of a determination of whether to restructure an insolvent company.

- Tax Shield Effect

7.455 The EC alleges an error concerning the alleged double counting of a tax shield effect.

7.456 Korea accepts that Anjin did erroneously double count tax shield effects, and attributes that error to an electronic spreadsheet link error. Korea submits, however, that the correction of this error would not cause the liquidation value to exceed the going concern value, and thus that the basic conclusion of Phase 1 of the Anjin report remains unaffected.

7.457 Given the agreement between the parties on the substance of the EC's allegation, there is no need for us to consider this matter further. We note, however, that the EC has not contested Korea's assertion that this error alone would not undermine Anjin's conclusion that the going concern value of DHI exceeded its liquidation value.

- Investment amounts used in calculating DHI's residual value

7.458 The EC criticizes the Anjin report for having assumed, in its computation of the residual value of DHI, that investment amounts would be forever smaller than depreciation. According to the EC, in calculating a residual value, investment should be at least equal to depreciation (and greater when inflation is positive). The EC asserts that, when computing the value of a company on the basis of perpetual cash-flows, investments should be set at a higher level than depreciation to take into account the impact of inflation: depreciation expense is fixed over the depreciation period, whereas replacement investments get more and more expensive with time.

7.459 Korea responds that, in fact, the amount of investment used by Anjin in the residual value calculation effectively was not lower than depreciation. In particular, in 1998 DHI revalued its property, plant and equipment ("PPE") in accordance with Korea's Asset Revaluation Law. This revaluation increased the value of depreciable PPE without increasing the company's cash outflows, and increased as well the amount of depreciation as from the year 1998. According to Korea, if this additional depreciation resulting from the revaluation, which had no impact on cash flow, were excluded from the calculation, the capital investment and depreciation amounts used in the residual value calculation would be almost the same. Furthermore, Korea asserts that DHI presented a business plan to Anjin which assumed that a substantial amount of capital expenditures was treated as maintenance and repair expense, rather than capital expense, considering the nature of the business as heavy industry, with large investments in the beginning stage of business.

7.460 The EC responds that even if assets were revalued in the past, at some point in the future investments would need to be made to replace the existing asset base and these investments should be in line with the depreciation for the computation of the residual value. Korea contends that the investments to replace existing assets would be affected by the market value, foreign exchange rate and inflation at the time of replacement. According to Korea, the 1998 revaluations and the forecasts performed by Anjin were affected by the depreciation of the Korea Won against the US dollar, with the result that the replacement amount in Korean Won to be spent in the future would be smaller than the nominal value of the existing asset base.

7.461 We take note of the EC's point that generally in residual value calculations, amounts projected for future investments normally will be greater than amounts for depreciation, given inter alia the effects of inflation. We also take note, however, of the points raised by Korea, including the effects of the asset revaluation and of the Won's depreciation, points on which the EC did not provide a response. On the basis of this exchange of views, we do not consider that the EC has established that the lower level of projected investments than projected depreciation constitutes an error in the Anjin report.

- EBIT margin

7.462 The EC further criticizes Anjin's calculation of DHI's residual value for using a perpetual ratio of earnings before interest and taxes ("EBIT") that the EC considers is too high. The EC questions whether an EBIT margin of more than **[BCI: Omitted from public version]** per cent, the highest level of the forecast period, is a long-term sustainable margin.

7.463 Korea responds that, in forecasting DHI's future performance, Anjin assumed that DHI's operations would stabilize from 2003 forward, after gradually recovering from low levels during the initial two or three years of the forecasted period. Korea states that in respect of DHI's estimated EBIT ratios, Anjin considered the EBIT margins of major Korean competitors of DHI during 1997, 1998 and first-half 1999. These companies recorded averaged EBIT margins that were higher than the level forecast for DHI. According to Korea, Anjin's analysis and DHI's business plan supported the forecast that DHI would achieve comparable performance levels to those of its major Korean competitors.

7.464 The EC notes that the very high EBIT margins for DHI's major Korean competitors, used as the basis for the forecast for DHI, were based on a very short period, and that these levels probably were due to the fact that Korean shipbuilders were selling ships in dollars and buying inputs in Korean Won, and that the Won was under heavy pressure at the time. The EC argues that according to standard practice, residual values should be calculated when the period of competitive advantage has disappeared and the market is in equilibrium. For the EC, it is not clear that EBIT greater than **[BCI: Omitted from public version]** per cent is the "perpetual equilibrium", looking at EBIT margin before and after the period presented by Anjin and for other Asian companies active in the sector (the EC presents statistics for Korean companies Samsung, Hyundai, and Hanjin, and for Japanese companies Mitsubishi HI, Kawasaki HI and Hitachi HI, for 1994-2002).

7.465 Korea responds that the exchange rate effect on the estimated EBIT margin was limited -- exchange rates declined steadily while average EBIT margins increased from end-1997 through mid-1999. Korea also disputes the relevance of the EBIT margins of the Japanese companies cited by the EC, as the fact that these margins were substantially lower than those of the Korean shipyards suggests that the cost and profit structures of the two sets of companies were not comparable.

7.466 The EC responds to Korea's argument in respect of exchange rates by asserting that the effect on EBIT of the Korean Won's depreciation in 1997 could have been much greater than Korea asserts. In particular, the EC argues that the Won's depreciation alone could have created an EBIT margin of 34 per cent on US dollar contracts of one year or more signed before the financial crisis in 1997. Thus, the EC argues, the Won's depreciation could have explained the high EBIT margins realized by Korean shipbuilders in 1997-1999.

7.467 Korea disputes the EC's estimate of the effect of the Won's depreciation by arguing, first, that the EC assumes that costs would be entirely in Won and revenues entirely in dollars, whereas shipbuilders incur costs in both currencies. Korea also argues that although the currency depreciation only began in late 1997, the EBIT margins of Korean shipbuilders already had reached high levels during the course of that year, such that the depreciation could not have affected them more than minimally. Furthermore, Korea argues, the forecasted EBIT margins used for DHI were lower than those actually realized by the other major Korean shipyards.

7.468 We take note that, as the EC points out, the EBIT margins for other Korean shipbuilders, which were used by Anjin as the starting point for its forecasts for DHI's EBIT margin, were relatively high during the period considered by Anjin. To us, however, this by itself does not mean that these margins were incorrect or unrepresentative, particularly given that the EBIT used by Anjin in the projections for DHI was in any case below those of the comparator Korean companies. While the EC advances a number of theories and possible alternatives which would, if correct, result in a lower forecasted EBIT margin for DHI, the EC has not demonstrated that any of these is unequivocally superior, nor that Anjin's forecast is clearly wrong.

- Perpetual growth rate

7.469 The EC criticises Anjin for having applied a perpetual growth rate of **[BCI: Omitted from public version]** per cent for cash flows after 2004, whereas in 2002 Nomura and Credit Suisse First Boston analysts were using perpetual growth rates of 2.0 and 0 per cent respectively. The EC submits that, during a period of slow economic growth, Anjin should not have been using growth rates at least 50 per cent greater than those applied by the market during a period of better economic growth.

7.470 Korea submits that it was appropriate for Anjin to use a perpetual growth rate of **[BCI: Omitted from public version]** per cent since that was the rate forecast by Wharton Econometric Forecasting Associates ("WEFA") for 2005. Korea notes that Anjin chose the WEFA global growth rate, even though higher growth rate forecasts were available for the shipbuilding sector. Korea also

asserts that the Nomura and Credit Suisse First Boston 2002 forecasts were not available in 1999, and therefore could not have been taken into account by Anjin.

7.471 We see no reason to consider that Anjin erred in applying WEFA's forecast rate of world economic growth, as we see no evidence that WEFA rates are in any way unsatisfactory or unreliable. Furthermore, we note that the EC refers to market growth forecasts made in 2002, three years later than the forecasts made and relied on by Anjin. Given the propensity for economic conditions to change rapidly over relatively short periods of time, we are doubtful that these growth rates can be directly compared.

- Interest coverage ratio

7.472 The EC criticises the Anjin report on the basis that the interest coverage ratio reflected in the report, **[BCI: Omitted from public version]**, was comparable to that of non-investment grade companies (i.e., B and CCC rated companies).

7.473 Korea submits that the interest coverage ratio referred to in the Anjin report in respect of DHI was an assumed ratio used only to determine the size of debt restructuring, and was not directly related to any credit rating as suggested by PWC. Korea further argues that in fact the interest coverage ratios of DSME and DHIM in any event exceeded the ratio assumed in the report.

7.474 We understand the EC to argue that DHI should not have been restructured since the interest coverage ratio used in the Anjin report indicated that DHI and its eventual spin-off companies were below investment grade.[259] We note, however, Korea's explanation that the ratio of **[BCI: Omitted from public version]** was used to calculate the size of debt restructuring, rather than being directly related to a credit rating, a point that the EC acknowledges.[260] Moreover, there is no question that DHI was insolvent, and therefore below investment grade, at the time of Anjin's report, but this is a separate issue from whether it was economically unreasonable to restructure it.

- Unbooked liabilities

7.475 The EC criticises Anjin for not taking into account commissions owed by DHI to Daewoo London. The EC asserts that these liabilities should have been taken into account by Anjin since their omission resulted in an inflation of going concern value relative to liquidation value. According to the EC, if a claim of X KRW had been booked in DSME, the value computed under the going concern scenario would have reflected the future payment of the X KRW claim and hence would have been lower than the value presented in Anjin's report. The EC asserts that the value under the liquidation scenario on the other hand would not have been affected by the same amount, as most of the assets had been provided as collateral for loans. Thus, the addition of a new claim would have had a much lower impact on the value of the liquidation scenario (indeed, if 100 per cent of the assets had been provided as collateral, the impact on the liquidation value would have been zero).

7.476 Korea submits that these liabilities did not need to be booked since they had not been confirmed by Daewoo London. In addition, Anjin considered they would not make any difference to the analysis since they would have the same impact under both the liquidation and going concern scenarios. Furthermore, Korea asserts that the liabilities would not have had any impact on the going

[259] Our understanding is based on page 5 of Exhibit EC – 145, where PWC stated that "[t]he point we wanted to highlight was that at the time of the restructuring and for the first three years of the forecast period, the financial ratios ... were foreseen to be in the range of the ratios of US companies having below investment grade ratings..." (emphasis in original).

[260] The EC also acknowledges that the actual experience of DSME was better than had been forecast. "We understand that the interest coverage ratio was used to estimate the size of the debt restructuring and we appreciate that the actual results of DSME were better than foreseen." Exhibit EC-145 at 5.

concern value of the two spun-off companies, since only those assets and liabilities that were directly related to operating activities were allocated to them.

7.477 We agree with Korea that Anjin was not required to take into account the relevant liabilities towards Daewoo London, since they were not confirmed at the time of the report. We also note that the EC does not challenge[261] Korea's statement that such liabilities would in any event not have been allocated to DSME.

- Receivables from Daewoo Affiliates

7.478 The EC notes that DHI receivables from certain Daewoo affiliates were not included in the going concern value because, according to the Anjin report, of "the non-finalization of the due diligence investigations of affiliated companies".[262]

7.479 Korea submits that the relevant receivables were included under Phase 1 of Anjin's analysis, but were attributed a value of **[BCI: Omitted from public version]** when Anjin calculated the liquidation and going concern values because, at the time of valuation, Daewoo affiliates were undergoing due diligence review by other accounting firms. Korea submits that the exact amount reported for receivables from Daewoo affiliates does not affect the Phase 1 comparison of the liquidation with the going concern value, since in any event the same amount would be used for both the Phase 1 liquidation and going concern values. Korea submits that the recoverable amount of receivables from affiliates was valued at 30 per cent of receivables under Phase 2, and was included in both the liquidation and going concern scenarios under Phase 2. Again, Korea submits that the exact amount of value booked to receivables from affiliates does not really matter, provided the same amount is booked under both liquidation and going concern values.

7.480 The EC has not made any arguments to cause us to doubt Korea's assertion that the exact amount of receivables from affiliates would have had no impact on Anjin's Phase 1 and 2 analyses, provided the same amount was included in the liquidation and going concern values used for Phases 1 and 2 respectively. In particular, we note that the EC has not disputed Korea's argument in its comments on this issue in Exhibit EC – 158.

7.481 In Exhibit EC – 158, the EC instead asserts that the **[BCI: Omitted from public version]** per cent recovery rate on DHI assets was almost the same as the **[BCI: Omitted from public version]** per cent recovery rate on DSME/DHIM assets. The EC submits that this does not seem to reflect the objective of the restructuring. Korea submits that, in deciding whether or not to restructure a company, what matters is whether going concern value exceeds liquidation value. Korea asserts that the ratios of recovery from different business divisions in the event of liquidation are simply not relevant to the decision whether or not to restructure.

7.482 While we note that Table 3 on page 11 of Exhibit EC – 158 demonstrates that the recovery rate for DSME/DHIM in the event of liquidation would only be slightly better than the recovery rate for DHI under liquidation, we fail to see the significance of this to the case at hand, since it has no relevance to the issue of whether or not the going concern value of DHI exceeds the liquidation value of DHI (Anjin's Phase 1). Once a determination is made that the going concern value of DHI does exceed the liquidation value of DHI, the relevant issue becomes which of the restructuring scenarios would provide the greatest rate of return for creditors (Anjin's Phase 2). Again, the Table 3 is of no relevance to this issue, since Table 3 is based on asset recovery rates under liquidation, whereas Phase 2 of Anjin's report concerns the effect of different restructuring scenarios.

[261] The EC's comments on Exhibit KOREA-141 do not address this issue (see Exhibit EC – 158, page 3).

[262] See Exhibit EC – 145, page 6.

- Conclusion

7.483 We recall that the EC has pointed to the decision of foreign creditors not to participate in the restructuring, as well as to certain alleged shortcomings or flaws of the Anjin report, in support of its argument that the decision to restructure Daewoo was not on market terms. As above, we approach the question of benefit from the Daewoo restructuring by considering whether the EC has demonstrated that the decision to restructure Daewoo was commercially unreasonable. As discussed above, the evidence concerning the reasons for the differing behaviour of domestic and foreign creditors is mixed. Furthermore, while the EC has raised certain questions and doubts about the Anjin report, we do not consider that the EC has demonstrated that any of these alleged flaws constitutes an unequivocal error or distortion such that the conclusion that Daewoo's value as a going concern exceeded its liquidation value was manifestly incorrect or biased, and the decision to restructure was clearly commercially unreasonable. While another analyst performing the same task might have used assumptions closer to those preferred by the EC, this does not mean that the assumptions used by Anjin are demonstrably incorrect. We therefore do not consider that the EC has established that the decision to restructure DHI instead of liquidating it was commercially unreasonable.

7.484 We recall that the EC also has argued that the terms of the DHI restructuring were not on market terms. We thus now turn to this issue.

The debt write-off / rescheduling

7.485 The EC submits that the write-off / rescheduling of DSME's debt constitutes a subsidy. Since the EC has not made any arguments regarding the terms on which DSME's debt was written-off / rescheduled, we understand that the EC's claim concerns only the fact that the write-off / rescheduling actually occurred. In other words, the EC claims that the write-off / rescheduling as such confers a benefit and therefore constitutes a subsidy because market operators – as was the case with foreign creditors – would not have participated in it.

7.486 Korea submits that the debt write-off / rescheduling did not constitute a subsidy since it was based on the Anjin report, and therefore consistent with market principles.

7.487 Regarding the issue of whether or not market operators would have participated in the debt write-off/rescheduling, we recall that the EC has relied on the decision of foreign creditors not to participate. As discussed above, while this is certainly relevant, we do not find it decisive on this issue. As the very essence of restructuring is the writing off and rescheduling of debts, we disagree with the EC that the fact that such write-offs and rescheduling took place, as such, conferred a benefit. The existence of a benefit would have to be determined on the particular terms and conditions of the write-off / rescheduling, about which the EC has presented no evidence or argument. We do not consider, therefore, that the EC has established that the debt write-off/rescheduling was commercially unreasonable under the circumstances at the time of the restructuring.

Debt-for-equity swap

7.488 The EC submits that the debt-for-equity swap constitutes a subsidy because it was not conducted on the basis of market principles. In particular, the EC submits that DSME's creditors overpaid for the equity in the debt-for-equity swap by **[BCI: Omitted from public version]** million, based on a comparison of the share value paid at time of the swap and when it was first publicly traded several months later. The EC asserts that the share price as valued by the stock market, which is the best approximation of a free and undistorted market, is the only available benchmark, even though it acknowledges that it is an imperfect (and conservative) benchmark. The EC also asserts that two months after the spin-off, an Australian investor offered to purchase Daewoo-SME for what it deemed to be the market price, based on the actual value of shares on the stock exchange at the time, which was lower than the price agreed in the context of the debt-for-equity swap.

7.489 Korea submits that the debt-for-equity swap could not have resulted in benefit because creditors merely exchanged their debt for equity, and therefore could not have overpaid for their equity. Korea asserts that the debt-for-equity swap was conducted on the basis of Anjin's market assessment of the value of DSME's equity. Korea rejects the EC's *ex post* comparison of the terms of the debt-for-equity swap with the price at which DSME shares were subsequently publicly traded. Korea asserts that DSME's share price exceeded the terms of the debt-for-equity swap soon after DSME's shares were publicly traded, and that the Australian investor referred to by the EC offered a price higher than that paid by DSME's creditors in the context of the debt-for-equity swap.

7.490 In principle, we accept the EC's argument that a benefit could be conferred through a debt-for-equity swap if creditors exchange too much debt for equity. Although Korea argues that creditors could not have overpaid since there was no more that they could have demanded, we consider that they could have overpaid by exchanging too much debt for a given amount of equity. This could occur if the equity were over-valued, which is precisely what the EC alleges in the present case.

7.491 Regarding the substance of the EC's claim, we consider that the terms of the debt-for-equity swap should not be analysed *ex post*, on the basis of the price at which DSME's shares were publicly traded, or the price offered by potential buyers of DSME. Instead, the terms of the debt-for-equity swap should be assessed in light of the facts before creditors at the time they decided upon them. This is because facts may change over time, to the extent that a market's assessment of the value of DSME shares on one day will not necessarily be the same as its assessment of the value of those shares on another day. Indeed, even the EC would appear to agree with such an approach, since it stated at the first substantive meeting with the parties that:

> Moreover, Korea cannot invoke in its favor the fact that the share value of the restructured yards increased over time. As also pointed out by the United States, there is no room for an *ex post* analysis. The only relevant question is whether a private creditor/investor would have agreed to the restructuring packages on the basis the information available to him *at the time of the restructuring*. [263] (italics in original)

7.492 We note that the EC has not presented any arguments against the terms of the debt-for-equity swap based on the information available to DSME's creditors at the time that they decided to participate in it. Although the EC has argued that market operators would have liquidated DHI rather than participate in the debt-for-equity swap, this argument is based on the EC's foreign creditor market benchmark that we have already rejected. In the absence of relevant argumentation by the EC, we reject the EC's claim against the DSME debt-for-equity restructuring.

Conclusion

7.493 We have found that the various instruments involved in the restructuring of DHI were financial contributions in the sense of Article 1.1(a)(1)(i) of the *SCM Agreement*. We also have found that certain creditors of DHI at the time of its insolvency and restructuring were public bodies, but that the EC has not established that the private creditors were entrusted or directed by the government to make financial contributions to DHI via their participation in the restructuring. In terms of whether the financial contributions by public bodies conferred a benefit, we have based our analysis on whether the EC has demonstrated that the decision to restructure DHI rather than liquidate it, and/or the terms of DHI's restructuring, were commercially unreasonable. In this regard we note that when a company is insolvent, a creditor operating on a commercially reasonable basis will be seeking to minimize its losses / maximize its recovery.

[263] EC's Oral Statement, para. 85, page 21.

7.494 Concerning the arguments advanced by the EC relevant to the commercial reasonableness of the decision to restructure rather than liquidate DHI, we have found that while the absence of foreign creditor participation in the restructuring is relevant, it is not determinative, given the mixed evidence as to the reasons for it, and its significance. We have further found that the EC, while raising a number of relevant points concerning the credibility and validity of the Anjin report's analysis and conclusions, has not demonstrated that any of them individually or all of them collectively represents manifest error to the point that no reasonable commercial investor would have relied upon the report in reaching the decision to restructure DHI. Finally, we have found that the EC has not demonstrated that the terms of the restructuring, in particular, the write-off and restructuring of debt, and the debt-for-equity swaps, were commercially unreasonable.

7.495 For the foregoing reasons we find that the EC has not demonstrated the existence of a benefit in respect of the restructuring of DHI, and therefore has not demonstrated that the restructuring involved subsidization. Accordingly, we reject this claim of the EC.

(iii) The Halla reorganization

The Rothschild determination – the decision to restructure

7.496 In response to the EC's argument that Halla's creditors failed to act pursuant to market considerations, based on the non-participation of foreign creditors in Halla's restructuring, Korea submits that the reorganization was market-oriented as it was based on a report from Rothschild, a consulting firm retained by Halla, that the going-concern value of Halla exceeded its liquidation value. Korea also argues that, in any event, any benefit resulting from the restructuring was extinguished when HHI acquired Samho at arm's length for fair market value.

7.497 We recall that our approach to determining whether the restructurings conferred benefits is to ask whether the EC has demonstrated that the decisions to restructure, and the terms of the restructurings, were commercially unreasonable. On the first point, Korea relies on Rothschild's determination that the going-concern value of HHI exceeded its liquidation value, and we note that the EC has not challenged this determination.[264] Accordingly, we do not consider that the EC has demonstrated that this determination was commercially unreasonable.

Terms of the restructuring

7.498 As for the second point, although the EC purports to challenge the terms of the Halla restructuring, it relies exclusively on the non-participation of foreign outside investors in support of this argument, and makes no detailed arguments regarding the terms of the debt forgiveness, debt-for-equity swap, interest forgiveness and conversion of short-term debt. For example, there is no suggestion by the EC that the value of equity provided in the debt/equity swap was excessive, as the EC claims in respect of the Daewoo workout. In the absence of such detailed arguments, we do not consider that a simple reference to the non-participation of foreign investors is sufficient to establish that the terms of the restructuring were commercially unreasonable, especially given our finding above that the evidence is mixed as to the reasons for and significance of this non-participation.

7.499 We note Korea's defence that any "benefit" resulting from the reorganization of Halla was extinguished when HHI acquired Samho's shares at arm's length for fair market value. In response,[265]

[264] The EC complains in reply to Question 150 from the Panel that Korea has not provided a full going concern / liquidation value analysis in respect of all members of the Halla group. However, since Halla-HI was the only part of that group to be restructured (the others were liquidated), we consider that only the going concern / liquidation value analysis conducted in respect of Halla-HI is relevant to the present proceedings.

[265] Paragraph 54 of the EC's second oral statement makes it clear that the EC's argument was made in response to Korea's alternative "extinction" argument: "the fact that Hyundai-HI's purchase of Samho took place at less than fair market value means that it did not extinguish the benefits from the subsides". This

the EC asserts that HHI's acquisition of Samho was not at arm's length for fair market value because HHI underpaid for the Samho shares. In light of our finding in the preceding paragraph, that the EC has not demonstrated that there was a benefit, there is no need for us to consider the parties' arguments regarding Korea's defence.

7.500 We have found that the various instruments involved in the restructuring of Halla were financial contributions in the sense of Article 1.1(a)(1)(i) of the *SCM Agreement*. We also have found that certain creditors of Halla at the time of its restructuring were public bodies, but that the EC has not established that the private creditors were entrusted or directed by the government to make financial contributions to Halla via their participation in the restructuring. In terms of whether the financial contributions by public bodies conferred a benefit, we have found that the EC has not demonstrated that the decision to restructure Halla rather than liquidate it, and/or the terms of Halla's restructuring, were commercially unreasonable.

7.501 For the foregoing reasons we find that the EC has not demonstrated the existence of a benefit in respect of the restructuring of Halla, and therefore has not demonstrated that the restructuring involved subsidization. Accordingly, we reject this claim of the EC.

(iv) The Daedong reorganization

7.502 In response to the EC's claim that the Daedong reorganization plan[266] was not market-based because creditors approved it despite Daedong not being creditworthy, Korea asserts that creditors participated on the basis of a determination that the going concern value of Daedong exceeded its liquidation value.

7.503 We recall our approach to the restructurings is to ask whether the EC has demonstrated that they were commercially unreasonable. Here, as a first issue, we note that the EC has not argued that the determination that the going concern value of Daedong exceeded its liquidation was not proper. We therefore consider that the EC has not established that this determination was commercially unreasonable.

7.504 Turning to the terms of the restructuring, although the EC purports to challenge the terms of the Daedong debt restructuring and interest exemption, it relies exclusively on the non-participation of foreign investors, as it also did in the case of the Halla restructuring. It does not make any detailed arguments regarding the terms of the debt restructuring or interest exemption. For the same reasons

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statement also makes it clear that the EC was concerned with "the subsidies" resulting from earlier transactions, rather than the terms of HHI's acquisition of Samho *per se*. Furthermore, the EC's request for establishment only refers to "corporate restructuring subsidies in the form of debt forgiveness, debt and interest relief and debt-to-equity swaps". It does not refer to subsidies resulting from straightforward share acquisitions.

[266] We note that the reorganization plan adopted by creditors envisaged three elements: (i) debt restructuring / exemption from interest; (ii) a capital infusion; and (iii) the issuance of corporate bonds. While the terms of the debt restructuring / interest exemption were determined by creditors when they adopted the reorganization plan, the creditors did not determine the terms of the capital infusion and issuance of corporate bonds. These were finalized after the reorganization plan was adopted, on the basis of advice from KPMG, and in negotiation with the providers of the new capital and the purchaser of the bonds, i.e., STX. The EC's claim against the Daedong reorganization plan, therefore, does not include the terms on which STX acquired the relevant shares and bonds. It is confined to the terms of the debt restructuring / interest exemption, and the decision to seek a capital infusion and issue corporate bonds. We consider that the terms of the share and bond acquisition are only relevant to these proceedings to the extent that Korea relies on them as a defence to argue that the share and bond transactions extinguished any benefit conferred by the debt restructuring/ interest exemption. Accordingly, we shall only examine the terms of the share and bond acquisition to the extent that we uphold the EC's claim against the debt restructuring/ interest exemption.

as enunciated above in respect of Halla, we reject the claim of the EC that the restructuring of Daedong involved subsidization.

2. Daewoo tax concessions

(a) Arguments of the parties

7.505 The EC claims that the Daewoo workout provided for subsidies in the form of tax concessions. The EC initially claimed that the tax concessions were provided pursuant to various provisions of the Special Tax Treatment Control Law ("STTCL") and Corporate Tax Act ("CTA"). In its rebuttal submission, however, the EC submits that its "core claim" concerned a KRW 236 billion tax concession provided under Article 45-2 of the STTCL and Article 46 of the CTA. The EC submits that Article 45-2 STTCL extended tax incentives provided under Article 46 CTA to spin-offs carried out under a workout program approved on or before 31 December 2000. The EC submits that the Article 45-2 exemption constitutes a financial contribution because "government revenue that is otherwise due is foregone or not collected" in the sense of Article 1.1(a)(1)(ii). The EC argues that the Appellate Body interpreted the phrase "government revenue that is otherwise due" in *US – FSC*, where it held that the term "otherwise" refers to a "normative benchmark" established by the tax rules applied by the Member in question.[267] The EC asserts that Daewoo-HI/Daewoo-SME would normally have been required to pay additional taxes (absent the STTCL), and that this is the normative benchmark against which the foregoing of revenue should be assessed. The EC argues that the fact that the tax exemption was not "normal" is shown by the fact that Article 45-2 did not apply to restructuring before 21 October 2000 or after 31 December 2000.

7.506 The EC also submits that the Anjin report did not analyse the tax consequences of the restructuring plan. According to the EC, this fact either adds to the flaws of the Anjin Report already identified by the European Communities and further reduces DHI's going concern value or it shows that the entire restructuring was precooked from the beginning with Anjin knowing about the tax exemption well before it was adopted.

7.507 Korea denies that the workout resulted in any subsidy under Article 45-2 of the STTCL. According to Korea, Article 45-2 STTCL states that if a domestic corporation divides itself in accordance with a workout plan, then the provisions of Article 46(1) CTA apply. Article 46(1) in turn provides that, if a spun-off company carries out a valuation of the assets it acquires from the original corporation, an amount equivalent to the valuation gains may be treated as losses for the purpose of calculating taxable income for the fiscal year in which the spin-off takes place. Korea emphasises that Article 46 CTA mandates specific tax treatment with respect to "gain" or "profit" realized to the spun-off company as a result of the "valuation" of assets conducted in the course of spin-off. Korea submits that, in the case of the DHI spin-off, there was no valuation gain or profit because the DHI assets were simply allocated at "book value" to the two spun-off companies and what remained of DHI. Korea asserts that, because the assets were simply moved from one entity to another, there was no taxable event and no forgoing of any government revenue that was otherwise due. Korea therefore submits that Article 45-2 did not confer a benefit.

7.508 Korea asserts that while DHI may have enjoyed a tax exemption under Article 99 of the CTA, the EC has not presented a claim under this provision. Korea also notes that any tax exemption under Article 99 of the CTA did not need to be taken into account in the Anjin report since it would not have affected DHI's going-concern value.

[267] Appellate Body Report, *US – FSC*, para. 90.

(b) Evaluation by the Panel

7.509 We note that the "focus"[268] of the EC's tax exemption claim concerns benefit allegedly accruing to the spun-off companies, DSME and DHIM, under Article 45-2 STTCL and Article 46 CTA. The EC states that Article 45-2 STTCL extended the tax incentives provided under Article 46 CTA to the spin-offs carried out under a workout. The EC states that if a newly spun-off company acquires the assets of an old company, Article 46 provides that an amount equivalent to the gain on the transfer of these assets may be treated as an expense in the accounts of the new company, thereby lowering the new company's taxable income. The parties therefore agree that Article 45-2 STTCL and Article 46 CTA provide for tax exemptions for spun-off entities in the event that they "gain" on the transfer of assets from the original company.

7.510 In the context of the Daewoo restructuring, the Spin-Off Balance Sheet at Appendix 10 of the Anjin report indicates the same total value of assets before and after the spin-off. This demonstrates that the assets were allocated between DHI and the two spun-off companies at book value. Since the transfer of assets took place at book value, the transfer did not result in any "gain" for DSME or DHIM. There was, therefore, no basis for any tax exemption under Article 45-2 STTCL and Article 46 CTA. The EC relies on a press article[269] to argue that a tax exemption was provided under these provisions. Even were that press article to have been sufficient to establish a *prima facie* case that a tax exemption was provided under these provisions, the above facts would rebut that *prima facie* case. In the absence of any more compelling evidence from the EC, we therefore reject the EC's claim under Article 45-2 STTCL and Article 46 CTA.[270]

7.511 In its reply to Question 116 from the Panel, Korea presented information suggesting that DHI may have benefited from a tax exemption under Article 90 of the CTA. However, we note that there is no reference to this provision in the EC's Request for Establishment of a panel.[271] Our terms of reference therefore do not include any claims under Article 90 of the CTA.

3. Specificity

7.512 Pursuant to Article 1.2 of the *SCM Agreement*, a subsidy is only subject to the disciplines of the *SCM Agreement* if it is "specific" in accordance with Article 2 thereof. Thus, we may only uphold the EC's actionable subsidy claims if we find that the relevant transactions are subsidies, and that such subsidies are specific.

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[268] See the EC's reply to Question 141 from the Panel.

[269] See Exhibit EC – 136.

[270] Although the EC's first written submission also refers to Article 38 of the STTCL, the EC's legal analysis does not set out any basis for a claim under that provision. To the extent that the EC makes any claim under Article 38, we therefore find that it has not established any *prima facie* case in support of that claim. We further note the EC's argument that taxation issues were not properly considered by Anjin in establishing DHI's going concern value. First, we note that the EC has not properly established that there were any tax issues to be considered. In particular, the EC has not demonstrated any tax concessions under Article 45-2 STTCL and Article 46 CTA. With regard to the possible tax concession under Article 90 CTA, we note Korea's explanation that any such tax concession would benefit DHI, rather than DSME and/or DHIM. Since DHI's going concern value was calculated on the basis of estimated cash flows from DSME and DHIM, and these cash flows have not been shown to have been affected by any tax concession under Article 45-2 STTCL or Article 46 CTL, and would not benefit from any tax concession (to DHI) under Article 90 CTA, we do not consider that DHI's going concern value would be affected by any tax concession provided to DHI under the latter provision.

[271] The relevant part of the request for establishment provides that "[t]he Special Tax Treatment Control Law, more specifically, the special taxation on in-kind contribution (Article 38) and the special taxation on spin-off (Article 45-2) scheme, establishes two tax programmes limited to companies under corporate restructuring and provides tax concessions to Daewoo, the combined benefit of which is estimated at won 78 billion." (WT/DS/273/2).

7.513 We only consider it necessary to address the issue of specificity in respect of those measures that we have found to constitute subsidies. Since we have rejected the EC's claims of subsidization in respect of the three corporate restructurings, and the alleged DHI tax concession, there is no need for us to consider whether they are specific in the meaning of Article 2 of the *SCM Agreement*.

7.514 We recall that we have already found that the individual APRG and PSL transactions identified at para. 7.331 *supra* are specific subsidies.[272] We made this finding in the context of the EC's prohibited export subsidy claims, on the basis of Article 2.3 of the *SCM Agreement*. Korea argues that such subsidies are not specific for the purpose of the EC's actionable subsidy claims, since the EC failed to argue any specificity other than Article 2.3 of the *SCM Agreement*. Korea asserts that such subsidies are therefore not actionable. In our view, however, the effect of Article 2.3 is not restricted to prohibited export subsidy claims. Rather, we consider that Article 2.3 applies in respect of the entirety of the *SCM Agreement*. Thus, a subsidy that is specific under Article 2.3 (as a result of export contingency) is specific for the purpose of both Part II (prohibited export subsidy) and Part III (actionable subsidy) claims.

4. Conclusion

7.515 For the above reasons, we reject the EC's claims that the restructuring of Daewoo, Halla and Daedong involved subsidization. We also reject the EC's claim that Daewoo received subsidies through tax concessions under Article 45-2 STTCL and Article 46 CTA. We recall that we have upheld the EC's prohibited subsidy claims in respect of certain individual APRGs and PSLs.

D. SERIOUS PREJUDICE

1. Annex V information

7.516 As discussed above, the EC invoked the procedures in Annex V to the *SCM Agreement* in this dispute. During the course of the proceedings, both parties submitted extensive material in response to questions posed to one another. We have relied on the parties to bring to our attention such of that material as each considers relevant to its case. In other words, we have not ourselves conducted our own review of this material since, were we to have done so, we would have run the very considerable risk of making one or the other party's case for it, which of course we must not do.

2. Summary of the claim

7.517 In its Request for Establishment of a Panel,[273] the European Communities refers to claims of serious prejudice based on price undercutting, price suppression, price depression, and lost sales. During the course of the dispute, the EC has clarified that it is pursuing its serious prejudice claim only on the basis of price suppression/price depression.[274] Thus, while the EC provides certain anecdotal evidence concerning instances in which it alleges that EC shipyards lost sales to Korean yards, it has explicitly confirmed that it has adduced this evidence to illustrate the suppressed and depressed price levels alleged to have been caused by subsidized Korean competition.[275]

7.518 The EC also has clarified that the focus of its price suppression/depression claim is three particular types of commercial vessels: container ships, product/chemical tankers (that is, tankers that can be used for either petroleum products or chemicals, rather than tankers dedicated exclusively to one or the other), and liquefied natural gas carriers, or "LNGs".[276] The EC has presented certain

[272] See paras 7.192 and 7.308 *supra*.
[273] WT/DS/273/2.
[274] First Oral Statement of the EC, para. 97.
[275] Response to Panel question 35, para. 152.
[276] First Written Submission of the EC, para. 417; First Oral Statement of the European Communities, para. 101; Second Written Submission of the EC, para. 275

information and argumentation in relation to the world commercial shipbuilding market as a whole, but states that in its view the Panel would need to evaluate the existence and causation of price suppression/depression for each of the three vessel types separately, rather than trying to assess them collectively.[277]

7.519 In this respect, in response to an oral question at the second meeting, the EC indicated that it was requesting the Panel to make three separate serious prejudice findings, one for each of the three vessel types. In the written version of its answer to this question, however, the EC indicated the reverse, stating that serious prejudice is to the interests of a WTO Member and that therefore there is no need for three separate serious prejudice findings.[278] The EC explained that; just as serious prejudice can be found based on various combinations of Article 6(a)-(d), it also can be based "on multiple findings of price depression and/or suppression in the global market (albeit in three different sub-markets of commercial vessels)".[279] According to the EC, the subsidies at issue were granted to shipyards that produce a variety of commercial vessels, such that the same subsidy caused price suppression and/or price depression in the three product markets at issue. Nevertheless, the EC argues, the finding of serious prejudice should be based on price suppression and/or price depression in the three "product markets", each of which is a "global geographic market".[280]

7.520 In respect of price suppression/price depression, the EC argues, first, that the alleged subsidies have enabled the Korean shipyards to reduce their prices or keep their prices stable, in spite of strong increases in demand and production costs which otherwise would have led to price increases.[281] Second, the EC argues, the market for each of the three types of ships is global, [282] and Korea is the global price leader.[283] Thus, the price pressure caused by the subsidies has set the world price levels for the three types of ships covered by the EC claim, leading EC shipyards either to become discouraged from bidding (given the high cost of preparing and submitting bids); or to lose bids that they do make, due to their inability to meet the Korean/world price level; or to earn less revenue and profits than they should on the bids that they win, due to the suppressed/depressed global price levels.

3. Scope of the claim

7.521 We note that the adverse effects claims (under part III of the *SCM Agreement*) that are before us are considerably narrower than was indicated in the EC's Request for Establishment of the Panel. In particular, the serious prejudice claim was narrowed to exclude price undercutting and lost sales, and thus is based exclusively on price suppression/price depression. In addition, the EC did not pursue its claim of injury to the EC domestic shipbuilding industry which was referred to in the Request for Establishment. Thus, under Part III of the *SCM Agreement*, the only claim before us is that of serious prejudice based on price suppression/price depression.

4. Legal framework

7.522 Before considering the details of the claims and arguments before us in this dispute, we first consider the legal framework that must be applied in determining whether a subsidy has caused serious prejudice to the interests of a Member.

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[277] First Written Submission of the EC, para. 455.
[278] Responses to Questions from the Panel by the EC, para. 120.
[279] Responses to Questions from the Panel by the EC, para. 121.
[280] *Id.*
[281] First Written Submission of the EC, paras. 446-455, for all types of vessels; *Ibid*., paras. 430-434 and 458, for LNGs; *Ibid*., paras. 460-463, for Container Ships; *Ibid*., paras. 469-473, for Product and Chemical Tankers.
[282] First Written Submission of the EC, para. 424.
[283] First Written Submission of the EC, para. 433 and 447, for LNGs; *Ibid.*, para. 460, for Container Ships; *Ibid*., para. 470, for Product and Chemical Tankers.

(a) Article 5(c) – serious prejudice

7.523 Under the *SCM Agreement*, the legal basis of all adverse effects claims pursuant to Part III of the *Agreement* is Article 5, which identifies three possible kinds of adverse effects: (a) injury to the domestic industry of another Member; (b) nullification or impairment of benefits of another Member, in particular of benefits from *GATT 1994* Article II bindings; and (c) serious prejudice to the interests of another Member. Given that the EC's adverse effects claim exclusively refers to serious prejudice (based on price suppression/price depression), the relevant part of Article 5 is Article 5(c), which reads:

> "No Member should cause, through the use of any subsidy referred to in paragraphs 1 and 2 of Article 1, adverse effects to the interests of other Members, i.e.:
>
> [...]
>
> (c) serious prejudice to the interests of another Member.[13]
>
> _____
>
> [13] The term "serious prejudice to the interests of another Member" is used in this Agreement in the same sense as it is used in paragraph 1 of Article XVI of GATT 1994, and includes threat of serious prejudice."

7.524 It is clear from the text of Article 5(c) that, in the first instance, a specific subsidy (i.e., a subsidy referred to in paragraphs 1 and 2 of *SCM* Article 1) must be found to exist. Our findings in respect of the EC's claims of subsidization are contained in section VII., *supra*.

(b) Article 6.3(c)

7.525 Article 6 provides certain specific guidance concerning the establishment of "serious prejudice" in the sense of Article 5(c). The particular provision cited by the EC in its claim is Article 6.3, and more specifically Article 6.3(c), which reads as follows:

> "6.3 Serious prejudice in the sense of paragraph (c) of Article 5 may arise in any case where one or several of the following apply:
>
> [...]
>
> (c) the effect of the subsidy is a significant price undercutting by the subsidized product as compared with the price of a like product of another Member in the same market or significant price suppression, price depression, or lost sales in the same market."

7.526 Significant price suppression or price depression is the particular basis of the serious prejudice to its interests alleged by the EC as a result of subsidies to Korean shipbuilders. While Article 6.3(c) also is the pertinent provision for serious prejudice based on price undercutting and lost sales, those parts of that provision are not before us, given the narrowing of the EC's claim.

7.527 The text of *SCM* Article 6.3(c) in respect of price suppression/price depression, taken as a whole, identifies a number of discrete elements, in respect of which the parties have argued extensively. The elements that have been addressed in the parties' arguments are:

- Price suppression or price depression;

- Significance (the price suppression or price depression must be "significant");

- Causation – "the effect of the subsidy" is, *inter alia*, significant price suppression/depression;

- Like product – The major threshold question joined by the parties in this dispute in respect of this element is whether the concept of like product applies in price suppression/depression cases;

- Same market – The price suppression/price depression caused by the subsidy must be "in the same market"; and

- Serious prejudice – Is significant price suppression/depression caused by a subsidy in itself serious prejudice? If not, what in addition must be established?

7.528 The parties have raised two main sets of issues in respect of the legal analysis or framework to be applied in respect of price suppression/price depression-based serious prejudice claims: First, how and on what basis is the existence of significant price suppression/price depression as the effect of a subsidy established? Second, if price suppression/price depression resulting from a subsidy is established, does this in itself constitute "serious prejudice" in the sense of Article 5(c), and if not, what else must be established?

7.529 We start with the text of the relevant provisions, to identify any guidance that they may contain in respect of both of these two main sets of issues. Concerning the establishment of significant price suppression or price depression as the result of a subsidy, Article 5(c) contains only the term "serious prejudice to the interests of another Member", while footnote 13 thereto states that this term is used in the same sense as in Article XVI:1 of *GATT 1994* and includes threat of serious prejudice. Neither the provision nor its footnote, however, defines or elaborates on this term, in general or as it pertains specifically to price suppression/price depression.

7.530 Turning next to Article 6.3, we note that this Article itself refers simply to "significant price suppression [or] price depression", without elaboration, and that it is the only provision in Article 6 dealing specifically with price suppression/price depression. The other parts of Article 6 either address certain aspects of serious prejudice in general, or other specific bases for serious prejudice. For example, Article 6.5 provides certain specific guidance in respect of the establishment of price undercutting in the sense of Article 6.3(c) (which of course is not before us).

7.531 As to the second main set of issues, Korea points to the word "may" in the chapeau of Article 6.3, i.e., that "[s]erious prejudice [...] *may* arise" where one or several of the situations listed in subparagraphs (a)-(d) applies. On the basis of the word "may", Korea argues that the existence of one or several of the listed situations is a necessary but not a sufficient condition for a finding of serious prejudice, in that serious prejudice is something that must be caused by one of the situations referred to in (a)-(d). The EC disagrees, stating that the situations in (a)-(d) (i.e., including significant price suppression/price depression resulting from a subsidy) themselves constitute serious prejudice.

7.532 Both parties have submitted extensive legal argumentation concerning the analysis that must be conducted to determine if subsidies have caused price suppression and/or price depression, and concerning the meaning of the term "serious prejudice". They then apply their respective legal interpretations to the factual situation. We take a similar approach, that is, we first consider and reach a conclusion in respect of the analytical framework that we must apply, and we then apply that framework to the facts and arguments as presented to us by the parties.

5. Meaning of price suppression or price depression

7.533 We begin our consideration of the legal, analytical framework with the terms "price suppression" and "price depression" themselves. We note that while the Agreement contains no

definitions or other interpretative guidance, these concepts seem more or less understandable on their own, and the parties do not seem to disagree over their meaning. In particular, both parties use the term "price suppression" to refer to the situation where prices have not increased when, or have increased less than, they otherwise would have. Both use the term "price depression" to refer to the situation where prices decline when they should have remained stable or increased.[284] In particular, the EC states that the dictionary definition of "depression" is "the action of pressing down; the fact or condition of being pressed down", such that price depression is where prices are pushed downward; and that the dictionary definition of "suppress" is to "prevent or inhibit (an action or phenomenon)", meaning that for price suppression there must be a showing that price increases have been inhibited. Korea agrees, and in fact quotes the EC on the meaning of the term "price suppression".[285]

7.534 Based on this reading, as a threshold issue the *existence* of lower than expected price increases, or of price reductions, would have to be established as a matter of fact, as one necessary condition for proving a claim of serious prejudice based on price suppression or price depression caused by subsidies. We emphasize here, however, that trends in prices would not themselves constitute price suppression or price depression : as discussed *infra*, we view these terms as implicitly including a certain built-in concept of causation.

7.535 A related issue is *whose* prices are to be examined to determine if there is price suppression or price depression. For Korea, serious prejudice to a Member based on price suppression or price depression must have to do primarily with that Member's prices for the product in question. The EC states that Korean prices have been suppressed or depressed by subsidies, that this in turn has suppressed or depressed *world* ship prices and EC shipyards' prices. For the EC, the suppression or price depression of world prices is "the critical element".[286] We understand this to mean that for the EC suppression or price depression of the *world* price for a product in respect of which the EC competes in itself constitutes or causes serious prejudice to the interests of the EC. Here the parties seem to agree that the subsidizer's prices *inter alia* also are relevant.

6. Existence of price suppression/depression

7.536 It may be relatively simple to establish that, as a threshold factual matter, the price of a particular product has decreased. Similarly, it may be relatively simple to establish that the price of a product has been flat or has increased only slightly. Conceptually, however, it is likely to be more difficult to show that prices should not have decreased, or should have increased by more than they did.

7.537 In particular, the existence of a flat or declining price trend, on its own, would not be a sufficient basis on which to conclude that prices were "suppressed" or "depressed". For such a conclusion to be reached, the *causes* of these observed trends would need to be examined. In other words, price depression is not simply a decline in prices but a situation where prices have been "pushed down" *by something*. Price suppression is where prices have been restrained *by something.* In other words, for a finding of "price suppression" or "price depression" in the sense of *SCM* Article 6.3(c), there must not only be a flattened or downward price trend as a prerequisite, but in addition this trend must be the result of an exogenous factor, namely the subsidy or subsidies in question. Thus, the analysis that seems to be called for by the Agreement (by virtue of the concepts of

[284] These concepts also are well-known in the area of trade remedies. In the context of anti-dumping and countervailing measures, for example, price suppression is described as the situation where "price increases, which otherwise would have occurred" are prevented "to a significant degree".

[285] At paragraph 522 of its First Submission, Korea, citing the EC submission states: "[...] price suppression can be defined as the prevention of price increases that otherwise would have occurred".

[286] EC response to question 35 from the Panel.

price suppression and price depression themselves), concerns what the price movements for the relevant ships *would have been* in the absence of (i.e., "but for") the subsidies at issue.[287]

7. Does the concept of "like product" apply in respect of price suppression/price depression?

(a) Arguments of the parties

7.538 The parties disagree as to whether the concept of "like product" applies in the context of price suppression/depression. For the EC, it is clear from the text of Article 6.3(c) that this concept does not apply in this context, and the EC therefore declines to define any "like products" in the sense that that term is used in the *SCM Agreement*. The EC nevertheless indicates that its adverse effects claims are in respect of the three identified kinds of ships (LNGs, product/chemical tankers, and container ships), which categories it says are "analogous" to like products. Korea takes the opposite view, arguing that the concept of like product does apply and that the EC, by not addressing the issue or defining "like products", has failed to meet its burden to establish a *prima facie* case of serious prejudice. Furthermore, for Korea, even if the EC had argued that the product categories it identifies were like products, these categories would be too broad to fit the Agreement's definition of like product.

7.539 The EC relies on the fact that in Article 6.3(c), the term "like product" appears only in connection with price undercutting, and not in connection with price suppression/price depression or lost sales. For the EC, this textual difference must have meaning, and in particular can be explained on the basis of economic logic: that products that are not identical, but broadly similar and in competition with one another, can and do influence one another's' prices.[288] The EC argues that by not referring to like product in the context of price suppression/depression, the negotiators created flexibility as to how to determine the "same market" in which price effects occur (which term for the EC has both a product and a geographic connotation). That is, according to the EC, *SCM* Article 6.3(c) allows the tailoring, on a case-by-case basis, of criteria appropriate to capture price developments in the relevant product and geographic market affected by subsidization. For the EC, it is precisely because the like product definition in the *SCM Agreement* is very narrow that the negotiators chose to omit it as a requirement for price suppression/depression analysis.

7.540 Korea disagrees, arguing that like product is a strict requirement for price suppression and price depression (as it explicitly is for price undercutting), and criticizing the EC for failing to address this required element. In particular, Korea argues that by declining to define a like product or to present evidence in respect thereof, the EC has omitted one of the key necessary elements of the price suppression/price depression analysis, and thus has failed to establish a *prima facie* case of serious prejudice. Korea argues that the Panel should dismiss the EC's serious prejudice claim on this basis.

7.541 Concerning the text at issue, Korea argues that the reason the words "like product" are not repeated in the second part of Article 6.3(c) (the part dealing with price suppression/price depression and lost sales), while the words "same market" are repeated there, is that repetition of the former would be "superfluous" while repetition of the latter is not. That is, the geographic markets to which the subparagraphs of Article 6.3 refer vary from one subparagraph to another, while the term "like product" retains the same meaning throughout Article 6.3. Korea then argues that if like product does

[287] We note that the panel in *Indonesia – Autos* applied an analogous "but for" analysis in its consideration of the claims of displacement and impedance of imports. We discuss this *infra* in connection with causation.

[288] Indeed, the EC argues as a theoretical point, although not as the basis for its claim, that the prices for all types of ships are sufficiently interlinked, due in particular to the broad capabilities of most shipyards to produce a wide range of different kinds of ships, that a price change for any one ship type will have rippling price effects on *all* other ship types. Responses by the EC to Question 29(c) from the Panel.

not apply in respect of price suppression/price depression, this would mean that a "new and undefined standard" has been introduced by negotiators for price suppression/price depression, but with no express words to that effect, a proposition that Korea does not find credible.

7.542 For Korea, the concept of like product is a cornerstone of the *SCM Agreement* and of the *WTO Agreement* as a whole. To not apply like product would imply, for Korea, a series of separate and distinct causation analyses under the different subparagraphs of Article 6.3, based not just on the different alleged subsidies but also with respect to every causal element (i.e., like product for some and "something else special" for price suppression and price depression).

(b) Evaluation by the Panel

7.543 Korea's argument that "like product" is a required element of price suppression/depression analysis seems to presuppose, in the first instance, the identification of a "subsidized product", which, in Korea's view, the product subject to the dispute must be "like". In particular, the question raised by Korea's argument is whether the adverse effects on the EC's interests in terms of price suppression/price depression must relate to a product that is "like" an identified "subsidized product".

7.544 We note that the Agreement contains a detailed definition of "like product", in footnote 46 to Article 15.1. We note further that this definition applies to the *SCM Agreement* in its entirety, as indicated by the definition's introductory phrase ("[t]hroughout this Agreement"):

> "Throughout this Agreement the term "like product" ("produit similaire") shall be interpreted to mean a product which is *identical*, i.e., alike in all respects to the product under consideration, or in the absence of such a product, another product which, although not alike in all respects, has *characteristics closely resembling* those of the product under consideration." (Emphasis added.)

Thus, if the concept of like product does apply in respect of price suppression/price depression, it would have the meaning set forth in footnote 46.[289]

7.545 We start our consideration with the relevant text of the *SCM Agreement*, which we note is somewhat ambiguous as to the applicability of "like product" in the context of price suppression/price depression. In particular, in *SCM* Article 6.3(c) which covers price undercutting, price suppression, price depression, and lost sales, the term "like product" explicitly appears in conjunction *only* with price undercutting. To recall, the provision in its entirety reads:

[289] The panel in *Indonesia – Autos*, in interpreting the term "like product" in the serious prejudice claims before it (which did not include price suppression/price depression), found the definition in footnote 46, including the term "characteristics closely resembling", to be quite narrow, and to be based principally on physical characteristics of the product. The panel then conducted a detailed analysis of the physical characteristics of the particular car models in the market segment that it was considering as the possible "like product" category. On the basis of this approach, the panel excluded as a "like product" a larger and more powerful car in an adjacent market segment to that of the subsidized car. The panel in *Indonesia – Autos* recognized that it could not feasibly limit the like product to strictly identical cars, but recognized as well that it would not make sense, and would not conform to the definition in SCM footnote 46, to identify the like product as "all passenger cars". Instead, the Panel considered the like product to be the market segment, as defined by a widely-used and well-respected market analysis firm, in which the subsidized Indonesian national car was classified. The market segments identified by the market analysis firm, although certainly encompassing non-identical cars, nevertheless were quite narrowly-defined, in terms of size and other basic physical characteristics, as well as other indicators such as price and customer perceptions which the Panel viewed as being based primarily on physical characteristics. The physical similarity of the cars within the segment found to be relevant by the panel, and the dissimilarity of these cars and cars in other segments, was considered and confirmed by the panel through further analysis of a number of key *physical* characteristics.

> "the effect of the subsidy is a significant price undercutting by the subsidized product as compared with the price of a like product of another Member in the same market or significant price suppression, price depression or lost sales in the same market".

7.546 Thus, Article 6.3(c) refers to "significant price undercutting" by the subsidized product in respect of a "*like product*" of another Member in the same market. By contrast, the provision then continues with the reference to price suppression/depression and lost sales, repeating the term "in the same market", but making no mention of "like product". Thus, the question is whether the lack of a reference to "like product" in the specific context of price suppression/depression means that like product is *not* a required element of price suppression/price depression analysis. The answer to this question would seem to have certain implications for the analysis that needs to be carried out.

7.547 In assessing the legal issue concerning the applicability of like product in respect of price suppression/price depression, we note first Article 6.3(c)'s lack of an explicit reference to like product in connection with price suppression/price depression. Thus, the text on its face does not explicitly impose a like product requirement. Clearly the question before us is whether this text nonetheless contains an implied reference to like product, as argued by Korea, or whether the absence of an explicit reference means that like product is not a required element of the analysis.

7.548 In respect of the text, we find significant that the term "the same market" is used twice in Article 6.3(c), including in connection with price suppression/price depression, while the term "like product" appears only once, not in connection price suppression/price depression. To us, the repetition of "same market" strongly suggests that the text also would repeat "like product" had this term been intended to apply in this connection.

7.549 Turning to the relevant context, the immediate context consists of the other subparagraphs of Article 6.3, all of which explicitly specify and require a particular product scope. Article 6.3(a) and 6.3(b) refer to "like product", and Article 6.3(d) refers to "a particular ... primary product or commodity". We view these references to product, variously defined, everywhere else in Article 6.3 as contextual support for the proposition that like product is not a legally required element in respect of price suppression/price depression analysis. In other words, we infer from the text that where it was intended that a product scope concept apply, this was made explicit. In this regard, we are not persuaded by Korea's argument that it would have been redundant to repeat the reference to "like product" in Article 6.3(c), while the existing repetition of "the same market" is not redundant. While it is true, as Korea argues, that the "markets" referred to elsewhere in Article 6.3 vary from one subparagraph to another ("the market of the subsidizing Member", "a third country market", "the world market"), this is clearly not the case *within* Article 6.3(c), which refers twice to "the same market". Whatever "the same market" means, it must mean the same thing in both places.

7.550 Korea points to *SCM* Article 15, which pertains to countervailing measures, as relevant context in support of the applicability of "like product" in respect of price suppression/price depression. While the relevant portion of Article 15.2 is phrased very similarly to that of Article 6.3(c), we do not see this by itself as determinative of this question. First, countervail and serious prejudice concern situations that are considerably different: material injury to a particular domestic industry producing a particular "like product", on the one hand, and adverse effects in the form of serious prejudice to a Member's "interests", on the other hand. Furthermore, unlike Article 6.3(c), Article 15 makes *explicit* that in the countervail context the price suppression or price depression referred to must be in respect of the "like product".[290]

[290] In particular, Article 15.1 requires an examination, *inter alia*, of "the effects of the subsidized imports *on prices in the domestic market for like products*", while Article 15.2 elaborates, with respect to the effect of the subsidized imports on prices (i.e., the analysis required by Article 15.1), that the authorities shall consider *whether the effect of the subsidized imports* is to depress prices to a significant degree or to prevent

7.551 We also find relevant the negotiating history of *SCM* Article 6.3(c). In the Uruguay Round, the first draft version of this provision linked the concept of price undercutting to the concepts of price suppression, depression and lost sales, as follows:

> "there is a significant price undercutting by the subsidized products as compared with the price of a like product of another signatory in the same market resulting in price suppression, price depression or lost sales;"[291]

In other words, in that early version of the text, a finding of price suppression or price depression could only result from a significant price undercutting by subsidized products of the like product. Had this language been retained, the causal linkage between price undercutting in respect of a like product and a consequent price suppression/price depression means that the price suppression/price depression also would have had to have been in respect of the like product.

7.552 The above-quoted original language was not retained in the final text, however, and the significant change incorporated in that final text is that price suppression, price depression and lost sales went from being downstream consequences of price undercutting to separate, independent bases for serious prejudice. In this respect, we find particularly significant that when these concepts were separated, the term "the same market", which had appeared only once in the original version, following price undercutting, was repeated so as to introduce it explicitly also in respect of price suppression, price depression and lost sales in the final version. No such change was made in respect of the term "like product", which in both the original draft and the final version of the provision appears only once, in the specific context of price undercutting.

7.553 On the basis of the foregoing considerations, we conclude that "like product" as defined in footnote 46 to Article 15 of the *SCM* Agreement is not a legal requirement for claims of price suppression/price depression pursuant to Article 6.3(c).

7.554 We now turn to the implications of this conclusion for the kind of analysis that needs to be conducted for price suppression/price depression cases. We recall here that Korea argues that if "like product" were not a required element, the subsidy disciplines would be undermined. We do not find this argument persuasive for the following reasons.

7.555 In particular, we first consider what the role of the "like product" concept, if applicable, would be in a price suppression/price depression analysis. We note here that the "like product" as referred to in the various subparagraphs of Article 6.3 is the product of a complaining Member that is "like" the subsidized product. In other words, the concept of "like product" presupposes that a "subsidized product" has been identified. Furthermore, where "like product" is referred to in Article 6.3, it is in the context of a comparison to be made between the subsidized product on the one hand and the like product on the other hand. Thus, under the first part of subparagraph 6.3(c), (price undercutting), the question to be answered is whether the effect of the subsidy is a significant price undercutting by the subsidized product as compared with the price of the like product of the complaining Member. Similarly, under subparagraphs (a) and (b), the question to be answered is whether the effect of the subsidy is to displace or impede the imports or exports of the complaining Member's like product. Determining displacement or impedance in turn involves an analysis and comparison of relative levels and trends in volume and market share of the subsidized product and the complaining Member's like product.[292]

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price increases which otherwise would have occurred, to a significant degree. Linking these two provisions, the analysis therefore seems to be an examination of whether "the subsidized imports" have significantly suppressed or depressed the prices for "the domestic like product".

[291] MTN/GNG/NG10/W/38.

[292] SCM Article 6.4 provides certain guidance as to how this comparative analysis is to be performed.

7.556 Thus, if the concept of "like product" applied in respect of price suppression/price depression analysis, this would seem to imply that it would be necessary to identify and define, in the first instance, a "subsidized product", as only then could the product that is "like" the subsidized product be identified. In turn, in the context of price suppression/price depression, the logical reason to identify a product that is "like" the "subsidized product" would seem to be so that their respective price levels and trends could be compared. That is, if the concept of like product applies, its principal analytical purpose would seem to be to ensure that such a price-to-price comparison would be made in all cases.

7.557 The main implication of our conclusion that the concept of "like product" does not apply in respect of price suppression/price depression analysis thus would seem to be that such a structured price-to-price comparison would not be *required* in terms of the *SCM Agreement*. In other words, given that the relevant text is that "the effect of the subsidy is [...] significant price suppression [or] price depression", the basic analytical question would be how to demonstrate such a causal relationship between the subsidy or subsidies in question, on the one hand, and movements in the prices of the product of concern to the complaining Member in the relevant market, on the other hand. In our view, this means that a main focus of the analysis would be levels and trends in the price for the product in question, as a whole, in the relevant market (i.e., "the same market"), as a whole, and the various reasons behind them. In terms of the present dispute, this implies that we are not required to base our assessment of the EC's claim of price suppression/price depression on a product-by-product comparison of price levels and trends for identified subsidized Korean products and corresponding like products of EC shipyards.[293]

7.558 We must emphasize, however, that this does not mean that product considerations are irrelevant to our analysis. To the contrary, we view product as a necessary, and indeed inescapable, part of an analysis of price suppression/price depression. Simply put, a price must always be for some particular thing, which the complaining party must identify. Here we recall that the EC has alleged that subsidies to Korean shipyards have had the effect of suppressing and depressing the prices of three specified categories of ships of interest to the EC, and requests us to conduct our analysis in respect of each of these categories separately.

7.559 In terms of the breadth or narrowness of the description of the product whose prices allegedly are suppressed or depressed, and the relationship of the price levels and trends with the subsidy in question, we note that of course in any WTO dispute it is always for the complaining party to determine the basis and nature of its own complaint. Thus, a complaining party is free to *claim* that a given subsidy of another Member has caused price suppression or depression to the detriment of the complainant's interests. Obviously, the prices in question will have to be identified as prices for some product or products in particular, of interest to the complainant, in a specified market. It will then be the complainant's burden to demonstrate the causal relationship between the subsidy and the particular price effects that it alleges (i.e., in respect of the particular product or products, however defined, of interest to the complainant).[294] That is, we view the product issue ultimately as pertaining to the demonstration of causation, on the basis of such facts as may be relevant to the particular case.

7.560 In this regard, we would observe that the nature of the demonstration that the complainant will need to make to establish causation in any given case, and the difficulty of doing so, will depend on a number of factors and factual circumstances, including but not limited to the breadth of the description of the product on which the complainant brings its case. Such factors might include

[293] We recall here that Korea considers that the EC is prohibited from advancing any arguments to the effect that Korea's prices are lower than the EC's for particular ships, as in Korea's view such arguments in fact constitute a revival of the EC's abandoned price undercutting claim.

[294] Given our view that product is an inherent element of price, we do not find it necessary to read the term "the same market" in the context of price suppression/price depression as combining both a geographic and a product element, as argued by the EC.

among others the nature of the subsidy, the way in which the subsidy operates, the extent to which the subsidy is provided in respect of a particular product or products, conditions in the market, the conceptual distance between the activities of the subsidy recipient and the products in respect of which price suppression/price depression is alleged.[295] Whatever the factual situation in a given case, the burden will be on the complainant to furnish specific factual evidence affirmatively demonstrating the causal link alleged, and the difficulty and ways of meeting this burden may be very different from one case to another.[296] In all cases, if the complainant fails to meet this evidentiary burden, its serious prejudice claim will fail. We note that issues of product definition as they relate to causation are before us in this case, and these issues are addressed in our analysis in section VII.D.12 and 13, *infra*.

8. Can "the same market" be the world market?

7.561 *SCM* Article 6.3(c) provides that price suppression/price depression must be in the "same market". The parties have different views as to the scope of the geographic market in which price suppression/price depression can be found, and in particular, whether the term "the same market" can refer to the world market as a whole.

(a) Arguments of the parties

7.562 On the possible scope of the relevant geographic "market", the EC argues that nothing in Article 6.3(c) would preclude defining the "world" market as the "same market" for purposes of price suppression/price depression analysis. In this regard, the EC cites our statement, in our decision declining to make a preliminary ruling on this issue, that "the same market" refers to "a market where Korean and EC producers of commercial vessels compete and where the alleged adverse effects of the subsidies on prices or sales will need to be substantiated". The EC argues in particular that unlike Articles 6.3(a) and 6.3(b) which explicitly refer only to national markets, Article 6.3(c) leaves the geographic scope of "the same market" undefined. The EC notes as well that there is precedent for a finding based on a world market, namely in the GATT *EC – Sugar Exports (Brazil)* dispute, where the panel found serious prejudice based on suppression/depression of the *world* market price level.[297]

7.563 In its request for preliminary rulings, Korea challenged the idea that "the same market" could be the world market and since then has reiterated this objection. Korea argues that "the same market" can only refer to a national market, not to the world market. Korea refers to Article 6.3(d), which does refer to "world market", as contextual support for this argument, by negative inference (i.e., the negotiators would have explicitly referred to the world market in Article 6.3(c), as they did in Article 6.3(d), if they had intended that it could be used as the market of reference there). Korea further argues, by way of context, that where the term "market" is used in Articles 6.3(a) and 6.3(b), this is a national market, and there is no reason to interpret the same word, "market", in Article 6.3(c) differently. According to Korea, the language "of the subsidizing Member" in Article 6.3(a) and "a third country" in Article 6.3(b) only designate "which" national market. For Korea, the term "market" itself is a "national market". The US agrees with Korea on this point, and takes issue with the EC's

[295] Of course, factors such as these presumably would be relevant in all types of serious prejudice cases.

[296] For example, in a case involving alleged significant suppression or depression of the price for a given kind of narrowly-defined product due to product-specific subsidization of a physically identical product produced by another Member, product definition issues presumably would figure little if at all in respect of the evidence necessary to demonstrate causation. The situation presumably would be quite different where the alleged subsidy was in respect of an input product, while significant price suppression or depression was alleged in respect of a downstream product of the complainant, or where a subsidy in respect of one product was alleged to cause significant price suppression or depression in respect of a completely unrelated product. Clearly in the latter two cases, product definition issues would create a significant, if not insurmountable, evidentiary hurdle in respect of causation.

[297] Second Written Submission by the EC, para. 350, *citing* GATT Panel Report *EC – Sugar Exports (Brazil)*, paras. 4.28-4.29.

basic premise, arguing that no matter what the product at issue is, a purchaser always has the option of importing it from a number of countries, but that this does not change the scope of the market where the sale takes place.

(b) Evaluation by the Panel

7.564 We note in the first instance that Article 6.3(c) places no geographic limitations on the concept of "the same market". We find no basis in the text to construe this term as exclusively referring to "national markets". Nor are we persuaded that the explicit references to particular national markets in Articles 6.3(a) and 6.3(b), and the explicit reference to the "world market" in Article 6.3(d) mean, by implication, that "the same market" in Article 6.3(c) can only be a national market. Indeed, each of these other provisions refers to a particular "market" that is relevant to it, whether a national market or the world market. By contrast, we find the absence of any geographic modifier in respect of "the same market" to indicate that Article 6.3(c) leaves flexibility to define "the same market" broadly or narrowly depending on the facts of a given case. That is, we view the lack of modifiers to the term "the same market" in Article 6.3(c) as encompassing (at least) all of the possibilities referred to in the other subparagraphs of Article 6.3 (the national markets of the subsidizer, of the complaining Member, or of a third country, and the world market), leaving the particular market to be defined in accordance with the specifics of each case.[298] Given the very specific and carefully crafted references to particular geographic markets in the other subparagraphs of Article 6.3, we do not find it plausible that the absence of such a reference in Article 6.3(c) either was the result of an oversight by the drafters, or was intended to imply that the market in question could only be a national one.

7.565 Our view is consistent with the approach taken in the two GATT *Sugar* disputes[299], and the *US - Upland Cotton* dispute, in all of which serious prejudice was found based on suppression or depression of world market prices.

7.566 In sum, we reaffirm our statement from our 19 September 2003 decision in respect of certain requests for a preliminary ruling that however defined, to be "the same market", the market in question must be one in which the EC and Korea compete for sales of commercial vessels of particular types (para. 32). In this regard, it would seem to be for the EC first to substantiate the geographic scope in which it alleges that the European and Korean industries compete in respect of each of the three types of commercial vessels, rather than necessarily having to prove as a general matter that the overall market for commercial vessels is a global market. The submitted factual information and parties' arguments on this point are discussed in section VII.D.12, *infra*.

9. "Significant"

(a) Arguments of the parties

7.567 The text of *SCM* Article 6.3(c) refers to serious prejudice based on "significant" price suppression/price depression. Specifically, Article 6.3(c) provides that serious prejudice may arise where the effect of the subsidy is, *inter alia*, "significant" price suppression or price depression. The parties' views differ as to how this term should be interpreted.

7.568 The EC argues that the term "significant" price suppression/price depression means that "complainants must show only that the effect on price is large enough to meaningfully affect suppliers who compete with the producers of the subsidized products". In advancing this argument, the EC

[298] We wish to emphasize that we need not and do not here opine on the possibility that geographic markets of a different scope might be defined, for example, regional markets comprised of more than one national market.

[299] *EC – Sugar Exports (Brazil)* para. V.(f), and *EC – Sugar Exports (Australia)*, para. 4.9.

explicitly relies on the analysis of this term by the panel in *Indonesia – Autos*. In addition, the EC argues that this interpretation of the term is consistent with the object and purpose of Part III of the *SCM Agreement*, in the sense that the degree of price suppression or price depression must be "important" or "consequential" to be capable of "seriously prejudicing" another Member's interests.

7.569 Korea rejects the EC's argument as to the meaning of the term "significant" in Article 6.3(c). For Korea, there must first be an assessment of price levels for like products, i.e., a measurement of pricing trends for specific "like product" vessel types, and then a determination of whether any price suppression or price depression that may exist is "significant". For Korea, significance must be assessed on a case-by-case basis, taking into account specific features of the products and market involved. According to Korea, the standard to be applied in this case-by-case assessment must be "strict and high", because a finding of serious prejudice has to do with the effect of price suppression and price depression on the EC shipbuilding industry as well as on "the interests of the EC at large". Furthermore, Korea argues, because a finding of serious prejudice can be based on a single factor (price suppression/price depression) unlike the multiple factors (i.e., the injury indicators, such as production, employment, etc.) involved in an injury analysis (of which, Korea argues, price suppression/price depression is just one), there must be a greater degree of price suppression/price depression for a serious prejudice finding than would be required for an injury finding. Otherwise, according to Korea, it would be easier to prove serious prejudice than injury.

(b) Evaluation by the Panel

7.570 We note that the Agreement provides no guidance on the meaning of the term "significant" in the context of Article 6.3(c), and we note further that no other provision of Article 6 contains this term. The ordinary meaning of "significant" to us seems relatively straightforward, in the sense that something that is "significant" is important or consequential.[300] So a "significant" price suppression or price depression would be one that is "important" or "consequential". Put another way, a price suppression or price depression that is unimportant, or inconsequential would not be "significant" in the sense of Article 6.3(c).

7.571 Previous panels that have examined this issue have taken a similar approach. The panel in *Indonesia – Autos* (which had before it a price undercutting claim rather than a price suppression/price depression claim) found that "the inclusion of this qualifier in Article 6.3(c) presumably was intended to ensure that margins of undercutting so small that they could not meaningfully affect suppliers [...] are not considered to give rise to serious prejudice".[301] Thus, the panel read the term "significant" as a *de minimis* concept intended to screen out very small, unimportant price effects that might be caused by subsidies but that would have no real impact in the market. The panel in *US – Upland Cotton*, in considering the claim of price suppression before it, noted similarly that the treaty language makes clear that it is the price suppression itself that must be "significant", in which case it is useful to consider the degree of price suppression in the context of the prices that have been affected.[302] Thus, the approach taken by the *US - Upland Cotton* panel was broadly consistent with that taken by the *Indonesia - Autos* panel. We agree, and are of the view that only price suppression or price depression of sufficient *magnitude* or degree, seen in the context of the particular product at issue, to be able to meaningfully affect suppliers should be found to be "significant" in the sense of *SCM* Article 6.3(c).

[300] *The New Shorter Oxford English Dictionary*, L. Brown (ed.) (Clarendon Press, 1993), defines "substantial" in this way: "important, notable; consequential".
[301] Panel Report, *Indonesia – Autos*, para. 14.254.
[302] *US – Upland Cotton*, at para. 7.1328.

10. "Serious prejudice *may* arise"

(a) Arguments of the parties

7.572 Korea argues, on the basis of the word "may" in the chapeau of Article 6.3 that a two-step analysis is required to establish the existence of serious prejudice, i.e., that the situations listed in Articles 6.3(a) through (d) are necessary prerequisites to a finding of serious prejudice, but that they do not in themselves constitute serious prejudice. Korea argues that serious prejudice is a separate, distinct concept, which must be a *result* of the situations in Articles 6.3(a) through (d).

7.573 As for the nature of "serious prejudice", Korea argues that it is similar to, but more severe than, "material injury". To demonstrate the existence of serious prejudice, therefore, the EC must demonstrate the elements set forth in Articles 11-15 of the *SCM Agreement*, i.e., must conduct an injury analysis of the EC domestic industry such as that required for a countervailing duty investigation, but with a higher standard of damage than "material injury", namely a significant overall impairment of the EC shipbuilding industry (i.e., the same standard as for a safeguard measure).[303] Korea further argues that, because serious prejudice is "to the interests of another Member", the EC must also show that the economic survival of the shipbuilding industry is "vital" to the overall interests of the EC.

7.574 By contrast, the EC argues that Article 6 sets forth a self-contained regime defining the notion of serious prejudice, in which Article 6.1 established a (now-expired) presumption of serious prejudice in certain situations, Article 6.7 excludes the existence of serious prejudice in certain situations, and Article 6.3 *permits* a finding of serious prejudice where one or more of the paragraphs (a)-(d) applies. In other words, for the EC, "may" connotes permission. The EC also points to footnote 13 to Article 5(c), which provides that the term "serious prejudice" has the same sense as under Article XVI:1 of GATT 1994, and notes that the findings of serious prejudice by the *Sugar* and *Indonesia - Autos* panels were based solely on price depression and price undercutting, respectively. Thus, for the EC, the situations in Articles 6.3 (a) through (d) in themselves constitute serious prejudice.[304]

7.575 Among the third parties, the US, while agreeing with Korea that serious prejudice is a separate requirement that must be satisfied (and relying, like Korea, on the word "may" as the basis for this view), disagrees with Korea that the provisions of *SCM* Articles 11-15 are relevant to serious prejudice. For the US, the relevant requirements are those in Articles 5 and 6. The US argues that the word "may" functions to ensure that serious prejudice would not automatically be found in every case where subsidization gave rise to any market effects, no matter how small.

(b) Evaluation by the Panel

7.576 We see the fundamental issue raised by this aspect of Korea's argument to be whether, to demonstrate the existence of serious prejudice, the *SCM Agreement* requires additional elements beyond those referred to in Article 6, such as injury to the domestic industry, and/or the importance of that industry to the overall interests of the complaining party. In this respect, we find neither textual nor contextual support for Korea's argument that a finding of serious prejudice requires the establishment of something like "serious injury" to the domestic industry of the complaining Member, or of the relative importance of the industry to that Member, and we note that Korea offers none.

[303] This argument is closely related to Korea's argument in relation to causation. In that context Korea argues that:

> "it is possible to consider both the causation and injury standards for countervailing duty investigations as lesser standards subsumed within the standards of Articles 5 and 6. Thus, proving the elements of injury and causation under Part V could be considered as necessary, but not sufficient, elements of demonstrating serious prejudice under Articles 5 and 6". (Korea's response to Panel Question 90)

[304] See EC response to Panel Question 101.

Rather, Korea's entire argument to this effect is based on the premise that the word "serious" connotes something stronger than the word "material", that material injury is a lesser standard subsumed within the standards of Articles 5 and 6, and that "serious" prejudice cannot be easier to prove than "material" injury. As an initial matter, given that the word "material" does not appear in the serious prejudice provisions of the *SCM Agreement*, we fail to see the relevance of the juxtaposition of terms proffered by Korea. Nor do we agree that the absence of a requirement for an injury-type analysis in the context of serious prejudice claims would necessarily make it easier to prove serious prejudice than material injury. Rather, we view these as two distinct concepts.

7.577 We recall that *SCM* Article 5, the general provision of the *SCM Agreement* covering all forms of "adverse effects" for purposes of the multilateral subsidy disciplines in Part III of the Agreement, clearly separates the concept of "injury to the domestic industry of another Member", in Article 5(a), from the concept of "serious prejudice to the interests of another Member", in Article 5(c). Given this explicit differentiation in this single provision of the *SCM Agreement* between "serious prejudice to the interests of another Member", on the one hand, and "injury to the domestic industry of another Member" on the other, we disagree that the former is simply a more severe form of the latter. If serious prejudice had been intended to refer to, encompass, or require a showing of, injury to a particular industry, such a separation would be unnecessary, and, furthermore, the negotiators would have made this explicit, as they did in the context of countervail.[305] Nor are we convinced that the term "serious injury" in the Agreement on Safeguards informs the meaning of the term "serious prejudice" in the *SCM Agreement*. While the adjective "serious" appears in both places, these are two separate Agreements, which contain no cross-references to one another. We see no basis to assimilate them as suggested by Korea.

7.578 In short, we see serious prejudice as an entirely different concept from injury. Rather than having to do with the condition of a particular domestic industry within the territory of a Member (the subject matter of injury analysis), in our view serious prejudice has to do in the first instance with negative effects on a Member's *trade interests* in respect of a product caused by another Member's subsidization. Article 6.3 demonstrates this in providing that the recognized "adverse effects" of subsides on these interests include, in the context of serious prejudice, lost import or export volume or market share in respect of a given product (displacement or impedance, more than equitable share), and adverse price effects (implying lost trade revenue/income in respect of the product), or some combination thereof, in variously-defined markets.

7.579 Of course, negative effects of this type on a Member's trading interests in a product also would tend to be felt in the performance of the domestic industry producing that product. In this regard, we do not mean to suggest that particular effects on a given industry (e.g., employment, profitability, etc.) could not be examined in the context of serious prejudice.[306] Indeed, it is likely that situations such as those referred to in *SCM* Article 6 could manifest themselves in an impact on the state of the industry in question, and this might constitute relevant information in a given case. In this regard, we note that in this dispute the EC has presented certain information about the state of its shipbuilding industry. Our point is, rather, that we disagree that establishment of something similar to serious injury in the sense of the Agreement on Safeguards to the industry producing the product in question is a *required* element for a finding of serious prejudice.

7.580 We find uniform and extensive support for this view in the text of the relevant provisions of the *SCM Agreement*, in prior dispute settlement concerning serious prejudice, and in the relevant negotiating history.

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[305] For example, in SCM Article 11.2, which requires applications to contain information on the "relevant factors having a bearing on the state of the domestic industry, such as those listed in paragraphs 2 and 4 of Article 15".

[306] We note that the *US - Upland Cotton* panel (at para. 7.1392 and footnote 1493) took a similar view.

(i) Text

7.581 In the first place, we note the explicit cross-reference to Article 5(c) in the chapeau of Article 6.3: "Serious prejudice in the sense of Article 5(c)". The plain language of this cross-reference is a strong indication that the situations listed in Article 6.3(a)-(d) *are* serious prejudice "in the sense of Article 5(c).

7.582 Second, in respect of Article 6.3, the specific provision at issue, if the word "may" did not appear in the chapeau of this provision, the implication would be that serious prejudice inevitably would arise from any price or volume effect listed in Article 6.3 (a)-(d), without the need to consider the matter in depth. Given this, we see the word "may" in the chapeau as a general cross-reference to other specific requirements elsewhere in Article 6 for the establishment of serious prejudice on the basis of the price and/or volume effects referred to in subparagraphs (a)-(d) of Article 6.3. In particular, Article 6.4 establishes specific affirmative requirements for finding displacement or impedance of exports, while Article 6.7 sets forth particular situations where "displacement or impedance resulting in serious prejudice *shall not arise*" (emphasis added). Article 6.5 establishes methodological rules for price undercutting which must be followed before any finding of serious prejudice based on price undercutting can be made. In the same sense, we view the word "may" as a cross-reference to "significant" in Article 6.3(c), operating to rule out serious prejudice findings where any price suppression or price depression resulting from a subsidy is unimportant and inconsequential.

7.583 Another provision that we believe informs the nature of "serious prejudice" is Article 6.2, which establishes the basis on which the now-expired presumption of serious prejudice in Article 6.1 could be rebutted. In particular, Article 6.1 identified four situations of subsidization that were "deemed" or presumed, to give rise to serious prejudice.[307] In effect, this provision shifted the burden of proof from the complainant to the subsidizer as to whether the subsidies in question were causing serious prejudice. The four situations that gave rise to the presumption were: subsidization of a product by more than 5 per cent *ad valorem*; subsidization of operating losses of an industry; subsidization of operating losses of an individual enterprise, subject to certain exceptions; and direct forgiveness of debt. Thus, a complainant would, in the first instance, simply have to demonstrate the existence of any one of these kinds of subsidization to obtain a presumption that its interests had been seriously prejudiced by that subsidization. However, Article 6.2 provided that the subsidizer could rebut the presumption (in the sense that "serious prejudice shall not be found") by demonstrating that the subsidy in question had *not* resulted in any of the effects enumerated in Article 6.3 (displacement or impedance, price undercutting, price suppression/depression, lost sales). We thus view Article 6.2 as defining by implication the situations listed in Article 6.3 to be in themselves serious prejudice.

7.584 This reading is further supported by Article 27.8, which provided that no presumption of serious prejudice pursuant to Article 6.1 could arise in respect of developing country Members, and that instead such serious prejudice would need to have been demonstrated by "positive evidence, *in accordance with the provisions of paragraph 3 through 8 of Article 6*". The phrase "in accordance with the provisions of paragraph 3 through 8 of Article 6" further supports that those provisions identify both the situations constituting, and the evidence relevant to establishing, serious prejudice.

7.585 The provisions of the *SCM Agreement* governing the factual information relevant to serious prejudice disputes (Article 6.6 and Annex V – "Procedures for developing information concerning serious prejudice"), underscore that it is the trade effect, as such, on a Member in respect of a product, caused by another Member's subsidization that forms the substance of "serious prejudice". Article 6.6 requires any Member in whose market serious prejudice is alleged to have arisen to make available "all information that can be obtained as to the *changes in market shares* of the parties to the dispute as

[307] Article 6.1 lapsed on 31 December 1999, according to Article 31 of the *SCM Agreement*.

well as concerning *prices of the products* involved" (emphasis added). In similar vein, paragraph 5 of Annex V specifies that the information to be gathered through the Annex V process:

> "should include, *inter alia*, data concerning the amount of the subsidy in question (and, where appropriate the value of total sales of the subsidized firms), prices of the subsidized product, prices of the non-subsidized product, prices of other suppliers to the market in question and changes in market shares. It should also include rebuttal evidence [...]".

7.586 The provisions concerning rebuttal of serious prejudice also are relevant here. As mentioned, the former presumption of serious prejudice under Article 6.1 could be rebutted by demonstrating that the subsidy had "not resulted in" displacement or impedance of imports or exports in the sense of Article 6.3(a) or (b), or price undercutting, price suppression, price depression or lost sales in the sense of Article 6.3(c), or an increase in world market share of a primary product or commodity in the sense of Article 6.3(d). Similarly, the situations listed in Article 6.7 as rebutting a finding of displacement or impedance all are concerned with alternative reasons (including, for example, prohibition or restriction on exports, and situations of *force majeure* affecting production, qualities, quantities or prices of the product available for export) for declines in the overall volume and/or market share of the complaining Member *in respect of the product at issue*, that is, changes in trade flows.

7.587 In short, none of the information referred to in the Agreement as required for/relevant to either the establishment or the rebuttal of serious prejudice goes to the sorts of domestic industry "injury" indicators that would be relevant for a serious injury finding, and that Korea argues must be examined. Rather, the required information has to do with trade (volumes and/or prices) in the product at issue in particular markets. We conclude from this that serious prejudice to a Member's interests, in the sense of *SCM* Article 5(c), consists of adverse effects on that Member's trade in a particular product in a specified market, resulting from subsidization by another Member. That is, the situations listed in Article 6.3(a) –(d) in themselves constitute serious prejudice.

(ii) Prior dispute settlement

7.588 This view is fully consistent with the approach taken in all prior serious prejudice disputes. In this respect, we consider particularly relevant footnote 13 to Article 5(c):

> "The term 'serious prejudice to the interests of another Member' is used in this Agreement in the same sense as it is used in paragraph 1 of Article XVI of GATT 1994, and includes threat of serious prejudice."

7.589 This footnote does two things. First, it makes clear that the concept of serious prejudice includes threat of serious prejudice (just as the term "injury" in the *SCM Agreement* includes "threat of material injury"). Second, it states explicitly that the meaning of serious prejudice in the Uruguay Round Agreement is the same as under Article XVI:1 of *GATT 1994*. Turning to the text of Article XVI:1 of GATT 1994, we note that it contains no definition of serious prejudice. Instead, it provides for a right to consultation, with a view to limiting subsidization "in any case in which it is determined that *serious prejudice* to the interests of another contracting party is caused or threatened by any [...] subsidization" that "operates directly or indirectly to increase exports of any product from, or to reduce imports of any product into" the territory of the subsidizing Member.

7.590 While the text of Article XVI:1 does not contain a definition or any guidance as to the meaning of the term "serious prejudice", there were two serious prejudice cases based on Article XVI:1 of GATT 1947. Both cases involved EC subsidies (in the form of export refunds) on sugar, and the bases for the claims of serious prejudice included price suppression/price depression in both cases. Thus, to the extent that these cases clarified the meaning of "serious prejudice" in the

sense of Article XVI:1 of GATT, we consider that footnote 13 brings that meaning into the *SCM Agreement*.

7.591 In the *EC – Sugar Exports (Australia)* case,[308] the panel found that the subsidies at issue had increased at a time when world sugar prices were declining sharply, and that there was no effective limit to the amounts available as sugar refunds (i.e., that the refunds were not capped). Therefore, the panel concluded, the refund system had contributed to depress world sugar prices, resulting indirectly in serious prejudice to Australia in terms of Article XVI:1. In other words, Australia's allegation was of serious prejudice to its interests from the EC sugar export refunds, and in spite of the absence of any definition of that concept, the panel found that price depression in itself had seriously prejudiced Australia's interests. The panel additionally found that the EC export refund scheme contained no pre-established limits on production, price or amounts of export refunds, and thus constituted a permanent source of uncertainty in world sugar markets which itself constituted a (further) threat of serious prejudice in terms of Article XVI:1.

7.592 The *EC – Sugar Exports (Brazil)* case brought the following year[309] resulted in very similar serious prejudice findings. First, the panel made an affirmative finding of actual serious prejudice in terms of Article XVI:1, on the same basis as in Australia's case (i.e., on the basis of depression of world sugar prices due in part to the EC subsidies). The panel also found a threat of serious prejudice to Brazil, on the basis that the export refund system contained no pre-established or operational effective limits on production, price or the amounts of export refunds. For the panel this meant that the refund system would not prevent the EC from having a more than equitable share of world trade in sugar, and that the system thus constituted a permanent source of uncertainty in world sugar markets, this in itself constituting a further threat of serious prejudice in terms of Article XVI:1.

7.593 It is clear that in both of these cases, the panels' affirmative serious prejudice determinations were based on a conception of serious prejudice the substance of which was the effect of subsidies on markets, and on trade, in respect of the product, rather than treating these effects simply as stepping stones to a separate and distinct concept of serious prejudice. In other words, the existence of price depression in the world market for sugar, to which the EC sugar refunds were contributing, was found in itself to constitute serious prejudice, in the sense of Article XVI:1, to the interests of Australia and Brazil. Furthermore, the permanent uncertainty created on world sugar markets by the export refund system, and the possibility that the EC might obtain a "more than equitable share of world trade" by reason of the system's operation, also were found, in themselves, to constitute threats of serious prejudice in the sense of Article XVI:1. In addition, although Australia and Brazil both were unsuccessful in claiming serious prejudice based on displacement or impedance of their sugar exports, the reason for the failure of these claims was that the facts did not demonstrate that such displacement or impedance had taken place.[310] In other words, the concept of displacement or impedance potentially constituting, itself, serious prejudice seems to have been accepted by the panels, but the factual evidence did not demonstrate that it was occurring in those particular cases.[311]

7.594 We note here that, as the *Sugar* cases were based on Article XVI:1 of GATT, they did not involve the issue of the word "may" with which we are confronted here, as this word does not appear in Article XVI:1. It might therefore be argued that those findings are not directly relevant to the matter before us, i.e., the implications of the word "may" for the meaning of "serious prejudice".

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[308] *EC – Sugar Exports (Australia).*

[309] *EC – Sugar Exports (Brazil).*

[310] *EC – Sugar Exports (Australia)*, para. 4.26; *EC – Sugar Exports (Brazil*) para. 4.14-4.15.

[311] In answering a question concerning the significance of the *Sugar* cases for the meaning of "serious prejudice", Korea attempted to distinguish them on the basis that they concerned export subsidies, which were the province of Article XVI:3. See Korea's Response to Panel Question 89(c). We note that although the subsidies at issue were export subsidies, the serious prejudice claims were based and resolved on Article XVI:1.

7.595 We recall that the two serious prejudice cases to date based on the *SCM Agreement* have taken an approach consistent with that taken in the pre-Uruguay Round cases. Both panels considered, implicitly or explicitly, that serious prejudice concerns the effects of subsidies on a complaining country's trade in a given product as such, i.e., the volumes and prices of such trade, in markets variously defined. Neither looked to specific situations of or effects on the domestic industry producing the product at issue, or to other consequential situations flowing from the trade effects, such as the importance of the producing industry to the overall "interests" of the complaining party.

7.596 In *Indonesia – Autos* the meaning of the word "may" did not arise. That panel treated the situations listed in Articles 6.3(a) through (d) as in themselves constituting serious prejudice. In the displacement/impedance claims, the question that the panel addressed was whether "the effect of the subsidies [...] [was] to displace or impede [...] exports [...] from the Indonesian market".[312] The panel concluded in the negative on those claims. In respect of the price undercutting claim, the question addressed by the panel was "whether serious prejudice [arose] from price undercutting".[313] The panel found in the negative in respect of the claim of the United States, but in the affirmative in respect of the claim by the EC. In particular, the panel first found that price undercutting existed, then found that the undercutting was of such magnitude as to be "significant", and then that the price undercutting was "the effect of the subsidy". (On this latter point, the panel noted that Indonesia had conceded that the subsidy in question was essentially responsible for the price undercutting that had been found to exist.) On the basis of all of these elements, the panel concluded that the effect of the subsidies was to cause serious prejudice through a significant price undercutting as compared with prices of like products of EC origin in the Indonesian market.[314] In other words, establishment of all of the elements referred to in the relevant portion of Article 6.3 was deemed sufficient by that panel for a finding of serious prejudice. The panel did not find any additional requirements beyond those explicitly referred to in the pertinent provisions of the Agreement.

7.597 The *US - Upland Cotton* panel took a similar approach, stating that:

> "the Article 6.3(c) examination is determinative [...] for a finding of serious prejudice under Article 5(c). That is, an affirmative conclusion that the effects-based situation in Article 6.3(c) exists is a sufficient basis for an affirmative conclusion that 'serious prejudice' exists for the purposes of Article 5(c) of the SCM Agreement."[315].

(iii) Negotiating history

7.598 We turn therefore to the origins of the phrase "serious prejudice may arise", to see whether this history sheds additional light on this issue. We recall that this phrase first appeared in the *SCM Agreement*'s predecessor, the Tokyo Round *Subsidies Code* (the Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade, or the "*Subsidies Code*").

7.599 The *Subsidies Code* rules on serious prejudice were found in its Articles 8:3 and 8:4. Article 8:3 was the analogue of *SCM* Article 5, containing the basic rules on adverse effects, including serious prejudice. Article 8:3 read as follows:

> "3. Signatories [...] agree that they shall seek to avoid causing, through the use of any subsidy:
>
> (a) injury to the domestic industry of another signatory, [footnote omitted]

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[312] *Indonesia – Autos*, para. 14.207.
[313] *Ibid.*, para. 14.238.
[314] *Ibid.*, paras. 14.255 and 14.256.
[315] Panel Report, *US – Upland Cotton*, para. 7.1390.

> (b) nullification or impairment of benefits accruing directly or indirectly to another signatory under the General Agreement, [footnote omitted] or
>
> (c) serious prejudice to the interests of another signatory.[25]
>
> [25] Serious prejudice to the interests of another signatory is used in this Agreement in the same sense as it is used in Article XVI:1 of the General Agreement and includes threat of serious prejudice."

7.600 Article 8:4 of the Code, which provided certain guidance for interpreting Article 8:3, contained the term "may arise" in its chapeau, i.e. the same language that we are considering in the context of *SCM* Article 6.3. Article 8:4 read as follows:

> "4. The adverse effects to the interests of another signatory required to demonstrate nullification or impairment or serious prejudice *may arise* through
>
> (a) the effects of the subsidized imports in the domestic market of the importing signatory,
>
> (b) the effects of the subsidy in displacing or impeding the imports of like products into the market of the subsidizing country, or
>
> (c) the effects of the subsidized exports in displacing the exports of like products of another signatory from a third country market." (emphasis added, footnotes omitted)

7.601 The construction of the chapeau of Article 8:4 of the *Subsidies Code* differs from that of *SCM* Article 6.3, yet the term "may arise" appears in both places. To us, it is clear that the function of this term in the context of Article 8:4 of the *Subsidies Code* was to indicate that the list in subparagraphs (a)-(c) was illustrative, not exhaustive. That is, this list consists of examples of some situations that constituted serious prejudice (and/or nullification or impairment), with the word "may" leaving open the possibility that other situations as well might give rise to or constitute serious prejudice. We find support for this view in the fact that the listed situations include some but not all of the situations that had previously been examined by the GATT 1947 serious prejudice panels. For example, price suppression/price depression are not listed in Article 8:4. That they nonetheless remained a valid basis for serious prejudice claims is confirmed by the fact that both are explicitly referred to in *SCM* Article 6.3(c).[316]

7.602 In this respect, we find footnote 25 to Article 8:3(c) of the *Subsidies Code* to be particularly important, and note that it is virtually identical to footnote 13 to Article 5(c) of the *SCM Agreement*. The Tokyo Round *Subsidies Code* was the first separate agreement interpreting Article XVI of GATT, and we believe that footnote 25 to Article 8:3(c) must mean *inter alia* (as we have indicated above in respect of footnote 13 to Article 5(c)), that the interpretations of the term "serious prejudice" that had previously been developed in disputes based on Article XVI:1 of GATT 1947 remained valid under the *Subsidies Code*. That is, the purpose of the footnote was to preserve and incorporate into the *Subsidies Code* the *status quo ante* concerning serious prejudice based on Article XVI:1 of GATT, including in particular the jurisprudence thereunder. Thus we see these footnotes as establishing an unbroken chain of consistent meaning for the term "serious prejudice", beginning with Article XVI:1 of GATT 1947, through the Tokyo Round *Subsidies Code*, and then carrying through to Article XVI:1 of GATT 1994 and Part III of the *SCM Agreement*. The fact that price suppression/price depression,

[316] In the serious prejudice claim in *EC – Wheat Flour* brought under the Tokyo Round *Subsidies Code*, the panel took a similar approach to that taken by the *Sugar* panels, in the sense that it considered (although it did not issue a ruling on) the claim based on the alleged adverse trade effects, as such. The meaning of the term "may arise" was not an issue.

the basis for two Article XVI:1 serious prejudice findings, although not referred to in Article 8:4 of the *Subsidies Code*, now is explicitly included in *SCM* Article 6.3, confirms this.

7.603 We find it significant that the term "serious prejudice may arise" in *SCM* Article 6.3, chapeau, appears to have been directly imported from the Tokyo Round *Subsidies Code*. In particular, this phrase appeared in the chapeau of all versions of the negotiating text of what is now *SCM* Article 6.3 (i.e., in the so-called "Cartland" texts, MTN/GNG/NG10/W/38 and Revisions). We do not find it plausible that this directly-transposed phrase from the Code was intended to take on an entirely new meaning, for which the *SCM Agreement* contains neither explicit nor implicit basis. Again, if the intention had been to introduce substantial new and additional requirements, such as those advanced by Korea, we find it inconceivable that such a significant departure from all prior practice concerning serious prejudice would not have been expressed explicitly.

11. Causation

7.604 Concerning causation, Article 6.3(c) provides in relevant part that "the effect of the subsidy is [...] significant price suppression [or] price depression [...] in the same market". That is, there must be a causal relationship between the *subsidy* and the significant price suppression or price depression. The question before us is how to establish the existence of such a relationship.

(a) Main arguments of the parties

7.605 A threshold argument made by the EC in respect of causation is that as long as the subsidy is *a* cause of significant price suppression, depression or lost sales, the language of Article 6.3(c) is satisfied. In other words, the EC states, the text does not require that subsidies be the sole cause, but rather permits an affirmative finding where subsidies are one among multiple causes of serious prejudice. In support of this proposition, the EC cites *SCM* Article 15 as well as the Tokyo Round panel on *US – Norwegian Salmon CVD*.

7.606 As to the substance of the causal link, the EC argues that, given the similarity of language between *SCM* Article 6.3(c) on the one hand, and *SCM* Articles 15.5 and 15.2 on the other, the causation analysis should focus on the impact of "the subsidized product" on price suppression and price depression. Concerning the kind of subsidy that can potentially cause price suppression or price depression, the EC argues that Article 6.3(c) is not limited to subsidies that are tied to particular products or transactions, but also covers untied subsidies that benefit the total sales or production of a company. These latter subsidies, including "survival subsidies" such as debt forgiveness, tax incentives, capital infusions, or loans and guarantees, have the effect of maintaining or increasing capacity and lowering the firm's total costs, and "may be allocated pro-rata" to individual products or transactions. Given the fungibility of money, the EC argues, such cost reductions will enable price cuts across all products produced by the recipient firm, and these price cuts enabled by the subsidies can ultimately have the effect of significant price suppression or price depression. The EC argues, however, that it is not legally required to quantify the amount of subsidization.

7.607 Korea disagrees with the *"a* cause" standard advanced by the EC, arguing that whether or not other factors are present, the subsidization independently of these other factors must itself cause serious prejudice. For Korea, the causation analysis thus requires a quantification of the amount or degree of subsidization, which then should be compared to the degree of price suppression or price depression that may exist, to determine whether a causal link can be demonstrated. Furthermore, Korea argues that other causal factors, such as differences in productivity, differences in production costs, and need for restructuring, should be examined.

7.608 In answer to a question from the Panel concerning the kind of analysis that would be needed to determine the effects of subsidization independent of any other factors, Korea outlines a detailed

multi-step process of analysis, which can be summarized as follows.[317] First, the subsidy must be quantified with respect to each subsidized producer. Second, the effect of the subsidy on the prices of the subsidized shipbuilder ("the subsidy effect margin") must be quantified, by estimating the non-subsidized cost of the product and comparing this with the producer's price for the product. Third, a "price suppression and depression margin" must be quantified, i.e., the margin by which the prices of the complaining Member's like product have been suppressed or depressed. In this step, Korea argues, the effects of all other factors on prices (including cost reductions, competition from other, non-subsidized, sources, etc.) also must be identified and eliminated. In the course of this argument, Korea emphasizes in several places that because the EC has dropped its original *claim* of serious prejudice based on price undercutting, the EC is now legally barred from advancing any *argument* based on or referring to price undercutting.

7.609 Korea further argues that because *SCM* Articles 5 and 7.8 both refer to adverse effects of "any subsidy", and because *SCM* Article 6.3 refers in multiple places to "the subsidy", the complaining Member must prove the effect of each alleged subsidy individually, rather than the combined effect of the alleged subsidies together. In addition, Korea argues in this regard that at the implementation stage of a dispute, removal of one subsidy may be sufficient to eliminate the adverse effects of subsidization, but there would be no way to know this if no separate assessment of effects was made for each subsidy. Nonetheless, Korea states, after assessing each subsidy individually, it would still be possible to aggregate them for the "final causal assessment".

7.610 China's third party view is similar to that of Korea, in that China argues that in order to find a causal relationship between a subsidy and a significant price suppression or price depression, it should be found that the subsidy, independent of other factors, and through the suppressed or depressed prices of the subsidized product, causes significant suppression or depression of the price for the complaining party's like product in the same market. China also argues that the degree of price suppression or price depression should be compared with the extent of the subsidization, to determine whether a causal link can be established.

7.611 The US as third party takes issue with the basis (although not necessarily the conclusion) of the EC's argument, stating that the EC incorrectly focuses on the *SCM Agreement*'s countervail provisions for contextual support for understanding causation while, according to the US, the causation standard for countervail is quite different from that for serious prejudice. In particular, the US points to the fact that in respect of countervail, it must be shown that "the *subsidized imports* are, through the effects of subsidies" (in the sense of the effects of subsidized imports on the domestic market) "causing injury". By contrast, the US says, Article 6.3 requires a demonstration that price suppression or price depression is "the effect of the *subsidy*" (emphasis added).

(b) Evaluation by the Panel

7.612 As noted *supra*, we believe that the text of Article 6.3(c) implies a "but for" approach to causation in respect of price suppression/price depression. Price suppression is the situation where prices have been restrained by something, and price depression is the situation where prices have been pushed down by something. So the question to be answered is whether the "something" is subsidization. Looking at a counterfactual situation, i.e., trying to determine what prices would have been in the absence of the subsidy, seems to us the most logical and straightforward way to answer this question.

[317] Korea's response to Question 91 from the Panel. In its response, Korea notes a concern about burden shifting and recalls that a panel should not make a complainant's case for it. Thus, Korea reserves its rights so that its response cannot be interpreted as its agreement to assume a burden belonging to the complainant.

7.613 This "but for" approach is consistent with the approach taken in both *Indonesia – Autos* and *US – Upland Cotton*, the two prior serious prejudice disputes under *SCM* Article 6.3. Indeed, the *Indonesia - Autos* panel explicitly adopted such an approach, in respect of the displacement/impedance of imports claims. (There was no price suppression or price depression allegation in that dispute).[318] The panel made a negative displacement finding, noting that the complainants had not demonstrated that *but for* the subsidy, the complainants could have expected to participate proportionately in a growing market. The panel also made a negative impedance finding, specifically that the complainants had not demonstrated that but for the subsidies, their sales and/or market share would have increased, or would have increased more than they did in fact.

7.614 The *US – Upland Cotton* panel, while not referring to a "but for" analysis as such, nevertheless applied a similar framework. In particular, the panel found that increased production and supply of upland cotton which reaches the world markets has an effect on world prices, and further found that a number of the subsidies at issue were directly linked to world prices, thus insulating US producers from low world prices, and stimulating production that otherwise (in other words, *but for* the subsidies) would have been uneconomic.

7.615 Applying such a framework to the present dispute, the question to be answered in respect of the affirmative link between subsidies and prices is, in the case of alleged price depression, whether in the absence of the subsidies prices for ships would not have declined, or would have declined by less than was in fact the case. For price suppression, the question would be whether, in the absence of the subsidies, ship prices would have increased, or would have increased by more than was in fact the case. Such a framework implies also analyzing the various factors contributing to the particular market situation forming the subject of the complaint, i.e., supply and demand factors, production costs, relative efficiency, etc.

7.616 In conducting this "but for" analysis, we certainly will be mindful of the nature of the subsidies alleged to be causing price suppression and price depression, i.e., the individual APRG and PSL transactions, and in particular in relation to their alleged effects on general price levels for the ships at issue. That said, and while we have of course examined the APRG and PSL transactions individually to determine whether they involve subsidization, we do not agree with Korea that we are legally bound to separately determine the degree of price suppression or price depression that may be caused by each of these subsidies individually. We are unconvinced that references in the singular in *SCM* Articles 5 and 6 ("any subsidy", "the subsidy", etc.) constitute or give rise to such a legal requirement, and recall here that the opposite was true under Article 6.1(a) and Annex IV. Pursuant to these provisions, in determining the *ad valorem* subsidization of a product, subsidies under different programmes were to be aggregated. Any rebuttal under *SCM* Article 6.2 of a presumption of serious prejudice arising therefrom also presumably could have been presented in respect of the effects of the aggregate subsidies. Finally, we consider that Korea's concern over how eventually to "remove the adverse effects" does not pertain to an assessment of whether there are adverse effects arising from subsidies, but instead pertains to the issue of how to implement an eventual recommendation to remove any such effects.

7.617 We next consider the issue of non-attribution, in particular, whether and how to conduct a non-attribution analysis (i.e., an analysis to ensure that adverse effects caused by other factors are not attributed to subsidies). We note here that unlike the countervail provisions, *SCM* Articles 5 and 6 contain no specific non-attribution language, and we recall as well that in the *Sugar* cases, no such analysis was conducted. The panels in those cases instead found serious prejudice on the basis that

[318] The *Indonesia - Autos* panel also addressed a claim of price undercutting, the circumstances of which arguably were quite unique: the panel found that information provided by Indonesia in the Annex V process effectively conceded that the subsidies, which were transaction-specific tax and duty exemptions, reduced the price of the subsidized Indonesian automobile by an amount large enough to account for all or virtually all of the price undercutting that was found to exist.

the EC export refunds had *contributed* to depressing world sugar prices, and also constituted a permanent source of instability on world markets. The *US – Upland Cotton* panel, while noting the distinction between the countervail and serious prejudice provisions in general, and the lack of an explicit non-attribution requirement in the latter in particular, nonetheless analyzed other possible causal factors, with a view to determining whether such factors "would have the effect of attenuating [the] causal link, or of rendering not 'significant' the effect of the subsidy".

7.618 We consider the approach taken by the *US – Upland Cotton* panel to be logical and appropriate. In conducting our causation analysis, we too will bear in mind the need to take into account the effects of identified factors other than the subsidies, to determine whether such factors would attenuate any affirmative causal link that we may find, or render insignificant any price suppression or price depression effect of the subsidy that we may find.

7.619 We wish to emphasize that the aforementioned considerations make clear that there is no one single approach to determining causation for all claims of serious prejudice. Each case presents a unique combination of kinds of subsidies, of products, of markets, and of forms of serious prejudice, which operate together in a unique way. Causation analysis thus necessarily must be case-by-case, tailored to the particular situation presented in each individual dispute. The considerable variety of approaches taken by previous panels is simply a reflection of this reality.

7.620 In this respect we disagree with Korea's argument that the EC is legally barred from referring to the fact of price undercutting in support of its price suppression/price depression claims. Korea is certainly correct that the EC has not pursued its claim of price undercutting referred to in the Request for Establishment of the Panel, and we therefore conduct no analysis and reach no conclusions in respect of price undercutting as such, in the sense of *SCM* Articles 6.3(c) and 6.5. This is an entirely different issue, however, from what sorts of arguments and evidence the EC may advance in support of its claims. We see no basis in the WTO Agreement for proscribing the kinds of arguments that a party can make; any party to a dispute is entitled to make whatever *arguments* it wishes in presenting its affirmative or defensive case. The persuasiveness or relevance of these arguments is a separate issue.

7.621 We find it entirely plausible, and potentially highly relevant, that a complaining party claiming price suppression/price depression might in its arguments compare the trends *and* the levels of prices for the subsidized product with the trends and levels of prices for its own products. That said, we do not see that the relative price levels for the subsidized product and the complaining party's product in any case would be dispositive of a price suppression/price depression claim.

12. Summary of the EC's claims and general approach of the Panel

7.622 Having set out the legal and analytical framework that we will apply, we turn now to the specifics of the EC's claim. As noted above, the EC claims price suppression/price depression in respect of three categories of ships: LNGs, container ships and product/chemical tankers. We first will summarize the basic approach taken by the EC in setting forth its claims of serious prejudice, as well as the basic approach taken by Korea in its rebuttal arguments. We then will turn to a product-category-specific consideration of the parties' arguments concerning the EC's price suppression/price depression claims. Finally, we will present our assessment of those claims, on the basis of the subsidies that we have found (those in respect of certain APRGs and PSLs).

7.623 Concerning our presentation of the parties' arguments, we recall that we have rejected the EC's claims of subsidization in respect of the restructuring of Daewoo, STX/Daedong, and Samho/Halla. We have upheld the EC's claims that certain individual APRGs and PSLs are prohibited export subsidies. The EC alleges that the subsidized APRGs and PSLs have caused price suppression/price depression in respect of the three categories of ships at issue in this dispute, and its arguments in this regard are closely inter-related with its arguments concerning the alleged

restructuring subsidies. While we confine our analysis of the EC's serious prejudice claims to the relevant subsidized APRGs and PSLs, for ease of comprehension we summarize the EC's and Korea's arguments as to serious prejudice as they have presented them. Thus, to the extent that the parties' serious prejudice arguments in respect of APRGs and PSLs are interrelated with their arguments concerning restructuring, the restructuring-related arguments are included in the summary of arguments below.

7.624 We recall that the EC initially indicated that it wanted us to make separate serious prejudice findings in respect of each product category (LNGs, product/chemical tankers, and container ships), but subsequently changed its position, arguing that while we should analyse price suppression/price depression separately for each category, we should reach only a single serious prejudice finding.[319] The EC argues that whether we were to find price suppression/price depression in respect of one, two or all three product categories, our final conclusion would be the same, i.e., serious prejudice to the interests of the EC. Having considered this question carefully, we conclude that we should make separate serious prejudice findings in respect of each product category. We view this as necessary for analytical coherence, i.e., the scope of our final conclusions on serious prejudice will be consistent with the scope of our analysis of price suppression/price depression.

(a) Main arguments and general approach of the EC

7.625 Concerning the existence of price suppression/price depression, we recall that the EC allegation is at the level of *world* prices for each of the three types of ships. The EC argues that each of these ship types (as indeed commercial vessels generally) competes and is sold in a global market. The EC explains that by world market, or global market, it means that ships are by nature highly mobile (and transporting them is an insignificant cost compared to their value); that ships do not normally need to be imported, i.e. cleared through customs or subjected to duties; that regulations and standards are typically harmonised or international – and the existence of "open registries" and flags of convenience make attempts to impose significantly different national taxes and regulations unworkable; that shipbuilders operate on a large scale and are active throughout the "global market"; and that ship-owners are also large enterprises and are established in many different territories. The EC submits a number of documents that characterize shipbuilding in this way.[320]

7.626 The EC argues that world prices for LNGs have been depressed and suppressed by Korean subsidies, and that world prices for container ships and product/chemical tankers have been suppressed. As evidence that these prices should have increased, or increased more, the EC presents information showing increases in world order levels for each ship type, as well as increases in freight rates which, along with costs, are the main determinants of ship prices according to the EC. As evidence that Korean prices are lower than they should be, the EC presents indices of Korean prices versus estimated Korean costs for each ship type. Finally, the EC presents statistics on numbers of orders by country of building and by shipyard, as evidence that Korean shipyards have sufficient market share to exercise price leadership in the market for each ship type.

7.627 On Korean costs more specifically, the EC argues that ship prices must follow trends in costs, and must include cost escalation factors due to the several-year interval that normally elapses between the placing of an order and the delivery of a ship. The EC argues that the gap between Korean shipyards' prices and costs widened during the post-restructuring period, even after adjusting for any comparative advantages of the Korea yards. The cost of debt in particular was not taken into account by the Korean yards, given that the restructuring (which the EC alleges to be subsidized) had erased the debt from the restructured yards. In the absence of the restructuring, Korean shipyards' high cost structure and heavy debt burden would have driven some of them out of business, reducing Korean

[319] See para. 7.519, *supra*.

[320] See First Written Submission of the EC at paras. 426 and 427, and Exhibits EC-1 and EC-2. See also response of the EC to Panel Question 37(a).

capacity. Instead, the restructuring allowed that capacity not only to remain in operation but also allowed aggressive pricing by eliminating the debt cost from the companies involved. The EC, although arguing that it is not legally required to do so, presents some calculations of estimated per-transaction amounts of subsidies. On the basis of these calculations, the EC argues that current prevailing price levels for the ships at issue would be below the break-even point for the Korean producers if their debts had not been forgiven, i.e., if they had had to pay their debt servicing costs.

7.628 The EC also presents calculations estimating the degree of subsidization of certain APRGs and PSLs. In respect of these instruments, the EC argues that the APRGs and PSLs contributed to rescuing the shipyards and permitting them to aggressively pursue sales: the APRGs and PSLs had an impact that went beyond particular margins of benefit on individual transactions, in that they enabled the companies to fill their orderbooks. In the restructuring process, this in turn made the yards in question more attractive as "going concerns" than as facilities to be closed. In respect of the non-restructured yards, the EC argues that the APRGs and PSLs enabled these yards to compete at the new, lower price levels. Thus, the EC primarily characterizes the effects of the APRGs and PSLs in terms of overall effects on the relevant shipyards' ability to compete, as a complement to the effects of the restructuring, rather than approaching the issue in terms of a subsidized transaction-by-subsidized transaction analysis, or as a whole, in isolation from the alleged restructuring subsidies. That said, the EC also states that the *ad valorem* benefit from the subsidized financing was as much as 2 per cent, which the EC argues had a direct price effect on those transactions, and was an important factor in obtaining these orders.[321]

7.629 Concerning prices, the EC presents certain composite data characterized as representing *world* price levels and trends, but does not present a specific time series on EC shipyards' prices. It explains this by saying that, due to low prevailing world prices, EC shipyards have had very little success in winning the bids that they make, and in many cases therefore have become discouraged from even bidding (a very costly process), due to the suppressed and depressed world price levels. In other words, for the EC the suppression/depression of *world* prices constitutes serious prejudice to the *EC's* interests, because, due to the global nature of the market for ships, all shipyards must meet the prevailing world price level in order to make sales. The EC presents specific examples of individual bids it argues were lost to low-priced competition from Korea as evidence of the low and declining price levels confronted by EC shipyards.

7.630 The EC explains that its "interest" in the three ship types is particularly evident on the supply side in the sense that EC yards are capable of producing the full spectrum of sizes and particular types of ships in each category, and are interested in doing so, as evidenced by their attempts to win bids, and by information on EC shipyards' websites which identify these types of ships as within their product range. The EC argues that from a shipyard's perspective, ships are largely fungible, involving a series of steel panels to be welded together, and components and fittings to be assembled and installed. Thus, on the supply side, there is little product differentiation. The EC also provides information showing the participation by EC shipyards in various size ranges for each ship type, as evidence that the EC industry is active in all of the ship types at issue.

7.631 As for the pricing of ships of different sizes and characteristics within each category, the EC argues that on the demand side there is considerable potential for substitution. For example, a container ship owner can, from the technical point of view, equally operate a range of smaller to larger ships on a given route because these ships perform the same basic function. For this reason, the EC states, the decision as to which particular ship to operate on a given route has to do with operating

[321] In this regard, in response to our question, the EC confirmed in respect of alleged APRG and PSL subsidies that we correctly understand its main argument to be "that these instruments contributed to 'rescu[ing] th[e] shipyards from liquidation' by improving the attractiveness of keeping them in operation as opposed to shutting them down", while also stating that "the impact of [individual] APRGs or PSLs can indeed be very significant (up to 2% of the transaction price)" (EC response to Panel Question 40).

costs based on freight volume, not with fundamental functional differences between the different-sized ships. As a result, the EC argues, prices for different sizes of a given type of ship, e.g., container ships, tend to move together. On the supply side, as noted the EC argues that from the shipyard's perspective, there is little or no technical differentiation within ship categories (or even between them). The combination of these supply and demand factors means that a change in the price of one particular model of ship in a category will cause proportionate changes in all of the other models in that category.

7.632 In general terms, the EC argues that the basic factor leading to the alleged serious prejudice was the restructuring aid, which the EC terms "survival subsidies", complemented by the APRG and PSL subsidies, which also contributed to the keeping the yards in operation. In particular, the EC argues, the alleged subsidies maintained, on non-market terms, Korean capacity that otherwise would have been closed down, and also lowered the cost structure of the subsidized producers, enabling them to sell at prices that would have been impossible absent the subsidies. According to the EC the main reason for low world market prices is the subsidized overcapacity in Korea. The EC asserts that the three restructured yards have more than one-half of total global overcapacity which is estimated at 20 per cent. For the EC, it is not realistic to suggest, as Korea does, that this capacity would have remained in business even without the restructuring, as the other Korean yards could not have purchased these yards or their assets as they too were in financial difficulties. Nor did any foreign buyer express any interest in acquiring any of the yards or their assets.

7.633 The EC argues, citing the GATT 1947 *Sugar* cases and *Indonesia – Autos*, that correlation in time between an alleged subsidy and its effects is very important in establishing causation. In this regard, the EC argues that there is a clear coincidence in time between the alleged restructuring subsidies at issue and their price effects. According to the EC, the subsidies were massive, served to maintain capacity, and in turn brought down prices. For LNGs, for example, world prices declined when Daewoo entered the market in 1999, by which point Daewoo knew that it would be restructured.

7.634 The EC argues that the nature of the subsidies and the nature of the alleged serious prejudice also should be taken into account by the Panel when considering the methodology to use in determining causation. In particular, the EC states, its claim is an overall claim of price depression and suppression resulting *inter alia* from restructuring aids involving direct forgiveness of government held debt, as well as from KEXIM subsidies.[322] On the forgiveness of government-held debt, the EC argues that *SCM* Article 6.1 recognizes this as a particularly egregious form of subsidization.

7.635 Concerning price leadership by Korean shipyards, the EC refers to shipyard-specific statistics of orderbooks as of January 2004, as reported by Lloyd's Register, for three categories of ships.[323] According to the EC, these statistics show that Korea's shares of the world market for each ship type are very large. The data as referred to by the EC are set forth below:[324]

Container ships:	HHI 24.3 per cent; Samho-Halla 8.1 per cent; Daewoo 5.3 per cent; all Korea 65.7 per cent
Product tankers[325]:	STX-Daedong 14.5 per cent; HHI 5.6 per cent; Daewoo 3.1 per cent; all Korea 58.9 per cent

[322] Second written submission of the EC at para. 295.

[323] The EC indicates that the detailed Lloyd's Register data are reproduced in Attachment EC-2 to its answers to questions from the Panel following the first substantive meeting.

[324] Second written submission of the EC at paras. 371-374.

[325] We note that according to Attachment EC-2, the data on product tankers include but are not limited to product/chemical tankers.

LNGs:	Daewoo 29.3 per cent; Samsung 18.1 per cent; HHI 11.5 per cent; all Korea 58.9 per cent

According to the EC, with market shares of this magnitude it is clear that the Korean industry has the ability to set the world price level for the three ship types, which the EC argues in fact is the case. Concerning the fact that in some cases, the Korean yards with the largest market shares were not restructured (i.e., are not alleged to have received subsidies through restructuring), the EC argues that the restructuring affected the entire Korean industry, such that the restructured yards, even when not market share leaders, were price leaders, driving down prices for all Korean yards, which in turn pulled down world prices. First the EC argues that the three restructured shipyards account for around one-third of the orderbook in Korea as a whole, and 12 per cent of the global orderbook. More significant in terms of the effect on prices, according to the EC, is the behaviour of concentrations of capacity with intense competition among a limited number of companies operating in the most heavily contested market sectors suppressing prices. The EC further states that restructured yards "regularly appear amongst the small concentration of shipyards whose capacity is determining prices in many sectors".[326] The EC asserts that the low prices offered by the subsidised shipyards force competing Korean shipyards to offer low matching prices, irrespective of the long-term economic consequences that may not be evident until a number of years later. Otherwise, these competing shipyards will be unable to achieve the high volume of orders necessary to support their facilities, debt payments, and large workforces.[327] The EC further argues that the subsidized KEXIM financing helped to enable the non-restructured yards to follow the pricing lead of the restructured yards.[328]

7.636 On the basis of the foregoing arguments, we understand the EC's basic claim of serious prejudice to be: restructuring subsidies kept a huge amount of uneconomic capacity in the market, and greatly reduced the cost of operating that capacity, in particular by removing the companies' debt service burden. The removal of debt allowed the restructured yards to price aggressively in order to fill their excess capacity, which in turn led the other (non-structured) Korean yards to reduce their prices. The APRGs and PSLs, also played a role in maintaining excess Korean capacity on the market by improving the financial strength of shipyards threatened with closure, and in financing price cuts by both restructured and non-restructured shipyards. The large market shares and capacity of the Korean shipbuilders left shipbuilders in the rest of the world with no choice but to follow the formers' downward pricing lead. For the EC, this has meant that, as a result of the suppressed and depressed price levels, EC shipyards either lose bids that they make due to inability to meet the price level set by Korean competitors or, refrain from bidding at all, knowing that they will not in any case be able to compete at the prevailing price level. The suppressed and depressed world prices thus seriously prejudice the EC's interests.

(b) Main rebuttal arguments of Korea

7.637 Korea objects, first, to the EC characterization of the shipbuilding industry and market as "global". Korea argues that some markets are reserved for national producers (citing LNGs, and the US cabotage market, as particular examples). Korea further argues, as described above, that price suppression/price depression must be established in relation to (a) particular national market(s). Korea seems to imply that therefore a case based on a world market must fail on this basis alone.

7.638 Korea further argues that the price information presented by the EC is simply too broad-based to be meaningful. In particular, Korea argues that information should be presented on a "like product" basis, and suggests a number of detailed criteria to differentiate the like products within each ship category. At a minimum, prices should be broken out by size bands within each category which, if

[326] Attachment EC-2 at 4.
[327] Second written submission of the EC, para. 308.
[328] Second written submission of the EC, para. 270.

done, shows considerable price variation, with prices for some size bands in a given category increasing, some decreasing, and some staying flat.

7.639 Korea takes strong issue with the EC's characterization of the EC's shipbuilding interests. For Korea, EC yards simply do not compete head-to-head with Korean yards in any of the three categories. Instead, Korea states, EC yards are concentrated in smaller ship sizes than Korean yards, and in many cases are precluded from bidding for the largest ships by size constraints, and by lack of specialization and know-how that are important determinants of a yard's effective capabilities to build particular ships. Korea notes, and criticizes the fact, that the EC gave only a partial response the Panel's request for yard-specific information on EC capabilities and production history. For Korea, this confirms that the EC is unable to demonstrate that the EC and Korean yards directly compete.

7.640 Concerning the determinants of ship prices, Korea argues that there is no historical correlation with order levels. Furthermore according to Korea, compensated gross tons, the unit of measurement used by the EC to show the trend in orders, is misleading. If instead years of workload or number of ships were used, Korea argues that the trend would be fluctuating, rather than sharply increasing as alleged by the EC. Korea also takes issue with freight rates as a determinant of ship prices, arguing that currently the ship market is a buyers' market in spite of increases in freight rates.

7.641 On costs, Korea argues that its shipyards enjoy significant advantages in terms of materials (including for domestically sourced inputs, which are increasing in importance), wages and depreciation of the Won favouring exports, as well as productivity and economies of scale reflecting Korea's experience in producing in series.

7.642 Concerning the EC argument that the restructured yards pulled down the prices of all other Korean yards, Korea asks, "Why [...] stop at the Korean shipyards? If the subsidies triggered a price war, why then not also blame the Japanese shipyards or the Chinese shipyards or any other shipyards for that matter?"[329] According to Korea, the EC is claiming that the subsidies allegedly granted to Daewoo, Halla and Daedong have stimulated price competition among the Korean shipbuilders and that, therefore, the prices practiced by the other Korean shipbuilders have also caused price depression or suppression. For Korea, this is a "long stretch". Korea states that Article 6.3(c) requires that price depression or suppression must be *the* effect of *the* subsidies, and that the wording of this provision does not envisage that it would be sufficient that prices of non-subsidized shipbuilders caused price depression or suppression.

7.643 Korea argues that the “but for” analysis of capacity proposed by the EC falls far short of the standard required by Article 6.3. Rather, Korea states, the *SCM Agreement* explicitly requires the EC to demonstrate that the effect of the subsidy is significant price suppression or price depression, which has then caused serious prejudice. For Korea, this calls for the EC to present factual evidence as to the effects of the subsidy, rather than to try to establish serious prejudice via a “but for”-based conjecture. Furthermore, and in any case, Korea argues, the capacity in question would have remained in operation. Korea argues, first, that the restructuring was the most “market oriented” behaviour in the light of the circumstances at the time. Second, even if the companies had been liquidated rather than restructured, "liquidation" does not mean "termination" of the insolvent companies' business. Instead, for the creditors to recoup the “liquidation value” of the insolvent companies, normally they would repack and sell the production facilities to buyers who would use them for their original purposes. Therefore, contrary to the EC’s allegation, the three shipbuilders’ shipbuilding capacity would have remained in operation although the ownership of these facilities might have changed.

7.644 Korea asserts that the EC has not shown the effect of the subsidy on the alleged price suppression/price depression, which for Korea requires a quantification of the subsidy in relation to

[329] Second written submission by Korea, para. 261.

the amount of alleged suppression/depression. In this respect, Korea argues that a very detailed subsidy-by-subsidy, like product-by-like product analysis would be needed to determine what the theoretical price level for each ship would have been without the alleged subsidies, and after neutralizing the effect of all other factors influencing prices, compared with the actual, observed price. Thus, Korea rejects the notion that there is demand side substitutability of different ships within each ship category giving rise to mutual price influences. Korea also rejects the argument of general supply side fungibility of ships, arguing that EC yards in particular have significant physical and experience constraints that limit their participation in the full spectrum of ship sizes and types. As for the effect of the subsidies more generally on prices, Korea like the EC argues that only shipyards with sufficient market share in a given like product could affect prevailing price levels, but Korea disputes that any of the allegedly subsidized Korean yards have such shares.

7.645 Finally, Korea argues, the EC has not shown how the alleged price depression/price depression has seriously prejudiced the interests of the EC, including shipbuilders producing the three types of ships. As discussed above, Korea views "serious prejudice" as a separate requirement from price suppression/price depression.

13. Product-specific analysis

7.646 We turn now to our consideration of the EC's price depression claim in respect of LNGs. Here, as noted, while we present the parties' arguments as to both the restructuring and the APRGs and PSLs, we confine our analysis of alleged adverse effects to the APRGs and PSLs, given that we rejected the EC's subsidization claims in respect of the restructuring.

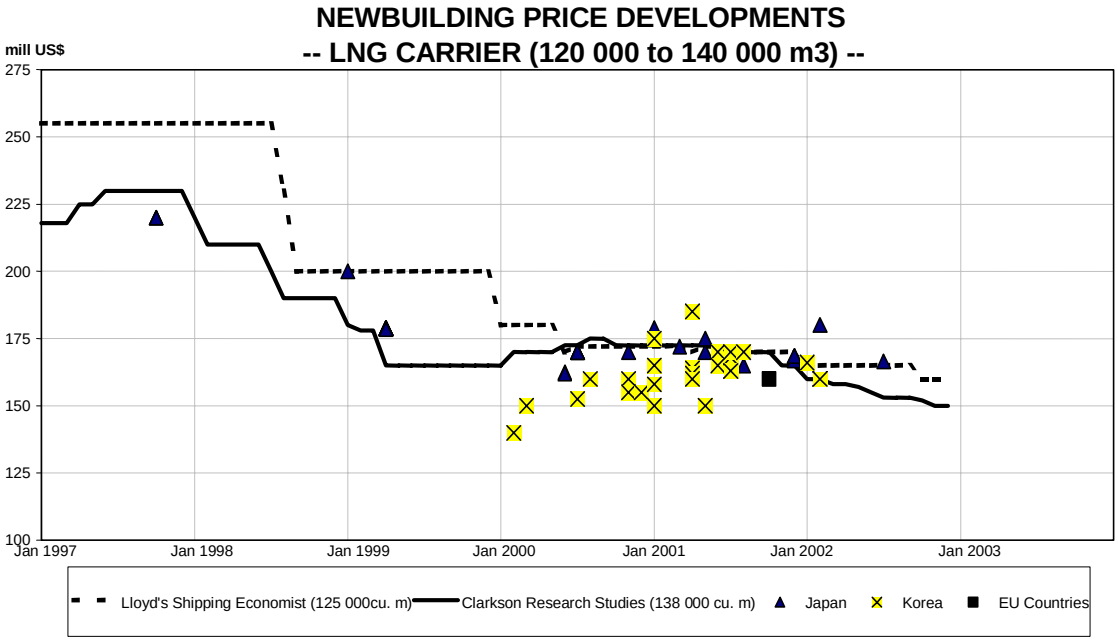
(a) Arguments of the parties

(i) LNGs

7.647 The EC argues that world prices for LNGs fell sharply between 1997 and 2000, stabilized for nearly two years, then continued their decline, in spite of a significant increase in the number of LNGs ordered. In support of this characterization of LNG prices, the EC presents Figure 30, entitled "newbuilding price developments" for LNG carriers from 1997 through 2002. The chart is reproduced below. As shown, the chart in Figure 30 consists of two price trend lines as well as price points for Japanese, Korean, and EC ships, for the period January 1997-December 2002. In answer to a question from the Panel, the EC indicates that this chart was published by Lloyd's register of shipping. We note that the same chart also appears as Figure D in the *OECD* document C/WP/SG(2003)10.[330]

[330] Exhibit EC-157.

FIGURE 30:[331]



7.648 The EC also presents a table showing the total number of LNGs ordered in each year from 1997-2002. This table is reproduced below. The EC states that the table shows that the number of LNGs ordered increased during the period shown. The EC argument is that world LNG prices declined, when they should have increased, given the substantial increase in orders. Korea does not dispute the accuracy of either the price chart or the information on the level of orders.

FIGURE 31: Number of ships ordered

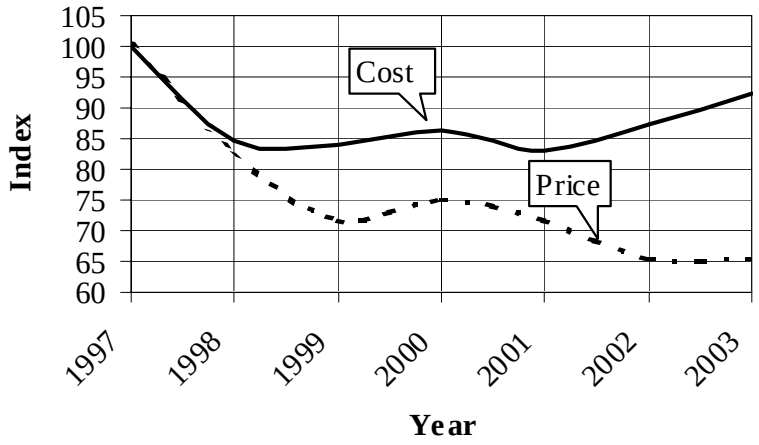
Number of ships ordered[332]	1997	1998	1999	2000	2001	2002
Total number of ships	**9**	**2**	**5**	**17**	**30**	**23**

7.649 The EC supplements this argument with price and cost indices for Korean LNGs, presented in Figure 38, reproduced below. According to the EC, costs of production for LNGs in Korea have risen since 2001, while prices have declined. Furthermore, the EC argues, freight rates also were increasing at the same time. Thus, the EC argues, the main price determining factors for LNGs – demand, costs, and freight rates – all were increasing yet prices declined. The EC argues that this situation, in particular the "dramatic" decline in the price of LNGs between 1997 and 2000, coincided with the industry restructuring in Korea.

[331] Source: Lloyds's register of Shipping.
[332] *Ibid.*

FIGURE 38

Cost and Price Indices for LNGs in Korea[333]



7.650 Korea rejects the EC arguments concerning LNGs for a number of reasons. First, Korea states that the apparent coincidence in time between the decrease in prices and Korea's first LNG sale on the world market is illusory, as the prices decreased before the first foreign order for an LNG was ever placed with a Korean shipyard. Moreover, Korea argues that these price declines began before the industry restructuring. On these points, the EC responds that even if prices began to decline before Korean yards entered the market, this does not mean that Korea was not responsible for price declines that occurred after that point. In addition, the EC states that Daewoo's price offer on the **[BCI: Omitted from public version]** project reflected the effect of the alleged subsidies, as Daewoo knew at the time that it made its winning bid that it would receive subsidies.[334]

7.651 Korea also disputes the causes of the price declines as presented by the EC. Korea points in particular to changes in size specifications to bigger ships than those produced in Europe, movement of LNGs from a specialty product to an increasingly standardized product, price pressure from owners, and technological improvements, as well as industry overcapacity. In this regard, Korea also disputes the EC's assertion that production costs in Korea are increasing. Korea states that, to the contrary, the Korean shipbuilding industry enjoys significant cost advantages compared to European shipyards, due to lower material and wage costs, higher productivity and the impact of the depreciation of the Won *vis-à-vis* the dollar, along with the appreciation of the euro, affecting the competitiveness of European yards. Korea states that every component of Korean costs fell further and faster than newbuilding prices. Korea argues that, at present, the market for LNGs is a buyers' market.

7.652 Furthermore, in Korea's view the EC must demonstrate that the shipyards benefiting from the alleged subsidies led the price declines for LNGs. In other words, Korea states that it is not sufficient to refer to the Korean industry as a whole.

7.653 On the latter point, the EC responds in part that because the Korean industry is highly competitive, the other Korean yards had to follow Daewoo's lead in cutting LNG prices. The EC states that these other yards received APRGs and PSLs, which partially offset the cost of the price cuts (up to 2 per cent of the selling price of a ship). Thus, for the EC, the alleged restructuring

[333] Source: FMI.

[334] Second submission of the EC at para. 368. "...the restructuring subsidies began to cause depression and suppression from the time when the shipyards first knew that they were expecting to receive benefit from the restructuring plans".

subsidies (along with subsidized KEXIM financing) to Daewoo have allowed it to set the prices for the Korean industry as a whole, with subsidized KEXIM financing to the non-restructured yards helping them to follow Daewoo's pricing lead. In turn, the subsidized low Korean price has forced down world LNG prices.

7.654 In respect of price leadership by Daewoo, and by Korea more generally, the EC argues that the low prices are a reflection of Daewoo's need to fill its capacity, which is capacity that would have exited the market if there had been no restructuring. In addition, the EC argues, the restructuring greatly reduced Daewoo's costs, by eliminating debt that otherwise would have had to be amortized over each vessel sold, and thus reflected in the ships' prices. Korea counters that even if Daewoo had been liquidated instead of restructured, its capacity would have stayed operational, as it was a modern facility for which a buyer would have come forward.

7.655 The EC also points to statistics comparing Korean and EC world market shares for LNGs. According to detailed order information on individual shipyards submitted by the EC, as at January 2004 Daewoo was the leading LNG producer in the world, accounting for 29.3 per cent of the market measured in terms of compensated gross tons, followed by Samsung with 18.1 per cent. HHI held a further 11.5 per cent share. Thus, the EC argues, the Korean industry accounts for 58.9 per cent of total outstanding orders of LNGs.

7.656 Korea objects that it is not possible to determine price leadership from market shares for LNGs. In particular, Korea argues that Koreas share of the LNG market has fluctuated greatly, from 0 to 73 per cent since it began selling LNGs. Korea says that it is therefore impossible to draw any conclusions as to price leadership from these market shares.

7.657 Finally, the EC presents a number of examples of LNG transactions to illustrate its price depression arguments. In these transactions, the EC states, EC shipyards bid against and lost to Korean yards, after a bidding process over the course of which the Korean offer prices were progressively reduced. According to the EC, in the end the EC yards were unable to reduce their prices sufficiently to win the orders. Concerning this EC argument, Korea objects in the first instance to what it sees as the EC's trying to reintroduce its abandoned price undercutting claim. Korea also argues that there is no link between the restructuring and the pricing by Korean yards for LNGs, because it was a non-restructured yard that obtained the first foreign order, because Daewoo's first LNG bid was made before it was restructured, and because non-restructured yards were offering similar prices at around the same time.

(ii) Product/chemical tankers

7.658 In respect of product/chemical tankers, the EC presents in Figure 42, reproduced below, a table concerning market shares, in terms of new orders, for the period 1993-2002.

Figure 42: Market Shares in Product and Chemical Tanker Sector for the period 1993-2002

	Average 93/97	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**Average 98/02**
EU	19%	12%	22%	11%	21%	22%	10%	3%	3%	7%	3%	5%
Skorea	19%	6%	16%	30%	12%	28%	46%	44%	51%	39%	35%	42%

Source: Lloyd's register of shipping

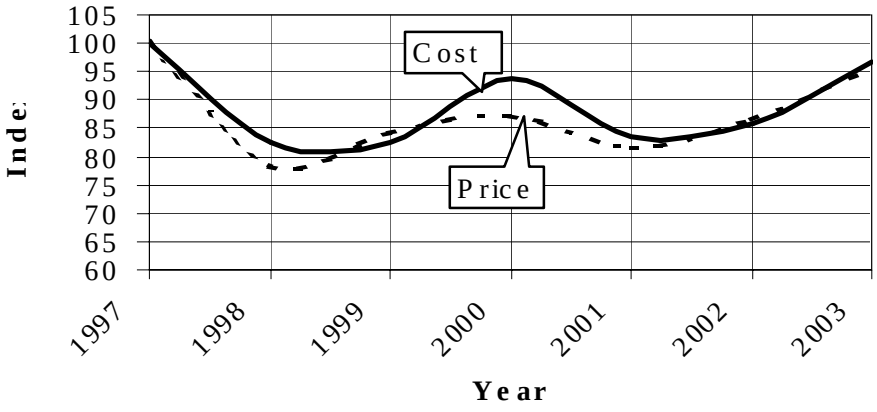
7.659 According to the EC, this table demonstrates that as from 1998, the year directly following the Won devaluation, Korean yards gained significant market shares and became market share leaders in this sector. In subsequent years, the EC argues, Korean yards consolidated their position, through a reckless low price policy, notwithstanding the recovery of the Won and increasing cost of production .

7.660 Korea rejects the EC's market share data, stating that these data do not support the allegation that Korea is the price and volume leader for product and chemical tankers, first because market share data lend no support for a conclusion on price leadership as a matter of course. In addition, Korea points out that the data in the EC's market share table reflect product tankers and chemical tankers, which the EC has admitted belong to different product categories. According to Korea, the EC's consultant FMI has admitted that the EC industry participates only in respect of chemical tankers, and that China has led chemical tanker prices since 2001.

7.661 The EC also presents in Figure 43, reproduced below, a chart comparing price and cost indices for certain product and chemical tankers produced in Korea. [335]

FIGURE 43[336]

Cost and Price Indices for Handysize Product and Chemical Tankers in Korea



7.662 According to the EC, the combination of rising demand, reflected in the high volume of orders for new ships and the higher freight rates, and the rising costs of Korean shipyards, should have caused the price of ships to increase, or to increase more steeply than they did. Korea argues in respect of costs that its industry enjoys significant cost advantages compared to European shipyards, due to lower material and wage costs, higher productivity and the impact of the depreciation of the Won *vis-à-vis* the dollar, along with the appreciation of the euro, affecting the competitiveness of European yards. Korea states that every component of Korean costs fell further and faster than newbuilding prices. Concerning freight rates, Korea argues that the information provided by the EC, which sets forth a single freight index tabulation, is uninformative. Korea argues that freight rates can vary by vessel segment and should be differentiated on that basis.

7.663 The EC asserts that the price suppression of which it complains is closely linked to price leadership that Korean shipyards have enjoyed since 1999.[337] The EC states that Korean prices are the starting point of sales negotiations in the shipbuilding industry, and are so low that EC producers often are not even requested to bid for contracts by brokers because the brokers are aware that EC shipyards will not be able to match the Korean price unless they sell at substantial loss.

[335] According to the EC, the size of ship presented (around 47,000 dwt) is typical of the class built in numbers in Korea, and also is a class of ship that would be of great interest to EC shipyards if the price were not so low.

[336] Source: FMI.

[337] WTO Trade Policy Review Mechanism of 2000 (Exhibit EC-82).

7.664 In this regard, the European Communities provides certain examples of sales that it alleged were lost by EC shipyards to Korean shipyards in the product and chemical tanker sector. The EC indicates that it is not making a claim of lost sales, but rather presents the examples to illustrate the price leadership of Korean shipyards in this sector resulting in suppressed prices.

7.665 The EC asserts that this price leadership helps the Korean shipbuilding industry to make use of the excess capacity that it brought on line in the mid-1990s.[338] According to the EC, the alleged subsidies i.e., the restructuring aid and the export subsidies as well as the tax concessions, allowed the preservation of unneeded facilities, compelling a significant decline in prices with Korean yards willing to sell at any price above the variable cost of production.

7.666 Korea denies that Korean shipyards are the price leaders for product and chemical tankers, on the basis of the report of the EC's consultant, and argues that in some cases European prices are lower.. Furthermore, Korea states, the examples of lost sales alleged by the EC are irrelevant, *inter alia* because in some cases the Korean shipyards involved were not among the restructured ones, and because of technical limitations on the part of the certain of the European yards involved.

(iii) Container ships

7.667 The EC presents in Figure 39, reproduced below, a table on market shares, in terms of new orders, in the container ship sector for the period 1993-2002.

Figure 39: Market Shares container ship sector for the period 1993-2002

	Average 93/97	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**Average 98/02**
EU	23%	34%	22%	26%	13%	23%	15%	13%	12%	20%	10%	14%
Skorea	27%	31%	26%	34%	27%	14%	45%	62%	52%	32%	52%	48%

Source: Lloyd's register of shipping

7.668 According to the EC, this table indicates that, from 1998, the year directly following the won devaluation, the Korean yards gained significant market share and became price and volume leaders in this sector. Yet, despite the recovery of the won and the increasing cost of production, Korean prices continued to decrease thereafter, allowing Korean yards to consolidate their price leadership and market dominance in the sector.

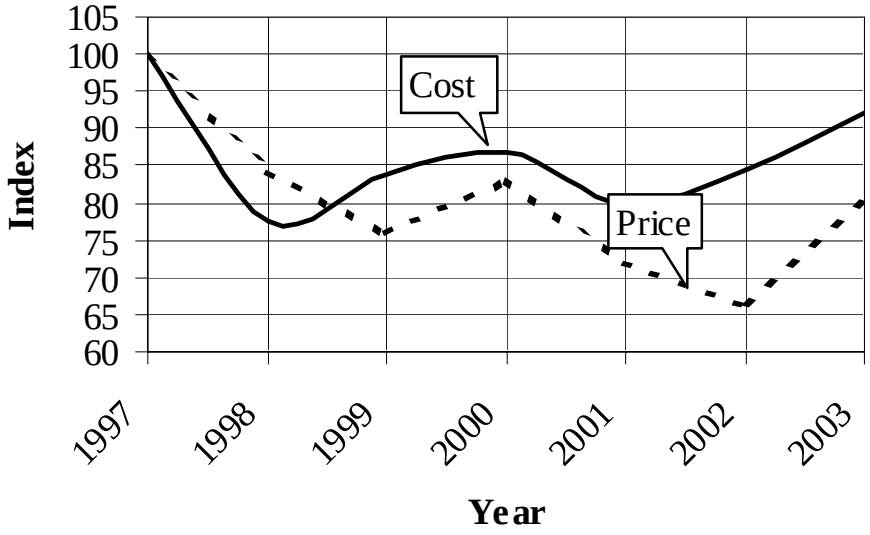
7.669 Korea disagrees, arguing that the market share data presented by the EC do not support the EC's allegation that Korea has become price and volume leader and that Korean prices continued to decrease thereafter. For Korea, in the first place market share data lend no support for a conclusion on price leadership as a matter of course. Furthermore, Korea argues that containerships cannot all be grouped together as the market share table does, because container ships do not constitute a single "like product". Rather, they show significant technical differences linked to their intended use and are perceived as such. According to Korea, the EC's own consultant, FMI, explicitly admitted that, as far as containerships are concerned, the Korean and European Communities' shipyards only compete for feeder containers where the prices have been led, again according to this consultant, by South Korea and China but with strong competition from Poland, Singapore and Taiwan. Korea argues that the European Communities are active in certain sizes of the feeder category, and the EC shipyards decreased their prices well before the appearance of Korean vessels of the same size on the market.

[338] FMI Background Report, at 23 (Exhibit EC-1).

7.670 The EC also presents in Figure 40, reproduced below, a chart comparing price and cost indices for 3,500 TEU container ships in Korea. [339]

Figure 40 Container ship

Cost and Price Indices for 3,500 TEU Container Ships in Korea (USD)[340]



7.671 The EC argues that the chart shows (in USD) that the price of, and the cost to produce, container ships declined sharply from 1997 until the middle of 1998. Since late 1998, the price has continued its general downward trend while costs have risen. The EC argues that the ability of the Korean shipyards to lower prices in the face of rising production costs is attributable to the alleged subsidies to the shipbuilding industry.

7.672 Korea's argument in respect of costs is that Korea has significant cost advantages compared to European shipyards, due to lower material and wage costs, higher productivity and the impact of the depreciation of the Won *vis-à-vis* the dollar, along with the appreciation of the euro, affecting the competitiveness of European yards. Korea states that every component of Korean costs fell further and faster than newbuilding prices. Concerning freight rates, Korea argues that the information provided by the EC, which sets forth a single freight index tabulation, is uninformative. Korea argues that freight rates can vary by vessel segment and should be differentiated on that basis.

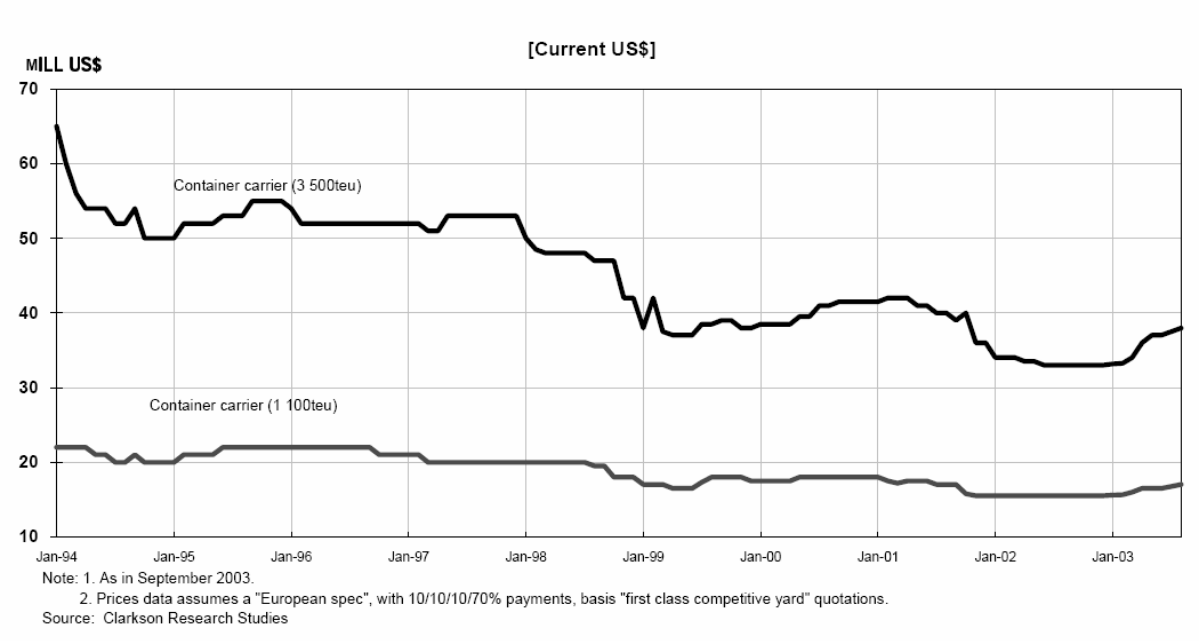
7.673 For the EC, Korea is the recognised world price leader: the downward trend of the prices charged by the Korean shipyards caused prices in the world market to decline as well. The EC submits a price index chart (Figure 41, reproduced below) in support of its argument that the world market price for container ships is declining. The price chart covers 3,500 TEU and 1,100 TEU containerships. According to the EC, competition between Korean and EC yards is particularly strong in the 3,500 TEU segment of container ships, while in the segment of smaller container ships Korean

[339] The EC notes that the term "TEU" stands for "twenty-foot equivalent unit", the key measurement of the cargo carrying capacity of a container ship.

[340] According to the EC, this is typical of the class of container ship for which there is strong competition between Korea and the European Communities. Since 1997, orders have been won by Daewoo, Halla, Hyundai Heavy, Samho and Samsung in Korea, and Volkswerft, HDW, and Odense in the European Communities.

yards are less active, explaining the less-pronounced price decrease for the latter class of container vessels.

Figure 41: World Market Price for Containerships



7.674 Korea counters with a chart of its own showing prices for feeder containerships, on the basis of which it argues that the EC shipyards depressed the price for feeder containership, well before the appearance of Korean vessels of the same size on the market.

7.675 The EC also submits an example of a sale of a container ship allegedly lost to a Korean shipyard, as illustration of price suppression by Korean shipyards in the container ship sector. According to the EC, Korean prices constitute the starting point of price negotiations, and no profit-seeking shipyard can meet these below-cost levels. Korea challenges the relevance of this example, arguing that one such order is does not constitute even *prima facie* evidence of significant price suppression, particularly when it is not demonstrated to be the effect of any existing subsidies.

(b) Evaluation by the Panel

7.676 We recall our findings that the EC has not demonstrated that the industry restructuring conferred subsidies on certain Korean shipyards. We also have found that the KEXIM legal regime as such, as well as the APRG and PSL programmes, as such, do not constitute prohibited export subsidies. We have, however, found that a number of individual APRGs and PSLs do confer subsidies. Some of these individual transactions involve the three types of ships that we are considering (LNGs, product/chemical tankers, and container ships), and some of these transactions involve other kinds of ships (e.g., crude oil tankers, bulk carriers, roll-on-roll-off vessels).

7.677 Thus, most of the alleged subsidies which the EC claims to cause adverse effects in fact cannot be considered in our serious prejudice analysis. The question that we must answer in respect of the EC's serious prejudice claim, therefore, is whether the EC has established that, in themselves, the relatively limited number of APRGs and PSLs that we *have* found to confer subsidies have caused significant price depression in respect of LNGs, and significant price suppression in respect of product/chemical tankers, and in respect of container ships. Applying the analytical framework that

we have described above, the question before us is whether the EC has established that but for these subsidized APRGs and PSLs, the prevailing market prices for these ships would have been significantly higher than they in fact were.

7.678 We recall here that the main premise of the EC's serious prejudice claim in respect of APRGs and PSLs is that this financing complemented the price depressive and suppressive effects of the allegedly subsidized industry restructuring. Thus, the EC alleges certain effects of these financing facilities as a whole, on the Korean shipbuilding industry as a whole, in the broader context of the industry restructuring which the EC alleged to confer subsidies. The EC's allegation in respect of the individual APRGs and PSLs thus is not based on an analysis of the subsidized transactions pertaining to LNGs, product/chemical tankers, and container ships in relation to the prevailing market prices for those categories of ships.[341] While the EC asserts that the individual subsidized APRGs and PSLs played a role in determining which shipyard obtained a particular contract, and states that the effect on the prices of the individual subsidized transactions was as much as two per cent *ad valorem*, for the EC the principal price effect of the subsidized financing was more generalized, i.e., assisting the restructured yards to maintain excess capacity in operation, which capacity in turn suppressed and depressed overall price levels for the three categories of ships, as well as, in general, helping to enable the non-restructured yards to follow the pricing lead of the restructured yards.[342] Thus, the EC does not distinguish, for purposes of its serious prejudice claims, between individual subsidized APRGs and PSLs on kinds of ships covered by those claims (LNGs, chemical/product tankers, and container ships), and on kinds of ships not covered by those claims (e.g., oil tankers, bulk carriers, and Roll-On-Roll-Off vessels, etc.).

7.679 In taking up the EC's claims concerning the APRGs and PSLs that we have found to be subsidized, we first must consider which of these subsidized transactions are relevant. In particular, we must decide whether to include or exclude from the subsidies whose effects we are considering the APRGs and PSLs on ship types other than LNGs, product/chemical tankers, and container ships. We understand that the EC's rationale for including them was that the availability of subsidized APRGs and PSLs in general had an impact on which shipyard obtained a sale and on the overall financial strength of the shipyards. While such an argument based on all subsidized APRGs and PSLs might have been plausible in the context of an affirmative finding of broad restructuring subsidies, we now are left with a relative handful of individual subsidized transactions involving a variety of ship types, some of which are not covered by the EC's price suppression/price depression claim. The EC has presented no evidence or argument seeking to demonstrate that subsidized financing of sales of ship types not covered by its claim (such as bulk carriers) had an identifiable impact on pricing for any of the ship types covered by its serious prejudice claims. In the absence of any such evidence or argument, we see no basis for taking into account in our analysis the subsidized financing of ship

[341] We recall the EC statement that its claim is "an overall claim of price depression and suppression on the world market resulting *inter alia* from restructuring aids involving direct forgiveness of government-held debt, as well as from KEXIM subsidies".

[342] The EC states in this regard that it is obvious that access to pre-shipment loans and APRGs at a time when private creditors either would not have provided such facilities, or, if they had, would have charged higher rates or fees based on market conditions, improved the shipyards' cash flows and profitability. The EC quotes from the 1998 KEXIM annual report in support of this argument as follows: "[KEXIM] as an export credit agency, played a rescue-operation role, transfusing emergency loans to Korean exporters and importers at the onset of the crisis *when the banking sector in Korea was nearly paralyzed*." The EC also cites the KEXIM Chairman's statement in the 1999 KEXIM Annual Report: "[KEXIM] contributed to the economic recovery by providing a variety of financing programs to exporters . . . who *experienced difficulty in obtaining adequate trade-related financing from commercial financial institutions*, due to the government-initiated restructuring plan in the financial and corporate sectors." Finally, the EC argues that KEXIM financing caused orders to be placed with the yards that later were restructured, which led to full orderbooks, which in turn led to optimistic sales projections for the purposes of establishing going concern value.

types other than LNGs, product/chemical tankers, and container ships. Rather, we consider that we should include in our analysis only the subsidized APRGs and PSLs that we know to relate to LNGs, product/chemical tankers, and container ships. These APRGs and PSLs are listed in Attachment 3.[343]

7.680 Furthermore, we recall that the EC has presented its serious prejudice case, and has asked us to conduct our analysis, in respect of each of the three categories of ships separately, and we will proceed on this basis, considering the possible effects on the prices for each ship category of the subsidized financing for ships in that category. In particular, we will consider first whether the evidence and arguments presented by the EC demonstrate a tangible relationship between the subsidized APRGs in respect of LNGs and the prevailing price for LNGs; between the subsidized APRGs and PSLs in respect of product/chemical tankers and the prevailing price for product/chemical tankers; and between the subsidized APRGs and PSLs in respect of container ships and the prevailing price for container ships. That is, we will look for evidence of a relationship between the subsidized transactions for a given ship type, on the one hand, and the prevailing market price for that ship type, on the other hand. If we find that there is evidence of such a relationship, we then will go on to consider in more detail questions of product definitions, geographic markets, timing of subsidization, movements in prices, evidence pertaining to costs, etc. for each product category, which would be needed for a full analysis of the serious prejudice claims.

(i) LNGs

7.681 Of the APRGs that we have found to be subsidized, three concern LNGs. These APRGs were contracted between 2000 and 2001, and expired between 2002 and 2004. We estimate the benefits of these subsidies to range from **[BCI: Omitted from public version]** per cent of the value of the ships involved. None of the PSLs that we have found to be subsidized concern LNGs. To put this into perspective, the EC has submitted data showing that as of January 2004, there were 62 LNGs on order around the world, 37 of them with Korean yards.[344]

7.682 While the estimated benefit amounts are relatively small, we do not doubt that even such modest subsidies may have played a role in obtaining the sales involved. In particular, we consider it entirely possible that they translated into equivalent price reductions on those specific transactions. That said, it is far from self-evident to us that a price reduction of **[BCI: Omitted from public version]** per cent on three transactions out of a much larger total would constitute, or lead to, "significant price depression" for LNGs as a whole.

7.683 Here we re-emphasize that in respect of this price depression claim, the appropriate focus of our analysis is the overall prevailing price level for the product category as a whole, and the possible link of the subsidized APRG transactions for LNGs to this price level. Indeed the EC's claim is based on overall price effects for this product category, and it asks us to resolve the claim on that basis. While we certainly accept the possibility that the subsidized financing affected the prices in the three individual transactions, we find nothing in the evidence and arguments before us demonstrating that the aggregate effect of the subsidized transactions is significant price depression for the entire product category of LNGs.

7.684 We therefore reject the EC's claim that subsidized APRGs have seriously prejudiced the EC's interests by causing significant price depression in respect of LNGs.

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[343] There are a number of APRGs and PSLs that we have found to be subsidized but for which we do not have information concerning the ship type involved, although we requested this information from the EC and the EC did not indicate that it was unavailable. (*See*, Question 139 from the Panel to the EC, and the EC response thereto.) Nevertheless, even if we were to assume that all of these unidentified transactions concerned either LNGs, product/chemical tankers, or container ships, this would not change our analysis and conclusions.

[344] EC Attachment 6, to answers to questions from the Panel following the first substantive meeting.

7.685 Given this, there is no need for us to consider the parties' detailed arguments as to product definitions, geographic markets, timing, etc. advanced in respect of LNGs.

(ii) Product/chemical tankers

7.686 Of the APRGs that we have found to be subsidized, two concern product/chemical tankers. These APRGs were contracted in 1999 and expired in 2001. We estimate the benefits of these subsidies to range from **[BCI: Omitted from public version]** per cent of the value of the ships involved. Of the PSLs that we have found to be subsidized, 24 concern product/chemical tankers. These PSLs were contracted between 2001 and 2002, and expired between 2001 and 2003. We estimate the benefits of these subsidies to range from **[BCI: Omitted from public version]** per centage points of interest on the loans involved. (No data are available as to these subsidy amounts restated on an *ad valorem* basis.) Data submitted by the EC show that as of January 2004, there were 370 tankers (including but not limited to product/chemical tankers) on order around the world, 218 of them with Korean yards.[345]

7.687 While the estimated benefit amounts are relatively small, we do not doubt that even such modest subsidies may have played a role in obtaining the sales involved. In particular, we consider it entirely possible that they translated into equivalent price reductions on those specific transactions. That said, it is far from self-evident to us that a price reduction of **[BCI: Omitted from public version]** per cent[346] on a relatively few transactions out of a much larger total would constitute, or lead to, "significant price suppression" for product/chemical tankers as a whole.

7.688 Here we re-emphasize that in respect of this price suppression claim, the appropriate focus of our analysis is the overall prevailing price level for the product category as a whole, and the possible link of the subsidized APRG and PSL transactions for product/chemical tankers to this price level. Indeed the EC's claim is based on overall price effects for this product category, and it asks us to resolve the claim on that basis. While we certainly accept the possibility that the subsidized financing affected the prices in the individual transactions, we find nothing in the evidence and arguments before us demonstrating that the aggregate effect of the subsidized transactions is significant price suppression for the entire product category of product/chemical tankers.

7.689 We therefore reject the EC's claim that subsidized APRGs and PSLs have caused serious prejudice to the EC's interests through price suppression in respect of product/chemical tankers.

7.690 Given this, there is no need for us to consider the parties' detailed arguments as to product definitions, geographic markets, timing, etc. advanced in respect of product/chemical tankers.

(iii) Container ships

7.691 Of the APRGs that we have found to be subsidized, eight concern container ships. These APRGs were contracted between 1997 and 2001, and expired between 1998 and 2003. We estimate the benefits of these subsidies to range from **[BCI: Omitted from public version]** per cent of the value of the ships involved. Of the PSLs that we have found to be subsidized, 21 concern container ships. These PSLs were contracted between 2001 and 2002, and expired between 2001 and 2003. We estimate the benefits of these subsidies to range from **[BCI: Omitted from public version]** percentage points of interest on the loans involved. (No data are available as to these subsidy amounts restated on an *ad valorem* basis.) Data submitted by the EC show that as of January 2004, there were 502 container ships on order around the world, 276 of them with Korean yards.

[345] Id.

[346] Because the figures cited are percentage points of interest, rather than *ad valorem* amounts, they would overstate the possible *ad valorem* impact of the subsidies involved to the extent that the financing in question was for less than 100 per cent of the contract value.

7.692 While the estimated benefit amounts are relatively small, we do not doubt that even such modest subsidies may have played a role in obtaining the sales involved. In particular, we consider it entirely possible that they translated into equivalent price reductions on those transactions. That said, it is far from self-evident to us that a price reduction of **[BCI: Omitted from public version]** per cent[347] on a small number of transactions out of a much larger total would constitute, or lead to, "significant price suppression" for container ships as a whole.

7.693 Here we re-emphasize that in respect of this price suppression claim, the appropriate focus of our analysis is the overall prevailing price level for the product category as a whole, and the possible link of the subsidized APRG and PSL transactions for container ships to this price level. Indeed the EC's claim is based on overall price effects for this product category, and it asks us to resolve the claim on this basis. While we certainly accept the possibility that the subsidized financing affected the prices in the individual transactions, we find nothing in the evidence and arguments before us demonstrating that the aggregate effect of the subsidized transactions is significant price suppression for the entire product category of container ships.

7.694 We therefore reject the EC's claim that subsidized APRGs and PSLs have seriously prejudiced the EC's interests by causing significant price suppression in respect of container ships.

7.695 Given this, there is no need for us to consider the parties' detailed arguments as to product definitions, geographic markets, timing, etc. advanced in respect of container ships.

VIII. CONCLUSIONS AND RECOMMENDATIONS

8.696 For the above reasons, we uphold the EC's claim that Korea has provided prohibited export subsidies in the form of the individual KEXIM APRG transactions set forth at para. 7.223 *supra*, and the individual KEXIM PSL transactions set forth at para. 7.330 *supra*, contrary to Articles 3.1(a) and 3.2 of the *SCM Agreement.*

8.697 However, we reject the EC's claims that Korea is in violation of Articles 3.1(a) and 3.2 of the *SCM Agreement* because prohibited export subsidies were and are provided pursuant to the KEXIM legal regime "as such", and the KEXIM APRG and PSL programmes "as such".

8.698 We also reject the EC's claim that Korea, by providing subsidies to Daewoo-SME/Daewoo-HI, Samho-HI/Halla-HI, and STX/Daedong through (i) workout plans and restructuring plans; (ii) tax concessions provided to Daewoo-HI/Daewoo-SME; and (iii) the grant of KEXIM APRGs and pre-shipment loans, has caused serious prejudice to the interests of the European Communities in violation of Articles 5(c) and 6.3(c) of the *SCM Agreement*.

8.699 Pursuant to Article 4.7 of the *SCM Agreement*, we are required to recommend that Korea withdraw the abovementioned individual APRG and PSL subsidies without delay.

8.700 Article 4.7 further provides that "the panel shall specify in its recommendation the time-period within which the measure must be withdrawn." Taking into account the procedures that may be required to implement our recommendation on the one hand, and the requirement that Korea withdraw its subsidies "without delay" on the other, we recommend that Korea withdraw the individual APRG and PSL subsidies within 90 days.

[347] Because the upper end of this range reflects percentage points of interest, rather than an *ad valorem* amount, it would overstate the possible *ad valorem* impact of the subsidy involved to the extent that the financing in question was for less than 100 per cent of the contract value.

ATTACHMENT 1

KOREA – MEASURES AFFECTING TRADE IN COMMERCIAL VESSELS (DS273)

Procedure under Annex V of the Agreement on Subsidies and Countervailing Measures

Report to the Panel from the Designated Representative of the Dispute Settlement Body

A. BACKGROUND

1. On 21 July 2003, a Panel was established at the request of the European Communities with respect to the above matter. In its request for establishment of a panel,[1] the European Communities alleged, *inter alia*, serious prejudice in the sense of Article 6 of the Agreement on Subsidies and Countervailing Measures ("SCM Agreement"), and in this context requested initiation of the procedure for developing information concerning serious prejudice provided for in Annex V to that Agreement.

2. As provided for in paragraph 4 of Annex V, the Dispute Settlement Body ("DSB") designated a Representative, Mr. András Szepesi, to facilitate the Annex V information-gathering process. The Designated Representative was appointed by the DSB on 21 July 2003, i.e., the date on which the Panel was established. This date was also considered by the parties to be the date on which the matter was "referred to the DSB" in the sense of paragraph 5 of Annex V. This meant that the 60-day period established in that paragraph for completion of the information-gathering process would have ended on 19 September 2003.

3. Shortly after the Panel was established, the Designated Representative met with the parties (the European Communities and Korea) to determine a schedule and working procedures for the Annex V procedure. Also, throughout the duration of the information-gathering process, he remained at the disposal of the parties. As reported below, he was called upon on a number of occasions by one or both of the parties to assist them by providing guidance or, if applicable, rulings with respect to different procedural aspects involved in the process.

B. WORKING PROCEDURES AND SCHEDULE

4. It was recognized that Annex V does not describe all aspects of the procedures for developing information concerning serious prejudice. Paragraph 2 of Annex V clearly foresees the possibility that parties to a dispute may pose questions to one another. In addition, however, the task of the Designated Representative is to ensure the timely development of the information necessary to facilitate expeditious subsequent multilateral review of the dispute, and paragraph 5 contains a non-exhaustive list of such types of information.

5. In view of these provisions of Annex V, and following consultations with the parties at an organizational meeting on 23 July 2003, the Designated Representative adopted a procedure the first step of which would be the submission of questions by the parties to the Designated Representative. The second step in the process was the preparation and transmittal to the parties and third-country Members of a questionnaire by the Designated Representative. That questionnaire would be based on the questions posed by the parties, but those questions could be amended, deleted or supplemented by the Designated Representative. In response to comments made by Korea, the Designated Representative agreed to make a draft version of his questionnaire available to the parties for comment, to allow them to identify any lacunae in the questions. The third step was the submission by each party and third-country Member of answers to the questions directed to it. The fourth and

[1] Document WT/DS273/2.

final step was a brief interval for the submission of any follow-up questions (concerning the clarification of answers received in the prior step) and answers thereto.

6. The schedule for the process as outlined was:

1 August 2003	Parties to submit to the Designated Representative questions to be posed to one another and to third-country Members
11 August 2003	Transmittal of questionnaires to parties and third-country Members by the Designated Representative
8 September 2003	Replies to questionnaires due
15 September 2003	Submission by the parties of follow-up questions (concerning the clarification of answers received by 8 September)
18 September 2003	Replies to follow-up questions due
19 September 2003	End of 60-day period / Report by the Designated Representative to Panel

7. At a late stage in the 60-day period, in fact just a couple of days before its expiry, the above schedule had to be modified, with the agreement of the parties, as a result of the additional time needed for the parties to translate certain voluminous documentation into one of the three WTO working languages. The amended deadline for completion of the Annex V procedure was 10 November 2003. The Panel was immediately informed of these modifications and the causes thereof.

C. PROCEDURAL ISSUES

8. A number of procedural issues arose during the Annex V information-gathering procedure. Those issues concerned the adoption and application of additional procedures for the protection of business / strictly confidential information, third party access to information, the timing of the submission of questions, the scope and review of questions, a request for the suspension of the Annex V procedure, and the translation of documents into a WTO working language.

1. Adoption and application of additional procedures for the protection of business / strictly confidential information

9. On 22 July 2003, Korea asked the Designated Representative to adopt additional procedures for the protection of business / strictly confidential information ("B/SCI"). The European Communities acknowledged the need for such additional procedures at the organizational meeting on 23 July. Each party submitted draft additional procedures.

10. In a meeting on 13 August, the Designated Representative noted that, although he was in favour of using additional procedures for the protection of B/SCI, the parties had proposed procedures that covered both the Annex V and Panel proceedings. While he found this approach fully understandable and justified, he had to express the view that only the Panel had the authority to adopt procedures governing both the Annex V and Panel proceedings. As a result, the parties asked the Designated Representative to forward their submissions regarding B/SCI to the Panel. The Designated Representative complied with this request. The Panel adopted procedures for the protection of BCI on 4 September 2003.

11. Subsequently, in a letter dated 15 September 2003, the European Communities asserted that in providing information Korea had not exercised restraint in the designation of BCI. The European Communities requested the Designated Representative to intervene in a manner envisaged by paragraph 20 of the procedures for the protection of BCI. In a letter dated 16 September, Korea asserted that it had acted in good faith, and in accordance with the definition of BCI as provided in the procedures for the protection of BCI, by designating as BCI information "not otherwise available in the public domain".

12. In a letter dated 16 September, the Designated Representative noted that the majority of questions asked of Korea were designed to elicit information that was of a commercially sensitive nature, and that the European Communities had failed to argue that such information was already in the public domain. He therefore declined to find that Korea had failed to exercise restraint by designating much of its questionnaire response as BCI, and declined to intervene under paragraph 20 of the additional procedures for the protection of BCI.

2. Third party / third-country Member access to information

13. The European Communities asked the Designated Representative to make information gathered under the Annex V procedure, including B/SCI, available to third parties or, at the very least, to third-country Members participating in the Annex V process. Korea asserted that there was no basis for doing so. Following a preliminary indication to that effect on 24 July 2003, on 4 September the Designated Representative informed the parties that, in his view, information gathered under the Annex V procedure did not need to be made available to third parties. In accordance with Article 10.3 of the DSU, third parties were entitled to receive all the submissions made by the parties to the Panel up to the first meeting of the panel. Since information submitted under the Annex V procedure did not constitute a submission to the Panel, such information fell outside the scope of Article 10.3. The Designated Representative saw no basis in the DSU or Annex V for treating third-country Members (which were also third parties) any differently.

3. Timing of the submission of questions

14. In a letter dated 22 July 2003, Korea asked the Designated Representative to introduce a staggered questioning process, whereby the European Communities would be required to submit its questions to the Designated Representative seven days before Korea.

15. In a communication dated 24 July, and on the basis of comments made by Korea at the organizational meeting, the Designated Representative stated that he understood Korea’s request to be motivated primarily by the concern that the European Communities would submit questions to third-country Members other than those identified in the European Communities' communication of 10 July 2003 (WT/DS273/3), i.e., China and Japan. The Designated Representative explained that, in view of the European Communities’ communication of 10 July, it could be assumed that the European Communities would only address questions to those two third-country Members. He indicated that he would consider carefully whether or not it would be appropriate to include questions addressed by the European Communities to other third-country Members in his questionnaire. Accordingly, the Designated Representative concluded that there was no need for a staggered questioning process. In light of a further submission by Korea on 25 July, the Designated Representative informed the parties on 28 July that he would provide them with a brief opportunity to comment on his draft questionnaire, to ensure that no questions were overlooked.

4. Review and scope of questions

16. On 22 July 2003, Korea asked for an opportunity to review questions submitted by the European Communities, to determine whether or not they adequately identified the nature of its serious prejudice allegations, and to enable Korea to ensure that the scope of the

European Communities' questions was properly limited to matters necessary to establishing its claims.

17. On 24 July, the Designated Representative stated that there was useful guidance in Annex V for identifying the information that would be most relevant to the serious prejudice claims at issue in this dispute. He noted, however, that it was ultimately up to each party to decide how it would respond to questions put to it. Since paragraph 8 of Annex V implied that there may be circumstances in which unreasonable questions might be put, he concluded that Annex V did not require any formal step providing for the *ex ante* assessment of the reasonableness of questions. (The provision of a draft questionnaire to the parties was merely to allow them to identify any questions that might have been overlooked by the Designated Representative.) He noted, however, that each party would be free to include comments on the reasonableness of questions when formulating its replies.

18. On 5 August, Korea nevertheless submitted a number of comments regarding the questions proposed by the European Communities on 1 August (which the European Communities had copied to Korea directly on that date). The European Communities was invited to respond by 6 August. Since no *ex ante* review of proposed questions was envisaged, the Designated Representative did not respond to the comments made by the parties.

19. Independently of these comments, and in line with his prerogative specified in paragraph 5 above, the Designated Representative did however amend or delete a number of questions submitted by the European Communities, to ensure that those questions did not exceed the scope of the Annex V procedure. Incidentally, such amendments / deletions also addressed some of the concerns raised by Korea. In a letter dated 8 August 2003, the European Communities commented on the scope of the Designated Representative's draft questionnaire to Korea. The European Communities asserted that, although the Designated Representative had restricted questions to Korea regarding the KEXIM Act and programmes to matters involving trade in commercial vessels, the serious prejudice claim relating to the KEXIM Act and programmes was not confined to exporters involved in trade in those products or to the shipbuilding sector.

20. On 11 August 2003, the Designated Representative asserted that he considered it appropriate to focus questions primarily on issues relating to trade in commercial vessels in light of the scope of the European Communities' request for consultations (WT/DS273/1) and request for establishment of a panel (WT/DS273/2).

5. Request for the suspension of the Annex V procedure

21. Consistent with its abovementioned submissions, on 8 August 2003 Korea expressed concern regarding the scope of certain questions included in the Designated Representative's draft questionnaire, and proposed that the Annex V procedure be suspended pending resolution by the Panel of legal issues concerning the scope of questions. Alternatively, Korea submitted that the Annex V procedure could proceed, but with the questionnaire responses of the parties and third-country Members being provided only to the Designated Representative (who would in turn provide the information to the Panel, but not to the parties).

22. On 11 August 2003, the Designated Representative stated that he intended to complete the Annex V procedure in accordance with his mandate from the DSB. He therefore declined to follow either of the courses proposed by Korea. He added that his mandate was to "ensure the timely development of the information necessary to facilitate expeditious subsequent multilateral review of the dispute". He stated that this mandate necessarily required the exercise of discretion on his part, and that he had exercised that discretion by including information-gathering questions on all issues that seemed to him to relate to those parts of the dispute covered by the scope of Annex V. He asserted that it was then up to Korea to determine to what extent it was prepared to respond to those questions.

6. Translation into a WTO working language

23. During the course of the information-gathering procedure, on 8 September both parties submitted documents drafted in a language other than a WTO working language. In particular, nearly half of all annexes submitted by Korea were provided, in whole or in part, in the Korean language. In letters dated 8 and 16 September 2003, Korea asserted that it was not required to provide all information in a WTO working language. Korea recognised, however, that it could be instructed, either by the Designated Representative or by the Panel, to undertake the necessary translation. On 15 September, the European Communities asserted that provision of a document in a non-WTO language was tantamount to non-provision of that document, and therefore non-cooperation.

24. On 15 September 2003, the Designated Representative informed the parties of his view that, since the Annex V procedure was a special or additional rule or procedure in the meaning of Article 1.2 of the DSU, it was formally part WTO dispute settlement proceedings. He therefore concluded that the Annex V procedure must be conducted in one of the three working languages of the WTO.

25. With the consent of the parties, in a communication dated 17 September 2003 the Designated Representative extended the deadline for completion of the Annex V procedure in order to allow sufficient time for the translation of certain documentation into one of the working languages of the WTO. Additional time was also allowed for follow-up questions and answers regarding such documentation. The modified schedule drawn up by the Designated Representative is attached hereto as Attachment I.

26. The extension of the deadline obviously meant that the information-gathering process could not be completed within the deadline specified in paragraph 5 of Annex V of the SCM Agreement, and this would necessarily impact on the schedule established by the Panel. However, not only does Annex V fail to provide any guidance that could have been relied upon in addressing the problems encountered, but also the extension was the only viable option for ensuring that the information obtained could meet the requirements specified, in particular, in paragraphs 2 and 5 of Annex V, and be of immediate use to the parties and the Panel. Furthermore, the deadline was extended with the consent of the parties, who cooperated in respecting the modified schedule. Moreover, the Panel was immediately informed, and did not express any disapproval, of these developments.

D. INFORMATION GATHERED

27. Questionnaires were sent to the parties and two third-country Members (i.e., China and Japan). A substantial amount of information was submitted in response those questionnaires. The questionnaires, replies to questionnaires, follow-up questions and replies to follow-up questions are contained in Annexes I – IV to this report. These Annexes are organized as follows:

Annex I-A	Questionnaire to the European Communities
Annex I-B	Replies by the European Communities to questionnaire
Annex I-C	Follow-up questions to the European Communities
Annex I-D	Replies by the European Communities to follow-up questions
Annex II-A	Questionnaire to Korea
Annex II-B	Replies by Korea to questionnaire
Annex II-C	Follow-up questions to Korea

Annex II-D Replies by Korea to follow-up questions

Annex III-A Questionnaire to China

Annex III-B Replies by China to questionnaire

Annex IV-A Questionnaire to Japan

Annex IV-B Replies by Japan to questionnaire

ATTACHMENT I

KOREA – MEASURES AFFECTING TRADE IN COMMERCIAL VESSELS (DS273)

MODIFIED SCHEDULE FOR THE COMPLETION OF THE ANNEX V PROCEDURE

Timetable for submission of document translations, and for follow-up questions and answers

15 September 2003	deadline for follow-up questions on information submitted 8 September 2003.
16 September 2003	provision of certain missing documents by Korea.
18 September 2003, COB[2]	deadline for answers to 15 September follow-up questions.
22 September 2003, by 10:00 AM	deadline for follow-up questions from EC on missing documents provided by Korea on 16 September.
26 September 2003, COB	deadline for answers of Korea to 22 September EC follow-up questions on the missing documents provided on 16 September 2003.
2 October 2003, COB	deadline for translations by the EC of EC documents as referred to in EC letter dated 15 September 2003.
	deadline for translations by Korea of documents identified in Attachment 1 to Korea's letter dated 16 September 2003 as requiring two weeks for translation.
6 October 2003, COB	deadline for follow-up questions on newly-translated documents submitted on 2 October 2003.
10 October 2003, COB	deadline for answers to 6 October 2003 follow-up questions.
16 October 2003, COB	deadline for translations by Korea of documents identified in Attachment 1 to Korea's letter dated 16 September 2003 as requiring four weeks for translation.
20 October 2003, COB	deadline for follow-up questions on newly-translated documents submitted on 16 October 2003.
24 October 2003, COB	deadline for answers to 20 October 2003 follow-up questions.
30 October 2003, COB	deadline for translations by Korea of documents identified in Attachment 1 to Korea's letter dated 16 September 2003 as requiring six weeks for translation.

[2] COB refers to "close-of-business", i.e., 5:30 p.m.

3 November 2003, COB	deadline for follow-up questions on newly-translated documents submitted on 30 October 2003.
7 November 2003, COB	deadline for answers to 3 November 2003 follow-up questions.
10 November 2003	submission of Designated Representative's report to the Panel.

ATTACHMENT 2

KOREA – MEASURES AFFECTING TRADE IN COMMERCIAL VESSELS (DS273)

PROCEDURES FOR THE PROTECTION OF BUSINESS CONFIDENTIAL INFORMATION

The following procedures apply to all business confidential information (BCI) submitted in the course of the Annex V procedure and the Panel process. These procedures will not apply to a party's treatment of its own BCI.

I. DEFINITIONS

1. "Approved persons" means:

   (i) representatives or outside advisors of a party, or employees of the Secretariat, when designated in accordance with the provisions of Article V of these Procedures;

   (ii) the Facilitator

   (iii) Panel members; and

   (iv) PGE members or experts appointed by the Panel who in the opinion of the Panel require access to the BCI.

2. **"Business Confidential information"** means any information that has been designated as Business Confidential by the party submitting the information, and that is not otherwise available in the public domain.

3. **"Conclusion of the Panel process"** means when:

   (i) pursuant to Article 16.4 of the DSU, the Panel report is adopted by the DSB, or the DSB decides by consensus not to adopt the report;

   (ii) pursuant to Articles 16.4 and 17.14 of the DSU, the Panel report is adopted (with modification, if any) with the report of the Appellate Body; or

   (iii) when the authority for establishment of the Panel lapses pursuant to Article 12.12 of the DSU.

4. **"Designated as Business Confidential"** means:

   (i) for printed information, clearly marked with the notation 'BUSINESS CONFIDENTIAL INFORMATION' and with the name of the party that submitted the document;

   (ii) for binary-encoded information, clearly marked with the notation 'BUSINESS CONFIDENTIAL INFORMATION' on a label on the storage medium, and clearly annotated with the notation 'BUSINESS CONFIDENTIAL INFORMATION' in the binary-encoded files; and

(iii) for uttered information, declared by the speaker to be "Business Confidential Information" prior to the disclosure.

5. **"Employee of the Secretariat"** means a person employed or appointed by the Secretariat who has been authorized by the Secretariat to work on the dispute, and includes translators and interpreters and transcribers present at the Panel meetings.

6. **"Facilitator"** means the Representative of the DSB appointed in accordance with paragraph 5 of Annex V of the *SCM Agreement*.

7. **"Outside advisor"** means a legal counsel or other advisor of a party, who has been authorized by a party to act on behalf of such party in the course of the dispute and whose authorization has been notified to the Chairman of the Panel and to the other party, but in no circumstances shall this definition include an employee, officer or agent (other than outside legal counsel who has represented a shipbuilder in connection with these WTO dispute settlement proceedings) of a private company engaged in the manufacture of commercial vessels.

8. **"Panel member"** means a person serving on the Panel.

9. **"Party"** means a disputing party.

10. "**PGE member**" means a person appointed to the Permanent Group of Experts established pursuant to SCM Agreement Article 24, and who has been requested to assist the Panel pursuant to Article 4.5 of the SCM Agreement.

11. **"Representative"** means an employee of a party or third party.

12. **"Secure location"** means a locked storage receptacle, to which only approved persons, or designated representatives of third parties, have access.

13. "**Third party**" means a Member having notified its interest in the dispute to the DSB pursuant to DSU Article 10.

II. ACCESS TO AND USE AND DISCLOSURE OF BCI

14. Access by parties to BCI:

(a) Only approved persons may have access to BCI submitted pursuant to these procedures.

(b) Documents or other recordings containing BCI submitted pursuant to these procedures shall not be copied in excess of the number of copies required by the approved persons. All copies of BCI shall be consecutively numbered. The making of electronic copies shall be avoided whenever possible.

15. Use and disclosure by parties and the Panel of BCI:

(a) Approved persons shall use BCI only for the purposes of the Annex V procedure, the Panel and possible subsequent appellate review proceedings and for no other purpose.

(b) No approved person shall disclose BCI, or allow it to be disclosed, to any person except another approved person or designated representative of a third party.

(c) The Panel shall not disclose BCI in its report, but may make statements or draw conclusion that are based on the information drawn from the BCI.

16. Access by Third Parties to BCI

(a) Only designated representatives of third parties may have access to BCI, and only to that BCI contained in the submissions of the parties to the dispute to the first meeting of the Panel, and only for the purpose of preparing their third party submissions and oral statements in the dispute. The third parties will provide the name(s) of the designated representative(s) to the parties and the Panel before the first submission of the complaining party. The procedures of Section IV of these procedures shall apply *mutatis mutandis* with respect to the third parties.

(b) The submissions of the parties to the dispute to the first meeting of the Panel containing BCI shall not be copied in excess of the number of copies required by the designated representatives. All copies of such submissions shall be consecutively numbered. The making of electronic copies shall be avoided whenever possible.

(c) No designated representative shall disclose BCI, or allow it to be disclosed, to any person except an approved person or another designated representative.

III. STORAGE

17. Approved persons and designated representatives of third parties shall store all documents or other recordings containing BCI in a secure location when not in use by an approved person or designated representative.

IV. DESIGNATION OF APPROVED PERSONS

18. Each party shall submit to the other party, to the Facilitator and to the Panel a list of the names and titles of its representatives and outside advisors who need access to BCI submitted by the other party and whom it wishes to have designated as approved persons. Each party shall keep the number of persons on its list as limited as possible, taking into account its administrative and political structures. The Director-General, or his designee, shall, in the same manner, submit to the parties, to the Facilitator, and to the Panel, a list of the employees of the Secretariat who need access to BCI in the dispute. The parties or the Director-General, or his designee, may submit amendments to their lists at any time.

19. Unless a party objects to the designation of an outside advisor of the other party on the lists submitted under paragraph 18, the Panel shall designate those persons as approved persons. If a party objects to the designation of an outside advisor of a party on the lists submitted, the Panel shall decide on the objection promptly. The possible grounds for objection to the designation of an approved person include a conflict of interest. If the Panel rejects the objection, no BCI of the party having objected to the designation may be disclosed to the person subject of the objection until that party has had a reasonable opportunity to withdraw the BCI. If that party decides to withdraw any BCI the Facilitator, the Panel and the other party shall promptly return the corresponding documents or other recordings, which contain the BCI in question, to the party submitting it.

V. SUBMISSION OF BCI BY A PARTY

20. Subject to the provisions of paragraph 21 and in accordance with the definition in paragraph 4, each party may designate what information contained in its responses to questions posed in accordance with Annex V of the *SCM Agreement* (hereinafter "responses to Annex V questions"), and/or its submissions, shall be treated as BCI. Each party shall act in good faith and exercise the

utmost restraint in designating information as BCI. The Faciliator and the Panel shall have the right to intervene, in any manner that they deem appropriate, if they are of the view that restraint in the designation of BCI is not being exercized.

21. To the extent possible, BCI should be submitted in an exhibit or annex to a response to an Annex V question, or to a submission. Under no circumstances shall an entire response to an Annex V question or an entire submission, or significant parts thereof, be designated as BCI.

22. A party or third party that wishes to submit or refer to BCI at a Panel meeting shall so inform the Panel prior to doing so. The Panel shall exclude persons who are not approved persons or designated representatives of a third party from the meeting for the duration of the submission and discussion of the BCI.

23. Where a submission by a party incorporates BCI first submitted by another party, the submission shall identify that information as BCI of another party.

VI. RESPONSIBILITY FOR COMPLIANCE

24. Each party and third party is responsible for ensuring that its approved persons and designated representatives comply with these procedures to protect BCI submitted by a/another party. The Secretariat shall take the appropriate steps to ensure that all other approved persons are aware of their obligations under these procedures.

VII. ADDITIONAL OR ALTERNATIVE PROCEDURES

25. At the request of a party, the Panel may apply any other procedures that it considers necessary to provide additional protections to the confidentiality of BCI.

26. The Panel may, with the consent of the parties, waive any part of these procedures.

VIII. RETURN OR DESTRUCTION

27. After the conclusion of the Panel process, within a period fixed by the Panel, the Panel and the parties shall return any documents or other recordings containing BCI. Alternatively, the parties may certify in writing to the Panel that the documents or other recordings will be destroyed consistent with the parties' record keeping obligations under their domestic laws. In the latter event the parties shall also certify in writing, at the appropriate time, that the documents or recordings containing BCI have been destroyed. At the conclusion of the third party session, the third parties shall return any documents or other recordings containing BCI. The Secretariat may retain one copy of the documents or other recordings containing the BCI for the archives of the WTO.

28. If the report of the Panel is appealed, the Secretariat shall transmit any documents or other recordings containing BCI to the Appellate Body as part of the record of the Panel proceedings. The Secretariat shall transmit such information to the Appellate Body separately from the rest of the record, wherever reasonably possible.

CONTAINS BUSINESS CONFIDENTIAL INFORMATION

ATTACHMENT 3
List of certain APRGs and PSLs in respect of sales of LNGs, product/chemical tankers and container ships

Description	Comm. Date	Expiry Date	Estimated Subsidy Amount
CONTAINERS			
PSLs			
[BCI: Omitted from public version]			
APRGs			
[BCI: Omitted from public version]			
LNGs			
PSLs - NONE			
APRGs			
[BCI: Omitted from public version]			
PRODUCT/CHEMICAL TANKER			
PSLs			
[BCI: Omitted from public version]			
APRGs			
[BCI: Omitted from public version]			

Source: Attachments EC-10, EC-11 and EC-12.

ANNEX A

EXECUTIVE SUMMARIES OF THE FIRST WRITTEN SUBMISSIONS OF THE PARTIES

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ANNEX A-1

FIRST WRITTEN SUBMISSION OF THE EUROPEAN COMMUNITIES

(22 December 2003)

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I. INTRODUCTION

1. The European Communities seeks a ruling from this Panel recommending that Korea withdraw the massive subsidies it provides to Korean shipyards, remove the adverse effects of these subsidies, and revoke or amend measures that constitute *de jure* violations of the *SCM Agreement*. The granting of these subsidies to the Korean shipyards from 1 January 1997 through present, and the enactment and maintenance of such measures, violate multiple provisions of the *SCM Agreement*.

2. At issue in this dispute are subsidies that the Government of Korea has provided to Korea's commercial shipbuilding industry since 1 January 1997. In its first written submission, the European Communities:

- Firstly, summarises the relevant factual background (Part II);
- Secondly, briefly describes the procedure leading to this Panel proceeding (Part III); and then
- Demonstrates, that the Government of Korea has granted, and continues to grant, both prohibited and actionable subsidies, contrary to its obligations under the *SCM Agreement* (Part IV).

II. FACTUAL BACKGROUND

3. The submission provides background information on the "commercial shipbuilding industry", including on the nature of the shipbuilding market, the types of ships involved in the dispute and on the main players in Korea and the EU. It also describes the history of Korean government intervention in the economy.

III. HISTORY OF DISPUTE

4. The European Communities requested consultations with Korea on 21 October 2002 to discuss subsidies provided to Korean shipbuilders that violate Korea's obligations under the *SCM Agreement*.

5. The European Communities and Korea held three consultations on 22 November 2002, 13 December 2002 and 7 May 2003. On 11 June 2003, the European Communities requested the immediate establishment of a panel.

6. On 21 July 2003, the Dispute Settlement Body (DSB) established the Panel with the standard terms of reference. On 10 July 2003, the European Communities requested that the DSB initiate the Procedures for Developing Information Concerning Serious Prejudice as provided in Annex V of the *SCM Agreement*. The Annex V procedure was terminated on 10 November.

7. Special procedures apply for the protection of "business confidential information" ("BCI") in this proceeding. The European Communities does not accept all Korea's claims of BCI but has endeavoured to respect them in the submission by marking such information "**[BCI]"**. All BCI has been omitted from this executive summary.

IV. LEGAL CLAIMS

A. INTRODUCTION

8. The European Communities demonstrates in its submission that Korea provides prohibited and actionable subsidies to its commercial shipbuilding industry. It:

- first addresses general issues relating to the burden of proof, best information available, and adverse inferences (Section B)

- then proceeds to consider the issue of prohibited subsidies (Section C); and

- finally addresses actionable subsidies (Section D).

B. BURDEN OF PROOF, BEST INFORMATION AVAILABLE AND ADVERSE INFERENCES

9. The general principle applicable in WTO dispute settlement is, as the Appellate Body stated in *EC – Hormones*, that the initial burden of proving a violation is on the complaining party, which must establish a *prima facie* case. It is also a well-established rule in WTO dispute settlement that "the party who asserts a fact, whether the claimant or the respondent, is responsible for providing proof thereof."[1]

10. However, as the Appellate Body recalled in *Japan – Apples*, the principle that the complainant must establish a *prima facie* case of inconsistency with a provision of a covered agreement does not require the complainant to offer proof of every fact that it asserts.[2] Where a defending party contests the adequacy or the pertinence of the facts presented by the complaining party, the burden may be on the defending party to establish those facts.

11. In particular, Annex V of the *SCM Agreement* sets out certain special rules to take account of the particular problems of fact-finding in such cases. They provide in particular that:

- The information provided under the Annex V procedure constitutes "the record" on the basis of which the Panel is to decide the case.[3]

- Where there is a lack of cooperation by the subsidising Member or any third-country Member, the complaining Member is entitled to make its case based on evidence available to it.[4]

- The Panel may then "complete the record as necessary relying on best information otherwise available"[5] and may seek additional information to complete the record that it "deems essential to a proper resolution to the dispute, and which was not adequately sought or developed during that process".[6] However in doing so, the Panel "should not request additional information to complete the record where the information would support a particular party's position and the absence of that information in the record is the result of unreasonable non-cooperation by that party in the information-gathering process."[7]

- The Panel is expressly instructed to draw adverse inferences from instances of non-co-operation.[8]

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[1] Appellate Body Report, *US – Wool Shirts and Blouses*, at 14.
[2] Appellate Body Report, *Japan – Apples*, para 157.
[3] *SCM Agreement*, Annex V, at paras. 6 and 9.
[4] *Ibid.* at para. 6.
[5] *Ibid.*
[6] *Ibid.* at para. 9.
[7] *Ibid.* at para. 9.
[8] *Ibid.* at para. 7.

12. The Appellate Body confirmed in *Canada – Aircraft* the drawing of adverse inferences from instances of non-co-operation is in fact a general principle of the *SCM Agreement* that is also applicable in the case of prohibited subsidies.[9]

13. The European Communities has exercised self-restraint in requesting the Panel to base its findings on best information otherwise available or to draw adverse inferences in accordance with paragraphs 6 to 8 of Annex V of the *SCM Agreement.* Whether it will be necessary for the Panel to draw further adverse inferences, to use best information otherwise available, or to seek further information through use of its powers under Article 13 of the DSU to seek technical advice and information from relevant individuals or bodies such as the OECD, will depend on the position taken by Korea on the case made by the European Communities.

C. PROHIBITED SUBSIDIES

14. The European Communities makes three distinct claims that Korean measures constitute prohibited subsidies under Part II of the *SCM Agreement.* These are:

(a) The regime established by the Export-Import Bank of Korea Act ("KEXIM Act"), the Enforcement Decree of the Export-Import Bank of Korea ("KEXIM Decree"), and the Guidelines for Interest and Fees ("KEXIM Interest Rate Guidelines").

(b) The KEXIM practice, undertaken pursuant to the KEXIM Act, Decree, and Interest Rate Guidelines of providing export subsidies through its advance payment refund guarantee ("APRG") and pre-shipment loan financing programmes.

(c) Specific grants of APRGs and pre-shipment loans to Korean shipbuilding companies by KEXIM.

15. The European Communities shows that all of the above constitute prohibited subsidies within the meaning of Article 3.1(a) of the *SCM Agreement.* The definition of subsidy in Article 1.1(a)(1) of the *SCM Agreement* encompasses financial contributions provided by "any public body". The European Communities demonstrates that KEXIM is a "public body" within the meaning of Article 1.1(a)(1) of the *SCM Agreement.*

1. The KEXIM Act, Decree, and Interest Rate Guidelines, As Such, Violate Article 3 of the *SCM Agreement*

16. The European Communities first explains that the fact that the regime established by the KEXIM Act and Decree does not expressly *require* the granting of WTO-inconsistent export subsidies does not alter the fact that the regime, as such, is contrary to the requirements of the *SCM Agreement* and Article 3.1(a) thereof.

17. The Appellate Body has recently laid to rest the notion that non-mandatory measures cannot be the subject of dispute settlement in *US – Sunset Review (Japan).* In that case the Appellate Body reviewed the alleged basis for this doctrine and reversed the reliance of the panel in that case on it, stating:

> Hence we see no reason for concluding that, in principle, non-mandatory measures cannot be challenged "as such".[10]

[9] Appellate Body Report, *Canada – Aircraft*, para 202 (footnote omitted).
[10] Appellate Body Report, *US – Sunset Review (Japan)*, para. 88.

18. While the mandatory or discretionary nature of a measure may be relevant in assessing the compatibility with certain WTO obligations, the Appellate Body held in *US – Section 211* that an assessment of the compatibility of a measure cannot end with the conclusion that it is discretionary.[11] The scope of WTO obligations, and the possibilities for invoking them against measures maintained by the Members, must be determined on the basis of the ordinary meaning of the text of the relevant WTO provisions, read in light of their object and purpose.

19. Nothing in the language of Article 3.1 of the *SCM Agreement* suggests that a Member can have discretion to provide export subsidies. Indeed, Article 3.2 of the *SCM Agreement* makes this clear since it provides that Members "shall neither grant nor *maintain* subsidies referred to in" Article 3.1 (i.e. prohibited subsidies).

20. The KEXIM Act, Decree, and Interest Rate Guidelines provide for the granting of prohibited export subsidies. They (a) establish as a main operational objective of KEXIM the promotion of Korean exports through the grant of loans and guarantees; (b) prohibit KEXIM from competing with other financial institutions; and (c) enable KEXIM to grant loans and guarantees without regard to financial risk, and in unlimited amounts. Consequently, this legal regime is inconsistent, as such, with Article 3 of the *SCM Agreement*.

21. KEXIM's legal framework, including the KEXIM Act, by providing for the grant of loans and loan guarantees in amounts not limited by consideration of the financial status of the borrower, and on more advantageous terms than the market would provide, confers a "benefit" on exporters. KEXIM's legal framework, including the KEXIM Act, provides for the grant of subsidies that are *de jure* contingent on export performance. Under Article 18 of the Act, the loans and guarantees are, by its own terms, "[f]or the purpose of facilitating exports of products." Thus, under the plain language of the statute, the subsidies, in the form of loans and guarantees, are *de jure* export contingent within the meaning of Article 3.1(b) of the *SCM Agreement*. As a prohibited subsidies under Article 3.1(a) of the *SCM Agreement*, the subsidies granted by KEXIM pursuant to KEXIM's legal framework are "deemed to be specific" pursuant to Article 2.3 of the *SCM Agreement*.

22. The European Communities also points out that the KEXIM Interest Rate Guidelines do, in fact, specifically require the grant of a subsidy at below-market markets under certain circumstances.

2. The KEXIM Advance Payment Refund Guarantee and Pre-shipment Loan Programmes constitute measures in the form of a "practice" of KEXIM pursuant to the KEXIM Act

23. KEXIM operates the **Advance Payment Refund Guarantee programme** pursuant to the KEXIM Act. Under this programme, KEXIM guarantees that a foreign buyer will be refunded 100 per cent of any advance payments made to a Korean exporter, including any accrued interest on the advance payments, if the exporter fails to perform its obligations under the relevant contract. The amount of the APRG, also known as an Advance Payment Bond, is determined by the total amount of advance payments actually paid to the Korean exporter, plus accrued interest on the advance payments that would be due in case of default.

24. KEXIM guarantees confer a "benefit" to Korean exporters by providing financial support on more advantageous terms than they would otherwise be able to obtain in the Korean financial market. Although KEXIM charges each exporter a certain fee (i.e. premium) when granting APRGs, the premium fails to reflect the degree of creditworthiness of the Korean exporters. KEXIM issues guarantees without proper consideration of the risk involved in the transaction – in many cases, granting guarantees to financially troubled companies that would not have been able to obtain a guarantee from a commercial bank.

[11] Appellate Body Report, *US – Section 211 Appropriations Act*, para. 260.

25. The evidence demonstrates that very few commercial banks granted APRGs to the Korean shipyards during the time of the financial crisis in 1997, and few have entered the market of granting APRGs since that time. The APRG programme, established by KEXIM pursuant to the KEXIM Act, provides prohibited export subsidies, as defined by Part II of the *SCM Agreement*. KEXIM guarantees (i) meet the definition of a "subsidy" under Article 1.1, (ii) are expressly contingent upon export performance in violation of Article 3.1(a) of the *SCM Agreement*, and (iii) are specific subsidies pursuant to Article 2.3 of the *SCM Agreement*.

26. The KEXIM **pre-shipment loan programme** provides loans to Korean companies in connection with export contracts, for the purpose of helping the Korean exporters to finance production.

27. KEXIM pre-shipment loans confer a "benefit" on the Korean exporters within the meaning of Article 1.1(b) of the *SCM Agreement* because the preferential interest rates provided by KEXIM place the Korean exporters in a more advantageous position than if they were to obtain such financing on market terms.

28. The pre-shipment loan programme, established by KEXIM pursuant to the KEXIM Act, provides prohibited export subsidies, as defined by Part II of the *SCM Agreement*. These KEXIM guarantees (i) meet the definition of a "subsidy" under Article 1.1, (ii) are expressly contingent upon export performance in violation of Article 3.1(a) of the *SCM Agreement*, and (iii) are specific subsidies pursuant to Article 2.3 of the *SCM Agreement*.

3. Specific Grants of Prohibited Subsidies

29. As detailed in the submission, KEXIM has charged premia that fall far below the rates that would have been charged by commercial banks. These individual transactions are not just evidence of KEXIM's APRG and pre-shipment loan "practices," but they are also themselves subject to challenge. The European Communities, therefore, also challenges as inconsistent with the *SCM Agreement* numerous individual transactions in which KEXIM has provided APRGs and pre-shipment loans to Korean shipbuilding companies at preferential rates that are well below the rates that would have been commercially available.

D. ACTIONABLE SUBSIDIES

30. The European Communities demonstrates in the submission that subsidies granted by Korea to its shipbuilding industry cause serious prejudice to the EC's shipbuilding industry. These subsidies were granted pursuant to the restructuring process of the Korean shipbuilding industry since 1997. They take the form of debt forgiveness, debt-for-equity conversions on non-market terms, tax concessions, and KEXIM APRGs and pre-shipment loans.

31. The European Communities first presents evidence that the Government of Korea has provided "financial contributions" in the form of debt forgiveness, debt-for-equity conversions on non-market terms, and tax concessions that confer a "benefit", and that are "specific" to certain enterprises within the meaning of Articles 1 and 2 of the *SCM Agreement*. The European Communities then shows that the subsidies, together with the KEXIM subsidies described in Section IV.C granted directly or indirectly by the Government of Korea constitute actionable subsidies that violate Articles 5(c) and 6.3(c) of the *SCM Agreement* by causing serious prejudice to the interests of the European Communities.

32. The Government of Korea has a long history of intervention in the country's financial and corporate sectors, directing the lending practices of financial institutions to promote the export-

oriented activities of selected *chaebols*. As described in Section II (Factual Background), each time these *chaebols* faced financial distress, the Government intervened to rescue them through favourable financial packages provided by government-controlled banks or private banks acting under the Government's instruction. This pattern of government intervention was repeated once again during the financial crisis that began in 1997. The Government of Korea played a central role of in the workout process; acted through a number of public bodies carrying out the Government policies; and entrusted and directed commercial financial institutions to support the Korean shipbuilding industry during a time of severe financial turmoil.

33. Indeed, the Government of Korea directed the workout process through, *inter alia*, (a) the participation, as creditors, of public bodies acting pursuant to Government policy; (b) the direct or indirect shareholding participation by the Korea Depository Insurance Company in the capital of many financial creditors of the ailing *chaebols*; (c) the purchase by the Korea Asset Management Corporation of non-performing loans from financial creditors; and (d) pressure exerted by the Government on other creditors—many themselves facing collapse—to abide by the Government's directives.

34. Public bodies acting pursuant to Government policy played a leading role in the council of creditors of the shipbuilding companies. At the same time, they pressured other "private" creditors that did not have an institutional nexus with the Government of Korea or did not pursue public policy objectives.

35. The submission demonstrates that six financial institutions (Korea Asset Management Corporation, Korea Depository Insurance Corporation, Bank of Korea, Korea Development Bank, Industrial Bank of Korea and KEXIM) which were involved as creditors of the shipyards in the work-out process are public bodies within the meaning of Article 1.1(a)(1) of the *SCM Agreement*. Advantages granted by them in the context of the workout process to Korean shipyards are, therefore, necessarily to be imputed to the Government of Korea.

36. Should the Panel adopt a different and more narrow interpretation of that term, the European Communities submits that these institutions are, in any case, private bodies "entrusted" or "directed" by the Korean Government within the meaning of Article 1.1(a)(1)(iv) of the *SCM Agreement*.

37. In addition to the above, commercial financial institutions that were creditors of the *chaebols* also provided financial assistance to the *chaebols* pursuant to the direction or entrustment of the Government of Korea. In the submission the European Communities sets out the general pattern of involvement of the Korean Government in the decision-making of the commercial financial institutions that were creditors of the three shipyards in the restructuring process.

38. The Korean Government and its public bodies took advantage of its multiple roles as decision-maker/strategist, legislator, executive, regulator, shareholder/owner, capital injector, guarantor, and lender to ensure that commercial financial institutions acted to support the Korean shipbuilding industry.

39. The European Communities demonstrates that the Government of Korea has granted **Daewoo HI/Daewoo SME** actionable subsidies that consist of: the workout plan, comprising several individual measures as implemented between August 1999 – December 2000; tax concessions provided to Daewoo-HI/Daewoo-SME under Korea's Special Tax Treatment Control Law; and grants of APRGs and pre-shipment loans by KEXIM. The European Communities also demonstrates that the Government of Korea has granted to **Samho-HI/Halla-HI** actionable subsidies that consist of the company's corporate reorganisation plan comprising of a number of individual components and the grant of APRGs and pre-shipment loans by KEXIM. Finally, the European Communities

demonstrates that the Government of Korea granted to **STX/Daedong** actionable subsidies that consist of the corporate reorganisation plan comprising several individual components and the grant of APRGs and pre-shipment loans by KEXIM.

40. Having established the existence of the subsidies, the European Communities demonstrates that they are actionable within the meaning of Articles 5(c) and 6.3(c) of the *SCM Agreement*. Through its use of subsidies to the shipbuilding industry, Korea has caused serious prejudice in the form of significant suppression or depression of prices for EC ships worldwide, in violation of Articles 5(c) and 6.3(c) of the *SCM Agreement*.

41. The European Communities' claims involve a number of distinct legal elements, each of which is established in the submission. First, the European Communities demonstrates that three types of ships produced in the European Communities and in Korea—container ships, product and chemical tankers, and LNGs—compete in the same product and geographic markets.

42. Second, the European Communities explains that Korean subsidies to Daewoo-SME/Daewoo-HI, Samho-HI/Halla-HI, and STX/Daedong cause depressed and suppressed prices for the European shipbuilding industry. To establish the causal link between the subsidies and this price depression and price suppression, the European Communities demonstrates that (a) the subsidies artificially maintained shipbuilding facilities that would not have been maintained under market conditions and materially enhanced the financial strength and freed up financial resources for use by Daewoo-SME/Daewoo-HI, Samho-HI/Halla-HI and STX/Daedong; (b) the need to utilise this capacity and the low costs resulted in lower bid prices for ships produced by the shipyards; and (c) given Korean price leadership, these lower prices caused price depression and price suppression in affected products.

43. Third, the European Communities shows that the price suppression or depression in the ship market worldwide, and in particular country or regional markets, has been "significant." Fourth, the European Communities demonstrates that the significant price suppression and price depression were of such a nature and quantity as to constitute "serious prejudice," and thus have created "adverse effects" to the interests of the European Communities.

V. CONCLUSION

44. For the above reasons, the European Communities asks the Panel to find that Korea has granted subsidies inconsistent with its obligations under the *SCM Agreement*, because:

- Korea through the KEXIM Act, KEXIM Decree and Interest Rate Guidelines provides prohibited subsidies, inconsistent with Article 3.1 and 3.2 of the *SCM Agreement;*

- Korea through the establishment and maintenance of the APRG and preshipment loan programmes provides prohibited subsidies, inconsistent with Article 3.1 and 3.2 of the *SCM Agreement;*

- Korea through individual grants of APRGs and preshipment loans provided prohibited subsidies, inconsistent with Article 3.1 and 3.2 of the *SCM Agreement;*

- Korea, by providing subsidies to Daewoo-SME/Daewoo-HI, Samho-HI/Halla-HI, and STX/Daedong through (i) workout plans and restructuring plans; (ii) tax concessions provided to Daewoo-HI/Daewoo-SME; and (iii) the grant of KEXIM APRGs and pre-shipment loans, has caused serious prejudice to the interests of the European Communities in violation of Articles 5(c) and 6.3(c) of the *SCM Agreement*.

45. The European Communities considers that the above violations of the *SCM Agreement* have nullified and impaired benefits accruing to it under the WTO Agreement and accordingly asks the Panel to recommend that Korea withdraw these subsidies or remove the adverse effects of the actionable subsidies in accordance with Articles 4.7 and 7.8 of the *SCM Agreement*.

ANNEX A-2

FIRST WRITTEN SUBMISSION OF KOREA

(9 February 2004)

I. OVERVIEW AND INITIAL MATTERS

1. Overview of the evidentiary deficiencies and legal omissions of the EC's First Submission -- The European Communities ("EC") has failed to establish a *prima facie* case with respect to its claims that Korea has provided export subsidies prohibited under Part II of the Agreement on Subsidies and Countervailing Measures ("SCM Agreement"), and actionable subsidies inconsistent with Part III of that Agreement. The EC has fundamentally misunderstood the requirements for meeting its burden of proving its case with established and proven facts and has, instead relied on mere assertions without proving the facts establishing such assertions.

2. Having refused to carry the burden of proving the facts it asserts, the EC then claims that Korea, as respondent, has the burden of disproving the EC's assertions, but must, however, prove all facts it asserts in that process. This reflects a profound mis-reading of the *Japan – Apples* decision which only drew a distinction between proving facts and establishing claims. The Appellate Body made clear the nature of the two step process of demonstrating a *prima facie* case and in no way relieved complainants of the burden of proving the case with demonstrated and established facts as required by the WTO treaty and general principles of international law.

3. Beyond mere assertions, the only "evidence" the EC provides in support of its claim regarding prohibited subsidies comes from an improper use of the SCM Agreement's Annex V process which is explicitly limited to developing information regarding serious prejudice cases under Part III thereof. The EC then goes on to attempt to improperly request that adverse inferences be drawn against Korea for allegedly not providing certain evidence under Annex V pertaining to export subsidies.

4. The EC's first submission does not present evidence or even address critical elements of establishing that adverse effects, within the meaning of Part III of the SCM Agreement, were caused by alleged Korean subsidization. The EC fails to establish that there was even a financial contribution in the context of the restructuring process that took place with respect to three Korean shipyards, i.e., Daewoo, Halla and Daedong. Financial contributions imply two participants in any alleged transfer, but the transactions identified by the EC do not meet these criteria. Moreover, the EC has not identified any current recipients of any benefits that allegedly arose with respect to such transfers. Finally, the EC's allegations regarding restructuring are based on a reading of the SCM Agreement that would require that insolvent companies be terminated and exit the market. There is no basis in the treaty for such a reading and its adoption and the associated undermining of every Member's insolvency laws would wreak havoc on the world's market economies.

5. The EC's failure to identify the "like product" is a fatal flaw in any attempt by a complainant to establish a *prima facie* case of serious prejudice under Part III. Having suggested using the tests for determining "like products" derived in the jurisprudence of Article III of the GATT 1994, the EC then failed to identify the like product based on arguments or evidence in accordance with such tests. The identification of the "like product" is a basic element of any trade effects-type determination with

which, as a matter of law, no countervailing duty investigation could be initiated under Part V of the SCM Agreement.

6. The EC fails to identify, and *a fortiori* to prove, the existence the "serious prejudice" that it has experienced either with respect to the industry(ies) producing the unidentified like product(s) or to its broader interests. To the extent that it even identifies a standard, it attempts to use the lower standard of *material* injury rather than *serious* prejudice.

7. The EC has failed to establish any causal link at all between the alleged subsidies themselves and the asserted serious prejudice as is required by Article 6.3(c) of the SCM Agreement. It has improperly attempted to rely on a link between the products and the alleged serious prejudice. Even then, the EC does not differentiate products made by Korean shipyards that did not undergo restructuring.

8. Contrary to the requirement under Article 6.3(c) of the SCM Agreement which provides that causation has to be by reason of the effects of the subsidy itself, the EC fails to present any evidence to establish that any alleged serious prejudice was not caused by factors other than the alleged subsidies such as competition from shipyards in Japan or other countries or the effect of the closed nature of the Japanese market which it acknowledges. Moreover, the EC Commission's Third Report on World Shipbuilding identifies the decades of the EC's heavy subsidization of its shipyards as a factor in the lack of competitiveness of the EC yards. The EC also does not address other matters such as the sharp appreciation of the Euro, and so forth.

9. The EC does not attempt to calculate the level of the alleged subsidization and rests with throwing out some unsupported and unexplained numbers with respect to the alleged restructuring subsidies. It further claims the right to present some econometric or other studies should either the Panel or Korea challenge its assertions. The EC misunderstands that this and other elements of proving its case do not entail further rights for the EC, but, instead, are obligations that it has failed to fulfil.

10. Article 13 of the Dispute Settlement Understanding ("DSU") provides the Panel with certain investigative powers but the Appellate Body has made it clear that there are limits on how these are to be used. In *Japan – Agricultural Products II*, the Appellate Body stated that: "A panel is entitled to seek information and advice from experts and from any other relevant source it chooses, pursuant to Article 13 of the DSU. . . to help it understand and evaluate the evidence submitted and arguments made by the parties, **but not to make the case for a complaining party**."[1]

11. Preliminary Ruling Requests -- Korea has asked for certain clarifications of issues left from the Panel's preliminary rulings.[2] Specifically, Korea has asked for clarification that the dispute is actually limited to commercial vessels and that the only claim pursuant to Article 6.3 is with respect to paragraph (c) of Article 6.3. Korea has also requested the Panel to rule that the dispute is limited to Article 5(c) as there are no arguments or even mention of Article 5(a) in the EC's first submission. Korea has also requested that the Panel rule that price undercutting under Article 6.3(c) and 6.5 is no longer included in the dispute as it is not addressed in the EC's first submission.

12. Korea re-iterated its request that the Panel consider the question of the EC basing claims under both Part II and Part III of the SCM Agreement on the same alleged export subsidies. Unlike every other provision of the WTO agreement, Part III SCM disputes require a showing of adverse effects. Thus, basing two separate claims under both Parts on the same subsidies can result in double-

[1] Appellate Body report in *Japan – Agricultural Products II* at para. 129. (emphasis added)

[2] Korea incorporated by reference its Preliminary Ruling Request as there were a number of issues in the request that the Panel decided to defer until later.

counting. This could result in attributing prejudice to non-injurious actionable subsidies based on the combined effect of such subsidies and export subsidies that have already been remedied elsewhere.

13. Korea asked the Panel to address the EC's misleading statements made to the Panel regarding Korea's preliminary ruling request as well as address the further evidence of abuse of the Annex V process. Korea noted that the EC asked the facilitator on 8 August 2003 to gather evidence on all products made by companies receiving KEXIM support as this purportedly was part of the EC's serious prejudice claims. On 5 September 2003 the EC told the Panel that it had "never" made any serious prejudice claim beyond commercial vessels. This mis-statement was made in order to avoid dismissal of the dispute for failure to identify the like products subject to the adverse effects claim.

14. Furthermore, the evidence submitted in the EC's first submission demonstrates that the EC used the Annex V process improperly to gather evidence to support an export subsidies claim that it did not have any support for. This is confirmed by the EC's request for adverse inferences on Part II claims under Annex V even though Annex V is explicitly limited to serious prejudice issues. Korea had raised concerns about the undue breadth of the Annex V requests for information in a number of respects, including concerns that the EC was using it with respect to its export subsidies claims. The EC denied that it was using the process for anything other than the adverse effects aspects of its claims with respect to the alleged export subsidies. This has been revealed as incorrect by the EC's first submission.

15. In order to protect its rights as well as the integrity of the dispute settlement process, Korea has asked the Panel to take appropriate steps in response to these abuses.

II. ALLEGATIONS OF PROHIBITED SUBSIDIES

16. The EC has alleged that the KEXIM Act and the Advanced Payment Refund Guarantee ("APRG") and pre-shipment loan programmes "as such" violate the provisions of Part II of the SCM Agreement. In order to prove the claim, the EC must establish that the Act and the programmes on their face are violations of the SCM Agreement. It is insufficient to argue that they *may* be interpreted and applied in such a manner. To find that a mere possibility of applying a law in a manner inconsistent with WTO obligations renders the law *per se* illegal would require all WTO Members to undergo a massive vetting and amending of all of their laws and regulations which would serious undermine the sovereign rights of WTO Members. Aside from the practical impossibility of such a course of action, it would be a major change in the jurisprudence of the GATT and WTO and not in accord with the terms of the treaty.

17. The EC has failed even to properly identify what measure is involved in its claims that the APRG and pre-shipments programmes are inconsistent with Part II of the SCM Agreement. These are not measures with identifiable parameters that one can point to and state that there is compelled action that could be inconsistent with the SCM Agreement. Rather, the two programmes are applications of the KEXIM Act and KEXIM's policies which further require KEXIM to extend financing facilities on a market-oriented basis. The remainder of the dispute with respect to the EC's claims under Part II of the SCM Agreement illustrates that there can be no violation "as such", for it is a fact-intensive inquiry as to whether, for instance, a benefit has been provided by a government or public body through government practice. Moreover, even if there was a *prima facie* violation of Article 3 of the SCM Agreement, the availability of safe harbours under items (j) and (k) of Annex I, the "Illustrative List", would nonetheless apply in the present situation. Thus, there can be no violation with respect to the KEXIM Act or the APRG and pre-shipment loan programmes as such.

18. KEXIM is not a part of the Government of Korea nor is it a "public body" for purposes of Article 1 of the SCM Agreement. Mere government ownership is insufficient to prove that it is a "public body". To establish the point, the EC must demonstrate that KEXIM is acting in a regulatory

or tax role, or a function that is analogous. The KEXIM Act provides a direction and general policy parameters within which KEXIM functions, but nothing more. The Government of Korea does not intervene in KEXIM's day-to-day operations. The facts are that KEXIM is required to act and has acted in a commercial and market-based manner. It is required to generate and has generated profits from its lending operations because credit is extended on a commercial basis.

19. The EC also has not demonstrated that there was a benefit provided to any of the shipbuilders identified by the EC. The EC has proposed inappropriate benchmarks as market rates ignoring substantial differences in the terms of the KEXIM loans and guarantees and the proposed benchmarks as regards factors such as collaterals, loan or guarantee periods or the past performance of the borrower or grantee.

20. The way in which the KEXIM premia and interest rates were built up from a base rate identified in the market plus spreads (also taking into account the creditworthiness of the borrower or grantee) demonstrate that KEXIM was operating on market principles in the APRG and pre-shipment loan programmes. This is confirmed when comparing these premium and interest rates against the closest comparable benchmarks in the market as was held by the Panel and Appellate Body in *Canada – Aircraft*. Korea also notes that the EC has failed to demonstrate any current financial contribution or benefit as is required by Article 1.1 of the SCM Agreement. The "evidence" offered by the EC relates primarily to the period of the financial crisis during which period market benchmarks for identical financing facilities were difficult to identify. In the more recent period, as financial markets have stabilized, the re-emergence of identifiable market benchmarks for identical facilities demonstrates the market-based nature of KEXIM's lending and guarantee programmes.

21. According to the Appellate Body, Item (k) of the Illustrative list in Annex I to the SCM provides by *a contrario* reasoning that export credits supplied by governments that cover the government's cost of borrowing are provided a safe harbour from the provisions of Part II of the SCM Agreement. Pre-shipment loans are made at rates higher than the government's cost of borrowing and, thus, are such measures as would fit within this safe harbour provision. By the same *a contrario* reasoning, guarantees and programmes covered by item (j) would also be within a safe harbour if the premiums charged were sufficient to cover the long-term operating costs and losses of the programmes. APRGs are such measures that would fit within the safe harbour because KEXIM has always earned a profit on the programme.

II. Allegations of Actionable Subsidies

22. Restructuring --The Government of Korea took actions pursuant to an agreement with the IMF to support its financial sector during the Asian financial crisis that began in 1997. According to the IMF agreement, Korea would require banks in difficulty to re-order their lending according to market principles. Korea was required to break down the interlocking system of financing that had left it vulnerable when the financial contagion spread from other countries in the region. It was also recognized that many commercial firms were insolvent and would need to go through some sort of insolvency procedure involving changes to their operational as well as their debt structures for the purpose of rehabilitation.

23. The IMF required that these procedures be undertaken based on market principles and that only firms that could demonstrate that there was a greater going concern value than a total liquidation value would be restructured.

24. The EC has wrongly adopted the position that the only market-based solution is termination of an enterprise and distribution of the assets. Despite efforts by the EC Commission to get the IMF to agree with their position, the IMF has maintained the position that Korea based the restructuring processes on market principles and successfully carried out their Agreement in this regard.

Commentators, including some writing articles for the World Bank, agree that Korea has pursued economically efficient and transparent restructuring procedures.

25. The EC has not been able to demonstrate that the restructuring process resulted in subsidies being provided to the three shipyards it has identified. First of all, the EC has failed to establish that there was any government involvement in the restructuring process either through the government or banks as public bodies. The EC has made numerous factual errors regarding the extent of the role of government-owned banks. Moreover, the EC has failed to establish that these banks were acting in a governmental role. On the contrary, the evidence is that they were acting on normal market principles and in their best self-interest to maximize the recovery of their debts throughout the restructuring process and, thus, acting in a manner fully consistent with any privately- owned bank.

26. Mere government ownership and broad policy parameters for lending activities do not render a bank a public body. It is common for liquidity to be provided to financial systems in developing countries through government-owned banks. It is not unfamiliar even in developed countries for different types of lending institutions to have different charters by law that restrict their operations to certain sectors. This is even more important in developing countries where expertise and capital may be scarce. The EC must show more than mere government ownership and general policy parameters for operations. The EC does not and, instead, offers only assertions and allegations unsupported by facts.

27. Further, the EC has failed to show that the Government of Korea directed or entrusted any private banks to provide "financial contributions" within the meaning of Article 1.1(a)(1), to the three Korean shipbuilders. The actions by the Government of Korea during the Asian financial crisis to stabilize its overall financial market do not constitute evidence of direction or entrustment with respect to the three restructurings in question. These general actions aimed at averting a national financial calamity cannot be considered as constituting the type and level of "explicit and affirmative action of delegation or command" as found by the panel in *US – Export Restraints*. All of the private financial institutions acted in their own commercial best interests to maximize the recovery of their outstanding debts from the insolvent companies.

28. The EC has failed to demonstrate that the measures upon which it bases its claims involved "financial contributions" at all. In all of the instances of loans restructurings and debt-for-equity swaps, there was only one party involved, namely the group of creditors, for the creditors became shareholders of the new companies. It is inherent in the notion of a financial contribution that something must be transferred from one entity to another. An entity cannot "contribute" something to itself.

29. The Appellate Body has made it clear that it is also inherent in the notion of a financial contribution providing a benefit that there be a recipient. In this case, the EC has not even identified any such alleged recipients or addressed this issue. The Appellate Body has ruled twice[3] (at the EC's request) that recipients must be currently benefiting from the alleged financial contributions. The EC has completely failed to identify any current beneficiaries of the alleged financial contributions.

30. Even if there were considered to be financial contributions and recipients, the EC has failed to demonstrate how such persons benefited from such measures. As noted above, the EC's primary argument is that the market allegedly required that the firms in question be wound up and exit the market. Such an extremist position is neither supported by the treaty text nor by logic.

31. In each of the three corporate restructuring instances identified by the EC, outside consultants or the insolvency court -- working objectively and without any government influence -- determined

[3] *US – Lead and Bismuth II* and *US – Countervailing Measures on Certain EC Products*.

that the three firms in question had positive going concern values, i.e., greater than their liquidation and wind-up values.

32. With respect to Daewoo, a private workout was undertaken based on the so-called "London Approach" developed in the United Kingdom during financial difficulties experienced there. The London Approach was suggested in order to provide market-based parameters for workouts that could be undertaken on a faster time frame than court-based procedures. Workouts were voluntary and required the approval of a super-majority of creditors. With respect to Hall and Daedong, court-based procedures were followed in which creditors still had a role in evaluating and voting on restructuring packages with the Courts providing oversight and final approval. In all three cases, the shareholdings of the original shareholders were largely or totally extinguished. The creditors took control of the companies with ownership based on the seniority and quantity of the loans in question.

33. In one restructuring case, the EC offers a contrary benchmark of a few foreign banks that had minor debts in the restructured company, and attempts to claim that the restructuring was not done according to market principles. These foreign banks were operating in a totally different set of circumstances than the Korean banks and it is to be expected that banks with different perspectives will negotiate somewhat differently. Furthermore, when the totality of the circumstances is looked at, the results are essentially similar. In two court-supervised reorganization cases, the EC goes on to offer an "outside investor/lender" standard; however, this cannot provide an appropriate benchmark for commercial behaviour of the then current creditors who had to collect their non-performing loans from the insolvent companies for the sake of their own credit ratings and compliance with BIS requirements. All of the restructurings took place pursuant to market-oriented terms where all financial institutions which were then creditors of the insolvent companies worked to maximize their financial returns on their outstanding loans.

34. Alleged tax subsidies – The EC alleged that certain tax provisions that applied in the case of the reorganization of Daewoo Heavy Industries ("DHI") constituted subsidies. However, the evidence shows that DHI did not take advantage of some of the alleged provisions. With respect to others, the EC has failed to show specificity. These are generally available corporate tax provisions that are found in most modern tax systems. Spin-offs involving no changes in ownership typically are not taxable events. The EC has provided no evidence that the tax provisions in question are of the type described in Article 1.1(a)(1)(ii) of the SCM Agreement.

35. Serious Prejudice -- The EC has failed to provide any evidence or argumentation with respect to serious prejudice. The EC has attempted to use the injury standards from countervailing duty investigations even though it is clear from the words and structure of Article 5 of the SCM Agreement that there is a distinction. The EC has ignored the Appellate Body's findings to the effect the term "serious" connotes a much higher degree of injury than "material".[4] The EC draws conclusions from Part V of the SCM Agreement as to what is required in a serious prejudice case. However, the EC fails to understand that Part V merely provides guidance as to what must be included in the assessment but that this is not sufficient to find serious prejudice. The EC must go beyond the elements required in a countervailing duty investigation to establish that there is serious prejudice caused by the alleged subsidies.

36. Geographic Market and "Like Product" Definitions -- The EC has not properly defined the geographic markets. The EC claims that there is a world market, but that is not consistent with the requirements of Article 6.3(c) that Member state markets be identified. When the drafters wished to consider world markets as appropriate, they made it explicit as in Article 6.3(d). Moreover, the EC leaves unexplained the implications of its assertions elsewhere that the Japanese market is closed for foreign-built vessels or market segmentation possibly caused by such factors as the US Jones Act.

[4] See, Appellate Body Report in *US – Lamb*, paras. 124, *et seq*.

37. As noted above, the EC has not even identified the "like products" that it considers the subject of the dispute. It refers in some places to a single product "market" implying a single like product for all commercial vessels. In other places, the EC offers three general categories of products. However, even though the EC has itself suggested that the jurisprudence of Article III of the GATT 1994 can provide guidance, the EC does not offer any of the elements of proof examined in such cases. There is no discussion of comparative physical characteristics. There are no discussions or market studies offered regarding cross-elasticities of demand or other measures to demonstrate competitiveness of products. There is no evidence of consumer preferences or end uses in the EC's submission. The EC offers no evidence as to whether it is appropriate to group small feeder container ships with large post-Panamax container vessels. Nor does the EC offer evidence as to whether there is a competitive relationship or lack thereof between LNG tankers and chemical tankers. The vague and empty nature of the EC's presentation in this regard is illustrated by the way it groups product tankers with container ships in one place and then hops them into the same category as chemical tankers in another. There is total silence as to whether there are common end uses, common physical characteristics or any cross-elasticities of demand. The discussion of the case simply cannot proceed without evidence and argumentation on this critical point from the complainant.

38. Without proof of like product categories, a national investigating authority would not be permitted even to initiate a countervailing duty investigation pursuant to the provisions of Part V of the SM Agreement. It is even more important in a case such as the present dispute, where there is no investigating authority, for the complaining party to carry its burden of proving a *prima facie* case. A complainant must establish the basic elements of its case by the first stage of the process or the whole proceeding itself threatens to become a mockery of due process. It is impossible for the respondent to respond or the Panel to evaluate a case when basic elements of the complainant's case are missing.

39. Condition of the Industry(ies) -- The EC has offered only the most cursory allegations regarding the condition of its industry(ies). There are some general allegations made, but no hard evidence that its industry(ies) are suffering serious prejudice at all, much less serious prejudice caused by alleged Korean subsidies. The EC's shipbuilding industry(ies) may be in perfect financial and overall economic health. There is no evidence provided to the contrary. Indeed, to the extent there is any evidence, it comes from Korea which has noted that the EC Commission has admitted in its Third Report on World Shipbuilding that the decades of heavy subsidization provided by the EC Member states to their shipbuilding industry(ies) have been counter-productive and have resulted in a lack of normal adjustment to technological and market developments.

40. Causation -- The EC does not establish causation of serious prejudice by the alleged subsidies themselves. The EC has attempted to rest its whole causation case on price depression in LNGs and price suppression in other products. The EC has abandoned its assertions of price undercutting and lost sales.

41. The EC has failed to establish that any price suppression or depression that exists in any product market(s) is "significant" as required by the treaty text. Price suppression allegations are based on assertions regarding increases in freight rates, cost of production or demand. Not only does the EC ignore other important factors that are present in the market such as efficiencies, changing demand and technological changes but, in addition, it bases its claims on general factual data without distinction by vessel type though market developments differed per type of vessel concerned. The EC notes the effects of currency fluctuations and makes allegations based on the relative increase of the Korean won. However, the EC ignores the even more dramatic rise in the Euro both with respect to the dollar and to the won.

42. The EC's own shipbuilding expert has concluded that EC and Korean vessels compete only within two limited product segments, feeder container vessels and small chemical tankers and has

affirmed clearly that in these segments, there is a significant presence of shipyards from other shipbuilding nations which influence prices. Hence, it is impossible to attribute price depression and suppression to all Korean ships indiscriminately or even to the Korean feeder container vessels or small chemical tankers. The EC has ignored the reality of the shipbuilding market, namely that vessels have increasingly become commodity-products with a corresponding decrease in prices starting from the early 1990s well before any of the alleged corporate restructuring subsidies were being granted.

43. In asserting its causation allegations, the EC does not differentiate between ships produced by the three entities that emerged from restructuring and the ships produced by the other Korean shipbuilders who did not undergo such processes. This is even more bizarre when the EC bases so much reliance on cost calculations. The EC seems to be making some sort of back door antidumping argument that Korean shipbuilders are selling below cost and therefore must be subsidized. The EC's evidence on the cost issue is deeply flawed and highly artificial. It would be unpersuasive in an antidumping case, but its role in a serious prejudice case is inexplicable. Moreover, this lack of differentiation between the restructured yards and others demonstrates the lack of value of such an approach. If Korean yards are operating on the same cost basis, as implied by the EC, then it serves as proof of lack of an effect of the alleged subsidies themselves if the unrestructured yards and restructured yards are selling on the same basis. Indeed, the instance of a lost sale alleged by the EC was with respect to a yard that was not subject to restructuring.

44. Furthermore, the EC does not provide any calculations for the levels of subsidization. It provides mere assertions at the end of its submission regarding the alleged restructuring subsidies but does not offer any support for the alleged levels of subsidization that it asserts. Indeed, the underlying calculations are not even provided so that neither Korea nor the Panel is able to see what elements went into these asserted numbers. The EC completely fails to provide any calculation of the alleged tax subsidies or the export subsidies. Without these calculations and full evidentiary support, the EC's case necessarily fails.

45. The EC claims a right to provide some sort of economic arguments at a later stage if any one challenges its bald assertions. However, there is no right to be maintained in this regard; rather, it was the EC's **obligation** to prove its case with established facts and sufficient arguments in its first submission. Korea recalls that the Appellate Body has specifically instructed panels that they are not to make the complainant's case for it.

ANNEX B

EXECUTIVE SUMMARIES OF THE ORAL STATEMENTS OF THE PARTIES – FIRST MEETING

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ANNEX B-1

ORAL STATEMENT OF THE EUROPEAN COMMUNITIES

(18 March 2004)

I. INTRODUCTION

1. In its oral statement, the EC first responds to a series of procedural and other obstacles that Korea is seeking to erect to obstruct the resolution of this case. Thereafter, it comments on a number of other issues but leaves a thorough refutation of Korea's many arguments to the rebuttal submission.

II. KOREA'S ROAD BLOCKS

A. BURDEN OF PROOF

2. The EC fully accepts that it has the burden of presenting a *prima facie* case. The EC worked on the principle that it is not necessary to state the obvious. Such proof is necessary only to the extent that Korea disputes in a substantiated way what we considered to be clear.

3. For example, the EC believes that it is sufficient to simply state that EC and Korean Liquefied Natural Gas carriers (LNGs) compete in the same market. Indeed, Korea even accepts that they are *a product*, thus making it otiose for the EC to prove that Korean LNGs compete with those built by the EC in the same market. As will be explained later, we reject the idea that there is a requirement to establish "likeness"; however, once there is a product such as an LNG, LNGs from Members are inevitably "like" each other. They are the same product. To the extent that Korea now has difficulties with other statements of fact, e.g. the definitions of other ship types, the EC will respond to that more fully below and in its rebuttal submissions.

4. Moreover, once the complainant has provided a *prima facie* case of a claim and the defendant seeks to refute it by asserting an additional fact, the onus is on the party asserting that fact to substantiate it. To illustrate this with another example, the EC has provided *prima facie* evidence that restructuring aids and other subsidies were a contributing cause for the price depression in the LNG market. If Korea wishes to counter that case by asserting further factors that may have caused a fall in prices, Korea must provide proof thereof.

5. The EC does not accept that there is any "fruit of the poisonous tree" doctrine whereby it may not rely at all (or at least not for the export subsidy claims) on the evidence gathered in the Annex V procedure because it was allegedly improperly sought. As the Appellate Body clarified in numerous cases, there is a duty on both parties to collaborate in the establishment of facts. This is particularly true in cases against subsidies that often involve complex economic facts that may not be easily accessible to the complaining party. Moreover, it should be noted that panels may seek information from the respondent relating to export subsidies under Article 13 of the DSU. The fact-gathering procedure foreseen in Annex V of the *SCM Agreement* in effect merely advances the provision of evidence to before the exchange of submissions by the parties rather than gathering the same information from the respondent later in the panel process.

B. EXPORT AND ACTIONABLE SUBSIDY – INSISTENCE ON CURRENT SUBSIDIES AND EFFECTS

6. There is no rule in the WTO that provides that a violation is forgiven once it is in the past. Obligations are drafted in the present tense to express the intention that they should apply all the time – in the past, in the present and in the future!

7. Of course, it may not always be possible to remedy past violations of WTO obligations. However, the Panel is not, in these proceedings, required by its terms of reference to specify what action Korea may have to take to bring itself into conformity with its WTO obligations.

C. PUBLIC BODY AND "ENTRUSTED AND DIRECTED"

8. Nothing in Article 1 of the *SCM Agreement* limits the types of evidence that may be used to demonstrate that a subsidy, i.e. a transfer of economic resources, can be linked to the government. Otherwise, circumvention would be easy. To the contrary, Article 1 of the *SCM Agreement* is based on a certain experience with governmental practices when granting subsidies. Thus, governments often act through public bodies or private bodies that do not formally constitute part of the government. Instead of requiring that each transfer of resources is linked back to the government by a piece of evidence, Article 1 of the *SCM Agreement* presumes that money that is handed out by a public body, or a private body which is a funding mechanism, can always be linked to the government.

9. Thus, the purpose of the concepts of "public body" and "private body" is to presume a link to the government in certain situations and thereby to avoid circumvention. Any financial contribution granted by a public body is necessarily imputed to the State. Similarly, a benefit granted by a funding mechanism to which the government contributes is legally imputed to the government.

10. Korea cannot rely on the panel ruling in *United States – Export Restraints* in support of its view that there must be proof of an explicit action relating to a specific transaction. That case concerned a general government intervention in the market – export restraints for a certain product, as opposed to a specific action of a government in a specific situation.

11. The use of the terms "funding mechanism", "entrusts" and "directs" in Article 1.1(a)(1)(iv) of the *SCM Agreement* indicates that governments may use many different instruments to make a private body transfer resources. These terms are not to be interpreted narrowly in isolation from one another. They are intended to cover all the many different means by which governments may influence the behaviour of a private body. Therefore, panels are tasked in accordance with Article 11 of the DSU to determine the motivations of the private body for transferring the resources. If these can be linked to governmental action on the basis of all relevant evidence - even if circumstantial evidence, including secondary sources - this is sufficient.

D. KOREA'S CLAIM THAT EXPORT SUBSIDIES ARE EXEMPTED FROM THE DISCIPLINES APPLICABLE TO ACTIONABLE SUBSIDIES

12. Articles 3 and 5 of the *SCM Agreement* outlaw different forms of governmental behaviour. The absolute prohibition of export subsidies in Article 3 of the *SCM Agreement* targets any subsidy that is export contingent independently from its actual trade effect. The obligation not to cause adverse effects to the interests of another Member through the use of any subsidy (be it export contingent or not) requires demonstration of certain well-defined trade effects. Already the Panel in *Indonesia – Autos* has recognised that cumulative assessment of different types of subsidies is possible.

13. Korea's argument that a double violation would create a double remedy fails. Assume that Korea implements an adverse Panel finding that KEXIM pre-shipment loans are prohibited subsidies by making them also available for sales to domestic buyers. In such case, the subsidy would no longer be *de jure* export contingent. However, it remains a subsidy benefiting the production of ships and continues to contribute to serious prejudice. Whether a Member has brought all its subsidies in compliance with Article 3 and or 5 *SCM Agreement* may raise new and difficult questions. However, these are to be addressed in the implementation phase and are not relevant to the prior issue of establishing violations of WTO law.

III. THE EXPORT SUBSIDY COMPLAINT

A. THE THREE LEVELS OF THE EC COMPLAINT

1. The individual export subsidy transactions

14. The EC identified in its first written submission over 200 individual cases in which KEXIM has provided an export subsidy to the export of a ship. Korea argues that only presently existing subsidies may be attacked.

15. As discussed above, the EC does not believe that a violation is forgiven once it is in the past. The EC is therefore entitled to a finding that the 200 specifically identified KEXIM export subsidies violate the *SCM Agreement*.

2. The pre-shipment loan and APRG schemes

16. However, having these specific export subsidies removed (or expire) will not solve the underlying problem, which is that KEXIM will continue to grant export subsidies in support of future exports of Korean ships.

17. That is why the EC also attacked the subsidies at a second level – that of the pre-shipment loan and APRG **schemes**.

18. Korea admits that "until March 1998, KEXIM did not take credit risks into account for its APRG transactions" and then only gradually developed a credit risk policy.

19. Again, the EC considers that it is entitled to a finding that the APRG and pre-shipment loan schemes have been inconsistent with the *SCM Agreement*. Whether or not they still are today is a matter for the implementation phase of this proceeding.

3. The statutory framework

20. Korea's arguments illustrate the need to address the fundamental causes of export subsidisation in Korea and not just the specific export subsidy transactions or schemes – which can easily be changed in the future to avoid the defects found while still providing a subsidy to exports.

21. That is why the EC also formulated its export subsidy complaint at a third level – that of the rules governing the operation of KEXIM and effectively instructing and enabling it to subsidise exports – the KEXIM Act, the KEXIM Decree and the KEXIM interest rate guidelines. The EC has shown that KEXIM was set up to promote Korean exports, receives huge capital injections from the Korean government, does not have to pay any dividends to the Korean government, enjoys an unlimited State guarantee for its liabilities and deficits, and is prohibited from competing with

commercial banks. This inevitably leads to export subsidisation and therefore, according to the EC, the contested provisions of the KEXIM Act, the KEXIM Decree and the KEXIM interest rate guidelines are inconsistent with Article 3 of the *SCM Agreement*.

22. Korea's principal argument in response is to invoke the so-called "mandatory/discretionary doctrine", relying on the fact that, according to Korea, none of these provisions specifically mandate the provision of export subsidies.

23. The Appellate Body has warned against the mechanistic application of this doctrine and has also made clear that an analysis of a measure cannot end with the conclusion that it is in some sense "discretionary". It is necessary to continue the analysis to see whether the provisions have the prohibited effects.

24. One major reason why the mandatory/discretionary doctrine cannot be a mechanistic rule is that state measures are always, by definition, mandatory in some sense and very often leave some element of discretion. There are always some exceptions possible to any mandatory rule.

25. WTO provisions come in many different shapes and sizes. Some are result-oriented (for example, "no less favourable treatment") while others are regime-oriented (for example, those relating to investigations, transparency and domestic regimes). A provision that prohibits Members from maintaining schemes or programmes of a certain description is clearly violated if such a programme exists, even if it may not be applied.

26. As the EC has explained in its first written submission, Article 3, and in particular Article 3.2, of the *SCM Agreement* is designed to prevent the maintenance of export contingent subsidy regimes, as well as the grant of individual export subsidies.

27. In any event, the EC does not accept that the APRG and pre-shipment loan schemes are not "mandatory" in any relevant sense. First of all, the KEXIM Act, the KEXIM decree and the interest rate guidelines are mandatory for KEXIM. It is "mandated" to use the state resources put at its disposal to carry out the functions attributed to it in its governing instruments. These include the promotion of exports and the provision of financial assistance to exporters where this is not available from private sources – or is not sufficiently available or not available on such beneficial terms.

28. Even if it is not stated expressly anywhere that KEXIM must grant loans or guarantees, we do not believe that the senior management of KEXIM would stay in their jobs for long if they were to defy the statutory objectives of KEXIM, and either allow the resources entrusted to it to lie idle, or to support imports or domestic commerce. Indeed, the same would surely also happen if KEXIM were to use its state resources in defiance of the injunction in Article 24 of the KEXIM Act and compete with commercial banks.

29. Accordingly, the EC submits that KEXIM's statutory framework specifically envisages the grant of export subsidies – and indeed, for all practical purposes, effectively **mandates** such action. It is the very purpose of KEXIM to assist exports.

B. THE CONSEQUENCES OF A FINDING THAT ARTICLE 3 OF THE *SCM AGREEMENT* DOES NOT APPLY TO "DISCRETIONARY" MEASURES

30. Korea's position would allow an export-driven WTO Member to introduce a scheme whereby the Minister for export promotion could award any sum he considered necessary to ensure that a Korean exporter wins a contract against foreign competition, when he considers this in the national interest. Since the award of the subsidy would not be "mandatory" for the Minister, the scheme

would not, according to Korea, violate the *SCM Agreement*. So WTO Members would be required to bring action against each individual subsidy grant once it has been made. And then, they would only have a pyrrhic victory. The scheme itself would not have to be changed, according to Korea, because it would still be non-mandatory.

C. SAFE HAVEN ARGUMENTS

31. Pre-shipment loans and APRGs do not fall within the scope of the first paragraph of item (k) (in the case of pre-shipment loans) or items (j) (in the case of the APRGs) of Annex I to the *SCM Agreement*.

1. Pre-shipment loans

32. Korea attempts to pass off credits to exporters as export credits within the meaning of item (k). There is a clear and important distinction between these two concepts.

33. An export credit is provided to *buyers*, not exporters, *for a period that extends past the time of delivery*. The OECD, for example, defines the notion as follows:

> Broadly defined, an export credit is an insurance, guarantee or financing arrangement which enables a foreign buyer of exported goods and/or services to defer payment over a period of time. … Export credits may take the form of "supplier credits" extended by the exporter or of "buyer credits" where the exporter's bank or other financial institution lends to the buyer (or his bank).

34. Indeed, the fact that export credits may only take the form of 'supplier credits' or of 'buyer credits' as defined above, **is** "*the shared understanding*" of all OECD shipbuilding nations - including Korea. The notion was considered so obvious that at the latest discussions on a revised text of the "Sector Understanding on Export Credit for Ships" the parties agreed to drop a specific reference into the text.

35. This understanding of the meaning of export credits has also been implicit in WTO jurisprudence discussing the applicability of item (k) of the Illustrative List.

36. Korea's pre-shipment loans, by contrast, are production loans granted to manufacturers who engage in exporting certain capital goods from Korea independent of any credit granted to the buyer (who may be entirely unaware of this loan to the exporter). Furthermore, the period of the loan is closely tied to the date of delivery (hence "*pre-shipment* loans"). These are not the characteristics of export credits, which are loans provided, directly or indirectly, to buyers, extending past the time of delivery. Item (k) is simply not applicable to Korea's pre-shipment loans.

2. APRGs

37. Similarly, APRGs are neither export credit guarantees nor, as Korea argues in the alternative, guarantee programmes against increases in costs. APRGs are, instead, guarantees of credits to Korea's exporting manufacturers.

38. Export credit guarantees are those provided to a *bank* or to the *exporter* to guarantee that the foreign buyer will repay the export credit that has been accorded to him. APRGs, by contrast, are made available to foreign *buyers* to ensure the repayment of sums paid in advance of the delivery of a capital good, in the event of default by the exporting manufacturer.

39. Korea tries to rely, in the alternative, on a further element of item (j) and to present APRGs as a guarantee programme against increases in the cost of exported products.

40. Item (j) is expressed to cover guarantee programmes ***against*** increases in the cost of exported products. It is an increase in the cost of the exported *product* that is to be covered, not the overall *expenses* of the exporter or credit risks taken by the purchaser.

41. Korea's broad interpretation would allow any subsidy to the exporter or to exported products that is formulated as a "guarantee programme" to be covered by item (j) since any such subsidy will tend to reduce the cost of manufacturing the exported goods for the exporter or of buying the exported goods for the purchaser.

IV. THE ACTIONABLE SUBSIDY COMPLAINT

A. SUBSIDIES WITHIN THE MEANING OF ARTICLE 1 OF THE SCM AGREEMENT

1. Financial Contribution

42. The Government of Korea controlled the work-out of Daewoo even at the level of the *Corporate Restructuring Agreement*. Through that agreement, domestic banks had essentially waived their rights to act fully independently by committing to the workout as the solution for bankruptcy and subjecting themselves to penalties for breach of the Agreement. The fact that the *Corporate Restructuring Agreement* was negotiated and signed within one week shows that this was not done *voluntarily* by the financial institutions

43. The EC provided powerful general evidence with respect to how the Korean Government influenced the decision-making of private banks in the form of the Kookmin Bank brochure. In addition, public bodies such as KEXIM, KDB and KAMCO were major or substantial creditors for each of the shipyards. Without their exercise of the voting rights, none of the restructuring measures would have obtained the necessary approval.

2. Benefit Benchmarks

44. Foreign creditors are the only actual market benchmark. The only key difference between domestic and foreign creditors in this case was that foreign creditors "behaved independently and in their own self interest". Their behaviour serves as the starting point to consider whether the discretion of the Korean creditors in the work-out proceedings was bound by the governmental interest to rescue the companies.

45. Korea cannot refute that evidence of subsidisation by claiming that the work-out agreed to by Korean creditors was based on the results of an evaluation carried out by professional financial advisors (Arthur Andersen), and their conclusions that the going concern value of the debtor company was greater than the liquidation value, making the debtor company viable. The EC takes issue with the Arthur Andersen report on several grounds showing that the decision to restructure Daewoo, instead of liquidating it, was pre-cooked and that the Arthur Andersen Report is nothing but a rubber stamp, and certainly not evidence that creditors acting under market conditions would have opted for the restructuring.

B. SERIOUS PREJUDICE

1. In the same market

46. Unlike the provisions in Articles 6.3(a)-(b) and 6.3(d) of the *SCM Agreement*, Article 6.3(c) does not have any geographic qualification. In the shipbuilding market, national boundaries have hardly any effect on the shipbuilding business, because ships are not "imported" but may be entered on the shipping registry of any country and operated from any country in the world.

47. The idea that a world market is the relevant market in which to consider price depression was already recognised by the GATT Panel in *EC – Sugar (Brazil)*, under Article XVI:I. of the GATT 1947. In any case, even under Korea's own view, the Panel would need to consider the complaint of the EC, because the world market can be seen as the sum of the relevant national markets in which the products compete. Article 6.3(c) of the *SCM Agreement* does not prevent Members from claiming price depression and suppression on several - or even all - "national" markets.

2. No formal "like product" test

48. The EC takes issue with Korea's argument that a price suppression or depression claim under Article 6.3(c) of the *SCM Agreement* requires a formal "like product" analysis. First, the term "like product" used in Article 6.3(c) SCM semantically refers only to "undercutting". All Article 6.3(c) requires is that the subsidies have the effect of "price suppression, price depression […] *in the same market*".

49. Ships are made to the specifications of individual purchasers, and no two ships are ever likely to be precisely "like". In this respect, the market for ships is very different from that for cars, for example, where individual purchasers do not determine the size, shape and design of their vehicles themselves.

50. The term "same market" in Article 6.3(c) has not yet been defined in dispute settlement. Given that the definition of the market must enable the Panel to assess the existence of price depression or suppression, the existence of cross-price elasticity should play an important role in defining the relevant market. Korea itself agrees in the context of the discussion of price depression that ship prices are, of course, deeply influenced by the interaction of supply and demand.

51. Thus, the market must be determined in a way that allows consideration of both the supply and demand side. Korea's approach of considering only whether, from the perspective of the ship-owner, products are "like" does not allow a correct understanding of the functioning of the market. The relevant market should also be determined from the perspective of the producers, i.e. the shipyards.

52. The EC has identified three distinct markets for which price developments have to be analysed. These are the markets for LNGs, container ships, and product and chemical tankers as the EC has clearly stated in its first written submission. Korea does not dispute that LNGs are a relevant product for which a price and market exists.

53. The contours of the market for container ships and product and chemical tankers – like any other market – are determined by the behaviour of the participants, buyers on one side and sellers on the other. From the point of view of **ship-owners**, that is from the demand side perspective, distinctions between markets are driven by freight market considerations. Thus, although it is practically impossible (or, rather, economically non-sensical) to replace a specialised ship type with

another specialised ship type on major trading relations (i.e. substitute a container ship for an LNG), there is no such clear division *within* the categories of specialised ship types, e.g. container ships.

54. Although further distinctions can be made by ship size, there is no strict rule for such distinctions, and sub-divisions depend on who is making them and for what purposes. Moreover, at least on smaller routes, there is overlap and different sizes of ships of one type are generally substitutable.

55. From the point of view of a **shipbuilder**, that is from the supply-side perspective, there is even greater potential for substitution between products. In the eyes of a shipbuilder, a ship is an assembly of steel panels, into which is fitted machinery, pipes, cables, accommodation and so on, and the ultimate function of the ship is largely irrelevant. In the eyes of a shipbuilder, a tanker, a dry bulk carrier and a container ship are broadly similar products, even though the arrangement and proportions of the parts that are assembled differ in each product. Whilst shipbuilders seek to improve economic efficiency by building similar products, very few shipyards specialise in a single product type.

3. No obligation to quantify

56. There is no obligation to quantify the effects of subsidies unless a complainant wishes to use Article 6.1(a) of the *SCM Agreement* in conjunction with Annex IV, which is no longer in force. The existence of purely qualitative presumptions in Article 6(1)(b)-(d) of the *SCM Agreement* corroborates that an adverse effects claim can be made without a quantitative calculation.

4. Actionable subsidy to be demonstrated subsidy by subsidy

57. There is no obligation to make a price depression or suppression case on a vessel by vessel basis. Article 6.3(c) refers broadly to the effect of a subsidy on prices on a market. A price in the market is generally the average of numerous sales of numerous products. If Korea had its way, the reference to price depression or suppression would be redundant since all cases under Article 6.3(c) would require proving lost sales with respect to one particular vessel.

5. Additional Serious Prejudice requirement?

58. The EC considers that under Art. 6.3(c) of the *SCM Agreement*, a complainant must show that:

(1) there is price depression or suppression,

(2) such price depression or suppression is significant, and

(3) subsidies are *a* cause of significant price depression or suppression;

then

(4) *ipso facto*, the effect of the subsidies is serious prejudice to the interests of the EC

59. Subsidies need not be shown to be the exclusive cause of price depression or suppression. A cause is sufficient. In fact previous GATT Panel reports referred to the subsidies as "contributing" or "amplifying" cause.

60. Korea itself acknowledges that no "such other factors are present" and that overcapacity suppresses prices. The EC demonstrated that the preservation of the capacity of the restructured yards has led to price suppression in the Korean industry in general and in turn in the rest of the world. Moreover, the capacity of the three shipyards is substantial.

61. There is no basis in the text of the Agreement to require as Korea suggests a separate demonstration of "serious prejudice". The purpose of Article 6 of the *SCM Agreement* is to provide a definition of serious prejudice. Contextually, the structure of Article 6 supports the concept that all that is required is to show that one of the elements in Article 6.3 is fulfilled. Thus, Article 6.1 laid down a presumption of prejudice in egregious cases, which could only be rebutted according to Article 6.2 by showing that no serious prejudice existed as described in sub-paragraph 3. It follows that, whenever one of the elements in Article 6.3 is fulfilled, serious prejudice exists, unless there is a case listed in 6.7 whereby serious prejudice "shall not arise".

62. Korea's argument that some additional element of injury was required is contrary to principles of effective treaty interpretation because it would render the self-standing definition of serious prejudice in 6.3(c) redundant. However, the European Communities would like to highlight that its industry is seriously prejudiced by the price depressing and suppressing effects of Korean subsidies to shipbuilding.

ANNEX B-2

ORAL STATEMENT OF KOREA

(18 March 2004)

I. INTRODUCTION AND OVERVIEW

1. Korea would like to thank the Panel, the Facilitator and the Secretariat for all of their hard work on a number of difficult matters.

2. Before going further into the legal and factual questions before the Panel, Korea would like to recall some of the broader aspects of the history of this dispute including the financial crisis that swept into Korea from Southeast Asia and how the EC has dealt with its shipbuilding industry for decades.

3. The European shipbuilding industry has been the beneficiary of decades of heavy subsidization, particularly direct operating subsidies meant to convey a focused and specific competitive advantage. There have also been healthy doses of export subsidization which even the Commission has had to constrain (but certainly not stop). Regional subsidies, research and development subsidies (including a new programme to provide R&D subsidies of 25 per cent), restructuring subsidies (totally inconsistent with the EC's arguments before this panel) tied aid export subsidies, and so forth. The amount of subsidization provided to the EC shipbuilding industries is enormous. Indeed, it is so enormous that it lends new meaning to the term "floating currencies".

4. Large amounts of these subsidies have provided short-term bandages and kept in business small and uneconomical yards that have not had sufficient incentive to grow and learn and expand on their own. In fact, the EC in its Third Report on World Shipbuilding admitted that overall the subsidies, i.e. operating aid, has served to cushion yards from the full rigors of the market. The Commission in this report further stipulated that state aid needed to be refocused to promote and underpin efforts to improve the competitiveness, in particular lagging behind their Far Eastern competitors.

5. In distinct contrast with the EC's industrial policy of lavish subsidization, Korea faced, quite simply, a broad-based financial crisis that threatened to destroy the whole Korean financial sector and then bring the rest of the economy down with it. The inflows of capital that had underpinned Korea's economic growth in the past decades was focused on short term borrowing (generally in US dollars) that had been liberalized. The government had retained limitations on medium and long term borrowings. Due to restrictions on foreign borrowing by corporations, most of the borrowing was done by banks. Of course, many aspects of this are quite typical of rapidly developing countries. Very few countries have the luxury of being able to borrow in their own currency. However, as the financial contagion spread out of Southeast Asia, funds dried up regardless of the underlying health of the economy. Rapid depreciation of the currency exacerbated the liquidity problems.

6. The result was a classic credit crunch where money was not available for rolling over loans. Banks, faced with increasing liquidity problems themselves, began to call in their loans. Perfectly viable firms were caught in short term insolvency. In this situation the Government of Korea turned to the IMF to obtain funds to re-float the financial sector. After some tough negotiations, agreement

was reached between the Government of Korea and the IMF and interim funding was provided. In turn, the Korean government used these funds to provide liquidity to the banks. There were conditions attached to this provision of funds, but they were market reinforcing conditions. Banks needed to reduce their outstanding bad debts. They needed to meet BIS standards. They needed to ensure that all restructurings and workouts were done pursuant to market principles including maximization of returns from their debt.

7. In the IMF's view, Korea implemented this market-based approach with great success. As Korea has pointed out in its First Submission, in responses to the EC Commission's several requests, the IMF specifically made the point that they were very satisfied that Korea was undertaking this painful process based on market principles. Korea is not arguing that this panel is somehow estopped from pursuing its inquiries because of the IMF's position. Rather, the point is simply that the IMF's views in this regard are important factual evidence of Korea's market-based approach to restructuring to put in the balance when the Panel weighs the facts of the case.

8. Regarding the EC's approach to this dispute, instead of using its First Submission to set the framework of the dispute and to advance all of the facts and proof needed to support its *prima facie* case, the EC took the route of simply dumping thousands of pages of information in the Panel's lap (information provided by Korea, it must be noted) and asking you to take over proving their case for them. According to the EC, they consider that they do not need to do anything more than make mere assertions.

9. Obviously, the EC's approach is not consistent with the jurisprudence of WTO dispute settlement and neither is it consistent with the most basic tenets of due process required under general principles of international law. With respect to the Panel's duties, the Appellate Body in *Japan – Agricultural Products II* made it very clear in confirming long-standing jurisprudence. The panel is to use its information gathering authority to help it understand the parties' arguments, not to make the complainant's case for it.

10. Neither is the burden on Korea in this respect. Korea is designated by the treaty as being the "respondent" in this case. This means, sensibly enough, that Korea is obliged to answer the EC's arguments and refute its positions, to *respond* once the EC has established a *prima facie* case based on supported arguments and proven facts.

11. As Korea noted in its First Submission, the Annex V process involved serious abuses by the EC. Misleading statements were made by the EC to the facilitator and the Panel regarding the breadth of the product coverage. Related to that, the Annex V process was manifestly used in an improper manner to support a fishing expedition for facts to support baseless allegations of export subsidies. This is irrefutable. The EC's conflicting statements are contained in the record. Moreover, the "evidence" the EC provided to support its export subsidy claims clearly comes from the Annex V process. To make it worse, the EC then had the presumption to demand adverse inferences under the rules of Annex V for claims made under Part II of the SCM Agreement. Annex V is by its terms meant as a process related to serious prejudice. It has never been used by any other Member to try to gather evidence for export subsidies nor to claim legal authority for adverse inferences and it should not have been used in such a fashion here. These are serious matters that the Panel will need to address.

12. The two distinct sets of claims by the EC under Parts II and III of the SCM Agreement with respect to the same alleged subsidies present a unique issue for the Panel because failure to take account of this aspect of the case could result in a double-counting of subsidies in a manner that could result in inequitable findings and disproportionate remedies. Specifically, the EC has submitted claims with respect to the KEXIM programmes under both Parts II and III of the SCM Agreement.

These sets of claims raise serious questions about how to evaluate and remedy alleged violations. The overlapping claims of export subsidization and trade effects with respect to the same alleged subsidies risks the possibility of finding adverse effects caused by a combination of export and non-export subsidies when the non-export subsidies alone would not have resulted in an affirmative finding. That would be inequitable in a situation where the export subsidies would be remedied separately under Part II and should not therefore be included in determining whether a second remedy is appropriate. That would be double-counting and would be as inappropriate in this setting as parallelism problems have been found to be in Safeguards cases. Therefore, while it is true that multiple claims sometimes arise under multiple WTO provisions, no other WTO provisions are like Part III of the SCM Agreement. Unique circumstances require unique solutions.

II. ALLEGATIONS OF PROHIBITED SUBSIDIES

13. As an initial matter, the EC must establish that KEXIM bank is a so-called "public body". There is no firm definition in the SCM Agreement of what the term "public body" means. It is a case-by-case assessment that must be established by a complainant to the satisfaction of the Panel.

14. The EC points to government ownership of KEXIM. It is true that KEXIM is majority owned by the government. But it is well established that ownership alone is insufficient. The EC also points to a public policy purpose for KEXIM. Yes, the actions of KEXIM are focused on the export sector, but privately owned institutions can have sectoral charters, too. Many countries are familiar with this in their own banking systems. That does not make such institutions public bodies. Something more is needed.

15. It seems clear that something more is the issue of whether or not the entity is fulfilling a function that by its nature is "governmental". These include regulatory and taxation functions most predominantly. Conversely, entities that function on a commercial basis in their normal activities are not considered "governmental", as indicated in Article I of the GATS.

16. The EC has asserted that the KEXIM Act and the APRG and pre-shipment loan programmes are inconsistent with the requirements of Part II of the SCM Agreement, "as such". In order to get there, the EC looks for support in the Appellate Body decision in *US – Sunset Review*. However, the issue there was whether a non-legally binding measure could be challenged, not whether a discretionary measure could be challenged on an "as such" basis. In other words, the issue was a preliminary jurisdictional question as to whether there was a justiciable matter; it was not a question of whether the measure was mandatory or discretionary. Certainly there was no hint in the *US – Sunset Review* case that the Appellate Body intended to overturn substantial GATT and WTO jurisprudence regarding the distinction between discretionary and mandatory provisions.

17. Korea would also like to note that the APRG and pre-shipment programmes are types of lending activities; there is no underlying written rule to challenge. They are mere practices. This is the sort of question that was before the Appellate Body in *US – Sunset Review*. To the question as to whether the EC is legally permitted to pursue a claim against these practices, Korea would answer yes, provided of course that the EC presents proven facts and arguments to establish a *prima facie* case. However, to argue that two "programmes" that are really nothing but types of lending practice can be challenged "as such" as establishing the existence of prohibited export subsidies, simply makes no sense at all.

18. The KEXIM Act provides authorization for a wide ranging set of financial activities related to the export sector. It also requires KEXIM to act on a commercial basis to maximize returns and, in fact, the evidence is that KEXIM has consistently operated at a profit. KEXIM is required to set its base rates according to market conditions. Credit risk spreads must be taken into account; collateral is

required accordingly. KEXIM borrows funds from many sources, generally from international markets. And, contrary to what the EC asserts, KEXIM does in fact compete with other institutions. This requirement is clear from a review of the whole KEXIM Act, not just the snippet cited by the EC. Most importantly, it is quite clear from the facts in the record.

19. The so-called "market adjustment rate" in the APRG and pre-shipment loan programmes does not mandate below-market rates as is asserted by the EC. In fact, the market adjustment rate is not relevant to the setting of the basic rate which is *built up* from the cost of funds to determine the lending or guarantee rate. Rather, the market adjustment rate is a limiting factor on how much of a *downward* adjustment can be made under the discretion of the lending office. As is normally the case in any banking business, the bank officials in charge of disbursing loans and guarantees have a certain amount of discretion that they can exercise in making final offers in order to bring in business. This is typically based on competitive pressures, the customers' payment history, etc. The "market adjustment rate" is intended to limit the ability of the bank officials responsible for that portfolio to make too large a downward adjustment in setting rates.

20. On the issue of the existence of benefits to the recipients of the APRG and pre-shipment loans, as complainant, the EC carries the burden of demonstrating that these programmes were applied in a manner more favourable to the recipients than what was available on the market. The EC has not met its burden. Indeed, here again, we see only the most cursory analysis of the issue. The EC has offered the APRG rates charged by a couple of non-Korean banks several years ago to support its allegations. However, this is far from establishing a legitimate market benchmark. These APRGs represented a statistically irrelevant sample. Further, APRGs are a highly technical and specialized area and the guarantee rates can be influenced by an assessment of the customer's past performance and likely future performance. This can be very difficult to assess for a bank dabbling in the market from afar. In addition, the EC ignores the substantially different characteristics of these APRGs. The KEXIM APRGs were always secured by substantial collateral, including the so-called Yangdo-Dambo which establishes important security interests on the hull and materials. In contrast, certain foreign supplied APRGs only had a security interest in certain bank accounts for a minority of coverage of the guarantee.

21. It is also worth noting that the alleged below-market APRGs were advanced during the period of the Asian financial crisis. However, as noted at the outset, this was a difficult period during which funding and guarantees of any sort were difficult to obtain. The main concern of Korean banks was with meeting and maintaining BIS standards and issuing APRGs was adverse to maintaining BIS rates.

22. The selection by the EC of corporate bonds as a benchmark comparison to a pre-shipment loan is virtually a random grasp for an argument by the EC. The corporate bonds the EC refers to were of different terms than the programmes the EC compares them to. These bonds were generally for 3 years. In stark contrast, the pre-shipment loan programmes were for shorter periods of time, generally less than 6 months. The EC does not make any attempt at all to adjust for these term differences which is the most basic question in lending or to determine how the financial crisis impact these term differences. A review of the actual applicable corporate bond rates, as demonstrated in Korea's first submission, shows that in every instance, the actual bond rate was considerably lower than the EC's hypothetical rate.

23. Furthermore, the EC also ignores the fact that pre-shipment loans always carried other assurances. Generally, security interests were offered in the form of Yangdo-Dambo as well as other corporate guarantees and security interests of various types. The EC compares such loans with corporate bonds for which collateral was normally not provided. The question of security interests and guarantees is another major determinant of interest rate charges. Of the Korean shipbuilders,

Daedong offered collateral for its corporate bonds, but the actual Daedong bond rates were considerably lower than the hypothetical suggestions of the EC.

24. Finally, the other major factor that determines the rates for programmes such as these is the repayment history of the companies in question. These are narrow, highly technical banking practices and because they are related to the performance history of the companies and close analyses of the market, it is not something readily participated in by banks outside their familiar territories. This has been ignored by the EC. Thus, we can see that the so-called benchmarks offered by the EC against which to determine whether there was a benefit are quite dissimilar with respect to the three most important factors influencing interest rates.

25. Korea is confident that the panel will agree that the EC has not established its case with respect to the issue of alleged export subsidies. Nonetheless, again in consideration of the necessity of providing arguments on all issues, in the alternative Korea notes that it is clear that the so-called safe harbours provided by items (j) and (k) of Annex I to the SCM Agreement apply to the APRG and pre-shipment loan programmes, respectively.

26. With respect to APRGs, Korea notes that an export credit guarantee in item (j) refers to assistance to the export of a product and does not refer to who receives the guarantee. Indeed, the phrase "against increases in cost of exported products" assumes that it can be with respect to the exporter rather than the buyer. Costs are an exporters' concern while prices are the concern of buyers. As Korea has demonstrated, the APRG programme has always been profitable; it certainly has covered its long-term operating costs.

27. Pre-shipment loans should be considered export credits within the meaning of Item (k); again there is nothing in the language that identifies who must receive the credit or loan. Moreover, the pre-shipment loan programme provided for credit at rates above the KEXIM's cost of funds.

III. ALLEGATIONS OF ACTIONABLE SUBSIDIES

28. There is no more fact-intensive case under the WTO dispute settlement system than a serious prejudice case brought pursuant to Part III of the SCM Agreement. Here the complainant carries the full burden of establishing the equivalent of a CVD administrative record upon which to base the decision. It is a heavy burden indeed. And it is neither the Panel's nor Korea's burden. Only when the EC has satisfied its burden of proof is there an obligation of Korea as respondent to rebut those arguments and dispute the supporting facts. In the present dispute, the EC has not come even vaguely close to carrying its burden of proof. There are major and very basic elements of its case that have been left unaddressed.

29. The EC's failures in this regard are manifest and multiple. In its First Submission, the EC failed to identify the financial contributions it actually was referring to with respect to the three insolvent companies, Daewoo Heavy Industries (DHI), Halla and Daedong. In fact, as part of its confused presentation, the EC does not even separate out the three companies from their successors and refers to them with compound names separated by slashes. One of the major reasons for this attempt to blur identities is the failure to establish exactly who the EC is claiming received the alleged benefits of the restructurings. Indeed, the EC fails to establish that anyone at all had received any benefit from anything at all.

30. With respect to the so-called restructuring subsidies, there was no government direction in these cases. The Korean economy was in danger of going into a free fall and it had to call in the IMF. As a part of the IMF bailout, restructurings had to be market–based. In fact, all of the banks involved bargained hard in order to maximize their own returns. This was required by both financial and

corporate restructuring schemes and that was the extent of the Korean government's involvement. The EC certainly cannot maintain that a restructuring scheme requiring banks to act on market principles and maximize returns is somehow improper governmental involvement.

31. There were some government-owned banks involved in the restructurings. However, these were banks operating purely on commercial terms; there was no governmental function involved in their participation. It also should be noted that each bank is somewhat different even though the EC chose to try to lump everything together. Indeed, it seems the EC wants to lump every entity in the whole Korean economy into one great government entity. Aside from being a stale and unfortunate stereotype, it certainly has no basis in reality in the present situation nor in the situation that existed during the financial crisis.

32. The EC simply has offered no evidence that these restructurings did not take place on market terms. Instead, the EC makes the suggestion that the "market" dictated that these companies be terminated and cease to exist. One needs to be a little careful with the terminology here for "liquidation" proceedings often result in the companies emerging simply in another form and continuing to carry on the same operations. For example, International Steel Group, the second largest steel manufacturer in the United States, is made up of several bankrupt steel manufacturers that were "liquidated." It is a fundamental aspect of a market economy that there be some method of addressing financially distressed companies short of termination. Certainly there is no functioning market economy in the world that operates without some sort of mechanisms to restructure such companies. And indeed, even the French authorities proceed with the restructuring of and financial support to the Alstom group with the approval of the European Commission, notwithstanding the doubts expressed by outside auditors, Ernst & Young and Deloitte Touche Tohmatsu, as to the going concern value of the group. Having said that, there really is not a single norm against which to measure restructurings. That is the case even within the EC itself.

33. Korea has established insolvency mechanisms that commentators consider fair and transparent and which contain elements of US-style Chapter 11 procedures combined with a more German-style civil law approach. Perhaps, given the difficulty of establishing a single norm against which to measure the Korean cases, it becomes easier to see why the EC urges the Panel to adopt a standard that absolutely no country in the world lives by; namely, termination and exit from the market on the part of insolvent companies. But that is no standard at all.

34. In all three instances in this dispute, the market assessment was that creditors would receive higher returns if the assets continued to be utilized. Whether the process happened under court supervision or pursuant to private agreement as in the so-called "London Approach" makes no difference. For that also is a function of normal market factors. Creditors decide which route to take to maximize their returns. All routes are available; they are not limited. They decide what is best for them financially and then pursue that path.

35. Furthermore, in the context of these restructurings, the EC has even failed to identify a "financial contribution". The main transfers the EC has identified that could possibly constitute a financial contribution are the debt-equity swaps. However, it is difficult to see how those could be financial contributions from the government. Those transactions consisted only of creditors exchanging one financial instrument (debt) for another of precisely equal value (new equity).

36. Finally, the EC also has never identified who the alleged beneficiaries are of these supposed financial contributions. In light of the EC's success in two disputes that focused on this very question of identifying current beneficiaries, their silence is remarkable. The EC successfully argued that "in the case of a change of ownership (including privatization), the investigating member is under

obligation to (re)consider the conditions of application of the SCM Agreement."[1] It is remarkable that they ignore this, but it is not surprising. The fact is the EC cannot identify any current beneficiaries of the alleged subsidies. The debts were the responsibility of the prior equity holders. But these equity holders were virtually wiped out.

37. In the case of DSME and Samho Heavy Industry, the new owners were the creditors who found the value of their loans seriously impaired and were left with salvaging the best returns possible out of the insolvent companies. The new owners simply were looking for the best return on their new equity. In the case of STX Shipbuilding Co., Ltd., a non-creditor buyer (STX) bought out substantially all the ownership of the old Daedong and the proceeds of this buyout were paid out to the creditors of Daedong. Presumably, this simple set of facts is why the EC tries to hide the lack of current beneficiaries behind the blurring of the identities of the three companies when the EC keeps referring to the companies with compound names linked with slashes. However, that attempt to blur the identities only shows that the EC is focusing on the assets, not the legal or natural persons. But, as is also clear from the EC's successful cases, the Appellate Body found that "any analysis of whether a benefit exists should be on 'legal or natural persons' instead of on productive operations."[2]

38. At this point it might be useful to provide a few observations about the individual restructurings. In the case of Daewoo Heavy Industries (DHI), it went through a workout based on the London approach. This choice was made by the creditors following a study and assessment by the Korean affiliate of Arthur Andersen. The Arthur Andersen study showed that the going concern value of DHI -- and the shipbuilding group, which later became DSME, in particular – was significantly greater than the value if it were liquidated and wound up. This was a totally objective assessment; Arthur Andersen had no incentive to choose one path over another and a lot of pressure to give an honest view of the best means to maximize creditor returns.[3] Strangely, the EC also argues that the Korean creditors got less than they should have compared to some foreign creditors. It would seem, however, that what the creditors got was neither too high nor too low; it was what the market determined it to be.

39. Regarding these foreign creditors, it is important to recall that they were marginal credit holders, virtually *de minimis*. Moreover, the EC's basis for assessing the returns is not a complete picture. The foreign creditors largely cashed out their debt. The domestic creditors stayed involved through a debt restructuring which worked out well over a longer period of time. The foreign creditors did also receive some quantities of warrants allowing them to participate to a lesser degree in any later gains from the equity markets. Thus, the small group of foreign creditors chose to take more up front and less in longer term participation than the domestic creditors. This is perfectly rational behaviour given the different situations of the two groups. Moreover there is simply no evidence that these terms were anything other than the result of hard bargaining by all parties concerned.

40. The final settlement came pursuant to a long series of creditor meetings. The first DHI workout plan was blocked by some minority debtors, again highlighting the point made above of the power of small, determined groups in such a process. Further it is worth noting that it is factually incorrect to state that KAMCO had a significant influence in determining the final settlement since KAMCO participated in the DSME debt equity swap at a later stage of the procedure after the structure and basic terms of the restructuring had already been formulated by the other creditors.

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[1] EC's second written submission to the Panel in *US – Countervailing Measures on Certain Products from the EC* at para. 108.

[2] Appellate Body Report in *US – Countervailing Measures on Certain Products from the EC* at para. 110.

[3] See Arthur Andersen Report page 3 at para. 2 and annex 1 to the Arthur Andersen Report which stipulates the purpose of the assessment.

41. Halla took a somewhat different route into its restructuring. Halla went bankrupt and was sent through court-based restructuring under the Corporate Reorganization Act. The court-appointed receiver drew up a reorganization plan based on the assessment of a financial advisor. This advisor, Rothschilds, assessed that the value of the assets as a going concern was higher than the value on liquidation and wind-up of the business. The advisor recommended that the going concern be maintained by way of transferring all the assets to a newly established company. This course was approved by the court and the previous shareholders equity was extinguished. Pursuant to the reorganization plan, the Halla assets were transferred to a newly established company, RHHI, and the entity was renamed Samho Heavy Industries. Hyundai was given a contract to manage the business. Hyundai was also given a call option at the par value of new shares. When Hyundai did exercise its call option and purchased all the shares of Samho, the par value was greater than the net asset value so Hyundai paid the higher par value amount. The new entity now is no longer Samho, but Hyundai Samho Heavy Industries, Co., Ltd.

42. Daedong also went through the court-based corporate reorganization proceeding. In the case of Daedong, the court determined, based on a financial advisor's valuation report, that the going-concern value was higher than the liquidation and wind-up value. The court extinguished the shareholding of the previous controlling shareholder and reduced the holdings of the remainder by 80 per cent. The court then approved Daedong's appointment of an outside advisor, KPMG, to find a buyer for Daedong. KPMG sent out an Information Memorandum to 13 possible buyers including foreign interests. Six of these were then identified as potential investors. Ultimately, STX was the winning bidder. In later open-market sales, STX reduced its holdings from 97 per cent to 54 per cent as of late 2003.

43. The EC also has failed to establish that any of the alleged subsidies were specific to the recipients. Corporate workouts were widely available to any creditors that wished to use them. DHI's creditors used this approach, but so did many others involved in corporate restructurings of all sorts of companies in all sorts of sectors. If that was not considered appropriate by the creditors, then court proceedings were also available. The other two shipyards, Halla and Daedong, availed themselves of this process pursuant to the Corporate Reorganization Act. And so did thousands of other companies, again involved in all sorts of sectors.

44. As for the tax provisions, the EC does not seem to have fully understood the facts. The EC has also failed to show how the tax provisions resulted in "government revenue that was otherwise due" was forgone or not collected. This makes it practically impossible for Korea to specifically respond to the EC allegations on these tax issues. Moreover, there was simply nothing specific to DSME about the tax provisions in question. They are quite standard sorts of tax provisions generally available in most WTO Members.

45. While the lack of evidence of the existence of a subsidy in any of the restructurings is quite plain, it is still necessary for Korea to highlight the failure of the EC to establish serious prejudice or causation even if the Panel were to find that subsidies existed. The most elementary aspect of demonstrating serious prejudice and causation is to identify the "like product". Without this, nothing else can be meaningfully discussed. It is literally impossible to review the state of the EC's industry(ies) if they are not defined. One cannot try to assess the impact of the alleged subsidies unless one knows what like products they are associated with and, therefore, can gauge their impact on the like product market. However, the EC has completely failed to identify the "like products".

46. Rather remarkably, the EC proposed using an analysis like that in GATT Article III to establish the like product categories, but then did not provide any such analyses. Instead, we had constantly shifting proposals for something the EC identified as the "market", presumably as distinguished from "like products." But, even then, no supporting evidence was provided for any of

these potential like product categories. No market studies; no descriptions of the relative physical characteristics; no facts regarding end uses or consumer perceptions. Simply nothing at all.

47. The EC does not address the question of what EC interests have been seriously prejudiced and how that might have occurred. There is no evidence supplied about the state of the EC industry or "industries", since we do not know if the EC claims one or several industries. It seems clear from the scheme of Articles 5 and 6 that a showing of adverse effects must satisfy the requirement of a causal link to serious prejudice of specific EC industry(ies) producing the like product(s), but it must also involve something more. Presumably there was a reason the term "interests" was chosen rather than injury and it clearly implies something more than just the alleged damage to specific industry(ies) for a Member's "interests" are necessarily broader than just that. But, once again, the EC has provided no argumentation or evidence whatever.

48. The EC also did not provide any evidence on the level of the alleged subsidization. At the very end of its submission, the EC offered some numbers which it claims could represent the level of subsidization. These numbers are not broken down by programme; no supporting calculations are offered; no evidence is provided regarding how these numbers are derived. Instead we are presented with another instance where the EC insists that it reserves its rights to provide some sort of economic study should either Korea or the Panel challenge its unsupported assertions. Of course, the EC has no such right; rather, it had an **obligation** to provide supporting evidence and argumentation.

49. Without knowing what the level of the alleged subsidies are, it is impossible to make a causation argument with respect to the issue of serious prejudice. Perhaps not surprisingly, the EC makes no causation argument at all except to imply that even an apparently infinitesimally small effect of subsidization would satisfy the treaty language. One of the problems here is that the EC has collapsed a two-step analysis into one. The first step is to determine whether the effects of the subsidy are to cause, for example, significant price undercutting. Then, in step two, if the effects of the subsidy are to do that, Article 6.3 provides that such price undercutting may be one of several factors that may cause serious prejudice to the interests of the complaining Member. Actually, the EC is not just collapsing the two steps, it really is ignoring them altogether and trying to make an argument that the products have caused serious prejudice regardless of the effects of the subsidies themselves and regardless of the strength of the causal connection. Indeed, it is difficult to see what relationship the EC's arguments have to the treaty language at all.

50. It is important to recall that the largest shipbuilder in Korea by a large margin is Hyundai and it is not involved in these allegations. There are many others as well. The restructured companies make up a minority of production and the panel should not accept allegations from the EC based on the practices of the "Korean industry". The EC must differentiate the parts of the Korean industry that it is referring to in order to establish the necessary causal link. Vague references to the "Korean industry" are totally meaningless without both distinguishing the like products and distinguishing the companies.

51. In this regard, it is important to note that the largest measure of growth in the "Korean industry" – whatever that might mean exactly -- occurred prior to the alleged subsidization. That is, the factors shaping the market are clearly on display during a period in which the EC is not alleging subsidization. Of course, there are other factors at play here as well such as a severe global downturn, the rise of other new competitors, such as China, and the practices of longtime competitors such as Japan, but there is this one large anomaly sitting here at the outset that one must address. The EC has the most heavily subsidized industry pursuant to practices that have extended over decades and the EC Commission has acknowledged that these subsidies prevent the EC shipyards from adjusting to the market, to take into account changes in consumer demand, technology and competition.

52. There is also the question of why the EC narrowed its claims and excluded price undercutting and attempted to rely on some undefined market mechanism that could have caused the price suppression and depression that the EC alleges. The reasons are twofold. First, the evidence is weak with respect to price comparisons and causation based on the Korean ships. It is non-existent with respect to the effect of the subsidy. Second, a review of the language of Article 6.5 shows that among other elements, it refers to a comparison of the prices of the subsidized and "non-subsidized like products" (which, of course, is also reflected in Article 6.4). The EC cannot demonstrate that their ships are non-subsidized because, in fact, they are the most subsidized ships in the world.

53. What is absolutely critical here is that the panel not allow the EC to make a case on price undercutting but avoid the requirements of Article 6.5. As a matter of law, the EC cannot be permitted to do this. Thus, at every single step in this process the Panel must press the EC on just what the market mechanism is -- to the *exclusion* of allegations of price undercutting -- that is responsible for the serious prejudice the EC is alleging.

IV. CONCLUSION

54. In conclusion then the Panel is faced with a dispute where the complainant has been unable to prove facts or establish the requisite arguments to make a *prima facie* case with respect to any claims. The EC claims have continued to shrink to avoid matters that they cannot prove, but what is left is based on conjecture, innuendo and broad generalizations that read more like a newspaper article than submissions sufficient to carry the substantial burden of proof required of the complainant in this dispute.

ANNEX C

WRITTEN SUBMISSIONS AND ORAL STATEMENTS OF THE THIRD PARTIES

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ANNEX C-1

EXECUTIVE SUMMARY OF THE WRITTEN SUBMISSION OF CHINA

(16 February 2004)

1. INTRODUCTION

1.1 In its third party submission, China focuses on the following key points:

(1) Mandatory/discretionary distinction in the context of Articles 3.1(a) and 3.2 of *the SCM Agreement*;

(2) Establishment of a benefit;

(3) Causation analysis in the context of Article 6.3(c) of *the SCM Agreement*.

2. NON-MANDATORY LEGISLATION IN THE CONTEXT OF ARTICLE 3 OF THE SCM AGREEMENT

2.1 On the basis of the Panel report in *US – Section 301*, the mandatory/discretionary nature of a piece of legislation is not exclusively decisive on whether it can violate a WTO agreement. Such a determination depends on, most importantly, the particular obligations imposed by a WTO agreement at issue. The Appellate Body in *US – Sunset Review* stated that "the import of the 'mandatory/discretionary distinction' may vary from case to case".

2.2 Panels in previous proceedings have already ruled that the mandatory/discretionary distinction shall be applied in the context of Article 3.1(a) of *the SCM Agreement*, and that in order to establish that a piece of legislation, as such, violates Article 3 of *the SCM Agreement*, such legislation must mandate the grant of prohibited subsidies that are inconsistent with Article 3.

2.3 China is of the view that the mandatory/discretionary distinction should be applied in the context of Articles 3.1(a) and 3.2 of *the SCM Agreement*, and therefore, non-mandatory legislation cannot *per se* violate these provisions.

3. ESTABLISHMENT OF A BENEFIT

3.1 It has been ruled by the Panel and upheld by the Appellate Body in *Canada – Aircraft* that in establishing the existence of a benefit, the focus should be placed on the recipient of a subsidy instead of the granting authority.

3.2 China takes note that in establishing a benefit conferred by the KEXIM legal framework and the workout plan of Daewoo-HI/Daewoo-SME respectively, the European Communities attaches much of its emphasis on the granting authorities at issue and thus fails to comply with the interpretation made by the Appellate Body in *Canada - Aircraft*. Therefore, the evidence and arguments presented by the European Communities in its submission do not persuasively prove that there is a benefit in each of the instances.

3.3 In *Canada – Aircraft*, the Appellate Body interpreted that a financial contribution will only confer a benefit if it is provided on terms that are more favourable than those available in the market. In China's view, in the process of conducting such comparison with commercial terms, all pertinent factors that have a bearing on the comparison must be taken into account properly and comprehensively. China finds supports of its view from Article 14 of *the SCM Agreement* and a statement by the Panel in *Canada – Aircraft*.

3.4 In China's view, the European Communities fails to consider certain pertinent factors when assessing whether the KEXIM legal framework and the workout program applied to Daewoo-HI respectively confer a benefit. In the former instance, the European Communities does not take note of the underlying reason why other commercial banks do not provide loans or guarantees similar to those provided by KEXIM. In the latter case, the European Communities takes the action of foreign financial institutions as a benchmark without regard to factors that may affect the comparability of such a "benchmark".

4. CAUSATION ANALYSIS IN THE CONTEXT OF ARTICLE 6.3(C) OF THE SCM AGREEMENT

4.1 China is of the opinion that the phrase "*the* effect of *the* subsidy" in Article 6.3(c) of *the SCM Agreement* requires that the subsidy, *independent from other factors*, must have caused significant price suppression or depression. In this respect, China shares the same view with Korea.

4.2 China thinks that the European Communities fails to correctly consider the implicit meaning of Article 15.5 of *the SCM Agreement* and the GATT Panel report in *US – Norwegian Salmon CVD*, and such failure leads to no evaluation of "the effect of the subsidy" in isolation of other factors that were affecting the price of commercial vessels.

4.3 China is of the view that, in order to establish a causal relationship between the subsidy and price suppression or depression of the like product in the same market, two inter-related causal relationships should be established: first, the subsidy *causes* the subsidized company to suppress or depress the price of its own product; second, such suppressed or depressed product price *causes* the suppression or depression of the price of like product in the same market. Establishment of these two causal relationships calls for assessment of three factors:(1) the magnitude of the subsidy; (2) the effect of the subsidy upon the price of the product supplied by the subsidy recipient; (3) the suppression or depression effect of the price of the recipient's product upon that of the like product in the same market. China thinks these three factors should be collectively and consecutively considered in the causation analysis.

4.4 In China's view, the word "significant" used in Article 6.3(c) of *the SCM Agreement* calls for quantitative examination in the analysis on causal relationship. It should be shown that the subsidy causes *significant* price suppression or depression to the recipient's product price and thereby causes *significant* price suppression or depression of the like product in the same market. China considers that the requirement of "significant" should be considered and satisfied throughout the entire process of causation analysis.

4.5 China considers that, the European Communities, without presenting any actual figures to support its argument of quantitative effect of the subsidy measures at issue, fails to establish that the subsidy causes *significant* price suppression or depression.

5. CONCLUSION

5.1 In conclusion, China is of the view that,

(1) Non-mandatory legislation cannot, as such, violate Articles 3.1(a) and 3.2 of *the SCM Agreement*;

(2) When establishing a benefit, focus should be placed on the recipient of the subsidy, and proper and comprehensive consideration must be given to all pertinent factors that affect the comparison with commercial terms.

(3) Article 6.3(c) of *the SCM Agreement* requires that in order to find a causal relationship between the subsidy and the significant price suppression or depression of the like product, it should be established that the subsidy, independent from other factors, and through the suppressed or depressed price of the product of the subsidy recipient, causes significant price suppression or depression of the like product in the same market; the term "significant" should be taken into account in the entire process of causation analysis.

ANNEX C-2

ORAL STATEMENT OF CHINA

(9 March 2004)

1. Thank you, Mr. Chairman, and members of the Panel. It is a pleasure to appear before you today to present the views of China in this proceeding. I wish to highlight certain aspects of the issues addressed in our written submission.

I. NON-MANDATORY LEGISLATION IN THE CONTEXT OF ARTICLE 3 OF THE SCM AGREEMENT

2. One of the key issues in this dispute is whether non-mandatory legislation can as such violate Article 3 of *the SCM Agreement*. In its written submission, China submits that the mandatory/discretionary distinction should be applied in the context of Articles 3.1(a) and 3.2 of *the SCM Agreement*, and therefore, non-mandatory legislation cannot *per se* violate these provisions.

3. First, the Panel in *US – Section 301* stated that, the mandatory/discretionary nature of a piece of legislation is not exclusively decisive on whether it can violate a WTO agreement. That Panel believed that the most important point under consideration should be the precise obligations contained in the particular WTO provision at issue. The Appellate Body in *US – Sunset Review* also had the view that "the import of the 'mandatory/discretionary distinction' may vary from case to case".

4. Second, WTO precedents show that, in order to establish that a piece of legislation, as such, violates Article 3 of *the SCM Agreement*, such legislation must mandate the grant of prohibited subsidies that are inconsistent with Article 3.

5. Third, China does not agree with the European Communities that the word "shall" in Article 3.1(a) of *the SCM Agreement* should be understood as prohibiting non-mandatory legislation providing for the grant of export subsidy. The Appellate Body in *United States – Section 211* held that it cannot be assumed that a WTO member will fail to implement its obligations under the WTO Agreement in good faith. Accordingly, it may not be appropriate to assume that KEXIM will act, under the legal framework of the KEXIM Act, inconsistently with the SCM Agreement. In addition, China believes that in the case of non-mandatory legislation where the grant of export subsidy and its export contingency may still be pending on the exercise of discretion enjoyed by the government, it is not reasonable to come to a conclusion that the legislation *per se* constitutes an export subsidy and hence should be prohibited.

6. Nor does China agree with the European Communities that the term "not maintain" used in Article 3.2 of *the SCM Agreement* should be interpreted as "prevent". The European Communities also submits that the ordinary meaning of "maintain" is to cause something to continue. Logically, the term "maintain" only points to existing things while "prevent" is used to address something that does not exist but may occur in the future. Therefore, to interpret "not maintain" as "prevent" would expand the obligation imposed by *the SCM Agreement* and thus fails to comply with Article 3.2 of the DSU.

II. ESTABLISHMENT OF A BENEFIT

7. The second key issue China would like to address is establishment of a benefit. In this dispute, the European Communities challenges certain Korean measures as constituting export subsidy and actionable subsidy. In demonstrating the existence of a subsidy, the element of a benefit is of great importance.

8. In this respect, China firstly submits that, in establishing the existence of a benefit, the focus should be placed on the recipient of a subsidy instead of the granting authority. This point has been made by the Panel and upheld by the Appellate Body in *Canada – Aircraft*.

9. China notices that in establishing a benefit conferred respectively by the KEXIM legal framework and the workout plan of Daewoo-HI/Daewoo-SME, the European Communities attaches much of its emphasis on the granting authorities at issue and thus fails to comply with the interpretation made by the Appellate Body in *Canada - Aircraft*. For this reason, China thinks that the evidence and arguments presented by the European Communities in its submission do not persuasively prove that there is a benefit in each of the instances.

10. Secondly, China believes that, in the process of making comparison between the terms on which financial contribution is made to the recipient and those available on the market, all pertinent factors that have a bearing on the comparison must be taken into account properly and comprehensively. China finds supports of its view from Article 14 of *the SCM Agreement* and a statement by the Panel in *Canada – Aircraft*.

11. In China's view, the European Communities seems to neglect certain pertinent factors when assessing whether the KEXIM legal framework or the workout program applied to Daewoo-HI confer a benefit. In the former instance, the European Communities does not take note of the underlying reason why other commercial banks do not provide loans or guarantees similar to those provided by KEXIM. In the latter case, the European Communities takes the action of foreign financial institutions as a benchmark without regard to factors that may affect the comparability of such a "benchmark".

III. CAUSATION ANALYSIS IN THE CONTEXT OF ARTICLE 6.3(C) OF THE SCM AGREEMENT

12. The third key issue China would like to highlight is causation analysis in the context of Article 6.3(c) of *the SCM Agreement*.

13. First, China believes that the phrase "*the* effect of *the* subsidy" in Article 6.3(c) of *the SCM Agreement* requires that the subsidy, *independent from other factors*, must have caused significant price suppression or depression. In this respect, China shares the same view with Korea.

14. China thinks that the European Communities fails to correctly and properly consider the implicit meaning of Article 15.5 of *the SCM Agreement* and the GATT Panel report in *US – Norwegian Salmon CVD*, and such failure leads to no evaluation of "the effect of the subsidy" in isolation of other factors that were affecting the price of commercial vessels.

15. Second, China also submits that, in order to establish a causal relationship between the subsidy and price suppression or depression of the like product in the same market, two inter-related causal relationships should be established: first, the subsidy *causes* the subsidized company to suppress or depress the price of its own product; second, such suppressed or depressed product price *causes* the suppression or depression of the price of like product in the same market.

16. China thinks that these two inter-related causal relationships link three factors that should be considered in the causation analysis:(1) the magnitude of the subsidy; (2) the effect of the subsidy upon the price of the product supplied by the subsidy recipient; (3) the suppression or depression effect of the price of the recipient's product upon that of the like product in the same market. China thinks these three factors should be collectively and consecutively considered in the causation analysis.

17. Third, in China's view, the word "significant" used in Article 6.3(c) of *the SCM Agreement* calls for quantitative examination in the analysis on causal relationship. It should be shown that the subsidy causes *significant* price suppression or depression to the recipient's product price and thereby causes *significant* price suppression or depression of the like product in the same market. China thinks that the requirement of "significant" should be considered and satisfied throughout the entire process of causation analysis. In China's view, the European Communities in its first written submission, appears to have not presented any actual figures to support its argument of quantitative effect of the subsidy measures at issue, and thus fails to establish that the subsidy causes *significant* price suppression or depression.

IV. CONCLUSION

18. This concludes my presentation. Thank you again for this opportunity to express China's views.

ANNEX C-3

EXECUTIVE SUMMARY OF THE WRITTEN SUBMISSION OF JAPAN

(9 February 2004)

1. Japan makes this third party submission to comment on certain aspects of this case. For the sake of convenience, this submission uses the same abbreviations as used in the EC First Submission.

2. First, Japan would like to emphasize that, as the EC argues, the market for commercial shipbuilding is generally considered to be a global market. Shipowners can virtually register their vessels in the shipping register of any country, and also operate them anywhere in the world, not just in the country where they are registered. National boundaries and laws hardly have any effect on the shipbuilding business, and traditional tariff and non-tariff barriers also have a limited effect. This "global" nature of the shipbuilding market emasculates the traditional antidumping and countervailing duty laws.

3. Thus, Japan has great interest in this case as it relates to the question of whether and to what extent subsidies in the shipbuilding sector can be effectively controlled under the WTO Agreement.

4. Second, with respect to the EC's claims that certain Korean laws and regulations, and certain financial programs by the KEXIM are in violation of the SCM Agreement *as such*, Japan would like to urge this Panel to appropriately elaborate on the findings of the Appellate Body in *US - Sunset Review (Japan)* on the issue of the mandatory law doctrine and properly determine the extent of the applicability of this decisions to this case.

5. Third, in Japan's view, the set of facts alleged by the EC indicate that the Korean shipbuilding companies were subsidized by financial contributions provided by their Korean creditor banks in connection with their restructuring plans, tax concessions granted in relation to the restructuring and export credit programs provided by the KEXIM for the shipbuilding companies. Given the facts alleged by the EC, Japan's position is that KAMCO, KDIC, BOK, KDB, IBK and KEXIM should be found to be "public bodies", as the EC claims. Thus, financial contribution provided by these institutions can be considered as a "subsidy" under the SCM Agreement. Also, Japan's position is that the set of facts alleged by the EC indicates that the Korean government granted a subsidy to its shipbuilding industry by directing or entrusting non-public Korean banks to make contributions to the industry. Japan agrees with the EC that the complaining party does not have to show a formal or official command by the government in order to prove "direction or entrustment".

6. Furthermore, given the facts alleged by the EC, in particular the fact that the government of Korea has a strong control over the creditor banks of the Korean shipbuilding companies, Japan considers plausible the EC argument that financial contributions (e.g. debt and interest forgiveness and debt-for-equity swap) that were made by creditor banks of the Korean shipbuilding companies in their restructuring plans have conferred a benefit to the Korean shipbuilding companies.

7. Japan considers that it is important whether or not Panel supports the EC argument that the scope of the relevant "market" should not be geographically limited under Article 6.3(c) of the SCM Agreement. Furthermore, Japan concerns the EC argument that the market for commercial vessels is indeed a global market, as mentioned above, and that "any assessment of price suppression, price depression, or lost sales must be conducted with respect to the world market."

8. Japan is also aware that despite the increase in demand, following 2000 the price of commercial vessels has been staying low or even falling. It seems to support the EC argument that the subsidy provided by the Korean government to its shipbuilding industry has resulted in "serious prejudice" to the EC's interests.

9. Japan's position is that the Japanese shipbuilding industry has been also adversely affected by the subsidies at issue. In addition, Japan would like to point out that during the period from 1997 to 2001, Japanese shipbuilders experienced a number of lost sales of LNG carriers in competition with offers made by Korean shipbuilders at the prices that were 10 to 27 per cent lower. During the same period, it was reported that Japanese shipbuilders also lost sales of some container vessels, since the prices offered by Korean competitors were 15 to 17 per cent lower.

10. Finally, Japan agrees with the EC's recognition that overcapacity in global shipbuilding would no longer exist if the Korean government had not subsidized its shipbuilding industry. Japan deems it reasonable to consider that the subsidy granted to the Korean shipbuilding industry, combined with the overcapacity maintained as a result of the subsidy, caused price suppression and depression in the global shipbuilding market.

11. As stated in the foregoing, Japan supports the EC's position in regard to its claim that it has been seriously prejudiced by the subsidies granted to the Korean shipbuilding companies.

ANNEX C-4

ORAL STATEMENT OF JAPAN

(9 March 2004)

1. Mr. Chairman and distinguished Members of the panel, on behalf of the Government of Japan, I thank you for your attention to this matter. Japan joined this proceeding as a third party to address its substantial trade interest in the matter before this Panel. We would like to focus on four points presented by other parties regarding the EC claims on the actionable subsidy provided to the Korean shipbuilding industry.

2. Japan would like to discuss the following four points:

(a) Firstly, Japan will emphasize that the proceeding of this dispute should take place, taking due account of the nature of the globalized shipbuilding market.

(b) Secondly, Japan will demonstrate that Korea is erroneously dividing the shipbuilding market by overly emphasizing differences in the size of commercial vessels and downplaying the fact that the end-uses for those vessels are exactly the same.

(c) Thirdly, Japan will demonstrate that the EC is not arguing that debt forgiveness provided in bankruptcy proceedings is an illegal subsidy for bankrupt companies.

(d) Fourthly, Japan will refute Korea's apparent claim that the Japanese shipbuilding industry is responsible for the alleged injury to the EC shipbuilding industry.

I will now discuss each point in greater detail.

3. First of all, as stated in its third party submission, Japan emphasizes that the shipbuilding market is indeed globalized. We have to keep this fact in mind in order to discuss this dispute in a proper manner. The globalized nature of the market renders virtually meaningless to the Members' right under GATT Article VI of taking antidumping or countervailing duty measures in order to protect domestic shipbuilding industries from foreign competitors' dumped or subsidized exports. Japan urges the Panel to keep this in mind when examining the EC claims.

4. Furthermore, Japan disagrees with Korea's argument that the Panel should examine whether the subsidies at issue are causing "serious prejudice" to the EC industry based on national markets rather than the single globalized market. National boundaries and laws hardly have any effect on the shipbuilding business. By ignoring this reality of the shipbuilding market, no analysis could produce a satisfactory result in this dispute.

5. Also, in footnote 272 of its First Submission, Korea refers to an EC paper which argues that the Japanese market is isolated. In Japan's view, this statement should simply be disregarded as one example of the lingering prejudice about the Japanese market. More importantly, this is particularly untrue because the market is truly globalized. As Japan repeatedly stated, national boundaries and laws hardly have any effect on the shipbuilding business. Consequently, there is virtually nothing in the market that prevents the effects of a subsidy to a particular country's shipbuilding industry from

expanding its activities worldwide. Thus, considering the subsidy measures at issue, Japan believes that it would be unreasonable to conclude that the subsidy measures have not produced obvious negative effects on the competitors of the Korean shipbuilders which receive actionable subsidies.

6. Secondly, Japan submits that Korea is also erroneously dividing the shipbuilding market in terms of products. In the "like product" analysis, Korea overly emphasizes the differences in the size of commercial vessels, while illegitimately downplaying the significance of the fact that the end-uses are exactly the same. As long as the end-use of these two products is same, they are normally regarded as competing with each other. Further more, it is generally considered in the shipbuilding market that a lower-priced offer for a type of vessel will generate an immediate market effect on the market price of any other type of vessel. Cost factors are largely common for most types of vessels if it's not for all, and by this point of view, maritime transport companies usually consider that when a shipbuilder offered a lower price for a type of vessel, the shipbuilder can offer a lower price for all other types of vessel as well. Following this reasoning, maritime transport companies, then, increasingly demand a discount for any type of vessel vis-à-vis all other shipbuilders, and consequently, a low price prevails throughout the market for all types of vessels.

7. Thirdly, Japan does not see the relevance of Korea's argument that debt forgiveness provided in bankruptcy proceedings must not be found to be an illegal subsidy for bankrupt enterprises. Our understanding is that the EC is not arguing that debt forgiveness provided by banks to certain Korean shipbuilders in their restructuring proceedings *per se* impermissibly grants a benefit under the Subsidy Agreement. Rather, Japan understands that the EC's argument involves three steps: First, domestic banks that were under the control of the Government of Korea provided debt forgiveness to the Korean shipbuilding companies on more favourable terms than foreign banks which were not under the control of the Government of Korea; second, such foreign banks should be deemed to behave in accordance with market terms; and, as a result, third, the debt forgiveness provided by the domestic banks granted a "benefit" within the meaning of Article 1.1(b) of the Subsidy Agreement. Korea's argument in this regard to this issue misrepresents the EC claim.

8. In Japan's view, this issue also raises questions regarding Korea's rebuttal on the issue of specificity. The statutory framework for corporate restructuring may generally be applicable to any enterprise. In addition to the limited availability of this framework, however, Japan would like to remind the panel of how the EC defines "subsidy" measures. The issue is whether certain domestic banks granted debt forgiveness to the Korean shipbuilding producers on more favourable conditions than the market terms, pursuant to the direction or entrustment of the Government of Korea. Again, our understanding is that the EC is not challenging the corporate restructuring framework *per se*.

9. Fourthly, Japan would like to point out that Korea's First Submission attempts to shift responsibility for the alleged injury to the EC shipbuilding industry on to the Japanese industry. This claim is another attempt to divert the attention of the Panel from the focus of this case. Our understanding is that the primary issue is not whether the subsidy to the Korean shipbuilding industry caused the price decline for commercial vessels from 1997 to 1999, but whether such subsidy caused price suppression after the decline–;and specifically, whether the subsidy caused the market price to remain at the declined level from 2000 to 2003 despite the increase in demand and cost. We note that Korea itself argues that the focus should be on the current situation. Furthermore, Korea's claim concerning the Japanese industry is unreliable. The complexity of the actual market mechanism requires the analysis of many transactions and relevant factors such as negotiation process, in order to conclude which market participant or participants caused a price effect on the market. Therefore, Japan is of the view that the EC's analysis which refers to many transactions is more plausible than Korea's rebuttal. Rather, as stated in our third party submission, the Japanese industry has also been negatively affected by the aggressive pricing of the Korean shipbuilders. Also, Japan notes that

market share does not necessarily determine who is a price leader in the market. Heavily subsidized enterprises can lead price competition, especially with a considerable production capacity.

10. Thank you, Mr. Chairman and distinguished Members of the panel.

ANNEX C-5

RESPONSES OF JAPAN TO QUESTIONS FROM THE EUROPEAN COMMUNITIES AND KOREA

(22 March 2004)

Questions by the European Communities

Question 1: Japan considers in para. 10 of its Third Party Submission that on the basis of the facts alleged by the EC, KAMCO, KDIC, BOK, KDB, FFIK and KEXIM should be found "public bodies". In Japan's view, what factors should the Panel consider when determining whether an entity is a "public body"?

Answer

1. Japan is of the view that there is no single controlling factor; the comprehensive and case-by-case evaluation of all relevant factors may warrant a proper determination as to whether an institution is a "public body" within the meaning of Article 1.1(a)(1) of the Subsidy Agreement. Relevant factors include, but are not limited to, whether and what public policy objective the institution has, whether and to what degree the government has control over the appointment of management or budget, whether and to what degree the government owns shares in that institution, and whether and to what degree the government has supervisory power over operational planning.

Question 2: Japan considers in para. 12 of its Third Party Submission that the facts alleged by the EC indicate that the Korean government entrusted and directed non-public Korean banks to make contributions to the industry. Does Japan therefore also agree that circumstantial and secondary evidence is sufficient to proof entrustment and direction on a case to case basis?

Answer

2. First, as stated in paragraph 13 of its third party submission, Japan agrees with the EC that the complaining party does not have to show formal or official command by a government in order to prove "direction or entrustment". Second, Japan would like to point out that no provision in the Subsidy Agreement or the WTO Agreement sets forth that circumstantial or secondary evidence is inadmissible as proof for "direction or entrustment".

Question 3: In Japan' view, in the context of price suppression or depression claims in Article 6.3c), what is the geographic scope of the phrase "in the same market"? Please describe the geographic scope of the market for LNGs, product and chemical tankers, and containerships.

Answer

3. Japan is of the view that the "same market" under Article 6.3(c) of the Subsidy Agreement should mean, in terms of the shipbuilding business, the single global market for the same type of commercial vessels. It is widely recognized that the shipbuilding market is globalized. In our view, this recognition is based on the following two characteristics of the market:

4. First, shipowners can virtually register their vessels in the shipping register of any country, and also operate them for transportation anywhere in the world, not just in the country where they are registered. Thus, geographical elements are of little significance, in particular, for commercial vessels that are operated and, accordingly, compete with one another in the overseas transportation market.

5. Second, our observation is that shipowners have no particular preference in the nationality of shipbuilders. Japanese shipowners may procure vessels from abroad, and Japanese shipbuilders may export a number of vessels abroad. As indicated in Exhibit JPN-1 attached hereto, Japanese, European and Korean shipbuilders have competed one another in the LNG carrier market since the mid-1990s, when the Korean shipbuilders newly entered into this market. For product tankers and container carriers, as indicated in Exhibit JPN-2 also attached hereto, a number of shipbuilders, including those from Japan, Europe, Korea, and China, have been competing one another since the beginning of 1990s.

Question 4: Japan considers in para. 18 of its Third Party Submission despite the increase in demand following 2000 the prices of commercial vessels has been staying low or even falling. What evidence does Japan have concerning the price trends in world shipbuilding market? Do these trends reflect the demand and supply of vessels?

Answer

6. See the chart contained in Exhibit JPN-3, which indicates the relationship between the price of commercial vessels, and the aggregate amount of orderbook. This chart was prepared by the OECD.

7. This chart shows that the price and the aggregate amount of orderbook correlated with each other until 1996, when Korean shipbuilders increased their production capacity on a large scale, thus generating overcapacity in the shipbuilding market, and further, witnessing a significant price decrease. Since then, no such correlation can be found; rather, despite the increase in the aggregate orderbook, the price of commercial vessels has been staying low or even decreasing. Japan is of the view that the subsidy provided to some Korean shipbuilders has prevented the market mechanisms from dealing with this overcapacity problem by keeping those companies that were on the verge of bankruptcy in business as a result of the aforesaid aggressive capacity increase and resulting price decrease. Those companies would probably have been forced out of the market in the absence of the subsidy at issue.

Question 5: In Japan's view, the Japanese shipbuilding industry has been also adversely affected by the subsidies at issue. Why couldn't the Japanese shipbuilding industry match the Korean prices for LNGs and Containerships? Did such a situation prevail before 1997?

Answer

8. As noted in paragraph 18 of its third party submission, the prices offered by Korean competitors were 15 to 17 per cent lower than those offered by Japanese shipbuilders. These prices

were much lower than that the Japanese shipbuilders expected from the market situation before 1997, and thus, they could not keep up with the pricing practices of Korean competitors.

Question 6: Japan in para.16 of its Third Party Submission supported the EC argument that the subsidy provided by the Korean government to its shipbuilding industry has resulted in "serious prejudice" to the EC's interest. Does Japan therefore agree that there were no other relevant factors that disturb the causal link between the Korean subsidies and the price depression and suppression?

Answer

9. See the Answer to EC Question 4. Japan's view is that the subsidy granted to certain Korean shipbuilders has maintained the overcapacity in the shipbuilding market, and thus, is the primary cause of the continued low prices despite the demand increase after 2000, i.e. price suppression.

Exhibit JPN – 1

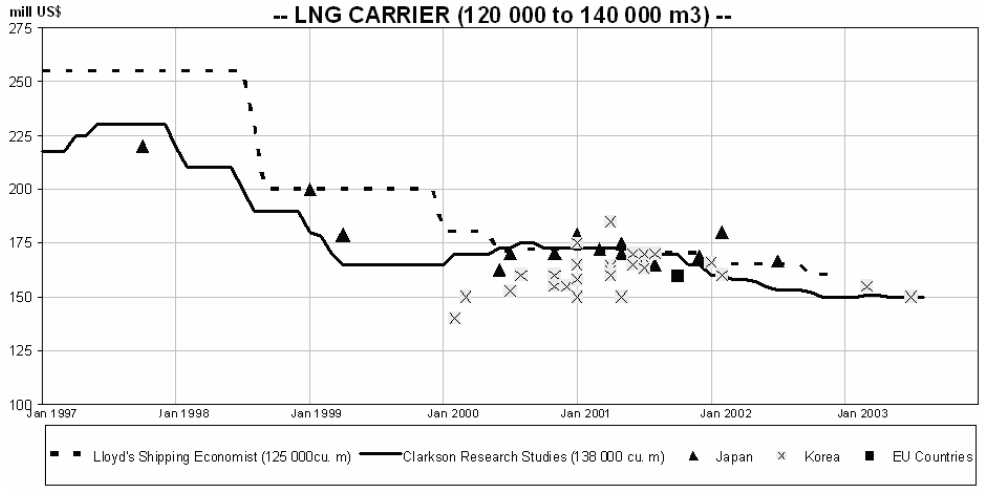
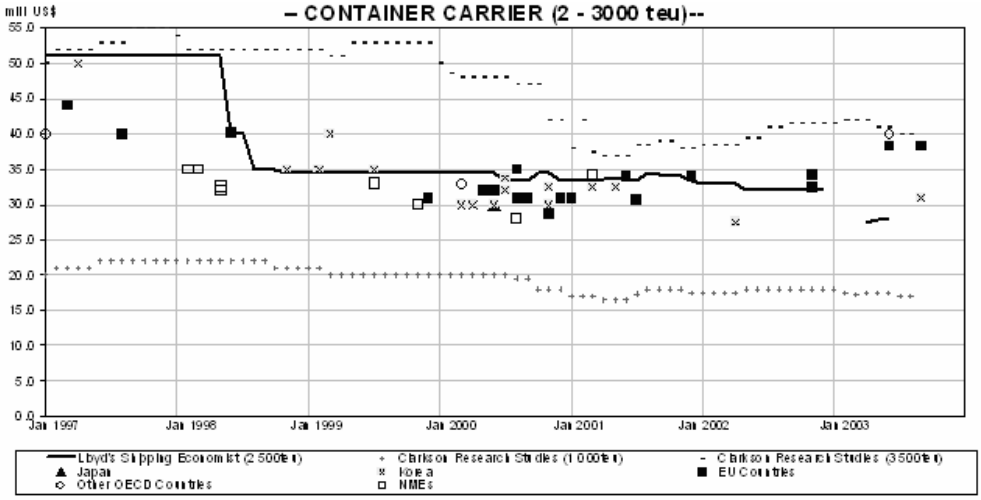


Exhibit JPN – 2



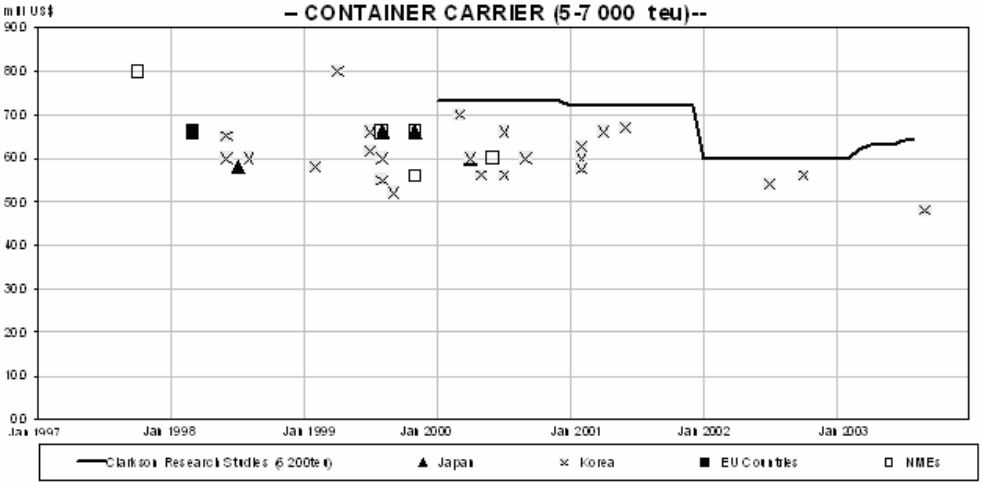
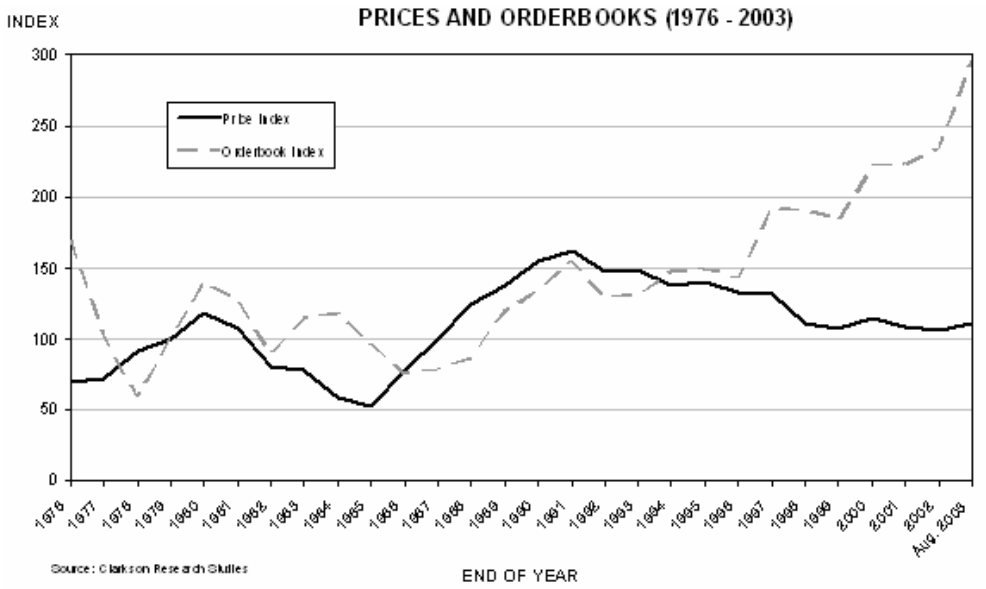


Exhibit JPN - 3



Questions by Korea

Question 1: The EC has indicated in the Sixth Report from the Commission to the Council on the situation in world shipbuilding[1] that order intake in Japan comes from domestic demand and that "[t]hese orders by Japanese shipowners are almost inaccessible to other shipbuilding countries and therefore provide a captive market for Japanese yards".

Did foreign builders participate in bids by Japanese shipowners for the building of LNGs or other vessels? If not, how does this affect the definition of the geographical market and the causation analysis submitted by the EC in its first submission?

Answer

1. This is simply another example of the lingering prejudice about the Japanese market. It is erroneous to consider that the Japanese market is a captive market for Japanese yards. First, nothing in Japan prevents foreign shipbuilders from participating in bids by Japanese shipowners. Further, there is no trade barrier (*de jure* or *de facto*) against imports of commercial vessels in Japan.

2. Second, the reality is that Japanese shipowners may procure commercial vessels from abroad. For example, the data compiled by Clarkson indicates that even referring only to current order stock for Korean shipbuilders, with respect to LNG carriers, at least Mitsui O.S.K. Lines, Nippon Yusen and Kawasaki Kisen have placed several orders in total; with respect to container ships, Nippon Yusen and Kawasaki Kisen have placed more than 10 orders in total.

3. Again, we would like to reiterate that it is widely recognized that the shipbuilding market is globalized. Shipowners can virtually register their vessels in the shipping register of any country, and also operate them for transportation anywhere in the world, not just in the country where they are registered. Thus, the shipbuilding market is not divided geographically.

Question 2: Japan claims that prices for Korean vessels were below prices for Japanese vessels (paragraph 18 of Japan's written submission) but the EC has not made a claim on price undercutting. What is the relevance then of Japan's claim?

Answer

4. Japan provided examples of lower priced offers by Korean shipbuilders in support of the EC argument for price depression or suppression caused by subsidies granted to Korean shipbuilders. Our understanding is that Korean shipbuilders offered and continue to offer lower prices than Japanese and other competitors, i.e. price undercutting, resulting in price depression or suppression in the global shipbuilding market.

Question 3: Can Japan provide the criteria on the basis of which it would propose to determine the like product for the vessels subject to this dispute?

Answer

5. Japan's view is that the type of vessels (e.g. LNG carriers, product tankers and container carriers) is a controlling factor in determining the scope of "like product" for commercial vessels. The term "like product", under GATT Article III or other WTO provisions, has taken into

[1] COM(2002)622 final, 13 November 2002, Section 2.2.3, page 8. See also Seventh Report from the Commission to the Council on the Situation in World Shipbuilding, COM(2003)232 final, 6 May 2003, Section 2.1.1, page 5.

consideration, on a case-by-case basis, such as (i) product properties, (ii) end-uses, (iii) consumers' preference, and less importantly, (iv) tariff classifications, of subject products. As Japan stated at the third party session, it is obvious that the type of vessels is closely connected to their end-use; the same types of vessels are competing with one another in the overseas transportation market.

Question 4: Does Japan consider that for the purpose of demonstrating that the effect of the subsidy concerned is significant price depression or suppression, the subsidy must be quantified. If so, what is the basis for such quantification?

Answer

6. Indeed, it would be easier to evaluate precisely whether a subject subsidy has caused price depression or suppression, if the amount of the subsidy is quantified. However, even if it is not quantified, Japan believes that it is still possible to find such a causal nexus between a subsidy and price depression or suppression. For example, assume, as the EC claims in this dispute, that certain producers would have been forced out of the market in the absence of a subject subsidy, and consequently, the lingering overcapacity problem would have ceased to exist. In this situation, given that the market price is also staying low despite the demand increase, it is reasonable to find that the demand increase should have elevated the market price in the absence of the subsidy. In other words, the subsidy caused price suppression.

ANNEX C-6

WRITTEN SUBMISSION OF NORWAY

(9 February 2004)

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A. INTRODUCTION

1. The present case concerns whether the rules set out in the Kexim Act, Kexim Decree and Kexim Interest Rate Guidelines establishing the Korean Export Import Bank (hereinafter referred to as KEXIM) and the rules concerning some of the programmes implemented by KEXIM violate Korea's obligations under the WTO Agreement on Subsidies and Countervailing Measures (hereinafter referred to as the SCM Agreement).

2. The case has been brought by the European Communities (hereinafter referred to as the EC), which asks the Panel to find that Korea has granted subsidies that are inconsistent with its obligations under the SCM Agreement, because:

- Through the KEXIM Act, KEXIM Decree and Interest Rate Guidelines, Korea grants prohibited subsidies that are inconsistent with Article 3.1 and 3.2 of the SCM Agreement*;*
- Through the establishment and maintenance of Advance Payment Refund Guarantees (hereinafter referred to as APRGs) and Pre-shipment Loan Programmes, Korea grants prohibited subsidies that are inconsistent with Article 3.1 and 3.2 of the SCM Agreement*;*
- Through individual APRGs and pre-shipment loans, Korea grants prohibited subsidies that are inconsistent with Article 3.1 and 3.2 of the SCM Agreement*;*
- By granting subsidies to Daewoo-SME/Daewoo-HI, Samho-HI/Halla-HI, and STX/Daedong through (i) workout plans and restructuring plans; (ii) tax concessions to Daewoo-HI/Daewoo-SME; and (iii) KEXIM APRGs and pre-shipment loans, Korea has caused serious prejudice to the interests of the EC in violation of Articles 5(c) and 6.3(c) of the SCM Agreement.

3. Norway has systemic interests as regards the interpretation and application of the SCM Agreement, and has thus reserved the right to participate as a third party in the present dispute. Norway will not address all the issues that are raised in the submissions by the two parties to the dispute, but will concentrate on certain issues of law and legal interpretation that are of importance to Norway.

1. Introductory comments

4. Norway's point of departure is that the existence of national guarantee institutions, and the guarantees and loans provided by such institutions, do not necessarily constitute a *prima facie* case of prohibited or actionable subsidisation under the SCM Agreement. Most countries have such institutions and arrangements in the field of shipbuilding.

5. However, Norway is of the opinion that the services provided by such institutions should be provided on market terms. The price of the services offered should not contain any elements of subsidisation. Where the price of the services offered are not offered on market terms, then there may be a *prima facie* case of prohibited or actionable subsidisation provided that the relevant conditions of Articles 1 and 2 of the *SCM Agreement* are met. Due regard must be given in this respect to the qualifications contained in Annex I to the *SCM Agreement*, paras. "j" and "k", to the effect that not all practices by such institutions are considered prohibited export subsidies. In our opinion the rules governing the Advance Payment Refund Guarantee (hereinafter the APRG) and the Pre-shipment Loan programmes (administrated by KEXIM) as set out in the Kexim Act, Kexim Decree and Kexim Interest Rate Guidelines would seem to go beyond what is a normal market practice. KEXIM by granting loans under these programmes may thereby have violated the *SCM Agreement*. Whether,

and to what extent, there is subsidisation in respect of a particular ship or contract will depend on the specifics of each case.

2. General interpretative issues in Article 1 of the SCM Agreement

6. The assessment of whether there are actionable or prohibited subsidies in the present case raises certain issues of interpretation related to Article 1 of the SCM Agreement. These are concerned in particular with whether KEXIM falls within the definition of a "public body", whether there is "a financial contribution" and whether "a benefit is thereby conferred".

(a) A financial contribution

7. It does not seem to be in dispute that loans and grants have been provided by KEXIM, and that they may constitute "a financial contribution" within the meaning of Article 1.1.(a)(1)(i). The argument put forward by Korea[1] centres around the words "government practice" in Article 1.1(a)(1), which is alleged to restrict the scope of transfers that may be considered as a subsidy.

8. Norway finds it difficult to follow Korea's argument, since Korea appears to be using the term "government practice" to refer to something different from "public body practice". The word "government" is defined in Article 1.1(a)(1) as including "public body" throughout the SCM Agreement. Making a distinction based on the argument that "government" in this sub-paragraph must mean a reference to certain functions that are normally vested in governments (e.g. regulatory powers or taxation) runs counter to the general definition of "government" in Article 1.1(a)(1), and should not be upheld.

(b) A public body

9. The term "public body", which appears in Article 1.1(a)(1) of the *SCM Agreement*, is not defined in the agreement.

10. However, the General Agreement on Trade in Services (GATS) has two definitions that are of interest here. Firstly, the definition of "measures by Members" (i.e. Member Governments) includes central, regional or local governments and authorities, and also "non-governmental bodies in the exercise of powers delegated by central, regional or local governments or authorities" (GATS Article I:3(a)(ii)). Secondly, in paragraph 5(c) of the Annex on Financial Services to the GATS Agreement "public entity" is defined as:

> a government, a central bank or a monetary authority, of a Member or <u>an entity owned or controlled by a Member</u>, that is principally engaged in carrying out governmental functions or activities for governmental purposes, not including an entity principally engaged in supplying financial services on commercial terms; or a private entity, performing functions normally performed by a central bank or monetary authority, when exercising those functions (our underlining).

11. Furthermore, in Annex 1, paragraph 6, of the Agreement on Technical Barriers to Trade, central government body is defined as "central government, its ministries and departments <u>or any body subject to the control of the central government in respect of the activity in question</u>" (our underlining). While Norway certainly recognises that no definition contains the precise words "public body", and that no transposition can be made directly from one agreement to another, the definitions

[1] First written submission by Korea, para. 161- 165.

in these agreements appear to be relevant when defining "public body" as used in the SCM Agreement.

12. It would seem from the above that "ownership" by the Government, or "control" by the Government in respect of the activity in question are necessary ingredients when defining "public body". However, ownership is not in itself enough, since many state-owned enterprises are not considered to be public bodies simply by virtue of their ownership.

13. The second element that may be inferred from the above, that the "body" (in order to be a "public body") must carry out governmental functions or activities for governmental purposes, is more difficult to assess. What is to be considered governmental functions or activities for governmental purposes is to a large degree dependent on the organisation of the State, and the extent to which its political leadership has decided that certain functions or services are to be provided by the government, directly or indirectly. There are great divergences between the Members of the WTO in this respect. The statutes of the body, its funding, and whether the government has guaranteed that the body cannot go into liquidation, are all elements that may indicate that the body in question is a "public body".

14. It should also be noted that "export credit guarantee or insurance programmes" are explicitly covered in the "illustrative list of export subsidies" in Annex I to the SCM Agreement. This is an indication that when government-controlled bodies provide such guarantees or insurance, this will normally be considered to be covered by the subsidy definition.

15. Norway submits that the following elements provide convincing evidence to the Panel in its assessment that KEXIM must be considered a "public body" within the meaning of Article 1.1.(a)(1) of the Agreement on Safeguards*:*

- According to Article 1 of the KEXIM Act KEXIM's task is "to promote the sound development of national economy and economic co-operation with a foreign country".

- In the KEXIM 2002 Annual Report, KEXIM is described as "an official export credit agency providing comprehensive export credit and project finance to support Korean exporters and investors" and facilitating "the development of the national economy and enhanc[ing] economic co-operation with foreign companies as a financial catalyst".[2]

- Since December 2002 KEXIM has been owned by the Government of Korea, the Bank of Korea and Korea Development.[3] The two latter bodies are government agencies.

- A number of other articles in the KEXIM Act confirm that KEXIM is a "public body" within the meaning of SCM Agreement Article 1.1.1(a)(1), see in particular Article 37 of the Act?, "any net loss incurred by the Export-Import bank during any fiscal year shall be covered by its reserves. If the reserves are insufficient to cover the net loss, the Government shall provide funds to cover such net loss".[4]

- See also KEXIM Act Articles 36(2), 11, 21, 32 and 33, which clearly underline that KEXIM is a "public body" within the meaning of Article 1.1(a) of the SCM Agreement.

[2] See Exhibit EC-14
[3] See KEXIM 2002 Annual Report, p.34 (Exhibit EC-14)
[4] See KEXIM Act (Exhibit EC-10)

(c) A benefit is thereby conferred

16. Further, Article 1.1(b) of the SCM Agreement requires that a "benefit" has to be conferred. The term has not been defined in the SCM Agreement, but has been interpreted in WTO jurisprudence in a number of cases. In The Panel Report *Canada – Aircraft* the term was defined as:

> [A] financial contribution will only confer a "benefit", i.e., an advantage, if it is provided on terms that are more advantageous than those that would have been available to the recipient in the market.[5] (our underlining)

17. The Appellate Body upheld this interpretation.[6]

18. Article 26 of the Kexim Act clearly states that "*Except where inevitable for maintaining the international competitiveness to facilitate the export,…* the interest rates, discount rates and fee rates applicable to loans, and guarantees extended under paragraphs (1) and (2) of Article 18 shall be so set as to cover the operating expenses…"

19. In Norway's view, the wording of Article 26 implies that the Government of Korea (hereinafter GOK) *de facto* instructs Kexim, to offer lower interest rates on pre-shipment loans and premiums on APRGs than the market rate, if such practice is necessary in order to secure export contracts for Korean companies. Thus, the Kexim Act allows for financing "on terms that are more advantageous than those that would have been available to the recipient in the market" and may thereby confer a "benefit" within the meaning of Article 1.1 (b) of the *SCM Agreement*.

20. Norway will not discuss in detail whether the terms on which KEXIM programmes, in question, are granted are more advantageous than those that would have been available to the recipients in the market. This is for the parties to the dispute to argue. Norway wishes to point out, however, that if this is the case, it may thus constitute a prima facie case of "benefit".

(d) Conclusion

21. Based on the above, Norway submits that we are faced with a "*financial contribution"* by a "*public body"* that may confer a "*benefit"* and thereby constitute a "subsidy" within the meaning of the SCM Agreement Article 1.

B. PROHIBITED SUBSIDIES

3. The APRG and the Pre-shipment Loans constitute a subsidy which is "specific" within the meaning of Article 2.3

22. According to Article 2.3. of the SCM Agreement any subsidy falling under the provisions of Article 3 is to be deemed to be specific.

4. The APRG and the Pre-shipment Loans constitute a subsidy which is "contingent on export performance" within the meaning of Article 3.1(a)

23. According to Article 3.1, for a subsidy to be prohibited it must be contingent on either export performance (a) or the use of domestic goods over imported goods (b). The APRG is in our opinion contingent on export performance.

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[5] Panel Report, *Canada - Aircraft*, para. 9.112., but also Brazil – Aircraft, para 7.24 and US – Lead and Bismuth II, para 6.66

[6] AB Report *Canada – Aircraft*, paras 154, 157.

24. The wording of the KEXIM Act clearly shows that the purpose of the KEXIM programmes is to facilitate export. For example, Article 18 of the Act states that the loans are given "for the promotion of the export of goods". The wording of the Act leaves no doubt that the programmes represent a subsidy whose goal is to promote the export of Korean goods. The subsidy is contingent on export performance and is therefore a prohibited subsidy within the meaning of Article 3.1(a)

5. Conclusion on prohibited subsidies

25. According to the facts presented by the EC regarding the specific grants (paras 166-182) , these grants are provided on terms that are more advantageous than those that would have been available to the recipient in the market. Based on these findings, Norway is of the opinion that the Panel should find that the specific grants provided under the APRG and the Pre-shipment Loan Programmes are inconsistent with Article 3.1(a) of the *SCM Agreement*.

C. ACTIONABLE SUBSIDIES

26. In its first written submission, part IV D, the EC demonstrates that Korea granted subsidies, as defined by Part I of the SCM Agreement, to Daewoo-SME/Daewoo-HI, Samho-HI/Halla-HI and STX/Daedong, and that those subsidies were specific. The EC further argues that the subsidies provided by Korea are actionable subsidies within the meaning of Articles 5(c) and 6.3(c) of the SCM Agreement.

27. Norway will in this respect only address certain issues of interpretation arising from Article 6.3(c) of the SCM Agreement.

28. Article 6.3(c) states that:

> "the effect of the subsidy is significant price undercutting by the subsidised product as compared with the price of a like product of another Member in the same market or *significant price suppression, price depression* or *lost sales* in the same market" (our emphasis).

29. The EC is only claiming the existence of "price suppression" and "price depression", not "price undercutting". The question of interpretation thus only arises as regards the second alternative in Article 6.3(c), i.e. "or significant price suppression, price depression or lost sales in the same market."

30. Norway therefore presents the following arguments as regards the interpretation of the legal definition of (1) the "same market" as used in Article 6.3(c) in the context of the shipbuilding industry, and (2) how price depression or price suppression is related to a "like product" or other comparison between products.

1. Same market

31. A geographical market, in the ordinary meaning of the word, can refer to a market of any size, with national, regional or even global dimensions. Unlike Article 6.3(a) and 6.3(b), which impose geographical limitations on the term "market" (i.e. national markets), Article 6.3(c) includes no such limitation. If the negotiators had intended to limit the term market in 6.3(c) to national markets, they could have done so by using wording similar to that in 6.3(a) and 6.3(b).

32. The term "same market" has not been defined in jurisprudence. Norway submits that the term "same market" in Article 6.3(c) should not be interpreted narrowly as a Member's national market, but that due regard must be given to the special characteristics of the shipbuilding industry.

33. In the case of commercial vessels, it is widely recognised that the market is global. In its comments to the OECD regarding possible measures used to regulate low-price "dumping" by shipbuilders, the Korean Shipbuilders' Association noted that: "[t]here is only a single fully integrated global market in this sector, wherein shipbuilders compete with each other without any restriction on market access, purchasers, or movement of vessels. No meaningful distinction of national markets exists in the world shipbuilding industry." [7]

34. The fact that the market for commercial vessels is global needs no clarification; ships can sail anywhere, be owned by anyone, and be registered anywhere in the world regardless of the nationality of the shipowner and his place of business. This has been the trend for a large number of years, in particular since the 1970s, when there was a rise in the number of "international ship registers". Shipowners themselves do not operate within geographical boundaries when they order new vessels. The only "boundaries" in the shipbuilding world, where there are highly sophisticated shipbuilding companies everywhere, is in reality the price. Subsidies in any form, in this highly competitive industry, can have a major impact and steer the market towards a particular country.

35. Based on the above Norway submits that the only meaningful interpretation of the "same market" in this particular context is a global market without any national boundaries.

2. "Like product" or other product comparison

36. Article 6.3(c) makes reference to a "like product" in respect of "price undercutting", but does not make a direct reference to a "like product" in respect of price suppression, price depression or lost sales in the same market.

37. It is clear, however, that price suppression, price depression and lost sales can only occur when the products are competing for the same contracts. "Like product" must therefore be understood to refer not only to "price undercutting" in the first alternative in Article 6.3(c) but also to price suppression, price depression and lost sales in the second alternative. Furthermore, in respect of ships, due regard must be given to the many sub-categories of ships (e.g. Aframax, Panamax, Suezmax) that do not compete with each other.

D. CONCLUDING REMARKS

38. Norway respectfully requests that the Panel take the arguments presented above into consideration when making its findings and recommendations in this case.

[7] OECD Council Working Party on Shipbuilding, Industry Hearing on Establishing Normal Competitive Conditions in World Shipbuilding, Submission by the Korean Shipbuilders' Association, C/WP6(2002)3/ADD1/REV2.

ANNEX C-7

ORAL STATEMENT OF NORWAY

(9 March 2004)

Mr. Chairman,
Distinguished Members of the Panel,
Ladies and gentlemen,

Introduction

1. First of all, I would like to thank you for this opportunity to present the Norwegian view on certain aspects of the present case without any reference to BCI. In its third-party submission, Norway addressed certain issues of legal interpretation which we consider to be of crucial importance for the settlement of the case. I will not repeat all these arguments here, but concentrate on certain legal aspects of the KEXIM pre-shipment loans.

2. I will start by commenting on whether the loans in question can benefit from a safe haven based on item (k) of Annex I to the SCM Agreement. I will continue with the discussion of whether these loans can be considered prohibited subsidies within the meaning of Article 3.1 (a) read in conjunction with Article 1 of the Agreement, and in this regard I will limit myself to discussing the requirement that a benefit must be conferred.

3. I will also comment on the discussion of whether the loans are actionable subsidies according to Article 5(c) read in conjunction with Article 6.3 (c). In this respect I will limit myself to some remarks on the interpretation of the term "same market" with regard to commercial vessels.

The understanding of Annex I item (k)

4. In its first written submission Korea states that its pre-shipment loans are excluded from the ambit of Article 3 of the SCM Agreement as they are covered by the exception in item (k) of Annex I to the SCM Agreement.[1]

5. According to the second paragraph of item (k) the application of an export credit practice should not be considered a prohibited export subsidy if 1) the Member applying the practice is a party to an international undertaking on official export credits to which at least twelve Members are parties and 2) the practice is in conformity with the provisions of the relevant undertaking.

6. Korea together with more than 12 other Members[2] is party to an international undertaking under the auspices of the OECD, the "Consensus Agreement" [3], thus fulfilling the first criterion. The

[1] See Korea's first written submission paras. 269-277

[2] The OECD Export Credit Arrangement currently has 23 participants (counting the EU Member States), all of which are WTO Members.

[3] Arrangement on Officially Supported Export Credits of 11 February 2004 TD/PG(2003)24

question remains therefore whether the contested loans are covered by and "in conformity" with the provisions of that Agreement.

7. Article 5 of the Consensus Agreement concerning the scope of the Agreement clearly states that "the Arrangement shall apply to all official support provided by or on behalf of a government for export of goods and/or services … which have a repayment term of **two years or more".**

8. In para. 277 (ii) of its first written submission, Korea states that the pre-shipment loans are provided with the usual maturity of 90 -180 days. Thus the loans have a shorter repayment term than required and consequently fall outside the scope of the Consensus Agreement.

9. In conclusion, Korea cannot claim a safe haven under the exception in Annex I item (k) for its KEXIM pre-shipment loans, which means that the loans must be assessed under the general rule in Article 3 of the SCM Agreement on prohibited subsidies.

Article 1.1 (b) – what constitutes a "benefit"

10. As I have already mentioned, Article 3 refers to Article 1, which defines the term "subsidy" for the purpose of the SCM Agreement. I would now like to discuss what constitutes a "benefit" according to Article 1.1 (b). The term "benefit" is not defined in the SCM Agreement, but has been interpreted by panels and the Appellate Body in a number of cases. According to *Canada-Aircraft*[4] "a benefit is conferred if a financial contribution is provided on terms that are more advantageous than those that would have been available to the recipient in the market".

11. Article 26 of the Kexim Act states that "Except where inevitable for maintaining the international competitiveness to facilitate the export,… the interest rates, discount rates and fee rates applicable to loans and guarantees extended under paragraphs (1) and (2) of Article 18 shall be so set as to cover the operating expenses…"

12. In Norway's view, the wording of Article 26 of the KEXIM Act implies that the Government of Korea *de facto* instructs KEXIM to offer lower interest rates on pre-shipment loans if such a practice is necessary in order to secure export contracts for Korean companies.

13. I will not assess whether the interest rates provided by KEXIM place the Korean exporters in a more advantageous position than if they were to obtain such financing on market terms. However, if the Korean exporters enjoy such an advantageous position, we are faced with a *prima facie* case of "benefit".

The concept of "same market" in Article 6.3(c)

14. I will now turn to the interpretation of the concept "same market" in Article 6.3(c), which have a bearing on whether the loans are "actionable subsidies" within the meaning of Article 5 (c) of the SCM Agreement.

15. In Norway's opinion Article 6.3(c) provides two alternative ways to establish serious prejudice in the sense of Article 5(c): 1) the effect of the subsidy is a significant price undercutting by the subsidised product, as compared with the price of a like product of another member in the same market *or* 2) the effect is either a significant price suppression, price depression or lost sales in the same market.

[4] Panel Report , *Canada-Aircraft*, para. 9.112 and AB Report *Canad-Aircraft*, paras. 154,157.

16. It is Norway's understanding that the EC, in the present case, claims that the effect is a significant price suppression or depression. However, to decide whether this is the case, both the geographical market and the product market concerned must be considered.

Geographical market

17. First some comments as regards the geographical market: In the ordinary meaning of the phrase, geographical market can refer to a market of any size, with national, regional or even global dimensions. Unlike Article 6.3(a) and 6.3(b), which impose geographical limitations on the term "market" (i.e. national markets), Article 6.3(c) contains no such limitation. If the negotiators of the SCM Agreement had intended to limit the term "market" in 6.3(c) to national markets, they could easily have done so by using wording similar to that in 6.3(a) and 6.3(b).

18. The term "same market" has not been defined by jurisprudence. Norway believes that the extent of the geographical market will vary depending on the characteristics of the products in question.

19. In the case of commercial vessels, it is widely recognised that the market is global. In its comments to the OECD regarding possible measures used to regulate low-price "dumping" by shipbuilders, the Korean Shipbuilders' Association noted that: "[t]here is only a single fully integrated global market in this sector, wherein shipbuilders compete with each other without any restriction on market access, purchasers, or movement of vessels. No meaningful distinction of national markets exists in the world shipbuilding industry."

20. This was confirmed last week by the OECD Special Negotiation Group for shipbuilding. The participants, including the delegation from Korea, agreed that there is only one single fully integrated market for commercial vessels – that is the global market.

21. In this respect, there are several examples of the fact that Norwegian yards compete with shipbuilders all over the world, including Korean yards, i.a. regarding contracts on product and chemical tankers. This supports the idea that, in the field of commercial vessels, there is only one meaningful interpretation of the term "same market" in Article 6.3 (c) and that is a global market.

The product market

22. Finally some remarks on the determination of the "product market": This must be defined on a case-by-case basis. Norway is of the opinion that one must look to the specifics of the particular sector in question – that is the building of commercial vessels. In this sector there is a great potential for substitution between products as many yards all over the world are able to build different types of ships.

With this, Norway would like to thank the panel for this opportunity to comment on certain issues of the case at hand and hopes that they may be helpful.

Thank you for your attention.

ANNEX C-8

RESPONSES OF NORWAY TO QUESTIONS FROM THE EUROPEAN COMMUNITIES AND KOREA

(22 April 2004)

Questions from the European Communities

Q1: In Norway's view, are the APRGs and PSLs supplied by KEXIM provided on terms more favourable than is otherwise available on the market?

Reply

As a third party, Norway has not undertaken any assessment of whether the actual interest rates provided by KEXIM place Korean exporters in a more advantageous position than if they were to obtain such financing in the market. If however this is the case, as stated by the European Communities, a ”benefit” is conferred.

Further, as explained both in our written submission and our oral statement, Norway is of the view that the wording of Article 26 of the KEXIM Act implies that the Government of Korea *de facto* instructs KEXIM to offer lower interest rates on pre-shipment loans than what is otherwise available in the market –provided that such practice is necessary in order to secure export contracts for Korean shipbuilders.

Q2: In Norway's view, do price suppression or depression claims under Article 6.3(c) of the SCM require the complainant to perform a "like product" analysis?

Reply

As a third party Norway has not undertaken any concrete assessment of the question raised.

Q3: In Norway's view, in the context of price suppression or depression claims in Article 6.3(c), what is the geographic scope of the phrase "in the same market"? Please describe the geographic scope of the market for LNGs, product and chemical tankers, and containerships.

Reply

Concerning the geographical scope of ”the same market” in Article 6.3(c), the Norwegian view is that the wording of this provision – unlike the wording in Article 6.3 (a) and 6.3 (b) which imposes geographical limitations on the term ”market”- has no such limitations in it. We believe that the negotiators of the Agreement – left the geographical scope to be defined depending on the characteristics of the market and product in question. In other words, the scope may vary and be national, regional or even global depending on the product concerned.

The geographic scope of the market for LNGs, product and chemical tankers and container ships are global as many yards all over the world are able to build these types of ships which operate internationally. This means that a buyer of the commercial vessels concerned may by and large address yards all over the world and choose the one able to provide the ship according to the required specifications at the best price.

Questions from Korea

Q8: In the assessment to determine whether a "public body" exists, Norway proposes to take into account whether the body concerned must carry out governmental functions or activities for governmental purposes. What does Norway consider to be governmental functions or activities for governmental purposes?

Reply

As a third party Norway, as stated in its written submission, limits itself to pointing out that it is difficult to undertake a general assessment of what constitutes governmental functions or activities for governmental purposes as such functions or activities to a large degree are dependent on the organization of the state, and the extent to which its political leadership has decided that certain functions are to be provided by the government, directly or indirectly. This could vary from one Member country to another as there are great divergences between the Members of the WTO in this respect.

Q9: Does Norway consider that the US market is open, i.e. that all shipbuilders whatever their origin can participate in bidding or sales processes for the commercial vessels concerned? Does Norway consider that the fact that a national market is open or closed is relevant for the assessment on adverse trade effects and on the definition of geographic market?

Reply

Norway as a third party, fails to see the need for – and will refrain from commenting upon any specific national market restrictions that may exist. However, any such restrictions that may exist cannot alter the fact that the overall market for commercial vessels in international trade is a global and integrated market as explained by Norway in its submission and oral statement.

ANNEX C-9

EXECUTIVE SUMMARY OF THE WRITTEN SUBMISSION OF THE UNITED STATES

(12 February 2004)

I. INTRODUCTION

1. Although this dispute raises a host of issues that are of systemic importance to the operation of the *Agreement on Subsidies and Countervailing Measures* ("SCM Agreement"), properly identifying the "like product(s)" is one of the fundamental prerequisites for a *prima facie* case of serious prejudice under Article 6.3. If the Panel were to agree with Korea that the EC has failed to properly identify the like product(s), it would be appropriate for the Panel to deny the EC's actionable subsidy claims on that basis and to refrain from making findings with respect to the other issues raised in this dispute.

II. GENERAL ISSUES

2. The United States questions the accuracy of the EC's characterization of the report in *Japan - Apples*, given that the Appellate Body stated in paragraph 157 "that the party that asserts a fact is responsible for providing proof thereof". In addition, if the EC is asserting that Annex V somehow removes the burden of proof from the complainant, then the EC would be in error. Nothing in Annex V in particular or the SCM Agreement in general supports such an assertion.

3. If the EC is asserting that a Panel is limited to the consideration of information gathered through the Annex V process, then the EC is in error. Under Article 6.8 of the SCM Agreement, the "record" includes, but is not limited to, information developed through the Annex V process.[1] In addition, a complainant cannot invoke Annex V to support a prohibited subsidy claim under Part II, because Annex V does not apply to Part II.

4. The EC erroneously argues that legislation that authorizes, but does not mandate, the provision of export subsidies is inconsistent "as such" with the SCM Agreement. It is well established under past GATT and WTO dispute settlement practice that legislation of a Member is generally inconsistent with that Member's WTO obligations only if the legislation *mandates* action that is inconsistent with those obligations or precludes action that is consistent with those obligations. The EC reliance on the panel report in the *US - Section 301* dispute is misplaced. Even assuming for purposes of argument that the analysis of the panel in that dispute was correct, the EC has failed to explain how Article 3 of the SCM Agreement equates with Article 23 of the DSU – the provision at issue in *US - Section 301*.

5. Contrary to the EC's assertions, the application of the mandatory/discretionary distinction to Article 3.2 does not render the word "maintain" meaningless. Also, the EC's brief discussion of the

[1] The United States is unsure what the EC means when it refers to "the record". There is no formal "record" for purposes of these dispute settlement proceedings. Presumably the EC means to refer to all the evidence and information provided to, or obtained by, the Panel.

Appellate Body report in the *Japan Sunset* dispute is misleading, because the Appellate Body distinguished the question of whether an instrument is a measure from the separate question of whether the instrument, if it is a measure, mandates a breach of any WTO obligation under the mandatory/discretionary distinction.[2]

III. ISSUES CONCERNING THE IDENTIFICATION AND VALUATION OF SUBSIDIES

6. The United States does not take issue with the EC's conclusion that KEXIM and the other five Korean financial institutions analyzed by the EC are "public bodies". However, the criteria considered by the EC should not be regarded as constituting the *exclusive* standard for determining whether an institution is a "public body" for purposes of Article 1.1(a)(1). The United States urges the Panel to limits any findings on this issue to the facts of this dispute. With respect to Korea's arguments concerning the concept of "public body," the text of the SCM Agreement provides no support for the notion that a public body ceases to be a public body if it carries out a function that is also carried out by private bodies.

7. With respect to the EC's allegation that the Korean Government directed private financial institutions to provide subsidies to the shipyards, the United States is in general agreement with the EC's analysis of the phrase "entrusts or directs". Korea asserts that the EC must document an explicit and affirmative governmental action delegating responsibility for subsidy actions to each of these institutions. Korea has not cited to any language in the SCM Agreement to support its assertion, and there is no such language.[3]

8. Regarding the existence of a "benefit," there is no basis for a general presumption that a facile sorting of banks into "foreign" or "domestic" categories is sufficient in every case to establish which institutions provide an appropriate "market" benchmark. This is necessarily a fact-specific exercise, particularly in a case such as this where there is an allegation that the government entrusted or directed private banks to provide subsidies.

9. Korea incorrectly asserts that once a creditor bank becomes an owner of a company, the bank is no longer capable of making a financial contribution to that company, such as through a debt-to-equity swap or debt forgiveness. If the drafters of the SCM Agreement had contemplated having ownership of a company operate as an exemption from subsidies disciplines, they would not have listed equity infusions as an example of a form of financial contribution in Article 1.1(a)(1)(i).

10. With respect to Korea's assertions concerning the IMF and World Bank, there is nothing in the SCM Agreement stating that a prohibited or actionable subsidy ceases to be prohibited or actionable if it has some sort of blessing by the IMF or the World Bank. In addition, Korea incorrectly asserts that the activities of KEXIM do not constitute a "government practice" within the meaning of Article 1.1(a)(1)(i). Export promotion through financial support is a very common government function, and pre-shipment loans and APRG's are precisely the types of transactions whereby a government may provide a subsidy to exporters.

11. Korea incorrectly asserts that because DSME performed successfully after its spin-off, Daewoo's creditors necessarily made the correct decision and acted in a market-oriented fashion. In evaluating whether a financial contribution confers a benefit, one should focus on the economic indicators and other information that would have been available to the provider of a financial

[2] The United States also requests that if, in the course of this proceeding, the EC should pursue its claim under Article 5(a) of the SCM Agreement, the United States and other third parties be given the opportunity to comment on the arguments of the parties concerning Article 5(a).

[3] The United States also disagrees with Korea's assertions that "unofficial" commentary and circumstantial evidence may not be used to demonstrate government "entrustment" or "direction".

contribution at the time the decision to provide the financial contribution was made. Korea also incorrectly asserts at various places in its submission that the fact that the companies in question went through established insolvency procedures automatically means that no subsidies could have been provided.

IV. ISSUES CONCERNING SERIOUS PREJUDICE

12. The United States disagrees with Korea's assertion that export subsidies cannot be included in a serious prejudice case. Nothing in the text of the SCM Agreement supports this proposition, and Article 13(c)(ii) of the Agreement on Agriculture makes clear that prohibited subsidies can be the subject of a serious prejudice case. To the extent that Korea is arguing that an export subsidy cannot be *simultaneously* the subject of both a prohibited subsidy claim and a serious prejudice claim, the United States also disagrees. Here, too, Korea does not cite to anything in the text of the SCM Agreement to support this proposition. Instead, it simply asserts that action under both Articles 4 and 7 of the SCM Agreement somehow results in some sort of unfair "double-counting". The presence of both prohibited and actionable subsidy claims with respect to the same subsidy, however, may have an impact on the findings made by the Panel. Because the Panel is charged with making findings to promote the prompt settlement of disputes, the Panel might want to consider making separate findings with respect to the claims of serious prejudice; *i.e.*, one set of findings that applies to all of the subsidies found by the Panel to be specific – including the subsidies found by the Panel to be prohibited – and another set of findings that applies only to the subsidies that the Panel finds are specific, but not prohibited.

13. The United States agrees with Korea that "serious prejudice" is a separate requirement that must be satisfied. Thus, a finding that one of the conditions described in subparagraphs (a)-(d) of Article 6.3 exists does not necessarily mean that "serious prejudice" exists. This conclusion follows from the use of the phrase "may arise in any case where one or several of the following apply" in the *chapeau* to Article 6.3. The United States does not agree with Korea's assertion that the standard of proof for "serious prejudice" is much greater than the standard for "material injury". The standards are different, but it cannot be said that one is necessarily higher than the other, because "prejudice to the interests of another Member" and "injury to a domestic industry" are not the same thing. The United States also disagrees with Korea's assertion that in order to demonstrate serious prejudice, the EC must demonstrate the elements set forth in Articles 11 through 15 of the SCM Agreement. To the contrary, the elements that the EC must establish are set forth in Articles 5 and 6.

14. The EC incorrectly argues that the phrase "in the same market" in Article 6.3(c) of the SCM Agreement can refer to the "world market". In subparagraphs (a)-(c) of Article 6.3, the drafters likely intended "market" to mean national market, and the limiting language in subparagraphs (a) and (b) was not intended to distinguish between national markets and a "world market," but instead was intended to distinguish between particular national markets. Interpreting "market," as used in Article 6.3(c), to include the world market would render the word "same" in the phrase "the same market" ineffective, because the subsidized and non-subsidized products always could be deemed to be in the same "world market". Finally, the EC never explains its assertion that if the phrase "in the same market" does not encompass a "world market," Members would be precluded "from challenging subsidies on the many products that are traded in world markets such as aircraft and ships".

15. Referring to the term "meaningfully affected" that the panel in *Indonesia - Autos* employed, the EC asserts that the price depression/suppression it alleges is "significant" because EC yards have had to close or have lost market share as a result of Korean subsidies. In particular, the EC argues that over-capacity in the shipbuilding industry has resulted in excessive price competition to obtain orders. Korea takes issue with the EC's approach. Although the United States does not agree with all of the conclusions drawn by Korea, it does agree that the EC 's approach is incorrect.

16. Article 6.3(c) requires that "the effect of the subsidy" is "significant price suppression," but "significant" is not defined. The EC argues that the Panel should follow the standard employed in *Indonesia - Autos*. In that report, the panel wrote that the word "significant" was included in the text on price undercutting "presumably" to ensure that the text did not capture "margins of undercutting so small that they could not meaningfully affect suppliers of the imported product". It is difficult to ascribe much weight to that panel's finding, however, given that (1) the panel did not conduct a textual analysis of the provision, and (2) the panel itself explained that it was making an assumption about the provision's meaning. The panel went on to find, essentially, that a price that is 33.77 per cent lower represents "significant" price undercutting under anyone's definition.

17. A textual analysis of Article 6.3(c) would, as always, begin with its ordinary meaning. The ordinary meaning of "significant" is "important, notable; consequential," which suggests that the price suppression must reach a level at which it is important, notable, and consequential in order to be inconsistent with Article 6.3(c). The United States further notes that the term "significant" modifies "price suppression or depression"; therefore, it is the effect on *prices* that must be "significant" and not the direct effect on *producers* , as the EC argues. By shifting the analysis to the effect on producers, the EC is improperly collapsing the separate requirements of "significant" price suppression or depression and "serious prejudice".

18. The United States has two concerns regarding the arguments made by both the EC and Korea with respect to the issue of causation and price depression or suppression.

19. With respect to the EC's arguments, the EC appears to assume that the phrase "effect of the subsidy" – the phrase used consistently in Article 6.3 – is the same as the term "effects of the subsidized imports" – the term used consistently through Part V of the SCM Agreement.[4] While the United States does not necessarily disagree with the EC's ultimate conclusion that subsidies need not be shown to be the exclusive cause of the effects identified in Article 6.3, this conclusion cannot be based on a supposed similarity in language between Article 6.3 and the provisions contained in Part V of the SCM Agreement. In this regard, the United States notes that, under Part V of the SCM Agreement, an investigating authority is expected to assess "the effects" or "the impact of the subsidized imports" on domestic prices and the domestic industry, not the "effect of the subsidy," which is what Article 6 of the SCM Agreement refers to.[5]

[4] *See, e.g.,* SCM Agreement, Articles 15.1 and 15.2.

[5] *Compare* Article 15.1, 15.2, 15.3 and 15.4 of the SCM Agreement *with* Article 6.3 of the SCM Agreement. Indeed, Article 15 only refers to the "effects of the subsidies" – as opposed to the "effects of the subsidized imports" – on one occasion, the first sentence of Article 15.5. However, even there, the Agreement's negotiators added a footnote specifically indicating that the investigating authority was to assess the "effects of the subsidies" as set forth in Article 15.5 by performing the analysis described in Articles 15.2 and 15.4. Article 15.5, fn. 47. Articles 15.2 and 15.4 both clearly indicate that a material injury analysis must focus on the "effects" or "impact" of the "subsidized imports" on the industry and its prices, not on the "effects of the subsidy" itself. *Id*.

V. CONCLUSION

20. The United States thanks the Panel for providing an opportunity to comment on the issues involved in this proceeding, and hopes that its comments will prove to be useful.

ANNEX C-10

ORAL STATEMENT OF THE UNITED STATES

(9 March 2004)

Introduction

1. Mr. Chairman, members of the Panel, it is my privilege to appear before you to present the views of the United States in this dispute. Today, I intend to discuss certain issues that were not addressed in the US written submission. These issues are KEXIM financing, and changes in ownership of companies.

KEXIM Financing

2. Turning first to KEXIM financing, the United States disagrees with Korea's assertion that KEXIM's Advance Payment Refund Guarantees (APRG) and pre-shipment loans are protected by items (j) and (k), respectively, of Annex I to the SCM Agreement.[1]

APRG

3. With respect to the APRG, item (j) of Annex I covers insurance or guarantee programmes pertaining to the following: (1) export credits; (2) increases in the cost of exported products; and (3) exchange risks. The APRG does not fall within any of these three categories of programmes.

4. The APRG does not involve the guarantee of an export credit. Export credit guarantee programmes typically consist of a contingent obligation by an export credit agency to pay a private lender in the event of a default by the foreign buyer. By contrast, the APRG does not refer to the extension of credit. Instead, the APRG consists of a guarantee of the obligation of the exporter to refund the foreign buyer's cash down payment in the event that the sales transaction is terminated. The cash down payment is the element of an export sales transaction that does *not* represent the extension of credit.

5. In addition, the APRG does not address increases in the price of the exported product or foreign exchange risk. Instead, the APRG addresses only the obligation on the part of the exporter to refund the down payment in the event that the sales transaction is terminated. However, there is no suggestion that the guarantee applies only to export sales contracts that were terminated because of the increased cost of the exported product or because of exchange rate fluctuations.

Pre-Shipment Loans

6. Turning to the KEXIM pre-shipment loans, the EC asserts that they are available to Korean exporters, manufacturers and raw materials providers.[2] However, they do not appear to fall within the

[1] Korea Submission, Sections V. 5 and V.6.
[2] EC Submission, para. 155.

scope of item (k), because they are neither "export credits" nor "the payment . . . of all or part of the costs incurred by exporters or financial institutions in obtaining credits."

7. First, these loans do not come within the description of "export credits" on the OECD website cited by Korea, which provides that "an export credit arises whenever a foreign buyer of exported goods and services is allowed to *defer payment.*"[3] The OECD description mentions two types of export credits: "supplier credits" and "buyer credits." "Supplier credits" are extended by an exporter directly to an overseas buyer. "Buyer credits" are extended by an exporter's bank or another financial institution as loans to the buyer (or the buyer's bank). Both types of credits are extended to the buyer or its bank. By contrast, the KEXIM pre-shipment loans are extended not to the buyer, but to the exporter. While such credits may be export-contingent, in that they would not be made by KEXIM but for the contemplated export, they are not export credits in that they do not finance the actual export.

8. Second, the pre-shipment loans do not appear to involve "the payment . . . of all or part of the costs incurred by exporters or financial institutions in obtaining credits." While the loans are made to exporters, there is no indication that they are at all related to "costs incurred . . . in obtaining credits."

Existence of a "Benefit"

9. Before leaving the topic of KEXIM financing, the United States would like to comment on one point made by Norway in its third-party submission. As the United States understands it, Norway argues that Article 26 of the KEXIM Act allows KEXIM to sometimes lend below its cost where concerns of "international competitiveness" make it necessary to do so. According to Norway, this proves that KEXIM financing allows for the conferral of a benefit on a *de facto* basis.[4] The implication in this statement, however, is that KEXIM financing does not confer a benefit in the non-exceptional situation where Article 26 requires KEXIM to cover its operating expenses.

10. Assuming we have understood Norway's argument correctly, then the United States must disagree with the standard that Norway suggests. The Appellate Body has indicated previously that "the marketplace provides an appropriate basis for comparison in determining whether a 'benefit' has been conferred ... ."[5] Actors in the marketplace seek to earn a profit and not merely cover their costs. Therefore, even in non-exceptional situations, KEXIM financing confers a benefit because, as a general requirement, Article 26 requires KEXIM to lend at cost.

Changes in Ownership

11. We now turn briefly to the second topic that we wish to discuss in this afternoon's statement. At various places in its first submission, Korea argues that the EC has failed to take into account the effects of changes in ownership on the existence and amount of subsidization.[6] With respect to this argument, the United States simply notes that the Appellate Body has found that under certain circumstances, the privatization of a government-owned or -controlled company may have an effect on certain types of subsidy benefits that the company had received prior to its privatization.[7] According to the Appellate Body, the precise effect depends upon the nature of the privatization transaction, and may include the complete extinguishment of prior subsidies. However, an analysis of

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[3] Korea Submission, para. 266 (emphasis added).

[4] Norway Third-Party Submission, paras. 18-19.

[5] *Canada - Measures Affecting the Export of Civilian Aircraft*, WT/DS70/AB/R, Report of the Appellate Body adopted 20 August 1999, para. 157.

[6] *See* Korea Submission, paras. 27-30 (Introduction), 374-375, 441 and 449.

[7] *See United States - Countervailing Measures Concerning Certain Products from the European Communities*, WT/DS212/AB/R, Report of the Appellate Body adopted 8 January 2003.

the facts and circumstances of the privatization transaction is critical in determining whether certain subsidy benefits have, in fact, been extinguished.

Conclusion

12. Mr. Chairman, that concludes the third-party statement of the United States. Thank you for your attention.

ANNEX C-11

RESPONSES OF THE UNITED STATES TO QUESTIONS FROM THE PARTIES (FIRST MEETING)

(22 March 2004)

QUESTIONS FROM KOREA

5. Korea has introduced the IMF's views as an element of evidence to be weighted by the Panel. Does the US consider the IMF's views legally or factually irrelevant? If so, on what basis?

1. As a general proposition, the views of the IMF might be relevant to the question of whether a "financial contribution" exists. The IMF would be particularly well-placed to assess the extent of the Korean Government's involvement in the bail-out of troubled Korean firms.

6. Regarding the last sentence in Paragraph 10 of its Oral Statement, is the US now arguing that "benefit" is determined by cost to government?

2. No, the United States is not arguing in favor of a cost-to-government standard for determining the existence of a "benefit." To the contrary, as paragraphs 9-10 of the US Oral Statement make clear, the United States was contesting the apparent suggestion by Norway that a cost-to-government standard should be applied in analyzing subsidies provided by KEXIM. Indeed, in the last sentence of paragraph 10, the United States noted that there would be a benefit even in the non-exceptional situations where KEXIM was required to lend at cost. Such an assertion is hardly consistent with a cost-to-government standard.

3. In order to avoid any confusion on this point, the United States would add that commercial lenders do not routinely lend at cost, because they must seek to earn a profit. For that reason, financing at-cost by KEXIM in "non-exceptional" situations almost certainly would result in the conferral of a benefit under a "benefit-to-recipient" approach. The benefit would be even greater in those "exceptional" situations where KEXIM lends below its cost.

If the determination of "benefit" is based on a market benchmark, of what legal relevance is cost?

4. If a market benchmark is used to determine the existence of a benefit, then what should be relevant is what a commercial lender charges a borrower for financing, not the lender's costs. A focus on what the lender charges (or what the borrower pays) is the essence of the benefit-to-recipient approach.

Does the US statement in paragraph 10 go to the issue of "benefit" or "public body"?

5. The US statement goes to the issue of "benefit." It cannot be seriously maintained that KEXIM is not a "public body" within the meaning of Article 1.1(a)(1) of the SCM Agreement.

7. In either case, if the actual evidence shows that KEXIM operated at a profit, would this change the US view expressed in paragraph 10?

6. No. As noted above in connection with Question 6, the benefit-to-recipient approach must be applied to KEXIM financing. That approach, in turn, requires a comparison of KEXIM financing to a market-based benchmark; i.e., comparable commercial financing. Evidence that KEXIM earned a profit would be irrelevant to this exercise, because it would not prove that KEXIM was charging market rates.

7. For example, assume that: (a) 5 per cent is a rate that covers KEXIM's costs and allows KEXIM to earn a profit; (b) 7 per cent is the rate KEXIM charges; and (c) 10 per cent is the market rate. In this scenario, KEXIM would be earning a profit, but still would be providing a benefit because it would be lending at below-market rates.

QUESTIONS FROM THE EC

1. Does the US believe that a "public body" in the context of Article l.l(a)(l) should only be considered a public body when, as Korea contends, it is "acting in an official capacity on behalf of the people as a whole"?

8. No.

2. Does the US believe that in order for a "private body" to be entrusted or directed in the context of Article l.1(a)(iv), such a body must receive explicit and affirmative direction from the government?

9. The phrase "explicit and affirmative direction" appears to be based upon *dicta* contained in the panel report in *United States - Measures Treating Export Restraints as Subsidies*, WT/DS194/R, Report of the Panel adopted 23 August 2001. The phrase cannot be found in the SCM Agreement itself. The United States has never been certain as to what the panel meant by "explicit and affirmative," but to the extent that the phrase is considered to require a direction in the form of a written command from the government to a private body, the United States disagrees.

3. Does the US believe, as Korea asserts, that it is impossible to distribute a subsidy through a creditor that owns a share of the enterprise that is receiving the benefit?

10. No.

4. Does the US believe that governmental actions undertaken with IMF or World Bank approval are exempt from the disciplines of the SCM Agreement?

11. No.

5. According to the US, when a panel decides whether a creditor acted according to market incentives in the context of a bankruptcy proceeding, should the panel consider the subsequent performance of the enterprise or should it consider only the information that was available at the time of the bankruptcy proceeding?

12. A panel considering a dispute under Part III of the SCM Agreement (or an investigating authority in a countervailing duty proceeding under Part V) must put itself in the shoes of the creditor

at the time of the investment decision. Because such a creditor would not have knowledge of the firm's future performance, the panel/investigating authority should not consider such information.

6. Could the US elaborate on their own experience regarding the GOK direction of credit to Korean companies and in particular their views on KEXIM so called market oriented behaviour?

13. With respect to this question, the United States refers the EC to the countervailing determinations of the US Department of Commerce in cases involving products from Korea. More specifically, the Department's treatment of particular Korean subsidy programmes can be found at <www.ia.ita.doc.gov/esel/eselframes.html>.

ANNEX C-12

RESPONSES OF THE UNITED STATES TO QUESTIONS FROM THE PANEL (SECOND MEETING)

(2 July 2004)

Q: The parties disagree on whether or not APRGs and PSLs constitute export credit guarantees and export credits respectively. The EC submits that they do not, whereas Korea asserts that they do. Would your export credit agency treat APRGs as export credit guarantees, and PSLs as export credits? Please explain and provide relevant documentation.

1. The United States thanks the Panel for the opportunity to reply to this question. As background for its reply, the United States notes that the Export - Import Bank of the United States (Ex-Im) is the principal US export credit agency.

Advance Payment Refund Guarantees (APRGs)

2. It is the understanding of the United States that under the APRG programme, the Korean Export-Import Bank (KEXIM) issues guarantees to foreign buyers that Korean exporters will refund any cash down payments made by the buyers in the event that the sales transaction is terminated prior to export. As explained in paragraph 4 of the Oral Statement of the United States (9 March 2004), while the APRG is a guarantee issued in connection with a proposed export (and which may, therefore, be export-contingent for purposes of Article 3.1(a) of the *Agreement on Subsidies and Countervailing Measures*), it is not a guarantee of an export *credit.* An export credit typically consists of a loan to the foreign buyer. If the loan is extended by the seller or by a private bank, the export credit agency may guarantee the lender against a default by the buyer regarding repayment. Such a transaction would be an export credit guarantee.

3. Section 9 b) of the OECD Arrangement on Officially Supported Export Credits (the *Arrangement*) provides that "Official support for ... down payments shall only take the form of insurance or guarantee against the usual pre-credit risks."[1] Ex-Im does not consider the APRG to fall within this definition. Ex-Im's practice with respect to pre-credit risks is to provide cover to the insured party (US exporter or lender acting on behalf of the US exporter) against the risks of contract cancellation by the foreign buyer, not for the foreign buyer. Moreover, Ex-Im is unaware of any other export credit agency that offers the type of cover to the foreign buyer that Korea provides under the APRG programme.

Pre-Shipment Loans (PSLs)

4. It is the understanding of the United States that under the PSL programme, KEXIM provides pre-shipment loans to Korean exporters. Pre-shipment loans are not export credits. Export credits typically are loans to foreign buyers. Although the OECD *Arrangement* does not define "export credits", Section 5 (Scope of Application) of the *Arrangement* states that:

[1] Arrangement on Officially Supported Export Credits, TD/PG(2004)12, 11 June 2004.

> The Arrangement shall apply to all official support provided by or on behalf of a government for export of goods and/or services, including financial leases, which have a repayment term of two years or more.
>
> (a) Official support may be provided in different forms:
>
> (1) Export credit guarantee or insurance (pure cover),
>
> (2) Official financing support:
>
> - direct credit/financing or refinancing, or
>
> - interest rate support.
>
> (3) Any combination of the above.

5. The *Arrangement* definition of "official support" is limited to support provided "for export" of goods and/or services. This definition would preclude pre-export financing to the *exporter*, such as the PSL programme. This interpretation is reinforced by language on the OECD's website, "Export credits, about", which states as follows:

> Governments provide official export credits through Export Credit Agencies (ECAs) in support of national exporters competing for overseas sales. ECAs provide credits to *foreign buyers* either directly or via private financial institutions benefiting from their insurance or guarantee cover. ECAs can be government institutions or private companies operating on behalf of the government.[2]

While the PSL programme involves the extension of credits to Korean exporters that may be export contingent for purposes of the *Agreement on Subsidies and Countervailing Measures*, these credits are not export credits within the meaning of the OECD *Arrangement*.

6. US Ex-Im Bank has a Working Capital Guarantee Programme, under which Ex-Im offers a guarantee to the commercial lender providing export-related working capital to the US exporter. If the US exporter defaults on its commercial bank loan, Ex-Im makes payment on the guarantee, and seeks collection against the US exporter. Because the Ex-Im guarantee covers the risk of the US exporter, rather than the foreign buyer, Ex-Im does not consider this programme to be an export credit within the meaning of the OECD *Arrangement*.

[2] http://www.oecd.org/about/0,2337,en_2649_34169_1_1_1_1_37431,00.html. Visited 30 June 2004 (emphasis added).

ANNEX D

RESPONSES OF THE PARTIES TO QUESTIONS FOLLOWING THE FIRST MEETING OF THE PANEL

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ANNEX D-1

RESPONSES OF THE EUROPEAN COMMUNITIES TO QUESTIONS FROM THE PANEL

(22 March 2004)

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LIST OF EXHIBITS D-43

A. QUESTIONS TO EC

1. Question 1

What makes an entity a public body? Is the power to regulate and tax a necessary and sufficient condition to qualify an entity as a public body?

Response

1. The purpose of Article 1.1(a)(1) of the *SCM Agreement* providing that financial contributions can be made by "any public body" as well as by "a government" is to capture all use of State resources to influence the decisions of enterprises in pursuit of a public policy objective. Accordingly, the EC considers the following factors to be relevant in an assessment of whether an entity is a public body:

- Whether the entity is controlled by the government, be it through ownership or by a public statute establishing the body;
- Whether the entity pursues public policy objectives;
- Whether the entity has access to State resources either through the use of capital on which it is not obliged to secure a commercial return or through a government guarantee of debts or losses.

2. The Panel does not need to decide in this case whether it is sufficient that one of these conditions is fulfilled or whether all of these conditions need to be fulfilled cumulatively to make an entity a "public body". All the entities claimed to be public by the EC in this case are established and controlled by the government through public statutes that set public policy purposes and give these bodies access to state resources.

3. The powers to regulate and tax are essential governmental powers. Thus, an entity that shares these powers can be considered to be part of the government. These powers may therefore be considered sufficient conditions to make an entity part of the government. These powers are not however necessary conditions for an entity to be a public body.

2. Question 2

Para. 83 of the EC's first written submission describes the purpose of permitting prospective challenges against mandatory legislation. What would be the purpose of prospective challenges against non-mandatory legal instruments? What would Members protect themselves against by bringing a prospective challenge against another Member's law that allows, but does not require, the grant of prohibited export subsidies?

Response

4. A power for a government to make grants obviously allows the grant of a prohibited export subsidy. But it would be an improper presumption of bad faith to assume that it would be so used.

5. However a law that provides a public body with explicit objective or instruction to promote exports or assist exporters with subsidised funding and a prohibition on competing with commercial banks goes further than simply allowing the grant of an export subsidy – it *specifically envisages* the grant of export subsidies. It is not an improper presumption of bad faith to assume that public bodies will do what they are created and instructed to do.

3. Question 3

Please comment on para. 119 of Korea's first written submission, regarding the interpretation of the word "maintain" set forth in Article 3.2 of the SCM Agreement.

4. Question 4

What is the basis for interpreting Article 3.2 in a manner that prohibits legislation containing a discretion to provide prohibited export subsidies?

Response (to questions 3 & 4)

6. The EC agrees that the word "maintain" implies continuance rather than prevention but believes that this argument misses the point.

7. The EC considers that the word "maintain" in Article 3.2 signifies that the prohibition of export subsides applies not only to individual grants of subsidy but also to schemes (or programmes, to employ the term that is used in the *SCM Agreement*) under which they are granted. Individual subsides are granted, not maintained. Subsidy schemes or programmes are maintained, not granted.

8. The fact that schemes or programmes are covered by the prohibition of export subsides is confirmed by the other provisions of the *SCM Agreement*. For example, Article 28.1 refers to:

> Subsidy programmes which have been established within the territory of any Member before the date on which such a Member signed the WTO Agreement and which are inconsistent with the provisions of this Agreement …

9. And, even more significantly, Articles 29.2 and 29.3 both refer to "subsidy programmes falling within the scope of Article 3".

10. Also, item (j) of the illustrative list of export subsidies in Annex I to the *SCM Agreement* deems to be an export subsidy prohibited by Article 3.1: "export credit guarantee or insurance *programmes*, of insurance or guarantee *programmes"*. The ordinary meaning of the word "programme" is: "A plan or outline of (esp. intended) activities; *transf.* a planned series of activities or events".[1]

11. This definition does not imply that the programmed acts are "mandatory", only that they are planned or intended. Accordingly, the prohibition of export subsidy programmes applies not only to measures that "mandate" the grant of subsides but also to measures that plan or intend, or, as the EC puts it, specifically envisage, the grant of individual export subsidies.

5. Question 5

What were the credit ratings, by Korean Investor Services, of each Korean shipyard alleged to have received subsidies, for each of the years 1997-2003, inclusive?

Response

12. The EC does not know the credit ratings accorded these companies by Korean Investors Services but presumes that these credit ratings are similar to those provided by Korea in

[1] Shorter Oxford English Dictionary (4th edition, 1993), p. 2371.

attachment 1.1(24)-1 of its Annex V replies.[2] Indeed, as stated by Korea, prior to the new credit system adopted by KEXIM, KEXIM compared the credit ratings made by various credit information companies including the Korean Investor Services (attachment 1.1(24) to Korea's Annex V replies). However, the credit ratings were only provided for each of the years 1997-2002. Year 2003 is not available.

6. Question 6

Is the EC of the view that finance / guarantee measures provided under the KEXIM legal regime would necessarily be inconsistent with Articles 3.1(a) and 3.2 of the SCM Agreement? Please explain.

Response

13. The EC considers that it is possible that measures taken by KEXIM (either a subsidy programme or an individual subsidy grant) would not be inconsistent with Articles 3.1(a) and 3.2 of the *SCM Agreement*.

14. The question before the Panel is however whether some 200 individual grants, the actual pre-shipment loan and APRG schemes described in the EC's first written submission and the KEXIM legal regime itself are inconsistent with Articles 3.1(a) and 3.2 of the *SCM Agreement*.

15. The EC does not believe that a legal regime such as that of KEXIM will only be inconsistent with Article 3.1(a) and 3.2 *SCM Agreement* if it is absolutely inevitable or certain or "mandatory" (in the sense that Korea uses this term) that export subsidy programmes or individual export subsidy grants will arise in all cases. For the reasons explained above, it is sufficient if this is the intent or purpose of the measure.

7. Question 7

The KEXIM 2002 Annual report (Exhibit EC-14) contains a chapter entitled Bank Operations. That chapter refers to a decline in KEXIM's export credit business. It states that "[m]ajor Korean exporters were reluctant to use bank loans, instead they preferred raising funds from direct markets which was possible due to their successful corporate restructuring". Does this suggest that KEXIM's export credit terms are less attractive to Korean exporters than the terms for competing financing from other sources? Please explain.

Response

16. The KEXIM 2002 Annual report uses the term "export credits" for loans to exporters - as evidenced by the reference to Korean exporters as the takers of these loans. Loans to foreign buyers – for which the term "export credit" is conventionally reserved – are referred to as "direct loans" in the Annual Report[3] and, in the same section as that referred to by the Panel, KEXIM reveals that it granted the first true export credit in its history in 2002.

17. Although the volume of these loans to exporters showed a decrease in 2002, they still represented 89.2 per cent of KEXIM's disbursements. (The same section of the report explains that it has decreased from 95 per cent to 89.2 per cent in 2002).

18. Thus, although it may be true that the major beneficiary of these loans – Korean shipbuilders – were able, due to the infusions of subsidised equity or loan capital or resulting improved access to

[2] Exhibit EC – 30.
[3] Page 2 of KEXIM's Annual Report (Exhibit EC-54).

finance from the corporate bond market to reduce their use of short term pre-shipment loans from KEXIM, it is still clear that the amount of loans to exporters was still very high in 2002 – KRW 7,473 billion.

19. The statement does not therefore demonstrate that KEXIM's export loans are less attractive to Korean exporters than the terms for alternative finance. It only suggests that the margin of advantage involved in using KEXIM's export loans may have reduced due to alternative finance becoming easier. The high level of KEXIM's export loans shows that these are still offered at very attractive rates.

20. What is clear from the statement referred to is that it constitutes an admission by KEXIM that previously companies were unable to obtain finance on such favourable terms as available from KEXIM.

8. Question 8

Para. 122 of the EC's first written submission states that the KEXIM legal regime, as "confirmed by KEXIM practice", provides for the grant of subsidies. Is the EC challenging "KEXIM practice" as well as the KEXIM legal regime as such, or does the EC rely on evidence regarding "KEXIM practice" in support of its claim against the KEXIM legal regime as such? If the latter, please explain how evidence regarding "KEXIM practice" is relevant to the Panel's assessment of whether the KEXIM legal regime as such is, or is not, in conformity with the SCM Agreement.

Response

21. The EC's position is that KEXIM's legal regime is inconsistent with Article 3 of the *SCM Agreement* because it *specifically envisages* the grant of export subsidies. The EC considers that this conclusion derives principally from:

- KEXIM's statutory objectives of promoting economic development and financing exports – Article 1 of the KEXIM Act;
- Financial contributions granted by KEXIM, pursuant to Article 18 of the KEXIM Act, are "for the purpose of facilitating exports of products", and, therefore, contingent on export within the meaning of Article 3.1(b) of the *SCM Agreement*;
- The huge amount of new capital (over KRW 1.9 trillion between 1998 and 2003) provided by the Korean government[4] for free – Article 37 of the KEXIM Act provides that it is not to pay dividends to the Korean Government;
- The KEXIM Act, including Articles 19, 36(2), and 37 thereof, guarantees that KEXIM does not need to act on market terms or with proper regard to risk, and provides KEXIM with virtually unlimited funds from Korea;
- The KEXIM Act imposes no requirements that KEXIM take market conditions into account when disbursing funds. Instead, Article 24 of the KEXIM Act prohibits KEXIM from competing with other financial institutions, thereby providing a benefit that is not available on the market;
- Article 26 of the KEXIM Act provides that interest rates do *not* need to be set "to cover the operating expenses, commissions for undertaking of delegated operations,

[4] Korea's Response to Annex V Questions, Attachment 1.1(11) (BCI).

interest on borrowed funds, and depreciation of assets" when "*inevitable for maintaining the international competitiveness to facilitate the export*." This demonstrates that KEXIM values the "international competitiveness" of Korean export-oriented industries over its own financial condition, a condition that increases KEXIM's ability to provide support on terms better than those available in the market.

- **[BCI: Omitted from public version.]**

22. KEXIM's practice of granting pre-shipment loans and APRGs at subsidised rates confirms the soundness of this understanding of KEXIM's legal regime.

23. The practices are however separate violations in their own right although these are linked to the violation inherent in KEXIM's legal regime in the sense that the former is the consequence of – as well as confirmation of – the latter.

9. Question 9

How does the EC's claim against the "APRG programme" as such differ from its claim against the KEXIM legal regime as such? Isn't the "APRG programme" based on the KEXIM legal regime? Is it conceivable to assess one of them differently from the other?

Response

See answer to question 8 above.

10. Question 10

Is the website document cited in footnote 109 of your submission the only basis for your statement that PSLs are not export credits?

Response

24. The definition of "export credits" given by the OECD reflects the generally accepted meaning of term as evidenced by the documents cited to in paragraphs 57-59 in the EC Oral Statement.

25. In addition it is clear from the reference to the OECD Arrangement in paragraph 2 of item (k) that the term "export credit" used in the second paragraph has the meaning given to it in the OECD Arrangement.

26. In view of the close parallels between the first and second paragraph it must be assumed, in the absence of any indication to the contrary, that the term has the same meaning in both the first and second paragraphs.

11. Question 11

How does the EC's claim against the "PSL programme" as such differ from its claim against the KEXIM legal regime as such? Isn't the "PSL programme" based on the KEXIM legal regime?

Response

See answer to question 8 above.

12. Question 12

Do the activities of KEXIM in the form of APRGs or PSLs constitute "government practice" in the sense of Article 1 of the SCM Agreement? Please explain.

Response

27. Yes, KEXIM's APRG and pre-shipment loan programmes constitute 'government practice' within the meaning of Article 1 of the *SCM Agreement*.

28. Article 1.1(a)(1) of the *SCM Agreement* lays down that the first component of a subsidy is:

> a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government")

29. It makes clear therefore that wherever the word "government" appears in the Agreement, it means government or public body.

30. The first instance of a financial contribution that is given is:

> (i) a government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees);

31. This therefore covers loans and guarantees made by governments (in the strict sense) and loans and guarantees made by public bodies.

32. Practice is defined by Oxford English Dictionary as "usual or customary action or performance".[5] Because KEXIM is a public body, its practice (i.e., "usual or customary action or performance") must be considered "government practice" because KEXIM is a public body, its loan and guarantee practices are financial contributions. Korea makes a fundamental error in paragraphs 161-163 of its first written submission when it defines "government practice" without reference to the fact that government is defined as both government and public body. For example, it states that "even if a body is a public body, it does not make a financial contribution if it is not involved in a government practice".[6] Korea forgets that government as defined in Article 1.1(a)(1) of the *SCM Agreement* also includes any public body.

13. Question 13

In note 163 to its first written submission, Korea asserts that "no allegations have been made about APRGs having been extended by KEXIM to Hyundai and Hyundai Mipo". During the first oral hearing, however, the EC stated that it was challenging APRGs provided in respect of Hyundai commercial vessel transactions. Please confirm the EC's position in this regard.

Response

33. Note 163 to Korea's first written submission is incorrect.

34. First of all, the APRGs listed in figure 12 of the first written submission of the EC as benefiting Samho HI/Halla HI were still outstanding when Hyundai took complete control of that entity.

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[5] Shorter Oxford English Dictionary (4th edition, 1993) at p. 2317.
[6] First written submission of Korea, para. 161.

35. More generally however, the EC explained, in paragraph 173 of its first written submission, that "other Korean shipyards … have paid significantly lower premiums for APRGs granted by KEXIM than for similar APRGs".

36. It is true that the European Communities only proceeded to provide details in this section of APRGs to Hanjin and Samsung, but this was clearly by way of example. (In the case of pre-shipment loans, the examples included Hyundai Mipo and Hyundai HI but not Samsung.) Contrary to what is suggested by Korea in its footnote 163, there is no implication that Hyundai Mipo and Hyundai HI did not benefit from APRGs at subsidised rates. This is also clear from the conclusion in paragraph 182, where the EC stated that it had "detailed the specific grants of APRGs and pre-shipment loans of which it is aware".

37. The EC's claim against the pre-shipment loan and APRG schemes as such are not, by their nature, limited to these shipyards but relate to the schemes.

38. The EC is not however asking the Panel to rule that any specific APRGs granted to Hyundai Mipo and Hyundai HI (apart from APRGs to Samho which were outstanding when it became part of Hyundai HI) are prohibited export subsidies.

39. Although Hyundai and Hyundai Mipo have received APRGs almost exclusively from KEXIM, the EC cannot establish what the benefit is since it lacks the necessary information.

14. Question 14

Regarding your argument at para. 239 of your first written submission that GOK will guarantee losses by private financial institutions participating in the chaebol-restructuring process, please indicate precisely which provisions of the Chaebol Restructuring Plan explicitly provide for such guarantee.

Response

40. The Agreement for the Restructuring of the top 5 chaebols of December 1998[7] refers in point 18 to the GOK

> upholding the soundness of the financial institutions in connection with the implementation of the agreed restructuring plan.

41. Even if the agreement does not use the term "guarantee" the language used in policy notes have effectively constituted one. A normal reading of the provision by a bank means that they can proceed with the restructuring without being constrained by possible financial losses.[8]

42. In other instances, the Korean Government was even more explicit. For example, with regard to investment trust companies which were holders of Daewoo bonds (and creditors of DHI) the

[7] Exhibit EC-40.

[8] The 1998 December Agreement for the Restructuring of the Top 5 Chaebols was preceded by an Agreement **in January 1998 and followed by a third in August 1999**.

> The EC cannot provide the content of these agreements as the Government of Korea refused to provide to the European Communities, in the context of the Annex V procedure, a copy claiming that "*the question [was] irrelevant*". However, the European Communities considers that this document is quite relevant to this dispute because it shows the degree of intervention of the Government of Korea in the corporate sector. The European Communities therefore asks the Panel to draw adverse inferences from Korea's refusal to provide a copy of the January Agreement

Ministry of Finance promised that it would "pump public funds" into market stabilization funds with a view to buying "unlimited amounts of corporate bonds from the investment trust firms" which are exposed to the dismantled Daewoo Group. In particular, it stated that:

> In a bid to stabilize interest rates, the government will inject 20 trillion won in bond-market stabilization funds into the financial market by October 15. The funds will be used to buy out corporate bonds that investment trust firms, which are exposed to the dismantled Daewoo Group, may sell to raise the funds necessary to cope with possible massive redemption from their depositors. If needed, the government will also expand the size of funds to buy unlimited amounts of corporate bonds from the investment trust firms. …..
>
> If investment trust firms face fund shortages, the government will pump public funds into those firms to guarantee the payments to their investors.[9]

43. Furthermore, Korea explained in detail the massive action plan taken by GOK to assist financial institutions including the

> Restructuring and recapitalization of financial institutions based on sound rehabilitation or closing where needed and with mergers including with foreign financial institutions if needed and the acceleration of non-performing loans as well.[10]

44. In fact, the Korean Government pumped into the financial institutions over **[BCI: Omitted from public version].**

45. Thus, financial institutions depended on GOK for their liquidity and/or survival.

46. Moreover, the GOK made access to this liquidity assistance subject to a number of conditions, the most important of which was participation of banks to corporate restructuring. These conditions were clearly spelled out in Korea's policy statements to the IMF. For example, the Letter of Intent (LOI) of 24 September 1998:

> Government confirms that public funds will be used only: …..- where the bank is making adequate process on implementation of sound corporate debt restructuring….[11]

47. This condition was further refined in the LOI of 13 November 1998 where it was made clear that there would be no KAMCO purchasing of bad debts, no capital injections to banks which do not wish to participate in the restructuring of troubled firms.

> In order to enhance the incentives for banks to participate fully in the corporate restructuring process, no public funds, whether by way of KAMCO purchases or capital injections or other means, shall be made available to banks which are not certified by the FSC to be performing their role in the corporate sector restructuring process.[12]

48. The above condition was included in all of Korea's policy notes to the IMF until at least July 2000. Thus, Korea effectively ensured that only financial institutions which participated in the restructuring effort would have access to public funds.

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[9] MOFE press release – published on MOFE website on 6 October 2000 (Exhibit EC – 101).
[10] Attachment 5 of First written Submission by Korea.
[11] Korea Letter of Intent to IMF of 24/09/1998 (Exhibit EC-102).
[12] Exhibit EC-36.

15. Question 15

Please provide the Panel with an estimate of the magnitude of the total amount of subsidization resulting from the measures identified in your Article 5(c) claims, along with an explanation and demonstration of how this estimate was derived. Please relate this estimate to the degree of price suppression / depression alleged by the EC.

Response

49. The EC attaches an estimation of the magnitude of the amount of subsidisation resulting from the measures identified in the EC's Article 5(c) claims in **Attachment 1** to this submission. The EC also attaches as **Attachment 2** an estimation of price depression and suppression together with other relevant information prepared by the EC's consultants, First Marine International.

50. However, the EC maintains that there is no obligation to quantify the amount of subsidisation and its relation to price depression and suppression for all serious prejudice claims. . **[Add text]**

16. Question 16

In its third party submission in the US – Export Restraints case, the EC argued that there is no government entrustment or direction in a case where freedom of action is "limited", but not "curtailed", i.e., where "the producer can still make choices". Does the EC consider that the freedom of action of private financial institutions participating in the restructuring process was (i) "limited" or (ii) "curtailed"? Were those companies able to make choices regarding their participation in the restructuring process? Please explain.

Response

51. The *US - Export Restraints* case related to a rather particular situation. It concerned the rather contorted position taken by the US in its countervailing duty practice that export restraints constitute the entrustment or direction of private parties to sell more goods on the domestic market than they would otherwise. The panel in that case was therefore considering a very different situation to that prevailing in this case which relates not to a general legislative measure but to specific measures taken with regard to the policies of banks. Obviously, operators who cannot export are not entrusted or directed to sell more domestically. They can simply not produce that which they would have exported if this were allowed.

52. The EC would approach the application of Article 1 of the *SCM Agreement* to the present case by interpreting the words of that provision according to their ordinary meaning and in the light of their context and purpose rather than interpreting words used to describe the way the provision might apply in a very different case.

17. Question 17

Are you arguing in paragraph 73 of your oral statement that the banks that participated in the Corporate Restructuring Agreement thereby legally committed themselves up front to follow the direction of the government? Did such undertaking(s) by the banks affect <u>all</u> of the restructurings referred to in your complaint? Please elaborate and provide specific evidence.

Response

53. Yes, under the Corporate Restructuring Agreement (CRA), banks explicitly legally committed themselves to

- restructuring (as opposed to liquidation) through debt-for equity swap and other measures listed in the Agreement.[13]

- certain procedures, i.e., leader bank will chair meetings thereby influencing the process, majority voting.[14]

- shorter time for decision-taking.[15]

54. Korea themselves admits in its First Written Submission that by entering into this Agreement, domestic banks limited their ability to behave" *independently and in their own self-interest*" as opposed to (foreign) banks which did not sign the CRA.[16]

55. Hence, the CRA already generally curtailed the discretion of individual private banks in deciding how to use their rights as creditors, e.g., in the restructuring for Daewoo.

56. Furthermore, the signing of the CRA by banks under Government pressure should not be seen in isolation. Already the Agreement for the Restructuring of the top 5 Chaebols of December 1998[17] (originally also foreseen for Daewoo) reflects the Korean Government's policy of resolving the corporate crisis **through debt/equity swaps**.

57. Through the *Agreement for the Restructuring of the top Five Chaebols* of December 1998 major creditor institutions[18] agreed with the Korean government to support the restructuring of the top 5 chaebol particularly through debt/equity swaps.

58. Point 17 of the 1998 December *Agreement for the Restructuring of the Top Five Chaebols* provides:

> (17) Creditor banks will have primary responsibility for examining and monitoring implementation. Also, the creditor banks shall carry out pledges toward providing support to restructuring, such as debt/equity swap.

59. However, as explained by the European Communities in its First Written Submission and its Oral Statement, the discretion of Korean banks was then further curtailed by a number of "stick-and-carrot- measures".[19]

60. The EC in its Oral Statement has already produced evidence from private banks showing how the government was ready to use its influence with private banks to privilege certain sectors:[20]

> "by requesting banks to participate in remedial programmes for troubled corporate borrowers and
>
> by identifying sectors of the economy it wishes to promote and

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[13] See Articles 1 and 2.2 of the CRA (Exhibit-EC 42).
[14] See Article 15.2 of the CRA.
[15] 4-6 months, see first written submission of Korea, at para. 302
[16] First written submission by Korea at para 355.
[17] Exhibit EC-40.
[18] The agreement was signed by the Korea Development Bank, the Commercial Bank of Korea, the Korea First Bank, Hanil Bank and the Korea Exchange Bank.
[19] First written submission by the European Communities at paras 231 to 243
[20] Oral statement by the European Communities at para 75.

> by making low interest loans available to banks and financial institutions who lend to borrowers in these sectors.
>
> … government policy may influence us to lend to certain sectors or in a manner in which we otherwise would not in the absence of the government policy".[21]

61. In addition, the EC noted at the first substantive meeting with the parties that these banks were at the time of the restructuring in an immediate need of capital in order to ensure their survival. Therefore, one would have expected them to pursue all means to increase cash inflows including the liquidation of troubled borrowers. This was even more so for banks which were in possession of secured credits.

62. Under normal market considerations this fact would have tilted the decision of the banks towards liquidation as opposed to restructuring. Debt and equity do not have the same value. Debt is supposed to be repaid in full with interest while the return on shares and their value are highly volatile. A debt requires interest payment and repayment at a fixed moment in time. The swap into equity relieves the debtor from these obligations. The risk is entirely on the equity-holder whether the value of the shares raises and he receives dividends. The return is volatile and uncertain.

63. Thus, from the perspective of the creditor bank, debt-to-equity swaps not only do not generate any capital for the bank but also further reduce capital inflows as debt needs no longer be repaid; they are, thus, rather a luxury enjoyed by healthy banks which can afford to wait and see if the swap will eventually produce any benefits in the future.

64. Korean banks which participated in the restructuring of the shipyards were in exactly such an onerous situation. A careful examination of the situation of each of DHI`s creditors reveals that almost all of the creditors were facing at the time severe financial difficulties which led to government intervention. This intervention took many forms depending on the type of the financial institution involved and its particular needs such as:

- capital injections (in most cases leading to the Government of Korea obtaining important shareholdings - in some cases up to 100 per cent),
- assurance of government intervention in case of liquidity problems, or
- the outright provision of public funds.

65. On top of the above tailor-made measures all of DHI creditors benefited from the Korean Government's assistance through KAMCO, i.e., from KAMCO`s purchases of their bad loans which led to KAMCO obtaining 26 per cent of DSME shares after the debt-to-equity swap.

66. EC submits separately an **Attachment 3** which shows in what way each DHI creditor was assisted by the Korean Government.

67. In the above circumstances, where the above financial institutions depended on the Korean Government for their survival, it is highly questionable to what extent these institutions could maintain views which departed from those of the Korean Government concerning the restructuring.

68. Finally, banks which had received public funds were limited in the way they could exercise their independence in participating in a restructuring. Article 18 of the *Special Act on the Management of Public funds*[22] obliges banks to enter into written agreements with the companies

[21] Kookmin Bank brochure, p. 22, (Exhibit EC-100).
[22] Special Act on the Management of Public funds (Exhibit EC-103).

they wish to support the details of which are set out in a Presidential Decree.[23] Furthermore, banks are prohibited from providing funds if the agreements are not implemented or are not likely to be implemented.

69. In short, the banks already curtailed their choice between liquidation and restructuring through debt-for-equity swaps by signing the CRA . Their discretion how and when to provide funds to companies was then further curtailed by the other measures described above, which together form a clear demonstration of government involvement on the banks' financing decisions.

70. As the CRA framework was only set up in the first half of 1998, it was too late to be used by **Halla** and **Daedong** which faced problems already in 1997 and which were obliged to follow the then existing framework (court-supervised corporate reorganisation proceeding).Daedong applied for it on 10 February 1997 and Halla on 6 December 1997. This, however, did not change their situation as explained above and in question 21.

18. Question 18

How did the Daewoo debt-for-equity swap constitute a financial contribution by a public body, and on whom was any resultant benefit conferred? Is there evidence that debts were swapped for less than fair market value, or that equity was obtained for a price greater than its market value?

Response

71. The Daewoo debt-for-equity swap constituted a financial contribution because it involved forgiveness of debt and a debt-for-equity swap and therefore direct transfers of funds through grants and equity infusions within the meaning of Article 1.1(a)(1) of the *SCM Agreement*:

72. As has been explained in responses to Questions 14 and 17 above, the creditors deciding on the debt-for-equity swap were public bodies or private bodies entrusted or directed by the government within the meaning of Article 1.1(a)(1) of the *SCM Agreement*. Thus, the debt-for-equity swap constitutes a financial contribution.

73. The resulting benefit of this creation subsidy was conferred on the restructured company, Daewoo.

74. As to its amount, it is important to note that from the perspective of the recipient, i.e., the restructured Daewoo, a debt-for equity swap is not simply a reorganization of the balance sheet not involving flow of new money.

75. First, debt and equity do not have the same value, a debt is supposed to be repaid in full with interest while the return on shares and their value are highly volatile. Thus, formalistically, one could see a debt-for equity swap *per se* as conferring a benefit, in particular if the recipient is an insolvent company or is in such a poor financial state that no private investor would have participated in such an action. A debt requires interest payment and repayment at a fixed moment in time. The swap into equity relieves the debtor from these obligations. The risk is entirely on the equity-holder whether the value of the shares rises and he receives dividends. The return is volatile and uncertain. Having said this, it is difficult to generalize about these issues, as the facts of each individual case will vary. The existence of a subsidy and the amount of the benefit will depend on the circumstances of each case.

[23] During the Annex V process, Korea refused to provide the Presidential Decree stating that a translated copy of the Decree was not available; see Korea's response to the EC follow-up questions of 20 October 2003 under the section "attachment 2.1(6) at pages 7 and 8.

76. The *SCM Agreement* is not drafted in terms of flows of money. Article 1 provides for the existence of a financial contribution in the event of certain *actions* by a government, or by private parties acting at its behest. The existence of a benefit is determined in relation to what could have been obtained by the recipient on the market in arm's length transaction. The amount of benefit must also be assessed on that basis, as indicated in Article 14 of the *SCM Agreement*.

77. As evidenced by the calculations in **Attachment 1** to these responses, the creditors of Daewoo overpaid for the equity in the debt for equity swap on 14 December 2000 by KRW 649,089 million when compared to the price of the stock when it was first publicly traded on 2 February 2001.[24]

78. However, the EC wishes to clarify that the calculation of the benefit resulting from the debt-for-equity swap assumes that the restructuring plan itself was market based. Yet, the EC maintains and will further develop its argument that the market as evidenced by the foreign creditors would not have agreed to the restructuring plan including the debt-for-equity swap at all and that therefore, the amount of the benefit to Daewoo is significantly higher. (See response to Question 15 and exhibit 112).

19. Question 19

Please comment on para. 56 of Korea's oral statement, regarding the impact of changes-in-ownership on the benefit analysis.

Response

79. Korea's argument, if the EC understands correctly, is that the restructured yards did not receive a benefit because the restructuring process involved changes-in-ownership. However, the reference to the privatization cases is entirely misplaced. The fundamental rationale behind the privatisation cases is that it cannot be presumed that a privatised company continues to benefit from financial contributions provided to a former state-owned holder of the assets where the sale was at arm's length and for market value. In such a case, the benefit no longer accrues to the privatised company but to the former owner of the assets and if this is the government itself the subsidy is effectively withdrawn.

80. The situation is very different in the case before this Panel. The change in ownership **and** the subsidy constitute one and the same measure and it is the successor company that is the only recipient of the benefit; the predecessor company never receives a benefit. Moreover, the change in ownership was not at arm's length and indeed is part of the measure that constitutes the subsidy.

20. Question 20

The EC asserts (first written submission, para. 281) that KAMCO purchased non-secured loans held by foreign creditors of DHI on terms more favourable than those offered to domestic creditors. How is this relevant to the Panel's examination of the issues of whether or not there was a financial contribution and benefit to the restructured company?

Response

81. Over the period August 1999 to June 2000 KAMCO purchased **[BCI: Omitted from public version]** worth of Non performing loans (NPLs) of DHI.[25] From financial institutions of which **[BCI:**

[24] First written submission of the European Communities, paras. 258 and 284.

[25] Responses by Korea to the Annex V Questions (Business-Confidential Version) (Exhibit EC-39), response to question 30 at page 80.

Omitted from public version] related to Daewoo-SME[26] and became a creditor of DAEWOO-SME holding **[BCI**: **Omitted from public version]** of the shares after the swap.[27]

82. KAMCO bought Non-Performing Loans at rates of **[BCI: Omitted from public version]** from foreign creditors and **[BCI: Omitted from public version]** from domestic creditors of Daewoo-HI. KAMCO's purchase of non-secured loans at a discount is a financial contribution in the meaning of a grant/equity infusion in DSME.

83. The purchase by KAMCO proves that independently and market oriented behaving foreign creditors did not agree to restructuring. As Korea stated in para. 356 of its first written submission, the foreign creditors could have obstructed the liquidation. The purchase at a higher rate can be seen as evidence that the foreign creditors were "bought out".

84. Even according to the Arthur Andersen Report the total recoverable value compared to the creditors outstanding claims was only claimed to be:

- **[BCI: Omitted from public version]** under the Liquidation value scenario
- **[BCI: Omitted from public version]** under the "going concern value" scenario.[28]

85. KAMCO's purchase of more than **[BCI: Omitted from public version]** of DHI non-performing loans[29] provided a benefit to the restructured Daewoo Shipbuilding Company, because:

- it cleansed the balance sheets of DHI creditors which could not otherwise have agreed to proceed to a debt/equity swap given their precarious situation;[30]
- it enabled a public body (KAMCO) to swap debt for up to **[BCI: Omitted from public version]** of DSME's capital; and
- it allowed a substantial amount of DHI debt to remain idle in the hands of KAMCO until it is resold as opposed to remaining in the hands of creditors which would have pursued all available legal means to obtain repayment including through the liquidation of troubled borrowers.

86. In sum, these financial contributions were not made directly to Daewoo but did benefit it by facilitating its restructuring and allowing it to emerge with a healthier balance sheet than would otherwise have been the case.

21. Question 21

In paragraph 296 of its submission, Korea defends its action in the restructuring in the context of both workout proceedings and corporate reorganizations on the basis that they were subject to the majority votes of secured and unsecured creditors; and in the case of corporate reorganizations, Korea argues in addition that these were effected by court decision. Please comment.

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[26] *Responses by Korea to the* Annex V Questions (Business-Confidential Version) (Exhibit EC-39), response to question 36 at page 52.

[27] Attachment 3.1(13) of Responses by Korea to the Annex V Questions (Business-Confidential Version).

[28] The total recoverable Korea states in para. 348 of its First Written Submission.

[29] Korea's Responses to Annex V Questions (Exhibit EC-39) (BCI) question 30 at page 80.

[30] See reply to Question 17 above.

Response

87. With respect to the DHI workout, the EC has explained above (response to question 17) how creditors were directed by the Korean government in their decisions.

88. With regard to court-supervised proceedings, the EC would point out that the court only examines whether a number of conditions for opening of the restructuring proceeding, the approval of the restructuring plan and the closing of the restructuring proceeding are fulfilled. One of them is whether the creditors agreed with a 2/3 (for secured creditors) and 3/4 (for unsecured creditors) majority respectively to the restructuring plan.[31] Thus, it is the creditors that exercise the discretion. Without their agreement, the court cannot take a decision.

89. Thus, the fact that the restructuring of these firms was supervised by the court does not mean that there is no subsidy since the role of the court was merely to ensure that creditors had followed the proper procedures. Nowhere in the information submitted, it is even suggested that the court interfered with the decision making process or that it substituted its opinion for that of the creditors. On the contrary, Korea has repeatedly stated that creditors took decisions in these cases on the basis of their own interests.

90. Also, the fact that the Halla/Samho and Daedong restructurings took place under an existing legal framework (as opposed to the para-legal nature of the workouts) does not preclude a finding that a subsidy might have been granted. If such a view was to prevail, it would preclude the application of the *SCM Agreement* on any restructuring/bankruptcy proceedings – a result certainly not foreseen by the spirit or letter of that WTO Agreement.

22. Question 22

Please elaborate on your argument concerning the alleged specificity of the corporate restructuring, as referred to in paragraphs 87-89 of your oral statement. That is, setting aside the issues of financial contribution and benefit, what is the basis for your allegation that the restructuring was specific? Do you argue *de jure* or *de facto* specificity in this regard?

Response

91. The corporate restructuring subsidies are specific under Articles 2 (a) and (b) of the *SCM Agreement* because they are individual measures only applying to the restructured yard and are *per se* not generally available to all enterprises. The availability of the corporate restructuring subsidies is limited by law to individual enterprises, because it selectively benefits certain enterprises, as opposed to a broad economic policy measure, such as the reduction of corporate taxes.

92. More specifically, the amount of the benefit granted to, e.g., Daewoo, does *not* result from an automatic application of objective criteria within the meaning of Article 2(b) and footnote 2 of the *SCM Agreement*. These provisions state in relevant part:

> In order to determine whether a subsidy, as defined in paragraph 1 of Article 1, is specific to an enterprise or industry or group of enterprises or industries (referred to in this Agreement as "certain enterprises") within the jurisdiction of the granting authority, the following principles shall apply:
>
> (a) Where the granting authority, or the legislation pursuant to which the granting authority operates, explicitly limits access to a subsidy to certain enterprises, such subsidy shall be specific.

[31] First written submission of Korea, para. 302.

> (b) Where the granting authority, or the legislation pursuant to which the granting authority operates, establishes objective criteria or conditions[2] governing the eligibility for, and the amount of, a subsidy, specificity shall not exist, provided that the eligibility is automatic and that such criteria and conditions are strictly adhered to. The criteria or conditions must be clearly spelled out in law, regulation, or other official document, so as to be capable of verification.
>
> [2] Objective criteria or conditions, as used herein, mean criteria or conditions which are neutral, which do not favour certain enterprises over others, and which are economic in nature and horizontal in application, such as number of employees or size of enterprise.

93. The benefit resulting from a restructuring decision, e.g., the one in the case of Daewoo is nowhere laid down as "objective criteria" in the way required by Article 2(b) of the *SCM Agreement* and footnote 2. In particular, the *specific amount* of the subsidy and the eligibility criteria are not generally described and automatically applied to all other firms that apply for a restructuring proceeding. No Korean legislation or any other measures, and in particular not the CRA provide that all companies in difficulty are (i) restructured as is Daewoo and the (ii) receive the same *specific amount* of benefit resulting from debt-forgiveness, interest rebates, debt rescheduling and finally debt-for-equity swap enjoyed by Daewoo. Rather, the rules governing workout proceedings and restructuring are entirely procedural and leave the discretion of whether and how to restructure to the creditors in each individual case.

94. The individual nature of, e.g., the Daewoo restructuring measures is further corroborated by the fact that the eligibility criteria for work-out were in any case not strictly applied. The first "disqualifying criterion" [32], whereby an applicant "may be disqualified" is

> A company whose outstanding debts significantly exceeds its sales revenue and profitability of its core business.

95. It is evident from the Arthur Anderson report that this was very far from being the case for DHI.

[BCI: Omitted from public version.]

96. Indeed Korea agreed in the responses to the Annex V questions that this criterion was not fulfilled) and further admitted that these eligibility criteria were not strictly applied but are rather "factors to be considered in determining whether companies may be disqualified as candidates for a workout. None of these factors in isolation is decisive."[33]

23. Question 23

Is it your position, as Korea argues, that all insolvent companies should be liquidated and wound up, rather than restructured? If not, what criteria should determine whether to keep an insolvent company in operation? In this context, what weight or importance should be given to a going concern analysis or assessment?

Response

97. No, the EC fully accepts that bankruptcy law is a necessary part of a market economy and that a properly conducted bankruptcy proceeding would normally not give rise to a subsidy. However,

[32] First written submission of Korea, attachment 8, p. 2, last paragraph and p. 3.
[33] Korea's Response to Annex V Question (BCI) 3.1.2. 11, p.69.

where the outcome of a bankruptcy proceeding or a corporate restructuring is determined by public bodies - or private bodies acting under their direction – and leads to a more beneficial outcome for the enterprise than would have arisen if the creditors had acted according to market principles, all of the components of a subsidy are present. There is no basis in the *SCM Agreement* to allow insolvency to be a loophole in the subsidy disciplines.

98. The relevant criteria to determine whether to keep an insolvent company in operation are:

- Whether a market creditor/investor in similar circumstances, given probable market developments and the position of the undertaking would have acted in the same way, i.e., agreed to waive or reschedule debts. With respect to a debt for equity swap, it should be considered whether a rationale private investor operating in a market economy would have purchased the equity at the price provided in the restructuring plan.

- Whether a restructuring plan exists that restores the long-term viability of the firm within a reasonable timescale and on the basis of realistic assumptions as to future operating conditions. The restructuring plan should also describe the circumstances that led to the company's difficulties, thereby providing a basis for assessing whether the proposed measures are appropriate.

- Whether the recipient is able to make a significant contribution to the restructuring plan from its own resources, including through the sale of assets that are not essential to the firm's survival, or from external financing at market conditions. Such contribution is a sign that the markets believe in the feasibility of the return to viability.

99. As to evidence, the EC considers that the primordial indicia is the behaviour of actual other creditors that were not influenced by the government (in this case foreign creditors). Moreover, the ability of the company to obtain credit or attract investment on the market is highly relevant. The existence of a going concern analysis can be an indicia that a hypothetical private creditor would have acted in the same manner, if that analysis contains the above elements and was provided to the creditors in sufficient time so as to take an informed decision.

24. Question 24

Where a government entity is a creditor of an insolvent company being restructured, will the restructuring <u>always</u> result in a subsidy? Why or why not?

<u>Response</u>

100. The restructuring will always result in a financial contribution where it consists of debt-forgiveness, debt-rescheduling or a debt-for-equity swap. However, such financial contribution would not necessarily always result in a benefit and therefore a subsidy. The existence of a benefit depends on whether the government creditor acted like private creditor would have done on the basis of the elements described in response to question 23.

25. Question 25

In your view, does the concept of "like product" apply in respect of claims of price suppression/depression? Please explain your view, including the textual basis and any other elements that you deem relevant.

Response

101. The relevant portion of Article 6.3(c) of the *SCM Agreement* does not refer to "like product" with respect to price depression and suppression. The EC considers that the Agreement therefore intends to give flexibility as to how to determine the "same market" in which price effects occur.

102. Thus, Article 6.3(c) of the *SCM Agreement* provides for the tailoring of criteria appropriate to grasp price developments in the relevant product and geographic market affected by subsidisation taking on a case-to-case basis.

26. Question 26

You have argued that a "product segmentation" approach should be applied in this case. In what respects, if at all, does this concept differ from "like product" as defined in footnote 46 of the SCM Agreement?

Response

103. The EC noted with approval the statement of the Panel in *Indonesia Cars* that a market segmentation approach is consistent with the criteria for a like product analysis under the *SCM Agreement* (as opposed to a like product analysis under Articles III:2, III:4, of the GATT 1994 as argued by Korea).

104. Footnote 46 of the *SCM Agreement* provides in relevant part:

> Throughout this Agreement the term "like product" ("produit similaire") shall be interpreted to mean a product which is identical, i.e. alike in all respects to the product under consideration, or in the absence of such a product, another product which, although not alike in all respects, has characteristics closely resembling those of the product under consideration

105. Products belonging to one market segment will generally have characteristics closely resembling each other, because buyers and sellers will consider that the products have the same or similar end-uses. Accordingly there will be a strong correlation between prices of products with the same end use. Hence, changes in price by one producer will affect the prices of other producers of that product. Generally, the goal of like product analyses is to assess precisely the effects of a subsidy given to the producer of one product on the prices for products produced by other producers. Thus, *in effect*, a market segmentation analysis involves similar questions as posed in a like product analysis under the *SCM Agreement*.

27. Question 27

Korea argues that there is considerable variation or diversity of products within each of the product segments proposed by you, meaning that these product segments are too broad and should be broken down, for example, at least into different size ranges. Please comment on the diversity of products within each of the product segments that you propose, and in this context please respond specifically to Korea's arguments on this point.

Response

106. Korea contents itself with generally questioning the three market segments identified by the European Communities (LNGs, container chips and product tankers)[34] without any substantiated argument, why these should not be correct. If at all, Korea asserts that the market segments should be further broken down according to different sizes within these ship types.[35]

107. As already explained in our Oral Statement there are no standard classifications for ships. The difficulty of classifying ships results from the fact that they are customized and made-to-order product and thus show a considerable variety of technical specifications.

108. Within the OECD Working Party on Shipbuilding, there is not even consensus as to whether there is

> *One* single market for *all* ship types or a number of market segments based on the *main* vessel types (i.e., a tanker market, a cruise market etc.). In defining the product market, there was a commonality of views among experts that demand substitutability and supply substitutability should both be considered.[36]

109. Curiously, Korea in that forum claims that "the level of supply substitutability was so high to make shipbuilding a single market for all vessel types" and invoked the "ability of shipbuilders to switch easily from the production of one vessel type to another as a strong evidence of high supply substitutability" while EC with other economies claimed that "the shipbuilding market [is] fragmented into ship type segments…".

110. For the purpose of this WTO dispute which requires an identification of markets in which the effects of subsidies can be felt, the EC has explained in its Oral Statement why both the perspective of the ship-owner (demand side) and the perspective of the shipbuilder (supply side) should be considered.

111. The EC submits that all analysts in this industry make the distinction between major ship types, and so do the Korean yards on the product pages of their web sites.[37] These support the use of the main types proposed by the European Communities for the purpose of this dispute, i.e., LNGs, market definition in container ships and product/chemical tankers.

112. However, contrary to what Korea argues, there is no basis of further segmenting relevant markets according to size. First, there standard size by which ships within these main types could be meaningfully distinguished. Indeed, curiously, Korea itself refers to different size bands even in its First Written Submission. Thus, for example, it refers to the "market in container vessels up to 1,999 TEU" and the "market in container vessels from 2,000 to 3,999 TEU" in para. 19 of its First Written Submission while then citing with approval to the vessel categories used in an analysis of FMI which looked at "container feeder vessels (up to about 3,500 TEU)" in para. 515 of its First Written Submission.

113. Any further segmentation of the main types according to size does not answer the question which ships serve the same end uses and are therefore substitutable from the perspective of the shipowner. The European Communities refers to figures 2.2 and 3.2 contained in Attachment 2.

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[34] First written submission of the European Communities, paras. 417, 418. See also Oral Statement, paras. 101-110.

[35] First written submission of Korea, paras. 514.

[36] OECD Council Working Party on Shipbuilding, Report by the Chairman of the Informal Experts Group Held on 1-2 March 2004 (C/WP6/SNG(2004)5, (Exhibit EC – 104) (Emphasis added).

[37] See compilation of products listed on websites of Korean and EC producers in **Attachment 4**.

They present a histogram of the frequency of all product tanker and container ship orders placed between 1997 and 2002 (based on Lloyd's Register data), distributed by deadweight.

114. While figure 2.2 shows certain peaks for product tankers, these size bands, e.g., between 32,000 dwt and 40,000 dwt cannot be seen as strict standards for sizes demarking a line for substitutability or end uses. Thus, a 31.000 dwt product tanker is fully substitutable to a 32,000 dwt tanker, for the purpose of end uses. With respect to container ships, this is even clearer, because figure 3.2 does not even reflect any clear peaks, and hence any subdivision as to sizes would be arbitrary.

115. As the European Communities explained in its Oral Statement, from the perspective of ship-owners size may *limit* full substitutability, however, both for container ships and product tankers there is a significant overlap between the end uses of ships of all sizes.[38] Indeed, there is no market, e.g., for a container to be transported through the Panama or Suez Channel or between main hubs and smaller ports. Shipping companies run networks of routes and exchange ships according to routes which are constantly adapted to market needs.

116. In any case, from the perspective of the shipbuilder, the distinction between even ship types is less important as the production technology is largely the same for all commercial vessels and in particular between the main types identified by the European Communities. Under no circumstances can one say that size plays a significant from the perspective of the shipbuilders.[39]

117. In short, the market segmentation proposed by the EC is sound both from the demand and supply side perspective.

28. Question 28

Please comment on Korea's statement that "the Korean and EC shipbuilders have and continue to operate in totally different segments of the shipbuilding market and that the segments where certain competition may exist are marginal and demand for those segments has shown slackening" (para. 19, Korea's first written submission).

Response

118. In paragraph 19 of its submission, Korea provides a snapshot picture and tries to minimise actual *participation* or *operation* of EC yards in certain selected size ranges within the three markets. However, for the purpose of a price depression or suppression claim it is not relevant whether EC and Korean producers actually "operate" or "participate" in the same market as argued by Korea. What is required is that EC producers compete for all the products and are able to build them.

119. In this respect it is important to recall that competition between yards materialises at the stage of tendering for a contract. Tendering involves first technical specifications and a price offer. It often also includes financing aspects and comes at substantial costs for the tendering yard. Hence, the absence of an order does not indicate an absence of competition in the market. EC shipyards are well experienced in all the contested market segments and are actively seeking opportunities to win orders in all sectors.

[38] Oral Statement by the European Communities at the First Substantive Meeting with the Panel, paras. 105-107.

[39] Oral Statement by the European Communities at the First Substantive Meeting with the Panel, paras. 108-109.

120. This can first be proven by the list of available standard product categories on their websites.[40]

121. Moreover, Korea itself recognises that EC yards and Korean yards compete in the same market segments and makes it clear in its recent Panel request in the case DS 301 of 6 February 2004 where Korea considers that

> the EC and its Member State measures referred to above are in breach of the EC and its Member State obligations under the following provisions: Articles I:1 and III:4 of GATT 1994 because the TDM Regulation and Member State implementing measures involving the bestowal of German, Danish, Dutch, French and Spanish grants to shipyards on a vessel-specific and product-related basis, *adversely modify conditions of competition between Korean commercial vessels* and the like vessels built in third countries *and Korean commercial vessels and the like vessels built in the EC, respectively***".**

29. Question 29

You argue that there are three market "segments" relevant to your price suppression/depression claim: LNGs, chemical/product tankers, and container ships.

(a) Is the implication of this that in your view, price suppression/depression should be found in respect of each of these segments separately?

Response

122. Yes.

(b) If so, what is the relevance of figures 33-36 of your submission? That is, please explain what conclusions about price and cost trends in respect of the particular kinds of ships referred to in your claim can be drawn from these graphs, which appear to represent averages for <u>all</u> ships of <u>all</u> types.

Response

123. Paragraphs 443-453 of our First Written Submission and Figures 33-36 deal with price suppression at an aggregate level before addressing price/cost developments in the three particular segments. The under-lying principles are the same whether considered at the aggregate level or specifically fore the three market segments as further elaborated above: Newbuilding prices have disconnected from the key economic drivers, namely order volume (i.e. demand), freight rates and costs of production.

124. The EC also notes that major shipbuilding consultants maintain a composite ship newbuilding price index, along with their more specific price information for particular ship-types. Also, the OECD issues regularly its own newbuilding price analysis which contains a composite price index with a timeline.

(c) Do you agree with Japan's argument that a low price for any individual transaction will put downward pressure on <u>all</u> types of ships, whether substitutable or not? If so, why? Does a decline in the price of a ship of a certain type, for instance a container ship, cause a decline in the price of ship of another type, e.g., a tanker or passenger ship? Is it not more defensible to argue

[40] See Attachment 4.

that a decline in the price of one ship causes a decline in the price of another ship with the same end-use?

Response

125. Yes we agree. As explained in the answer to question 30 below, the end use of the ship is to a large degree irrelevant to the shipbuilder, just as the end use of a building is largely incidental to the business of a construction company. It is common practice in shipbuilding for shipyards to shift their focus between market segments to respond to shifts in the market. Because of this ability, or even necessity, to shift, it is a misconception to assume that shipyards are only affected if they are competing directly for the ship types that are the subject of accusations of price suppression.

126. Therefore, a decline in prices for one ship-type will *de facto* always go hand in hand with price developments for another. However, the correlation between price developments will be higher for ships with the same end-use.

30. Question 30

In general, how much flexibility does a typical shipyard have to produce all or a broad range of ship types? What are the physical and other constraints on any given shipyard's potential product range? How important is prior experience to a shipyard's production cost and capability to build a particular type of ship? With reference to the above considerations, please describe the capabilities and experience of each EC shipyard that produces or is capable of producing some or all of the kinds of commercial vessels cited in your serious prejudice claim.

Response

127. All shipyards are ultimately constrained only by size. From the point of view of a shipbuilder, however, within this size constraint there is a great deal of flexibility for substitution between products.

128. In the eyes of a shipbuilder a ship is an assembly of steel panels, into which is fitted machinery, pipes, cables, accommodation and so on, and the ultimate function of the ship is largely irrelevant. In the eyes of a shipbuilder a tanker, a dry bulk carrier and a container ship are broadly similar products, even though the arrangement and proportions of the parts that are assembled differ in each product. Whilst shipbuilders seek to improve economic efficiency by series building similar products, very few shipyards specialise in a single product type, although there are examples of this. Thus, for example, Hyundai Heavy Industries, within the same shipyard, currently has orders for tankers of different sizes, container ships of different sizes, LPG tankers, dry bulk carriers and LNG tankers. Similarly, Daewoo is currently constructing tankers, LNG carriers, LPG carriers, car carriers and container ships within broadly the same facilities. Most shipyards take orders in this way, building a wide range of ship types.

129. In this respect shipbuilding can best be compared to the construction industry whereby a construction company will be capable of building a wide range of building types and the end use is of little relevance to the building process. The characteristics of the interim products produced by the shipyard from which the ships are assembled will be broadly similar between the different ship types and the assembly and outfitting processes will also be broadly similar, even though the final product assemblies will have widely different shipping functions.

130. Specific prior experience is of limited significance for most ship types. The exceptions to this are LNG tankers and cruise ships where entry costs are high and a significant amount of development will be needed to gain market entry.

131. The number of relevant EU shipyards is too many to be specific about the final part of this question. LNG tankers are on order in shipyards experienced in this sector in France (Chantiers de l'Atlantique) and Spain (Izar), and the market has been competed strongly by Finnish shipyards also well experienced in building LNG carriers, although as yet without an order. Container ships are built throughout Europe in all size ranges, with German and Danish shipyards concentrating in particular in the larger size ranges. Similarly there is a wide experience of building product tankers throughout EU shipbuilding, although with few orders won by European yards in the face of low price competition in recent years.

31. Question 31

Is "head-to-head" competition a necessary precondition for any finding of serious prejudice based on price suppression or depression? If not, why not? If so, how can such head-to-head competition in respect of various kinds of ships be observed? Please provide or refer to any relevant evidence to illustrate your response.

Response

132. Whilst there are numerous examples within EU shipbuilding of contracts lost in head to head competition with the disputed Korean shipyards, this is not a necessary precondition for finding serious prejudice based on price depression or suppression.

133. As explained in response to Question 29 it is sufficient to establish that producers of the complainant and defendant compete on the market segments for which serious prejudice is alleged. The ability and the willingness to produce vessels of any kind or size is the decisive factor and should not be confused with the actual regular success to secure specific orders in the market. Thus, the realistic presence of a yard (in terms of available facilities, technology and building slots) in a certain market segment is sufficient to establish the market mechanisms. Typically, brokers would be able to name yards that were invited to make a quote. The fact that brokers would consider a yard as a potential bidder, would prove presence in the market, irrespective whether the yard has recently been active in the market segment or not.

134. Ultimately shipyards will stop tendering for orders that they know they are incapable of winning, because the cost of tendering is so high. The exit of a shipyard in this way is the ultimate expression of serious prejudice resulting from price suppression and depression, but this will not be identified through an analysis of contracts lost in head to head competition.

32. Question 32

Please identify in as precise terms as possible the products, within each of the product segments that you propose, for which the European and Korean shipyards compete most directly. Please describe the nature of the competition between European and Korean ships of each of these types.

Response

135. The EC refers to **Attachment 6** which describes the ordering and market shares within the three product segments.

(a) Product tankers[41]

136. Within this market one can distinguish three sub-types bands above 20,000 dwt: handysize, handymax and panamax. These three types are demonstrated in figure 2.2 of **Attachment 2** which shows peaks in the size bands of:

- *32,000 to 40,000 dwt (Handysize)*
- *44,000 to 51,000 dwt (Handymax)*
- *69,000 to 76,000 dwt(Panamax)*

137. As to the nature of the competition between European and Korean ships within the product tanker segment, the EC refers to the further information in **Attachment 6**. Korea dominates all three sub-sectors, whilst EU shipyards have lost almost all share of the market in the face of low prices. There are currently four handysize ships on order in Italy and one in Spain. There are no ships of the two larger types on order in the EU. In the past this has been an important market sector for EU shipyards, with a considerable track record invested in EU shipyards.

(b) LNG carriers

138. Whilst there are, technically speaking, two variants of the LNG tanker, the spherical and the membrane type, the size of ships, at least up to now, has been fairly uniform (and there is no difference in the use of these two variants). This is demonstrated by figure 1.2 of Attachment 2 which presents a histogram of the frequency of all LNG tanker orders placed between 1997 and 2002 (based on Lloyd's Register data), distributed by deadweight. There are a very small number of ships built outside this range (four were ordered outside this range out of 86 total LNG carrier orders placed between 1997 and 2002), but the majority of ships lie in a relatively narrow band around 140,000 to 150,000 cubic metres cargo capacity.

139. As to the nature of competition within this segment, the EC refers to **Attachment 6**. Korea dominates, with almost 60 per cent market share, with very limited opportunities for EU shipyards to take orders. There are currently three ships in order in France, two in Spain, with a total market share of 7.3 per cent.[42] The capability to produce this ship type is inherent in a number of EU shipyards. The failure of European builders to gain any appreciable market share in this sector in the face of very low prices, and despite strenuous efforts at product development and cost reduction, has been the source of considerable frustration.

(c) Container ships

140. The container ship market is less clearly demarcated in terms of sub-classes by size, than the other disputed ship types, as is evidenced by figure 3.2 in Attachment 2 which presents a histogram of the frequency of all container ship orders placed between 1997 and 2002 (based on Lloyd's Register data), distributed by TEU.

141. Above the size band for feeder ships (ca. 500-3500 TEU), peaks can be seen for:

- *Panamax ships (between about 4,000 and 5,000 TEU)*
- *Post-panamax ships (above about 5,000 TEU)*

[41] As clarified in para. 103 of the Oral Statement by the European Communities, the claim relating to product and chemical tankers does not cover pure chemical tankers. Therefore, the EC will henceforth refer to this segment collectively as the "product tanker market".

[42] (Note: the very small ship on order in Netherlands is an unusual variant of this ship type and is not included in the general market for large LNG tankers of around 150,000 m3).

142. The nature of competition is described in **Attachment 6**. Korea takes around three-quarters of orders for both panamax and post-panamax ships. EU shipyards have lost all share of the post-panamax sector and retain less than 1 per cent of the panamax sector. This is despite considerable efforts at marketing in these sectors and a good track record of production. In the feeder sector Korea has the highest market share but without dominance. EU shipyards retain around one quarter of orders, primarily in German shipyards. Denmark and the Netherlands participate in this sector but only to a limited degree.

33. Question 33

Please provide the data underlying your estimates of 2002 EC market share referred to at paragraph 15 of your submission (i.e., 17 per cent of worldwide CGT, and one-third of world turnover for ships). How many ships of which types do these figures represent?

Response

143. The information on market share is based on Lloyd's Register data comes from the OECD.[43] The OECD does not refer to numbers of ships and only uses cgt as reference.

144. The economic and employment data for the EC shipbuilding industry are contained in the AWES (Association of European Shipbuilders and Ship Repairers) Annual Report for 2002.[44] AWES also has Norway, Poland, Romania and Croatia as members. The figures for these countries have not been included in the EC totals.

145. In terms of production (delivered ships in 2002) the AWES countries, excluding Norway, Poland, Romania and Croatia had an output of 289 ships. In its statistics AWES does not differentiate by country and ship type. Therefore the following breakdown refers to all AWES countries (total of 425 ships):

Deliveries in 2002 by ship type:

Oil tankers	4
Product/chemical tankers	22
Bulk carriers	3
General cargo ships	46
Containerships	66
RoRo ships	8
Car carriers	9
LPG tankers	1
Ferries	27
Passenger ships	28
Fishing vessels	66
Other	145

34. Question 34

As a general matter, please describe the precise nature of the analysis that you believe is required to establish serious prejudice through price suppression/price depression, including the following issues:

[43] OECD document C/WP6/SG(2003) 3 "WORLD SHIPBUILDING ACTIVITIES IN 2002". (Exhibit EC – 105).

[44] AWES – Annual Report 2002-2003 (Exhibit EC – 106).

(a) Must there be (at least *inter alia*) a demonstration that the prices for the complaining party's products have been suppressed or depressed, or is the focus of the analysis instead the prices for the allegedly subsidizing party's product? Or are both sets of prices relevant?

Response

146. The EC believes that there is serious prejudice in the form of price depression or suppression where prices are depressed or suppressed on any market in which the products of the complaining Member compete with those of the subsidising Member. As noted above, this competition can be "head-to-head" or simply at the level of being potentially able to tender for contracts to build the same ships. Thus price depression or suppression on a market may lead the suppliers of the complaining Member not to go to considerable expense of tendering for contracts at depressed or suppressed prices.

147. In other words price depression or suppression describes a condition of the overall market. (Establishing price undercutting on the other hand may require evidence of actual sales by the respective suppliers.)

148. Since the market for ships is a global one, price depression or suppression is not limited to one region. Rather all prices offered anywhere in the world may lead to price depression or suppression throughout the global market.

(b) How if at all should these two sets of prices be juxtaposed against or related to one another?

Response

149. As stated above, price depression or suppression has to be established on a market where the products of the complaining Member compete with those of the subsidising Member. Since, in the view of the EC, this is the global market, it is sufficient to show price depression or suppression of any prices. The EC has shown with its graphs price depression/suppression for Korean shipbuilders (prices not following the evolution of costs) and also price throughout the world (prices not responding to increased demand). Since Korean shipbuilders are the price leaders, price depression/suppression in Korea is particularly important. It affects, that is depresses/suppresses the prices of all shipbuilders throughout the world.

(c) How similar must the complaining party's and allegedly subsidizing party's products be?

Response

150. They need only be sufficiently similar that changes in the price of one affects the price of the other.

35. Question 35

The nature of your basic argument as to price suppression/depression in this case, and particularly as to the role and significance of Korean ship prices, is not fully clear. Please comment on the following:

(a) Is it your argument on price suppression/price depression that Korean prices have dropped, or failed to increase, in spite of various factors that should have caused them to increase, and that this situation (these trends in Korean prices)

itself constitutes the "price suppression" or "price depression" referred to in SCM Article 6.3(c)?

(b) Or is your argument that Korean prices have caused EC shipyards' prices to decline or have prevented them from increasing?

(c) Or is your argument rather that Korean prices have caused "world prices" for ships either to decrease or have prevented them from increasing, and that these trends in world prices constitute the price suppression or depression referred to in Article 6.3(c)?

(d) How do the examples described as "lost sales" in your first submission specifically relate to and support your allegations of price suppression/depression?

Response

151. All of the phenomena described in (a), (b) and (c) have occurred. The critical element is probably that described in point (c). This has been caused by the phenomenon described in (a) and has caused that described in (b).

152. Lost sales (d) were for purely illustrative purposes showing the actual effect of Korean prices on EC prices.

36. Question 36

Assuming that there is a world market that allows competition between all suppliers for the sale of a particular ship, is it your position that if a bid goes to, say, a Finnish or German or Japanese shipyard, the reason for the lower price of the winning bid is a natural competitive advantage (i.e., lower cost or higher productivity), while if the winning bidder is a Korean shipyard, you exclude such a possibility? Please explain.

Response

153. The EC accepts that different yards have different competitive advantages, also within a specific shipbuilding country or region. However, by systematically excluding certain cost factors such as debt servicing or inflation, Korean yards are able to offer prices that cannot be matched by any competitor. Shipbuilding costs are quite transparent and reasonable assumptions about key costs and profitability of yards can be made.

154. It should be remembered that the real costs of production appear only years after the tendering for and contracting of a vessel. Yards can make unreasonable quotes without needing a subsidy instantly. The EC alleges that the Korean subsidies have allowed certain yards to stay in the market and assume price leadership by setting artificially low prices that then became the new benchmark.

155. Furthermore, Japan in its Third Party submission clearly indicates[45] that "Japanese shipbuilders experienced a number of lost sales of LNGs carriers in competition with offers made by Korean shipbuilders at the prices that were 10 to 27 per cent lower.…Japanese shipbuilders also reported lost sales of some container vessels, since the prices offered by Korean competitors were 15 to 17 per cent lower". Japan makes clear that for certain shiptypes, only Korean shipyards made very low offers preventing other competitors to win bids.

[45] See Third Party submission of Japan, para 18.

156. The EC would recall however that it is not claiming prejudice in the form of specific instances of lost sales. It is rather complaining that prices have been depressed or suppressed significantly and this is due to a subsidisation of a number of Korean yards.

37. Question 37

You argue that "in the same market" refers to any market in which there is competition between the subsidizer and the complaining party, and that in the case of ships, which are not in any meaningful sense imported, the only relevant market in this sense is the global market. Concerning "the same market" you also quote with approval, at paragraph 392, the Panel's statement in its 19 September 2003 response to Korea's request for preliminary ruling, that "the same market" is "a market where Korean and European Communities producers of commercial vessels compete and where the alleged adverse effects of the subsidies on prices or sales will need to be established".

(a) What in your view distinguishes a "global market" from a series of national or perhaps regional markets, and how would price suppression/price depression analysis for a "global market" differ from such an analysis for a national or regional market? Please respond to the US argument that a purchaser of any product always has the option of importing it from a number of countries, but that this does not change the scope of the market where the sale takes place.

Response

157. National or regional markets are often distinct because buyers are not entirely free to purchase wherever they wish and sellers not entirely able to sell wherever they wish under the same conditions because of the existence of tariffs, different regulatory regimes or simply the costs of buying or selling far from home. None of these restrictions apply in the shipbuilding market. For example:

- Ships are by nature highly mobile (and transporting them is an insignificant cost compared to their value);
- Ships do not normally need to be imported, i.e. cleared through customs or subjected to duties;
- Regulations and standards are typically harmonised or international – and the existence of “open registries” and flags of convenience make attempts to impose significantly different national taxes and regulations unworkable;
- Shipbuilders operate on a large scale and are active throughout the “global market”;
- Ship-owners are also large enterprises and are established in many different territories.

158. Contrary to the US suggestion, the situation is significantly different for most other goods.

(b) Are ships in each of the "product segments" identified by the EC purchased in all regions/countries in the world?

Response

159. Yes. Ships in the three product segments identified by the EC are indeed purchased in all regions/countries in the world. This is demonstrated by the table contained in **Attachment 7**, showing the number of vessels ordered in the period January 1997 to December 2002, broken down per

"country of economic benefit"[46] (where such information is available). The table clearly indicates that the three relevant ship types are indeed purchased by a wide variety of countries.

(c) Do/have EC shipyards bid for business in all of these regions/countries for all of these product segments?

(d) Do/have the Korean shipyards?

Joint Response

160. Yes. The tables in **Attachment 7** also separate orders secured by EU yards and those secured by South Korean yards. From these tables, it appears that the orders secured by EU and Korean yards have been placed by a wide variety of countries, and that a significant part of those countries have purchased vessels both from EU and Korean yards.

161. It is recalled that in many cases the orders for vessels are the result of a tendering process by which all interested yards are free to make an offer, whatever their nationality. In case a ship broker is involved, he might guide the owner in his choice of a yard. For this purpose, the reputation of a yard for building a specific ship type and possibly the availability of an established standard ship may play a role, but the nationality of the yard is not a relevant criteria here. Indeed, most major yards worldwide will offer an acceptable design and quality for the relevant ships in their product mix.

162. In addition to the above mentioned tables, showing that both EU and Korean yards compete on a worldwide basis, the EC has also provided – in the framework of the annex V procedure – example of cases where EC yards have, in various instances, submitted a price offer for the three relevant sectors, but for which the order was subsequently placed with a Korean yard.[47] This was namely the case for most of the major orders placed for LNG's. This again demonstrates that there are bids by EC and Korean yards for the same projects, and that therefore both EC and Korean yards compete in the three relevant sectors.

(e) Are there any technical or legal constraints on the EC industry's (or individual EC shipyards') ability to compete for the full spectrum of this business?

Response

163. In principle, no.

164. However, only six EC yards have a track record in LNG carrier construction and currently only three of them participate actively in this market which requires extensive know-how and facility investment.

165. Eastern German shipyards which have a strong focus on container ships are still subject to capacity (i.e. cgt output) restrictions following the approval of earlier restructuring aid, but there is no known instance where these restrictions would have prohibited yards to participate in tenders for container ships. Rather, the restrictions have kept the concerned yards from seeking cruise ships contracts as this ship type has a significantly higher cgt contents than container ships or other non-passenger vessels.

[46] This term refers to the owner that derives benefit from the operation of the ship. Lloyd's Register now uses the term 'country of economic benefit' to designate the best country in which to count ownership, based on beneficial ownership. Indeed, whilst at first glance it may appear that the registered ownership may be the best guide to the owner of the ship there are a number of complications that cloud this category: registered owner may be a finance company, a web company that is registered offshore, etc.

[47] See EC reply to the annex V procedure, annex 7.

38. Question 38

In arguing, on the basis of US – Norwegian Salmon CVD and Article 15 of the SCM Agreement that an "a cause" standard is sufficient for a finding of serious prejudice, are you implying that the causation standard for serious prejudice is the same as that for a countervailing measure? If so, what is the textual basis for such an argument? If not, what is the relevance to this dispute of either SCM Article 15 or the standard applied by the Salmon CVD panel? In this context, please respond to the US comment pointing to the difference in drafting between SCM Article 6.3(c) and SCM Article 15 ("the effect of the subsidy [...]" versus "the effects of the subsidized imports [...]", respectively).

Response

166. The EC referred to Article 15 of the *SCM Agreement* as contextual support for its argument that the subsidies do not have to be the *sole* cause of the price depression or suppression, but rather *a* cause. Article 15 of the *SCM Agreement* distinguishes more precisely between the "effects of subsidies" as opposed to other possible causes (15.5) and the "effect/impact of the subsidised imports" on prices in the domestic market (15.1, 4, 6). This corroborates that the phrase "effect of the subsidy" must not be read to require that subsidies are the exclusive cause of price depression or suppression, as also agreed by the United States.[48]

39. Question 39

In Figures 11-25 of your first submission, you list individual APRGs and PSLs to Korean shipbuilders that you allege were made at below-market terms. Is it your contention that EC shipyards competed with the Korean shipyards for each of these sales? If so please provide details. If not please explain the significance to your adverse effects claims of these instances of financing.

Response

167. The listed transactions are produced as examples of KEXIM export subsidies and thus cover almost all major ship sectors including sectors not referred to in the actionable subsidies part such as oil tankers, Ro-Ros etc.

168. EC yards compete in all of these sectors. However, given that the information was only provided by Korea as BCI in the context of the Annex V process, the EC could not share this information with EU yards to verify whether they participated in any bidding relating to these transactions.

40. Question 40

You make no argument concerning the effects of individual APRGs or PSLs on the prices of the individual transactions in which those instruments were used. Instead, you seem to limit your argument in respect of the alleged adverse effects of APRGs and PSLs to the more general point that these instruments contributed to "rescu[ing] th[e] shipyards from liquidation", by improving the attractiveness of keeping them in operation as opposed to shutting them down.

(a) Is this a correct understanding of your argument as to the alleged adverse effects of the APRGs and PSLs?

[48] Third Party Submission by the United States, para. 50.

Response

169. Yes.

170. The EC wishes to clarify alleged adverse effects with respect to the APRG and PSL scheme merely indeed but not limited to specific transactions.

171. The EC does not accept that APRGs or PSLs have no effect on the prices of individual transactions in which those instruments were used. However, their effect is very difficult to calculate in the absence of the precise details of the transactions. In that respect, Korea has refused to provide the EC with key data such as the contract prices, the payment terms or the dates of deliveries of ships. (See Korea's response of 10 October 2003 at para. 3).

172. Nevertheless, the EC has produced in Attachment 5 an example of what the impact of an APRG and a PSL would be on a couple of transactions using best information available. The examples show that the impact of APRGs or PSLs can indeed be very significant (up to 2 per cent of the transaction price).

173. The EC, however, wants to underline the impact of the availability of these instruments on the market in general as the impossibility for a yard to offer an APRG to a buyer would more often than not lead buyers to shipyards which can offer such a guarantee.

174. Indeed, the availability of an APRG is so essential for a shipyard that Arthur Andersen in their reviewal of DHI's causes of financial distress[49] pointed to the refusal of Korean banks to provide APRGs to DHI and to the increase in the premia demanded by foreign banks as a principle cause of this financial distress. In particular, Arthur Andersen explained that the non availability of the APRGs (or the availability of expensive APRGs) led to DHI orders being cancelled or delayed.

175. Similarly, the availability of PSL means that a yard can offer a buyer heavy-tail payment terms (which buyers generally prefer as they need to advance less cash for the ship) without worrying about financing the construction costs.

(b) If so, what if any impact does the timing of individual APRGs and PSLs have on the analysis? If not, please explain.

Response

176. Both the APRGs and PSLs produce their impact at the time of the negotiations with the buyer as their availability influences the choice of the yard and the payment terms a yard can offer the buyer.

41. Question 41

Please respond to Korea's argument that you allege subsidization of some but not all Korean shipyards, that only shipyards receiving any alleged subsidies could possibly cause serious prejudice, but that nevertheless the information you present in the context of serious prejudice concerning the Korean industry covers the industry as a whole.

[49] Exhibit EC-64 at page 40.

Response

177. To respond to this argument it is necessary to understand the nature of the current competitive situation in shipbuilding in South Korea.

178. All shipyards are faced with an imperative to keep the order-book well stocked to support expensive facilities, potentially high debts and large workforces. This imperative is reinforced in South Korea by the search for high volume to try to counteract the effects of low prices through seeking economies of scale. For this reason shipyards are forced to take as high a share as possible of their chosen market sectors. With the major shipyards in South Korea targeting broadly the same market sectors, that is those that present the greatest opportunity for volume coupled to the (perceived) highest value, intense internal competition within South Korea results.

179. In the most heavily contested market sectors, where shipyards perceive the greatest value to be, up to three-quarters of the market can be controlled by as few as four shipyards. The dominance of a small number of suppliers has a significant effect on the market and, in particular, prices. It is competition against these major suppliers that a shipyard will have in view when setting the price of a contract. Detailed order-book statistics are attached in Attachments 2 and 6. They show South Korean shipbuilding being in a dominant position in all the disputed market segments, and the disputed shipyards being amongst the dominating yards in each sector.

180. Against this pattern of competition the low prices offered by the subsidised yards forces competitors to offer low matching prices, irrespective of the long-term economic consequences. It should be kept in mind that the economic consequences of taking an order will be felt in two to three years time when production takes place, not at the time of taking the order.

181. The ultimate determinant of the price of a ship is not ‘the market’ but the contract between the shipyard and the ship owner. This raises the question at what price can a shipyard afford to take an order? Surely the answer to this can not be at any price, irrespective of the effect on long term profitability and liquidity.

42. Question 42

Please respond to Korea's argument that the effect of any alleged subsidy must be "current", and thus that past subsidies should not be taken into account unless they can be shown to have such a current effect.

Response

182. As the EC explained at the first meeting with the Panel, there is no rule in the WTO that provides that a violation is forgiven once it is in the past. Obligations are drafted in the present tense to express the intention that they should apply all the time – in the past, in the present and in the future! However, it is also clear to the EC that Korean subsidisation is still having adverse effects in the form of prices depression/suppression on the world shipbuilding market. The EC presents in **Attachments 1, 2** and **5** to these responses analyses of the quantitative effect of the subsidies and the effects in terms of price depression/suppression of these subsidies. It will develop further in its rebuttal submission its explanation of the relationship between these phenomena, taking into account also the information produced by Korea in response to the questions put to it.

43. Question 43

Please comment on the US statement that your basis for asserting that the alleged price suppression/depression is "significant" is that EC shipyards are facing large problems as a result of suppressed/depressed world prices. Is this a correct characterization of your

argument? If so, please explain its textual and other bases. If not, please clarify the basis on which you assert that the alleged price suppression/depression is "significant".

Response

183. While the US is correct in stating that the EC shipyards are facing large problems due to suppressed and depressed world prices for ships, this is not the full extent of the EC's argument.

184. The EC has explained that price depression and suppression are significant.

185. The adjective "significant" only relates to the terms "price suppression and "price depression" (as opposed to the phrase "effect of the subsidy". Thus, there must be a decline in prices or absence of price increases which is noticeable as opposed to insignificant.

186. The fact that price falls were not only "significant" in themselves, but even drove us out the market only illustrates how significant these price falls were.

44. Question 44

We note that Article 6.3(c) establishes that price suppression or depression must be "significant" for any finding of serious prejudice on that basis to be made. How can the Panel know whether the effect of the alleged subsidies is significant if we do not know what price(s) would have prevailed in the absence of subsidies? On what basis can the Panel make any such judgement? Is not the size of the alleged subsidy relevant to this issue?

Response

187. The EC presents **Attachments 1, 2** and **5** to these responses to provide a further basis for establishing price depression/suppression resulting from the subsidies. However, the EC maintains that quantifying the effect of the particular types of subsidies at issue (which include forgiveness of government-held debt in several restructuring process) does not assist in fully understanding the effects of these subsidies. Article 6.1(d) of the *SCM Agreement* laid down a direct presumption of serious prejudice in case of direct forgiveness of debt *in addition* to the quantitative avenue provided for under Article 6.1(a) of the *SCM Agreement*.

188. The EC reiterates that the preservation of capacity in South Korea has led to very heavy competition between the major Korean shipyards, with shipyards having to offer matching low prices to achieve orders. Detailed cost modelling underlying the EC price suppression claim has revealed that this has led shipyards to ignore future profitability in the pursuit of order volumes. In particular prices have, in general, been found to not cover inflation, debt servicing costs and profit. It may be assumed that a balance of capacity and demand would have led the shipyards in South Korea into a position whereby they could fully cover costs, including debt commitments and inflation, and make a profit of 5 per cent profit. Thus, for example, for LNGs a price of around $168 million could have been expected. This compares to an indicated price $155 million at year end 2003. In its rebuttal submission the EC will seek to further assist the Panel in making the judgment it is called upon to make by drawing on this information and taking account of that produced by Korea in response to the questions put to it.

45. Question 45

Please comment on China's argument, in paragraph 46 of its written submission, that if the total amount of a subsidy is ten dollars only, it cannot be successfully demonstrated that the effect of such a subsidy is to significantly suppress or depress the price of a one-billion-dollar vessel.

Response

189. China's reads too much into the term "significant". That term relates exclusively to the degree of price depression or suppression. The amount of the subsidy is not directly relevant in that respect. Therefore, the term "significant" is no basis for an obligation to quantify the effect of the subsidy and to relate it to the degree of price depression or suppression. In any case, the hypothetical is unreal, because a $10 subsidy is unlikely to significantly depress the price of vessels that usually cost $1 bio.

B. QUESTIONS TO BOTH PARTIES

95. Question 95

Article 11-2 of the Guidelines for Interest and Fees (Amended) (Exhibit EC-13) provides that [BCI: Omitted from public version].

(a) To Korea: Does this suggest that KEXIM considers that foreign financial markets constitute an appropriate market benchmark? Please explain.

(b) To EC: What impact, if any, does this provision have on the EC's argument that KEXIM is not required to act on commercial principles? Please explain.

Response

190. KEXIM's interest rates are made up of a number of elements some of which involve some limited discretion. Article 11 relates to the base rates, which is the starting point for the calculation of actual rates. The principle that appears from Article 11 is that the base rate corresponds to the rate at which KEXIM is able to borrow funds on the financial markets (the "Export-Import Financing Bond" is issued by KEXIM for this purpose) – that is its cost of funds.

191. KEXIM's cost of funds does not however correspond to the market rate applicable to its clients for the kind of financing that they obtain from KEXIM. And the extent to which this rate can be adjusted upwards (or downwards) to take account of actual market rates offered by other financial institutions is limited to 0.5 per cent.

192. The provision does not therefore indicate either that KEXIM is required to or that it does in fact act **on commercial principles.**

96. Question 96

Can footnote 5 of the SCM Agreement be used to justify an *a contrario* reading of item (j) and the first paragraph of item (k) of the Illustrative List of Export Subsidies? Please explain.

Response

193. No. Footnote 5 has to be interpreted according to its terms which are that Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement.

194. Therefore only measures "referred to in Annex I as not constituting export subsidies" benefit from what is known as a "safe haven".

195. A generalised *a contrario* reading of footnote 5 would conflict with the fact that it is list of measures that are *deemed to be* prohibited export subsidy (whether or not they would otherwise fall under Article 3.1(a))[50] and that this list is only *illustrative.*

[50] This reading was confirmed, for example, by the panel in *Canada – Regional Aircraft* para. 7.395, where it held "item (j) sets out the circumstances in which the grant of loan guarantees is per se deemed to be an export subsidy" and the Appellate Body in *Brazil - Aircraft*, para. 179, where the Appellate Body held that "[t]he first paragraph of item (k) describes a type of subsidy that is deemed to be a prohibited export subsidy".

196. The Illustrative List, by its very terms, is not intended to be an exhaustive list of export subsidies. "Illustrative" is defined as "providing an illustration or example".[51] An *a contrario* reading of the list as "permitting" measures that otherwise falls under the definition of export subsidy under Article 3.1(a), would be the equivalent of treating the Illustrative List as an exhaustive list of export subsidies and conflict with the terms of Article 3.1(a) which prohibits all subsides contingent upon export performance *including those illustrated in Annex I.*

197. The first paragraph of item (k) does not 'refer to' any measures as 'not constituting export subsidies', and therefore can not be read in an *a contrario* manner. This is particularly clear from the context formed by the second paragraph, which clearly does refer to measures not being export subsidies. It would be bizarre for a single provision which explicitly refers to certain measures not being export subsidies to be interpreted *a contrario* as referring to all measures not falling under its terms not to be export subsidies. Where a provision is intended to be read *a contrario* as authorising that which is not prohibited, it would not include an explicit exception. Indeed, where if there is an explicit exception, it could equally be considered that the exception must be read *a contrario*, which would then completely undermine the distinction between principle and exception.

198. The fact that the focus must be on whether there is a "reference" to a measure not being an export subsidy was confirmed by panel in *Brazil – Aircraft*, Second Recourse to 21.5 which stated that "the first paragraph of item (k) does not 'refer to' any measures as 'not constituting export subsidies' within the meaning of the footnote [5]").[52]

199. Korea relies heavily on a statement by the Appellate Body in *Brazil-Aircraft.* Whatever the Appellate Body meant by that statement, it was not an interpretation of footnote 5 since it stated "[w]e wish to emphasize that we are not interpreting footnote 5 of the SCM Agreement, and we do not opine on the scope of footnote 5." Moreover, the Appellate Body's statement was an *obiter dictum* because it relied for its finding on the fact that the payments at issue were used to secure a material advantage.

200. The context of item (j) is very different from item (k) and it would seem possible to consider that the words "at premium rates which are inadequate to cover the long-term operating costs and losses of the programmes" constitute a proviso and thus refer to export credit guarantees at premium rates that cover the long-term operating costs and losses of the programmes as not constituting export subsidies.

97. Question 97

What is the meaning of the term "material advantage" in the first paragraph of item (k) of the Illustrative List of Export Subsidies?

Response

201. The EC does not believe that this question arises in this case since item (k) is not applicable to pre-shipment loans.

202. In any event it is admitted by Korea that its pre-shipment loans do not qualify as export credits under the second paragraph of item (k) and therefore the EC does not believe that the CIRR rate used in the OECD understanding provides a relevant benchmark. Indeed there is no CIRR corresponding to loans of the duration of pre-shipment loans.

[51] The New Shorter Oxford English Dictionary (1993), p. 1311.

[52] In paras. 5.274 and 5.275. See also the *obiter dictum* in the first panel report *Canada - Aircraft*, para. 9.117.

203. The Appellate Body in *Brazil – Aircraft (Article 21.5)* considered that it was necessary for a WTO Member which claimed that it was not providing a "material advantage" through the use of export credits to prove, first, that it has identified an appropriate "market benchmark"; and, second, that the rates it applied are at or above that benchmark.[53] Korea has done neither.

98. Question 98

As a legal matter, does the definition of export credits used by the OECD in the context of the Export Credit Arrangement govern the meaning of this term in the first paragraph of item (k) of the Illustrative List of Export Subsidies? Why/why not?

Response

204. As already indicated in response to question 10, the EC considers that the definition of "export credits" given by the OECD reflects the generally accepted meaning of term in the relevant circles, that the term "export credit" used in the second paragraph has the meaning given to it in the OECD Arrangement and that in view of the close parallels between the first and second paragraph it must be assumed, in the absence of any indication to the contrary, that the term has the same meaning in both the first and second paragraphs.

99. Question 99

Would you provide us with the rationale behind your definition of export credits and export credit guarantees? Does an export credit have always to be a credit extended by the exporter or a financial institution to the buyer, and does an export credit guarantee always have to be a guarantee of such a credit? PSLs are loans extended by KEXIM to the shipbuilder, not to the buyer. APRGs are guarantees extended by KEXIM to the buyer, not to guarantee a credit given by the exporter or by a private financial institution to the buyer, but to guarantee that an advance payment by the buyer to the exporter shall be refunded in case of a contractual default. Does this exclude APRGs and PSLs from the realm of export credits/export credit guarantees?

Response

205. Yes, pre-shipment loans and APRGs are not export credits/export credit guarantees.

206. The justification or rationale for providing special rules for export credits and export credit guarantees and insurance (including a safe haven in the second paragraph of item (k)) is that special rules and conventions for this form of export subsidy have bee developed internationally, in particular at the OECD. The principles that are applied are harmonisation and transparency.

207. This justification and rationale does not apply to pre-shipment loans and APRGs as developed by Korea, for which no international consensus …

208. Indeed, if the intention was that "export credits" were to include all types of state assistance which has some relevance to exports, then automatically all export subsidies would constitute export credits making the distinction between "export subsidy" and "export credit" obsolete.

100. Question 100

In the Indonesia – Autos dispute (the only circulated panel report to date addressing serious prejudice claims), the panel in analysing the claims of displacement or impedance of

[53] Appellate Body Report, *Brazil-Aircraft (Article 21.5)*, para. 69.

imports into the Indonesian market applied a "but for" approach. In particular, the panel asked the question whether, "but for" the subsidies, the complaining parties' sales volumes and/or market shares in the Indonesian market either would not have declined, or would have increased by more than they in fact did.

Would an analogous approach be appropriate here? That is, in assessing the price suppression/depression claims, should the Panel seek to answer the question whether, but for the subsidies, the prices in question either would not have declined, or would have increased more than they in fact did?

If so, what sorts of considerations should the Panel take into account in trying to determine what the price movements would have been in the absence of the alleged subsidies? If not, why not, and what other approach should be used?

Response

209. Yes. In accordance with *EC – Sugar* and *Indonesia – Cars*, the Panel should consider whether the subsidies established by the EC are a contributing or amplifying cause of the significant price depression and suppression demonstrated by the EC. This can only be done on a case to case basis. The Panel can consider factors such as price trends of the products over time, the evolution of prices of different ship types, the price behaviour of different shipyards, the evolution of prices compared to costs and the evolution of prices compared with that of demand.

210. The EC had provided further data in **Attachment 2** and will elaborate further in its second written submission in the light also of information to be submitted by Korea in response to the questions addressed to it. The EC also refers to its response to Question 44.

101. Question 101

Does the word "may" in the chapeau of Article 6.3 mean that a complainant of a "serious prejudice" must prove something more than the existence of price suppression/depression?

If so, what is it that the complainant has to prove beyond price suppression/depression, and what is the basis in the text for any such additional requirements?

If not, what is the significance of the word "may"?

Response

211. As explained in the EC Oral Statement, there is no requirement in Article 6.3 of the *SCM Agreement* to prove anything beyond the existence of price suppression or depression. The EC will explain in more detail below that the term "may" in the *chapeau* of Article 6.3 of the *SCM Agreement* is consistent with that interpretation.

212. The ordinary meaning of the term "may" is "to express possibility, opportunity, or *permission*".[54] The structure of Article 6 of the *SCM Agreement* confirms that the term "may" is used in Article 6.3(c) of the *SCM Agreement* to express "permission". Thus, Article 6 sets forth a self-contained regime defining the notion of serious prejudice. While Article 6.1 *presumed* the existence of serious prejudice is presumed in certain situations and Article 6.7 *excludes* the existence of serious prejudice in certain situations, Art. 6.3 *permits* a finding of serious prejudice if the complainant establishes that one or more of paragraphs of 6.3(a)-(d) apply.

[54] Random House Dictionary, cited in US submission at para. 38.

213. This interpretation is confirmed by the immediate context of the term "may" in Art. 6.3 (c), which uses the phrase "in *any* case where one of several" of paragraphs (a)-(d) apply. Therefore, a WTO Member can pursue subsidies as actionable under Article 6.(3)(c) in all cases where one of the effects described in Article 6.3(c), e.g., price depression or suppression is given.[55]

214. Furthermore, footnote 13 to Article 5(c) of the *SCM Agreement* clarifies that the term "serious prejudice" is used in the same sense as used in paragraph 1 of Article XVI of the GATT 1994. GATT (and WTO) Panels already found "serious prejudice" based solely on price depression and price undercutting, respectively.[56]

102. Question 102

In its arguments concerning price suppression/depression, the EC has focused on demand side factors. Korea, on the other hand, has focused on the supply side. Is it not more correct that the two aspects should be taken together. Please explain the impact of such an approach on your argument concerning price suppression/depression.

Response

215. The EC has made its price depression and suppression argument taking account of both demand and supply side factors because it considers that both are relevant in determining the markets for the products at hand and their prices.

[55] This also is confirmed by the Spanish language version : "en cualquier caso" and French "dès lors qu'il existe l'une ou plusieurs des situations ci-après".

[56] *EC-Refunds on Exports of Sugar* (p. 24, para. V.f) and the WTO Panel on *Indonesia – Autos* (paras. 14.254-14.246),

LIST OF ATTACHMENTS

Attachment 1 Quantitative analysis of restructuring subsidies

Attachment 2 Estimation of price suppression and suppression prepared by First Marine International

Attachment 3 Analysis of DHI creditors' situation

Attachment 4 Compilation of Products listed on websites of Korean and EC Producers

Attachment 5 *Ad valorem* impact of APRG and pre-shipment loans

Attachment 6 Further information on the nature of competition in shipbuilding

Attachment 7 Number of vessels ordered per "country of economic benefit"

LIST OF EXHIBITS

EC - 101 MOFE press release of 6 October 2000 – published on MOFE website

EC - 102 Korea Letter of Intent to IMF of 24/09/1998

EC – 103 Special Act on the Management of Public funds

EC – 104 OECD Council Working Party on Shipbuilding, Report by the Chairman of the Informal Experts Group Held on 1-2 March 2004 (C/WP6/SNG (2004)5

EC – 105 OECD Council Working Party on Shipbuilding, World Shipbuilding Activities in 2002 – 4 March 2003 (C/WP6/SG(2003)3

EC – 106 AWES – Annual Report 2002-2003

EC – 107 DHI 1999 Audited Accounts

EC – 108 DSME 2000 Audited Accounts

EC – 109 DSME 2001 Audited Accounts

EC – 110 Balance Sheets of DHI as of September 30, 2000

EC – 111 HHI Income Statement for 2002 and 2003

EC – 112 PriceWaterhouseCoopers' Analysis of the Arthur Andersen Report

ANNEX D-2

RESPONSES OF THE EUROPEAN COMMUNITIES TO QUESTIONS FROM KOREA

(22 March 2004)

Question 1

In the EC's view is an entity a "public body" for all purposes?

Response

1. Yes, an entity is either a public body or it is not.

Question 2

Are all State Trading (as per Article XVII of the GATT 1994) entities "public bodies"? For all activities?

Response

2. The EC does not see any necessary connection between these concepts. Its position on public bodies is set out in response to question 1 from the Panel.

Question 3

Regarding the previous question, if not, what are the criteria for distinguishing: (a) State Trading entities that are "public bodies" from those that are not? (b) "public body" related activities from those that are not?

Response

3. See EC response to Panel question 1.

Question 4

The EC argues that the Appellate Body's findings in Japan -- Apples provides that it does not have to prove every fact it asserts. Can the EC identify which facts it considers it must prove and which it does not have to prove?

Response

4. The question as posed is too general. The EC has explained its position most recently at paras. 9 to 15 of its oral statement.

Question 5

What criteria does the EC propose for determining which facts it must prove and those with respect to which it considers it has no burden?

Response

5. See answer to question 4 above.

Question 6

In its oral statement, the EC stated that it was "not necessary to prove the obvious". Recognizing that in the context of a dispute, it is possible that not all parties or the Panel might consider the same issues as "obvious", please identify those elements of its case which the EC considers "obvious" and that it is, therefore, not required to prove.

Response

6. An example is offered at para. 11 of EC's oral statement.

Question 7

Is the EC referring to the same concept in paragraph 10 of its Opening Statement and paragraph 61 of its first submission?

Response

7. If the question refers to the "prima facie" concept, the EC has explained that it accepts it has the burden of presenting a "prima facie" case. The EC considers that it has met this burden.

Question 8

Is empirical evidence of application of a measure of any legal relevance in establishing whether a measure "on its face" is inconsistent with WTO law?

Response

8. The notion of 'empirical evidence' is not clear. A government practice can be a separate violation in its own right and this can be evidenced by its actual application in individual instances. See the EC's response to question 8 of the Panel.

Question 9

If a measure provided a "benefit" at one point in time or in a particular instance, but not at another, can it be considered "on its face" inconsistent with WTO law?

Response

9. Yes, for example, if a government rules that export loans are to be granted in all cases (i.e. independently of the creditworthiness of the recipient) at a fixed rate of, say, 5 per cent a benefit will be granted with respect to some recipients but not necessarily with other recipients. Such a measure would be on its face inconsistent with WTO law.

Question 10

If a measure as applied is considered inconsistent with WTO law at an earlier period, but is not proved to be inconsistent in the most recent period, what would the remedy be under Article 4 of the SCM Agreement?

Response

10. The question of remedies is a separate issue from that of the existence of the violation and is one on which the Panel has not been asked to rule.

Question 11

Please identify and quantify all adjustments to reflect such factors as different time periods, security interests and redemption priorities that the EC made in its comparison of corporate bonds with pre-shipment loans?

Question 12

If the EC made no adjustments to reflect such factors, please explain the legal basis for comparability.

Response to questions 11 and 12

11. The EC has set out its views on the comparability of the benchmark in its first written submission, if Korea considers that adjustments are needed it should explain why and provide a basis for making them.

Question 13

Does the EC have any evidence of currently applicable extensions of APRGs that it considers confer a benefit on any Korean person? If so, please identify all such APRGs.

Response

12. The EC has provided evidence of subsidized transactions of which it is aware. The EC has no information to indicate that KEXIM has stopped issuing APRGS at subsidized rates. Please also refer to the EC response to question 42 of the Panel.

Question 14

Does the EC have any evidence of currently applicable extensions of pre-shipment loans that it considers confer a benefit on any Korean person? If so, please identify all such pre-shipment loans.

Response

13. The EC has provided evidence of subsidized transactions of which it is aware. The EC has no information to indicate that KEXIM has stopped issuing pre-shipment loans at subsidized rates. Please also refer to the EC response to question 42 of the Panel.

Question 15

In terms of benefit analysis, should the analysis in a debt-to-equity swap case be conducted from the perspective of the private investor or the perspective of a creditor holding distressed assets?

Response

14. A benefit analysis is in principle conducted from the point of view of the recipient. The EC has set out its views on the issue in response to question 18 from the Panel.

Question 16

Does the EC argue that the Daewoo creditors received (i) too high or, (ii) too low a return on their Daewoo debt?

Response

15. The public bodies and entrusted private bodies received too low a return And would not have agreed to the restructuring under market conditions.

Question 17

Please quantify the over or undervaluation you are alleging.

Response

16. See reply to Question 15 of the Panel.

Question 18

In the case of an insolvent company, does the EC believe that the option to sell its debt as followed by the foreign lenders was reasonably available to all creditors?

Response

17. The EC notes that KAMCO in fact bought the debt of foreign creditors separately and are more favourable conditions than it bought debt from Korean creditors.

Question 19

Did any EC shipyards bid on any Japanese LNG contracts? If so, please identify the bidders and the level of their bids?

Response

18. The EC does not understand the relevance of this question since the EC does not allege that Japanese shipyards are subsidized and causing serious prejudice.

Question 20

If the EC is no longer supporting the point made regarding the Japanese market in the Sixth Report from the Commission to the Council on the situation in world shipbuilding[1], is the EC repudiating the Commission's conclusions there? If so, please identify the facts that cause the EC to view the situation differently now.

Response

19. The EC's shipbuilding reports are political analyses of the situation in the world shipbuilding industry. They are not *strictu sensu* economic analyses. The chapter Korea refers to deals with the response in certain shipbuilding regions to market developments in the course of 2002. With regard to Japan the report states that Japanese yards are being restructured and that synergies have resulted from that. In particular the series production of bulk carriers (which are not subject to the EC claim of adverse effects) is mentioned, together with the fact that for these ships 50 per cent of the orders in Japan are of domestic origin. As a matter of fact, by the end of 2003, Japanese owners had 12 container ships, 2 oil tankers and 2 LNG carriers on order from Korean yards.

Question 21

Is the US market open to all ships in the product categories the EC proposes?

Question 22

If the US market is not open to all products, please provide data demonstrating what portion of the product categories are closed due to US import restrictions on a product-by-product basis.

Response to questions 21 and 22

20. Yes. Only the US cabotage market is not available to non-US yards, but this market comprises less than 1/3 of the orders from US owners, i.e. US owners place 3 times as many orders abroad as they place with US yards. According to Lloyd's Register the total orderbook backlog in the US end December 2003 amounted 0,8 mio CGT. In the meantime the orders for US owners worldwide amounted 2,7 mio CGT. US cabotage laws do not affect LNG carriers at all, and latest figures indicate that almost all of US foreign sea borne trade is done by non-US built vessels. The trades affected by US cabotage legislation are mainly to/from Alaska and Hawaii, and are thus limited in size and demand for vessels.

Question 23

Please itemize which factors should be taken into account in defining a product category?

Response

21. It is impossible to answer this question in the abstract. However, the EC has set out its position on the appropriate market segments to be used in this case in the oral statement and in its response to question 27 of the Panel.

[1] COM(2002)622 final, 13 November 2002, Section 2.2.3, page 8. See also Seventh Report from the Commission to the Council on the Situation in World Shipbuilding, COM(2003)232 final, 6 May 2003, Section 2.1.1, page 5.

Question 24

How did the EC take into consideration technical differences, payment terms, delivery terms and other differences in its causation analysis?

Question 25

How did the EC factor out ships built in countries other than in Korea in its causation analysis?

Joint Response to questions 24 and 25

22. Please refer to the EC answers to questions 34 to 39 of the Panel.

Question 26

How did the EC factor out Korean ships that were built by yards that were not restructured?

Response

23. Please refer to the EC response to question 41 of the Panel.

Question 27

What is the EC's position with regard to the conclusion of its expert, FMI, that EC and Korean yards compete only as regards feeder container vessels and chemical tankers?

Question 28

What is the EC's position on FMI's conclusion that even in these segments, it is impossible to identify Korea as price leader since they are characterized by significant competition from other countries practicing low prices?

Response to questions 27 and 28

24. The EC has explained, most recently in response to question 28 of the Panel that EC and Korean shipyards compete across the entire range of the product segments the subject of this dispute. As regards chemical tankers, the EC has clarified at the first substantive meeting that these are not subject to its claim. See also question 27.

Question 29

In the same vein, what is the EC's position vis-à-vis the table shown at page 4 of Korea's first submission indicating the EC and Korean vessels are only present in the segments below 100,000 GT (with a small presence in the segment between 150,000 and 200,000 GT but which is characterized by a sizeable presence of Japanese yards)?

Response

25. Please refer to the EC oral statement at paras. 109 and 110 as well as to the EC response to question 28 of the Panel.

Question 30

Considering this segmentation, please explain how the alleged corporate restructuring subsidies depressed or suppressed prices in all size segments?

Response

26. Please refer to the EC response to question 29 of the Panel.

Question 31

Do LNGs compete with any other vessels?

Response

27. Not directly, but please refer to the EC response to question 29 of the Panel on inter-segment relationships.

Question 32

Please identify all EC shipyards that produce LNGs or that the EC regards as capable of producing LNGs.

Response

28. Chantiers de l'Atlantique (Fr), Izar (S) and Kvaener Masa (FIN) have been active on the market in terms of bidding and/or orders. All other major EC shipyards would also be interested in building LNG's if the price level were not so depressed.

Question 33

Please confirm that the EC shipyards saw declining profitability in 1997 and 1998 and increasing profitability for 1999 through 2001. Please provide breakdown by shipyard and product and provide supporting data. Please also provide such data for 2002 and 2003.

Response

29. EC shipyard profitability figures were already provided to Korea in the framework of the Annex V procedure - see reply to Korea's question 4 (and accompanying Annex 4a and 4b).

Question 34

Does the EC consider that serious prejudice can exist in a shipyard that is making vessels not subject to competition from Korean shipyards? If so, please specify the market mechanism that transmits such effects.

Question 35

If not, what level of competitive overlap between Korean products and the EC shipyards' products is necessary for a subsidy to be a cause of serious prejudice?

Joint Response to questions 34 and 35

30. It is WTO Members that need to be shown to suffer serious prejudice, not individual shipyards. For a better understanding of inter-segment relations please refer to the EC response to question 29 of the Panel.

Question 36

Please explain in detail how the EC measures capacity in the shipbuilding industry?

Response

31. Capacity in shipbuilding is extremely difficult to measure, as it depends on the production facilities and the production portfolio.

32. In order to efficiently use their technical and human resources yards try to maintain a product mix. At the same time they try to fill their berths with ship types they are specialised in. This makes the actual production capacity dependent on the orders contracted and it may therefore change from year to year. Capacity in shipbuilding should be related to actual or historical production output (measured in cgt - compensated gross tonnes), as it is extremely difficult to derive an abstract production volume from the extent of the physical construction facilities. Physical construction facilities are generally defined by, among others, available steel cutting lines, dock space and cranage, but the same facilities can be used for simple ships (giving a small cgt figure) or for highly sophisticated ships (giving a high cgt figure). Therefore, the most appropriate means of a yard's production capacity is its maximum historical production output of the existing facility.

ANNEX D-3

RESPONSES OF KOREA TO QUESTIONS FROM THE PANEL

(22 March 2004)

I. QUESTIONS TO KOREA

A. GENERAL

46. Is there a financial contribution if a government provides a cash grant to a government-owned company? Please explain in light of Korea's argument that one cannot make a financial contribution to oneself (para. 319 of Korea's first written submission).

At the outset, Korea notes that, while the issues of financial contribution and benefit are legally distinct, many of the same facts and arguments are relevant to the two issues. The issue in this regard arises from the privatization cases wherein the EC argued for an absolute rule of looking through the assets to the actual owners to determine if there is a benefit. Necessarily, this means that if the owner and the contributor are the same "person" the issue arises as to whether there has actually been a financial contribution at all. There are indeed, some interesting legal issues arising from the reasoning championed by the EC in the privatization cases. The EC apparently wants one rule that applies to them in the situation of privatization they face and another that applies to the rest of the world when it is convenient for the EC. Of course, this cannot be the case; the WTO rules apply to every Member uniformly.

The Panel does not face such a sweeping issue in this dispute, however. To take just one example, Korea is of the view that so-called equity infusions into a government majority-owned entity can be a financial contribution. So-called "equity infusions" are often covers for direct subsidies to cover operating losses. As an illustration, over a long period of time the French government has made so-called equity infusions into their aircraft engine company, SNECMA. The purported capital calls generally were mere shams reflected by the unwillingness of minority shareholders to respond. The issue in a debt-for-equity swap made in an insolvency situation is different, however. In such cases, where the company is insolvent and, therefore, in the hands of the creditors, the swap reflects a change in form of financial instrument. The creditor financial institutions were not holding cash which they could invest in a range of financial instruments; they were holding debt and the issue was what they could do with the debt in order to maximize their return. More specifically, the creditors were holding debt in distressed companies in a country facing a financial crisis. The EC's odd diversion at the First Substantive Meeting into an elementary description of the different characteristics of the two forms of financial instruments was completely beside the point.

Thus, it does not automatically follow from this that any transfer of funds by the Government-owned company into a private company involves a financial contribution under Article 1.1 of the *SCM Agreement*. The EC again fails to apply the correct consequences of the WTO case-law indicating that "any analysis of whether a benefit exists should be on 'legal or natural persons' instead

of productive operations."[1] In this case, the benefit analysis adopted by the Appellate Body in the privatization cases has necessary logical implications for the issue of financial contribution.

B. KEXIM LEGAL REGIME

47. At Attachment 1, page 4, of its first written submission, Korea states that "KEXIM's interest rates and guarantee conditions started from a market base rate to which different spreads were added". Does Korea claim that KEXIM provides financing and guarantees at above-market rates?

As a threshold issue, it is necessary to clarify what the "market rate" is supposed to mean. There is no single "market interest rate" or "market premium". Rather, the market rate exists in the form of certain "ranges" or "bands" of different interest rates or premia. Otherwise, there can be no competition among banks in terms of interest rates or premia. Therefore, in Korea's view, the question is whether the KEXIM rates are within the ranges or bands prevailing in the relevant market.

Next, in order to answer the question, the structure for determining the interest rates and premia must be borne in mind. As Korea submitted in its First Written Submission and stated at the First Substantive Meeting, KEXIM's interest rates and fees are determined by adding up the base rate plus spreads such as "credit risk spread", "target margin", "Market Adjustment Rate", etc.

With respect to the interest rates, KEXIM sets the base rate differently depending on whether the loan is denominated in Korean won or in a foreign currency as well as whether the interest rate is fixed or floating as stipulated in the Interest Rate Guidelines (Articles 10, 11 & 11-2, Korea Annex V Response Attachment 1.1(15), Exhibit EC-13). Below is a chart summarizing the base rates currently in force for loans extended by KEXIM.

[BCI: Omitted from public version.]

While the base rates thus obtained are not the final rates at which KEXIM loans are extended, because various spreads are to be added thereto, the base rate by itself is designed to adequately reflect the prevailing level of interest rates in the financial market at the time of the loan as well as KEXIM's cost of procuring the required funds (e.g., overseas borrowing and the issuance of KEXIM bonds). Further, it is a standard market practice for all Korean commercial banks to use LIBOR rates or CD yield rates as the base rates for their floating rate loans (Korea notes that loans with floating interest rates account for the absolute majority of all loans extended by KEXIM). In light of this, KEXIM's interest rate structure ensures that the KEXIM interest rates fall within the "range" or "band" prevailing in the relevant market. In connection with this, Korea has not claimed that KEXIM interest rates are necessarily above "market rates".

With respect to the guarantee fees, until the occurrence of the Asian Financial Crisis, all participants in the APRG market, including KEXIM, had applied similar premia ranging from **[BCI: Omitted from public version]**. KEXIM offered premia within this range based on its past experience in this field and also taking into account the competition in the market. For the periods during and immediately following the crisis, however, other financial institutions seldom participated in the market. Therefore, there existed virtually no comparable premia offered by other financial institutions in Korea. During the crisis, KEXIM introduced the fee structure composed of the base rate and credit risk spread. The base rate was calculated mainly based on the historical cost associated with the provision of guarantees, and the credit risk spread was introduced to reflect credit risks involved in individual transactions. As the financial market has been stabilized after the crisis (more specifically since 2002), other commercial banks re-entered the market, bringing about competitions in the APRG market again. In response to this change in the market, KEXIM introduced another spread factor

[1] Appellate Body Report, *US – Countervailing Measures on Certain Products from the EC*, para. 110.

called the "Market Adjustment Rate" which gives the KEXIM managers flexibility to react to the market situations and reflect customer relationship. As a result, KEXIM's fee rate structure ensures that the premia charged fall within the range of "market premia".

48. In para. 133 of its first written submission, Korea "denies that the KEXIM Act, Decree and Interest Rate Guidelines provide for the provision of subsidies within the meaning of the *SCM Agreement,* let alone prohibited subsidies contingent upon export performance, within the meaning of Article 3(1)(a) of the *SCM Agreement*." Does Korea contest the EC's claim that loans and guarantees provided under the KEXIM legal regime are contingent upon export performance within the meaning of Article 3.1(a) of the *SCM Agreement*?

In the above-mentioned paragraph, Korea intended to emphasize simply that the KEXIM Act, Decree and Interest Guidelines as such cannot constitute subsidies within the meaning of the SCM Agreement and, thus, it was not necessary to discuss further any "export contingency" of such alleged subsidies. Korea has not taken any position as to whether such loans and guarantees are contingent on export performance.

49. Regarding para. 158 of Korea's first written submission, please provide evidence to support Korea's argument that GOK made capital injections into KEXIM in order to "avoid negative credit ratings" rather than to cover losses. If capital injections were made for this purpose, what impact would this have on Korea's assertion that KEXIM's operations are always profitable? In particular, why would KEXIM's credit rating have been at risk if its operations were always profitable?

As Korea submits in its First Written Submission, the capital injections into KEXIM were necessary for maintaining good credit rating as well as sound BIS adequacy ratio as KEXIM relied on overseas borrowings for procuring its required funds. **[BCI: Omitted from public version]** whereas other export credit agencies in Japan or the US procure 80~100 per cent out of their total required funds through borrowings from their governments. Therefore, maintaining high credit rating and the sound BIS adequacy ratio was key to the KEXIM operations.

As the BIS adequacy ratio is defined as the ratio of the "equity capital" of a company to "risk-weighted assets" that the company is exposed to (i.e., it is the product of equity capital divided by risk-weighted assets x 100 per cent), the operating profits have no direct relation or impact to the BIS adequacy ratio unless and until such operating profits are converted into the equity capital by way of "capitalization of reserves". Further, given the size of "risk-weighted assets" and "equity capital", the ultimate impact of the operating profits being converted into equity capital to the BIS adequacy ratio is generally insubstantial.

At the time KEXIM increased its capital in 1998 and 1999, the risk-weighted assets of KEXIM rose to a substantial degree as, among others, the majority of loans extended by KEXIM was composed of foreign currency denominated loans and the won-dollar exchange rates were extremely high. In addition, KEXIM anticipated that the demands for foreign currency denominated loans would substantially increase given the market situations.

Under these circumstances, KEXIM's BIS ratio and credit rating were expected to decline despite its overall profitability. Thus, KEXIM had to increase its capitals to sustain these indicators. For the reference purposes, Korea submits the credit rating changes by S&P for the relevant periods and the operating profits of KEXIM from its establishment.

[BCI: Omitted from public version.]

50. Does KEXIM's profitability of operations exclude the possibility that it has provided subsidies?

The issue of KEXIM's profitability really goes to two different questions.

First, Korea has not claimed that the profitability of KEXIM operations necessarily excludes the possibility that it has provided subsidies. However, the overall profitability of KEXIM operations directly refutes the EC argument that KEXIM has been required by certain provisions of the KEXIM Act and related guidelines to provide loans and guarantees at loss-making rates or without regard to commercial or market principles. As the market principle is to generate profits, Korea believes that KEXIM's continuous profitability shows that it has acted according to market principles.

Second, in response to the point raised by the United States that cost to government issues are determinative of the issue of benefit to the recipient, Korea has both pointed out the legally irrelevant nature of cost to benefit and then has followed up by showing that, in any event, KEXIM always has shown a profit indicating that as a factual matter, it does not operate at below cost.[2]

51. Regarding para. 159 of Korea's first written submission, what is the reason for conferring on GOK a status that is less preferential than other shareholders? Is this not suggestive of some form of special relationship between KEXIM and GOK?

The provision of Article 36 of the KEXIM Act as such does not suggest any special relationship between KEXIM and GOK. It would give a better understanding of this provision if it is read in the context of Article 4 of the KEXIM Act which lists the entities that can contribute capital to KEXIM. When the KEXIM Act was enacted on 28 July 1969, it was considered that only the Government would inject the equity capital to KEXIM. However, Article 4 of the KEXIM Act was amended on 24 December 1974 in order to induce commercial financial institutions and other entities to participate in capital contributions into KEXIM. With a view of encouraging those commercial financial institutions and other entities to invest in KEXIM, Article 36 was also amended to provide differential treatments between the Government shareholder and other non-Government shareholders. Moreover, it is not uncommon in private corporations that the major shareholders receive less dividends and take more risks than other minor shareholders.

52. In paragraph 128 of its submission the EC quotes from the KEXIM "On-Line Road Show" to the effect that KEXIM states that one part of its mission is to serve "a complementary but pioneering role and function for the national economy, which would be hard for commercial banks to shoulder". Is this not evidence of below-market financing by KEXIM?

The "On-Line Road Show" was prepared mainly to cater to the potential investors who subscribe for the bonds issued by KEXIM. In the above-mentioned On-Line Road Show, KEXIM attempted to describe the specialized role and function being performed by it as an export credit agency (ECA). Export credit agencies, such as KEXIM, generally provide specialized trade-related financing. Such financing typically involves longer-term project-related loans (e.g., mid- and long-term export loans), special payment terms (e.g., deferred or specially structured payments) or specialized collateralization methods. Given these peculiarities and specialties of the ECA financing, it is not inaccurate to say that there is "a complementary but pioneering" role and function which commercial banks find difficult to perform. Particularly, the long term export credit financing provided on deferred payment basis is the area in which only KEXIM specializes. However, it is

[2] For purposes of clarity regarding the response to this question, Korea notes that it is arguing in the alternative. In referring to cost to government, Korea does not concede that KEXIM is a public body. Korea would like to note that this issue of arguing in the alternative arises in numerous places through the answers and Korea requests that this reservation be accepted generally without the need to repeat it in each instance.

equally true that, as Korea explained at the First Substantive Meeting, commercial banks have advanced to most of the financing areas in which KEXIM operates and they are now competing with KEXIM pursuant to market terms. It is important to remember the context of the establishment of KEXIM. Korea was a developing country with inadequately formed capital markets, among other things. It is quite typical in such situations for specialist banks to be set up to provide such pioneering expertise. Thus, it is a matter of technical specialization and, as the Korean economy matures and expands, such expertise spreads, too, diluting the "pioneering role".

The "On-Line Road Show" has been presented against such background. It is simply irrelevant to the question of below-market financing by KEXIM.

53. Please explain your understanding of the "non-competition" clause in the KEXIM legal framework. What in practice does it mean to not compete with commercial banks? What does Korea mean when it argues that KEXIM does compete with commercial banks? You seem to explain this clause in terms of different maturities of KEXIM and commercial loans. Yet PSLs are for a period of 90-180 days, which falls squarely within the range of commercial bank terms. Further, APRGs are given for not less than 6 months and not more than 25 years, which covers a wide range in which commercial banks are operating. Please comment.

As Korea stated at the First Substantive Meeting, in order to properly understand the meaning and relation of Article 24 vis-à-vis Article 25.2, it is necessary to understand the major financial services provided by KEXIM. KEXIM financial services can roughly be categorized into the four (4) areas referred to below:

(1) *Export financing*: export loans; loans on deferred payment terms regulated by the OECD Arrangement; pre-shipment loans (which are the measure at issue);

(2) *Overseas investment credits*: These are the long-term credits extended by KEXIM in conjunction with overseas investment. Generally, these credits mature after 2~5 years;

(3) *Import credits*: These are also long-term credits extended in conjunction with imports of capital goods; and

(4) *Guarantees*: KEXIM extends performance guarantees, bid bonds, retention bond, warranty bonds and APRGs (which are the measure at issue).

These financial services generally involve longer-term trade-related financings and they also involve foreign-currency loans. When KEXIM was established in 1976, there were not many financial institutions to provide these types of financial services. Therefore, the principal purpose of establishing KEXIM was to provide such longer-term, trade-related financial services for which there was no competition from commercial banks at that time. Against this background, Article 24 was introduced to describe the specialized nature of KEXIM business. But the general "non-competition" statement in Article 24, by nature, was not intended to provide a very precise definition of the KEXIM operations. In this regard, Article 25.2 describes the KEXIM financial services in terms of the length of loan maturity by stating that the maturity of KEXIM loans should be between 6 months and 25 years. Of course, this provision was not intended to implement the "non-competition" statement in Article 24, as the '6 month-to-25 years' maturity is so broad that most of the financing services provided by other commercial financial institutions will fall within this '6 month-to-25 years' maturity. However, the 25 year maturity is a very long term for which few commercial banks provide financing. In this regard, Article 25.2 still indicates the special role of KEXIM focusing on very long term financing where commercial banks do not normally operate. In any event, it should be noted that none of these provisions is intended to prohibit other financial institutions to participate in long-term,

trade-related financial services extended by KEXIM or to require KEXIM to exit the market for these financial facilities as soon as they are provided by other financial institutions.

After KEXIM was incorporated, the Korean financial market has developed and commercial financial institutions began to provide the specialized financing services in which KEXIM had operated. Thus, at present KEXIM is in competition with commercial banks in all areas of financial services, except the long-term export credits with deferred payment terms which are regulated by the OECD Arrangement. As for the pre-shipments loans, KEXIM competes with other financial institutions which provide "general loans" or other short term loans. In the field of overseas investment credits, as the foreign exchange regulations were amended to allow commercial banks to provide such overseas investment credits, all financial institutions can now freely extend such credits. As for the APRGs, KEXIM took only a small portion of the market share (less than 20 per cent) prior to the Asian Financial Crisis, as Korea submitted.

Furthermore, the true meaning of Article 24 of the KEXIM Act can be clearly explained by reference to the changes in Article 18 of the KEXIM Act which directly enumerates the types of operations to be carried out by KEXIM. Prior to 16 September 1998, Article 18 provided that "KEXIM may engage in the operations prescribed in [each subparagraph of Article 18] that are not normally conductible by other financial institutions". In other words, Article 18 was clearly confining KEXIM's operations to those financial services that could not be provided by other financial institutions. However, by way of the 16 September 1998 amendment, such "non-competition" restriction on KEXIM's business scope was eliminated and Article 18 now provides that KEXIM "may engage in the operations prescribed in the [subparagraphs of Article 18]" without any limitations (please refer to Amendments to KEXIM Act and Decree, Korea Annex V Response Attachment 1.1(1)-3, Exhibit EC-12). This amendment explains how Article 24 of the KEXIM Act has been understood and applied.

As the situation in the financial market has changed since the enactment of the KEXIM Act, and in light of the above amendment to Article 18, the non-competition clause of Article 24 of the KEXIM Act should have been repealed. In fact, for this reason, KEXIM has been contemplating proposing the repeal of or amendment to Article 24 of the KEXIM Act. This is nothing unusual. Every jurisdiction in every WTO Member has some outdated statutory provisions on the books that should be changed, but sometimes are not in the press of crowded legislative agendas.

54. At para. 170, Korea asserts that Article 24 of the KEXIM Act should be read in conjunction with Article 25.2 thereof. In the absence of any explicit linkage between these provisions, please provide support in respect of this argument (such as the negotiating history of Article 24, for example). If Korea's assertion regarding the relationship between these provisions is correct, and if Article 25.2 explicitly sets restrictions on the term of financing that KEXIM may provide, what is the purpose of Article 24, i.e., what does it add to Article 25.2?

Please refer to Korea's responses to Question 53 above.

55. Regarding Article 26 of the KEXIM Act, Korea suggested at the oral hearing that this provision should be interpreted in the context of the entirety of that legal instrument. What other provisions of the KEXIM Act have a bearing on the interpretation of Article 26? Please explain.

Article 26 has no purpose other than to provide that all fees and rates must cover "at least" the costs when KEXIM provides financing. It does not prohibit KEXIM from earning profits and, instead, effectively requires it to carry on profitable operations. In fact, KEXIM has earned substantial amounts of operating profits since its establishment as shown in the response to Question 49 above. Further, other relevant provisions of the KEXIM Decree effectively require KEXIM to carry on its

business for profit. More specifically, Articles 17-3 through 17-13 of the KEXIM Decree provide the parameters for sound and profitable management of KEXIM. In addition, the Interest Rate Guidelines of KEXIM provides for the mechanism of determining interest rates and fees which is structured to align KEXIM rates always with market rates (see Chapters 2, 3 & 4 of the Interest Rate Guidelines).

56. Article 26 of the KEXIM Act provides, in particular, that except where "inevitable for maintaining the international competitiveness to facilitate [...] export [...]", interest rates shall be set so as to cover *inter alia* operating expenses.

(a) What is the meaning of the phrase "inevitable for maintaining the international competitiveness"?

(b) How is this phrase applied in practice? In any such case, where the interest rate is reduced to maintain international competitiveness, would this not imply that the final rate is below market?

As Korea noted during the First Substantive Meeting, the phrase mentioned above was included in the KEXIM Act in order to allow KEXIM the option to provide financing at below-cost level in exceptional situations when KEXIM faces severe 'rates' competition from foreign financial institutions. A typical example is a situation where KEXIM has to apply "matching" as permitted under the OECD Arrangement. Under the OECD Arrangement, if a counterpart export credit agency deviates from the guidelines under the OECD Arrangement, other export credit agencies are permitted to lower their interest rates to match such interest rates of their counterpart. In order to provide for such possibility, Article 26 was introduced into the KEXIM Act. However, as this "matching" would be exceptional, Article 26 uses the term "inevitable", which means that under normal or ordinary circumstances this exception must not be applied. Korea notes that this exception under Article 26 has never been applied in practice thus far. Further, KEXIM has interpreted this Matching mechanism in such a restrictive manner that it can be applied only for matching of **[BCI: Omitted from public version.]** (see Article 43 of the Interest Rate Guidelines).

In any event, Korea believes that the Panel's sub-question (b) does not appear to be relevant with the definition of subsidy or market benchmark. Because the benefit is not determined by reference to the cost of the granting authority, but to the advantages received by the beneficiary of the subsidy, a fact that KEXIM's interest rate may in exceptional cases go below its "operating expenses" referred to in Article 26 has noting to do with the finding of a 'benefit' or a 'subsidy'. Instead, as long as Article 26 permits KEXIM to match the low interest rates applied by other competing financial institutions, KEXIM will always end up applying the market benchmark, whether or not the KEXIM rate is below or above its "operating expenses". In sum, Article 26 does not imply that the final KEXIM rate is "below market".

C. APRG PROGRAMME

57. Are we correct in understanding that the Market Adjustment Rate means an upward or downward adjustment, toward the market rate, of the base rate plus spreads? Does this not mean that applying a Market Adjustment Rate could result in a below-market rate? Please explain.

First of all, as explained in its response to Question 47 above, Korea would like to clarify that the "market rate" should exist in the form of "range" or "band", not a single rate.

The Market Adjustment Rate is one of the spreads (or premium) that is to be applied upward or downward to the base rate in addition to other spreads such as "credit risk spread" and "target margin". **[BCI: Omitted from public version.]**

It is commercially reasonable and fully market-oriented that the rates of other competing financial institutions are considered in determining the final rates or that a borrower who has a long relationship with KEXIM and a good track record may obtain lower interest rates and/or fees. Korea would like to note that applying such Market Adjustment Rate or similar spreads is a market practice applied by all other commercial financial institutions.

[BCI: Omitted from public version.]

Korea does not believe that this Market Adjustment Rate causes the final fee rate to be set below the market rates. It is because the base rate and the spreads, including the Market Adjustment Rate, are determined and applied according to the market-oriented criteria and it is always assumed that the final rate will stay within the range of 'market rates'.

58. Please provide examples of KEXIM APRGs provided to purchasers of commercial vessels where the Market Adjustment Rate has been (i) upwards, (ii) downwards, and (iii) zero/neutral. During 2003, what proportion of the totality (i.e., shipping sector and beyond) of KEXIM's APRGs involved (i) upward, (ii) downward, and (iii) zero/neutral Market Adjustment Rates?

[BCI: Omitted from public version.]

59. In transactions in which there is no "export credit" to the Korean exporter, is the argument set forth in para. 263 of Korea's first written submission (that Korean exporters who export capital goods which qualify for loans under KEXIM policies on export loans also are eligible for APRGs) relevant? Would the APRG still constitute an "export credit guarantee" in such circumstances? Please explain.

Korea raised this issue as part of its arguments in the alternative relating to the safe harbors provided by Items (j) and (k) of Annex I. Korea invoked the similarity in eligibility criteria for export credits and APRGs as an additional indicator to support its conclusion that APRGs are export credit guarantees. The fact that APRGs may be granted when export credits in the narrow sense are not does not prevent APRGs from being qualified as export credit guarantees because it still is a guarantee accessory to an export transaction similar to a loan guarantee which covers a default by the borrower. Moreover, in the opinion of Korea, APRGs are guarantees against increases in the cost of the exported products in the sense of Item (j) of Annex I for the reasons explained in paras 265 to 267 of its First Written Submission.

60. Regarding the argument in para. 266 of Korea's first written submission, (that APRGs provide a safeguard against increases in the cost of production of a vessel, by relieving the shipbuilder of the need to borrow working capital) is it Korea's position that the provision of an APRG precludes any increase in the cost of producing a commercial vessel?

No Korea is not arguing that in the broadest sense that it precludes "any" increases in costs. The APRG programme is fairly limited. It only applies with respect to the cost associated with the working capital necessary to produce the ship. The reference to the guarantee against increases of costs also demonstrates that item (j) is not limited to guarantees extended directly to buyers, for the reference to "costs" – which are more closely associated with risks carried by the seller – is the term used rather than the reference to being a safeguard against increases in "prices", which would more clearly indicate a focus on buyers.

D. PSL PROGRAMME

61. In light of paras. 260 and 271 of Korea's first written submission, is it Korea's position that any official measure to promote exports constitutes an official export credit? Please explain.

Korea did not mean to imply that any official measure to promote exports constitutes an official export credit when it referred in paragraph 260 of its First Written Submission to Section 4 of the Sector Understanding for Export Credits for Ships. Korea also referred to Section 3 of the OECD Arrangement in paragraph 259 to clarify that export credits may be given in the form of direct credits/financing, refinancing, interest rate support, guarantee or insurance. Korea nevertheless invoked Section 4 in support of its argument that the concept of "export credit" and "export credit guarantee" should not be given an unduly restricted interpretation that would exclude APRGs from Item (j) while these show a close connection with the financing that the shipowner obtains for the building of the vessel covered by the APRGs. Korea also notes that the term "official export credit" is found only in the second paragraph of Item (k) and provides part of the definition of a narrow exception to the broader language in the first paragraph of Item (k). Thus, whatever would be an "official export credit" for purposes of the second paragraph of Item (k) necessarily would be included within the provisions of the first paragraph. The OECD references are illustrative here.

62. Regarding para. 272 of Korea's first written submission, do shipyards necessarily grant credits to buyers in every case that they avail themselves of a PSL?

Yes, in the sense that a shipowner is never required to settle the price for the vessel at once but in installments of which the time period and amounts vary depending on the negotiations between the shipbuilders and the shipowners. Hence, the shipowners are always allowed to defer payment as mentioned in the quotation in paragraph 272 of Korea's First Written Submission. The larger the amount that the shipowner is entitled to defer during the building of the vessel as a result of the payment term agreed upon, the greater the likely need of the shipbuilder for a pre-shipment loan or an equivalent financing facility for financing the purchase of materials and the building of the vessel concerned.

63. At paragraph 159 of its submission the EC quotes a statement by KEXIM that the PSL programme involves "larger credits and longer repayment terms than what suppliers or commercial banks would provide". Why is this not evidence that PSLs are provided on below-market terms?

Korea notes that Exhibit EC-21 referred to in footnote 116 at paragraph 159 does not contain the phrase quoted above. Further, Korea is not able to locate the quoted phrase in any other exhibits the EC provided. Hence, Korea is not in a position to respond to this Question at this time. Korea also notes that the sentence quoted does not, in any event, lead to the suggested conclusion. For example, providing a longer term than is generally available does not mean that the rates are below market. It depends on how they are adjusted to reflect the different terms. The size of a credit may or may not require different rates; it depends on factors extraneous to size alone. Therefore, that part of the statement would seem completely beside the point.

64. Please provide details of two Base Rate calculations for two fixed rate loans to Korean shipyards, taking into account and making reference to the component elements thereof referred to in the Interest Rate Guidelines.

As noted in the response to Question 47 above, the loans with fixed interest rate are rather exceptional. Nonetheless, Korea submits the details for two loans with fixed interest rate as below. **[BCI: Omitted from public version.]**

65. At para. 199 of its first written submission, Korea states that the terms of PSLs normally do not exceed 6 months. At para. 277, Korea asserts that the usual maturity of PSLs is between 90 and 180 days. Please explain these different descriptions of the maturity of PSLs. What is the typical maturity of a PSL?

Korea notes that the above two statements describe the same fact in a slightly different form. In terms of maturity of disbursements of PSLs, there is no "typical" maturity of a PSL. **[BCI: Omitted from public version.]**

66. Are all PSLs at floating rates? Are any made at fixed rates?

PSLs may take either floating rates or fixed rates. Korea submits examples of fixed rate PSLs in its response to Question 64 above.

E. INDIVIDUAL APRG TRANSACTIONS

67. Please provide internal documentation concerning KEXIM's review / authorization of the APRG issued on [BCI: Omitted from public version]. Please include in particular the worksheets and other documentation showing calculations of the interest rate and other terms, including consideration of collateral, related to KEXIM's review / authorization of this APRG.

Korea submits in Exhibit Korea - 57 the relevant minutes of the Board of Directors Meeting and related documents authorizing the APRG transaction concerned. Korea notes that it is not KEXIM's policy to keep and maintain worksheets and similar documents. Hence, Korea cannot provide such documents.

[BCI: Omitted from public version.]

68. Regarding para. 207 of Korea's first written submission, please explain the basis for Korea's assertion that the EC "confirmed" that the market which provides other alternatives available to the recipient must be confined to the domestic market.

Korea's statement in paragraph 207 of its First Written Submission, referred to in paragraph 145 of the EC's First Written Submission where the EC stated that the KEXIM APRGs confer a benefit to Korean exporters "by providing financial support on more advantageous terms than they otherwise would be able to obtain in the Korean financial market."

69. Regarding para. 213 of Korea's first written submission, please provide an example (with supporting documentation) of two instances in which different Korean shipyards were not able to select the APRG provider themselves. Please also provide supporting documentation for the instance referred to in note 161 to Korea's first written submission.

[BCI: Omitted from public version.]

70. Regarding the last sentence of the quote contained in note 157 to Korea's first written submission, is it only when "physical" collateral is provided that "the credit rating of the borrower will not influence the determination of the spread"? Please explain.

Attachment 1 of the Interest Rate Guidelines provides for the application of different credit risk spreads depending on the types of security interests provided. According to this Attachment, **[BCI: Omitted from public version.]**

71. Regarding the second sentences of paras. 218 and 221 of Korea's first written submission, and the third sentence of para. 223, please specify precisely which APRGs by which domestic financial institutions Korea considers would constitute a more appropriate market benchmark, and provide details thereof.

First, Korea re-emphasizes that the EC bears the burden of proof to establish the appropriate market benchmarks and has, so far, failed to do so and thereby failed to establish a *prima facie* case on export subsidies. However, for the purpose of showing that the EC has in fact selected and provided misleading data, Korea submits below certain APRG rates charged by other financial institutions which can be compared with the rates charged by KEXIM at the comparable time.

[BCI: Omitted from public version.]

F. INDIVIDUAL PSL TRANSACTIONS

72. Please provide internal documentation concerning KEXIM's review / authorization of PSL [BCI: Omitted from public version]. Please include in particular the worksheets and other documentation showing calculations of the interest rate and other terms, including consideration of collateral, related to KEXIM's review / authorization of this PSL.

Korea submits in Exhibit Korea - 60 the relevant minutes of the Board of Directors Meeting and related documents authorizing the PSL transaction concerned. Korea notes that it is not KEXIM's policy to keep and maintain worksheets and other similar documents. Hence, Korea cannot provide such documents.

73. Regarding paras. 233 and 240 of Korea's first written submission, please explain precisely how the collateralization and difference in maturity of the relevant PSLs accounted for the difference between the rates for those corporate bonds and the KEXIM PSL rates, which sometimes was as much as [BCI: Omitted from public version]. Please comment on Attachment 1 to the KEXIM Interest Rate Guidelines in this respect.

First of all, Korea notes that the corporate bond rates offered by the EC are hypothetical ones and, thus, cannot constitute comparable benchmarks to PSLs. The corporate bond rates offered by the EC are the rates which the Korea Securities Dealers Association ("KSDA") announces for the purposes of general indices. More specifically, in order for KSDA to post corporate bond yield rates daily, the securities dealers of 10 securities houses designated by KSDA provide KSDA with the daily yield rates which are not based on the statistics of actual yield rates, but based on their own projections taking into account the market situations on that date. In turn, KSDA simply averages those rates and posts it. Thus, the KSDA rates must also be hypothetical ones. The KSDA rates do not reflect the difference in the industry sectors which the issuing company belongs to, the different financial strengths of individual issuers (e.g., whether the company is an affiliate of a Chaebol), and, most importantly, the specific terms and conditions (especially the maturities and collateral) of the actual corporate bonds being traded in the market. When looking at the individual companies even having the same credit ratings, the companies may be perceived and treated differentially in the market considering various factors. Accordingly, the actual yield rates of the corporate bonds of the issuers with the same credit rating may be substantially different. Considering all these, there must be differences or gaps between the KSDA rates and the actual corporate bond rates of individual companies. Hence, Korea doubts, from the outset, whether the KSDA rates themselves can constitute appropriate benchmarks for PSLs, let alone the discussion on different terms and conditions (particularly the maturities and the collaterals).

Further, Korea notes that the collateralization substantially affects the application of credit risk spreads as explained in the response to Question 70 above, which in turn causes substantial differences in the final interest rates. **[BCI: Omitted from public version.]**

Further, as the graph attached hereto (Exhibit Korea - 62) clearly shows, the interest rates of loans with longer term maturity were generally higher than the loans with shorter term maturity. Also, KEXIM has applied higher credit risk spreads for the loans having over 1 year maturity than the spreads for the loans having 1 year or less maturity (see Attachment 1 to the Interest Rate Guideline). Thus, the difference in maturity also clearly affects the overall interest rate although the degree of such differences has varied from time to time.

74. Regarding para. 241 of Korea's first written submission, please provide a copy of the relevant agreement between KEXIM and Hyundai Heavy Industries.

Korea submits herewith KEXIM's notice of approval relating to the transaction as Exhibit Korea - 63.

75. Regarding paras. 272 and 273 of Korea's first written submission, do the terms on which PSLs are provided vary according to the amount, duration or terms of any credit provided by the Korean exporter to its customers? Please explain, and provide supporting documentation where relevant.

If the payment term agreed upon between the Korean exporter and its customer is tail-heavy, i.e., most of the purchase price is paid at a later stage during the manufacture of the product concerned and after its delivery, it means that the shipbuilder must procure the production cost through its own financing (e.g., PSLs), rather than through advance payment from the ship buyer (i.e., payments received prior to the delivery of the vessel concerned). Therefore, at least the 'amount' of the PSLs will vary according to the 'amount' and the "duration" of the credit provided by the shipbuilder to its customer. This will influence the term spread taken by KEXIM when granting the PSL.

However, Korea has no document that shows a clear linkage between the terms of PSLs and the terms of supplier credits to ship buyers.

G. ACTIONABLE SUBSIDIES

76. Does Korea accept the EC's argument that the Korea Depository Insurance Corporation and the Bank of Korea constitute "public" bodies in the sense of Article 1.1(a)(1) of the *SCM Agreement*? Please answer yes or no, and give reasons. If yes, what characteristics do these entities have that KEXIM does not? Do these entities have the authority to regulate and / or tax?

(a) Yes, Korea agrees that at least the Bank of Korea constitutes a "public" body in the sense of Article 1.1(a)(1) of the SCM Agreement. As explained below, the Bank of Korea possesses the essential powers characterizing the exercise of 'governmental' authority, that is, authority to 'regulate', 'restrain', 'supervise' or 'control'. Further, the Bank of Korea is not engaged in the supply of goods or services on commercial terms on markets which are open to private operators. KEXIM (and KDB and IBK as well) do not have such powers and characteristics.

The main powers and characteristics of the Bank of Korea include the following:

- As the central bank of the Republic of Korea, it issues the legal currency of Korea;

- It establishes and enforces the monetary and credit policies, controlling the amount and flow of money and stabilizing the prices;

- It acts as the "bank of the banks", receiving deposits from and extending loans to banks and other financial institutions, in order to sustain the systemic operation and security of the Korean financial market;

- It acts as the bank of the Government, receiving and paying the tax and other government revenues and keeping the Government-owned securities in custody;

- It operates and manages the nation-wide payment settlement system;

- It possesses and manages foreign currency-denominated assets of the Government and advises the Government on its foreign exchange policies;

- It maintains the stability and soundness of the national financial system by analysing and inspecting the operations of banks;

- It carries out the inspection and research of the overall status and development of the national economy and issues various statistical reports on the national economy;

- It represents the Korean Government in connection with any affairs, negotiations and transactions with international monetary or financial bodies of which the Republic of Korea is a member;

- In carrying out these powers, the Bank of Korea can exercise the power to order other banks and financial institutions to submit necessary materials and information;

- The Governor, Vice Governor, Auditor and employees of the Bank of Korea are treated as 'public servants' for the purpose of applying the criminal law and the penal provisions of other laws;

- The Bank of Korea is in principle prohibited from engaging, directly or indirectly, in any commercial (profit-generating) activities, and from receiving deposits from or lending money to individuals and corporations other than the Government, government agencies and financial institutions.

(b) The main powers and characteristics of the KDIC include the following:

- The KDIC is vested with two main functions: (i) operate the 'deposit insurance system' to protect depositors with the banks and financial institutions by paying deposits from a deposit insurance fund when the banks or financial institutions become unable to pay deposits to the depositors due to bankruptcy, etc.; and (ii) arrange for merger or assignment of business of 'unsound' financial institutions and provide financing in relation to such merger or business assignment;

- In carrying out such functions, the KDIC exercises the power to (i) require materials from, and inspect the financial institutions covered by the deposit insurances of the KDIC; (ii) institute legal actions against the directors, officers and employees of 'unsound' financial institutions, the directors,

officers, employees and major shareholders of the debtor company, or any other third parties which are believed to have contributed to the financial institution becoming 'unsound' (collectively the "responsible parties"); and (iii) require materials from and inspect the business and assets of the responsible parties;

- Any person who fails to submit the required materials or submits false materials to the KDIC or who refuses, interferes with or avoids the inspection by the KDIC will be punished by imprisonment or fine;

- The directors, officers and employers of the KDIC are treated as 'public servants' for the purpose of applying the applicable provisions of the criminal code.

77. If a loan is denominated in US dollars, isn't it appropriate to have regard to the US market in order to determine the prevailing market rate for such a loan?

KEXIM has carried on financing businesses in the Korean domestic markets in terms of customers and competing financial institutions. Therefore, KEXIM does not consider the US market rate as the prevailing market rate for KEXIM's US dollar denominated loans. **[BCI: Omitted from public version.]**

78. Regarding para. 347 of Korea's first written submission, was the liquidation / going-concern value assessment of Daewoo made on the assumption that there would be a particular restructuring (e.g., the restructuring proposed by Arthur Andersen), or instead on the assumption that no restructuring would take place? If the going concern value was based on the assumption of a given prospective workout or CRP process, what would be the value of your statement that in every case of restructuring of a ship producer, the going concern value was greater than the liquidation value? Is it not the case that with certain assumptions regarding the content of the restructuring process, any company however insolvent could be made to have a higher going concern value than liquidation value?

(a) It is not correct that the liquidation / going-concern value assessment of Daewoo Heavy Industry ("DHI") was made on the assumption that there would be a particular restructuring. The reverse was true. That is, Arthur Andersen proposed the restructuring of DHI after it had confirmed that the going concern value of DHI was greater than its liquidation value. The main responsibility of Arthur Andersen at the time was to carry out due diligence examination of DHI's assets and liabilities, to assess whether the going concern value was greater than the liquidation value, and, if the going concern value was found to be greater than the liquidation value, then to propose a feasible restructuring plan. Therefore, there could be no particular assumption of restructuring when Arthur Andersen made the liquidation/going-concern value assessment of DHI.

- This fact can be established by the history of Arthur Andersen's involvement and its role in the DHI workout. As clearly stated in Section 2(a) of the World Bank SAL II Policy Matrix on Corporate Restructuring (Exhibit Korea - 30), the role of the financial advisor was to indicate "*how best to maximize the return to creditors – i.e., through voluntary workout, composition, reorganization or liquidation"*, after the workout procedure had been initiated by the CCFI. Based on the professional assessment of this financial

advisor, the Lead Bank either proceeds with the preparation of a workout plan or proposes that the CCFI terminate the workout procedure initiated.[3]

- **[BCI: Omitted from public version.]**

These facts show that Arthur Andersen discharged its professional duty to analyze "how best to maximize the return to creditors – i.e., through voluntary workout, composition, reorganization or liquidation", without any pre-established assumption of the workout.

(b) In calculating the going-concern value of DHI, Arthur Andersen applied the 'discounted cash flow' (DCF) method whereby the enterprise value of the company is determined by discounting, with appropriate discount rate, the estimated cash flows to be generated by the company in future. (see Exhibit EC-64, Arthur Andersen Corporate Workout Report on DHI, pp. 103-104). In accordance with the modern financial management theory, the DCF method calculates the enterprise value (free cash flows) mainly based on the operational aspects (i.e., operating assets and operating liabilities). The assumption for the DCF valuation of the enterprise value is that the company continues as a going concern, but a "particular restructuring (e.g., the debt restructuring proposed by Arthur Andersen) was not considered at the stage of the assessment of DHI's enterprise value as a going concern.

Under the DCF valuation method, the going concern value of a company can be either higher or lower than its liquidation value, depending on the profitability and cash flows of the company's business operation. For example assume that a company holds operating assets (book value) of 1,000, operation liabilities (book value) of 300, interest bearing debt of 400 and equity of 300, with discount rate (WACC) of 10 per cent. And also assumes that in the case of liquidation, the company is expected to have liquidation value of 700. The comparison between the company's going concern value and the liquidation value is as follows:

1. In the case of annual operating cash flows being 100, the going concern value of the company would be 100/0.1=1,000, which is greater than the liquidation value of 700.

2. In the case of annual operating cash flows being 70, the going concern value of the company would be 70/0.1=1,000, which is the same than the liquidation value of 700.

3. In the case of annual operating cash flows being 50, the going concern value of the company would be 50/0.1=1,000, which is less than the liquidation value of 700

79. The EC states, at footnote 31 of the its submission, that Korea refused to provide a copy of the January 1998 Agreement with the top 5 chaebols on the grounds that this Agreement was "irrelevant". Is this correct? If so, please explain why this Agreement is irrelevant.

It is true that Korea did not provide copies of the agreements relating to the self-restructuring of the top five chaebol (hereinafter, "top-5 chaebols agreements"). Korea believed and still believes that the EC was making another fishing expedition by asking for documents which were irrelevant to the present dispute.

[3] Attachment 8 to Korea's First Written Submission, "Description of the Workout Procedures pursuant to the CRA."

The top-5 chaebols agreements are irrelevant to the present dispute because:

- These agreements provided for some principles of the so-called "self-restructuring", which was to be implemented voluntarily by each of those top-5 chaebols *outside of* the workout procedures under the Corporate Restructuring Agreement (CRA) framework or the court-supervised insolvency procedures. None of the corporate restructuring measures at issue in the present dispute was taken in the form of such "self-restructuring". Therefore, there was no reason for the EC to ask for the agreements relating to such self-restructuring.

- The EC argued, at footnote 31 of its First Written Submission, that "this agreement is quite relevant to this dispute because it shows the degree to intervention of the Government of Korea in the corporate sector." The EC attempts to mislead the Panel by intentionally using such vague words as "intervention … in the corporate sector." But the role of the Korean Government was confined to encouraging the top-5 chaebols to take self-initiated actions to enhance their management transparency, eliminate cross guarantees, improve financial structures (e.g., reduce debt/equity ratios), and dispose of non-viable affiliates and focus on core businesses.

- Such a limited role of the Korean Government in connection with self-restructuring by the top 5 chaebols was also clearly stated in section 3(h) of the World Bank Policy Matrix on Corporate Restructuring attached to the LOI between IMF and Korea (Exhibit Korea-30). It should be noted that this reference in the LOI to the top 5 chaebols' self-restructuring was made in the context of the corporate restructuring 'principles' set out in the LOI: i.e., "*All corporate restructuring should be voluntary (i.e., not government directed) and market oriented …..*" (See Exhibit EC-36, the LOI of 2 May 1992 between IMF and Korea, Attachment "Korea – Updated Memorandum on the Economic Program for the Second Quarterly Review, 1998"). Therefore, it is obvious that the top 5 chaebol agreements do not indicate the intervention of the Korean Government in the "corporate restructuring".

Furthermore, it is now clear that when the EC requested Korea to provide the January 1998 Agreement, it had already possessed the top 5 chaebols agreement of 7 December 1998 and understood what the top 5 chaebols agreements were all about (see Exhibit EC-40). Moreover, in its Annex V responses, Korea provided sufficient information on the contents of these agreements that clearly shows the irrelevance of these agreements to the present dispute (see Korean's Annex V Response, Sections 2.2 (20), (21) and (22)). In this regard, the EC's allegation of adverse inferences is baseless.

Despite the irrelevance of the top 5 chaebols agreements to the present dispute, Korea hereby submits the January 1998 Agreement as Exhibit Korea – 65.

80. Please explain the different debt-recovery rates paid by KAMCO for unsecured loans held by Daewoo's domestic and foreign creditors respectively.

[BCI: Omitted from public version.]

81. You argue that the restructuring was not specific, because many companies underwent restructuring during the same period as the shipbuilders. Is your argument that the restructuring packages and work-outs were essentially standardized, and subject to "objective criteria or conditions governing the eligibility for, and the amount of" the measures involved, and that such criteria and conditions were "strictly adhered to"?

Or is it the case that each restructuring or work-out was tailor-made to the particular company involved? Please explain.

Our argument is two-fold: First, assuming for the sake of argument that each of the creditor financial institutions of the three restructured Korean shipbuilders constitutes the "granting authority" as referred to in Articles 2.1(a) and (b) of the *SCM Agreement*, the granting authority, or the legislation pursuant to which the granting authority operates (i.e., the CRA and the Corporate Reorganization Act), did not explicitly limit access to an alleged subsidy to shipbuilders. Instead, the restructuring legislation or scheme provides for standardized sets of rules and procedures and is generally applicable to all companies irrespective of their industrial sectors. Therefore, no specificity can be found pursuant to the principle laid down in Article 2.1(a).

Second, we also argue that the restructuring legislation or scheme established "objective criteria or conditions governing the eligibility for, and the amount of, a subsidy" and, therefore, the non-existence of specificity can be established by virtue of Article 2.1(b). Footnote 2 of the *SCM Agreement* enumerates 'number of employees' or 'size of enterprise' as examples of 'objective criteria or conditions' as used in Article 2.1(b). However, 'objective criteria or conditions' is more broadly defined to mean "criteria or conditions which are neutral, which do not favour certain enterprises over others, and which are economic in nature and horizontal in application."

The CRA and the Corporate Reorganization Act, which constitute legal frameworks for the workout and corporate reorganization proceeding, respectively, authorized the creditor financial institutions or the court to grant the restructuring measures to any corporation which was insolvent or suffering liquidity problems but whose going concern value is greater than liquidation value. Korea believes that these criteria clearly govern the eligibility for the restructuring measures, and constitute "objective criteria or conditions" as defined in the footnote 2 of the SCM Agreement. Furthermore, according to the Operational Guidelines for Workout Agreement, if a request for workout is filed by a company, the lead bank must set up an independent Workout Eligibility Review Committee to review the eligibility of the subject company. The Review Committee is required to review the applicant's financial and management status to assess the viability of that company.

Although the amount of the alleged subsidy itself was not spelled out in the restructuring legislation or scheme in terms of numerical figures, the above going concern value standard would also constitute objective criteria or conditions 'governing' the amount of the alleged subsidy, in the sense that the alleged subsidy amount should be limited to the extent necessary for restructuring to realize the established going concern value and maximize returns to the creditors.

H. SERIOUS PREJUDICE

82. Please comment on the EC's assertion that the competition complaint filed by Samsung demonstrates the unfair pricing advantage enjoyed by restructured Korean shipyards.

The Ministry of Commerce, Industry and Energy ("MOCIE") intervened in the Hamburg Süd case in accordance with the provisions of the Overseas Trade Act. Article 43 of the Act authorizes the MOCIE to issue to exporters of goods a "coordination order" with respect to the terms of export (including without limitation prices, quantity, and quality), if, among others, the exporters engage in any of the following types of behavior and if it is deemed necessary to prevent acts which threaten to disturb fair competition in the export of goods or to impair Korea's external credit and reputation:

1. If an exporter unreasonably excludes other traders in connection with export of goods;

2. If an exporter unreasonably induces or coerces the counterpart of another trader to refuse to deal with that trader in connection with export of goods; or

3. If an exporter unreasonably interferes with the overseas business activity of other traders in connection with export of goods.

As can be seen from the above provision, this provision is a special *competition law provision* applicable specifically to export trade transactions. In common law jurisdictions it is closer to so-called tortious interference than competition law.

[BCI: Omitted from public version.] The MOCIE was not concerned with whether prices offered by the shipbuilders involved were high or low, but just looked into the way or fashion in which the competition was taking place. The MOCIE considered that the behaviour was problematic in light of the provisions of Article 43 of the Overseas Trade Act. As a result, the MOCIE issued the coordination order to stop unreasonable competition. This coordination order dealt with the unique situation of a particular case from a Korean competition law perspective, and in no respect supports the serious prejudice argument of the EC.

83. Does the EC correctly characterize your argument as being that no violation can be found based on a past action? Please explain your position on this issue, including any relevant past disputes. Does your position differ as between alleged prohibited and allegedly actionable subsidies?

Korea believes that the EC has not properly reflected Korea's position in paras 17 to 20 of its Oral Statement. Korea does not argue that the subsidies must still be current on the day that the Panel issues its report or on the day that the DSB adopts its report. However, where a statutory framework or a programme is challenged as such, as a prohibited export subsidy, such statutory framework or programme at the time of the initiation of the dispute settlement proceeding must still reflect the deficiencies complained about. Simply put, the facts are completely contrary to the EC's argument regarding the programmes "as such".

Moreover, in the present dispute, it must be recalled that the period under review is not a single continuum. It is not the case as it would be if this Panel were examining the long history of EC subsidization of its shipyards where the underlying economic conditions were relatively stable. In this case, the early part of the period the EC identifies was one of huge generalized financial and economic turmoil in Korea and other Asian countries. Reviewing this time of financial turmoil becomes of questionable relevance in light of the actions taken over a reasonable period of time in the most recent past. As Korea noted, the period of extreme financial turmoil does indeed make it difficult to find market benchmarks not just in this matter but in any other aspect of Korea's economy during that period. Korea is firmly of the view that, if proper adjustments are made to reflect these conditions, it is clear that there was no subsidization at that time either. Thus, is it not a question of a legal bar on examining the earlier part of the period, it is a matter of probity and relevance of the data.

The EC itself refers to the fact that a credit risk assessment was introduced in Korea's APRG transactions in March 1998. It is neither reasonable nor in line with Article 3.2 of the *SCM Agreement* that a possible deficiency remedied some 5 years before the initiation of the dispute settlement should still be challenged. In that sense, a WTO Member cannot be said to "maintain" a prohibited subsidy.

Korea wishes also to bring to the attention of the Panel that the EC in support of its arguments has relied on APRGs and PSLs that were frequently afforded up to some 5 or 6 years ago while Korea had submitted much recent data. Thus:

(i) for Daewoo: the EC shows APRGs issued from 1997 to 2001 (Figure 11 of the EC's First Written Submission) and PSLs issued from 1999 to 2001 (Figure 16 of the EC's First Written Submission);

(ii) for Halla: the EC shows APRGs issued in 2000 (Figure 12 of the EC's First Written Submission) and PSLs issued primarily between 2001 and 2002 with two only in May 2003 (Figure 17 of the EC's First Written Submission);

(iii) for Daedong: the EC shows APRGs issued in 1999 (Figure 13 of the EC's First Written Submission) and the PSLs issued in 2002 and three only in May 2003 (Figure 18 of the EC's First Written Submission);

(iv) for Hanjin: the EC shows APRGs issued in 2002 (Figure 14 of the EC's First Written Submission) and PSL's issued between 1999 and 2001 (Figure 21 of the EC's First Written Submission);

(v) for Samsung: the EC shows APRGs issued in 1997 (Figure 15 of the EC's First Written Submission);

(vi) for Hyundai Mipo: the EC shows PSLs issued between 1999 and October 2002 (Figure 19 of the EC's First Written Submission);

(vii) for Hyundai: the EC shows PSLs issued between 1999 and 2003.

The EC has made a selective approach of APRGs and PSLs and selected for a number of shipyards "old" APRGs or PSLs while additional data was provided by Korea on more recent APRGs and PSLs in Annex 1.2(31)-1 and 1.2(30) of the responses filed by Korea in the Annex V process, i.e.:

(i) Daewoo: APRGs issued by KEXIM in 2002 and 2003 were shown as well as PSLs with commitment dates in 1996, 1997 and 1998;

(ii) Halla: data on APRGs issued by KEXIM in 1997, 1998, 1999, 2002 and 2003 were shown as well as PSLs with commitment dates in 1996, 1997 and 2000.

(iii) Daedong: data on APRGs issued by KEXIM in 1998, 2000, 2001, 2002 and 2003 were shown.

(iv) Hanjin: data on APRGs issued by KEXIM in 1998, 2000, 2001 and 2003 were shown as well as PSLs with commitment dates in 2002 and 2003;

(v) Samsung: data on APRGs issued by KEXIM in 1998, 1999, 2000, 2001, 2002 and 2003 (many) were shown as well as PSLs with commitment dates in 1998, 2000, 2001 and 2002;

(vi) Huyndai Mipo: data on APRGs issued by KEXIM in 1998, 1999, 2000, 2001, 2002 and 2003 was shown as well as PSLs with commitment dates in 1996 and 1998;

(vii) Hyundai: data on APRGs issued by KEXIM in 1997, 1998, 1999, 2000, 2001, 2002 and 2003 was shown.

The position taken by the EC in paragraph 38 of its Oral Statement is simply incorrect as a matter of law. Panels cannot make rulings based on an assumption of bad faith implementation by Members. In addition, if the EC's point were taken to its logical conclusion, one fails to see what would be the use of consultations. If a settlement is found during consultations, the principle is that this obviates the need for a dispute settlement even if it is theoretically conceivable that a defending party could change its legal system again. What is the difference with a defending party that has itself remedied a deficiency in its legal or regulatory framework before there was even any mention of a

possible dispute settlement? As mentioned by China in its third-party submission (paragraph 18), the word "maintain" in Article 3.2 of the *SCM Agreement* does not mean "prevent".

The case of actionable subsidies covered by Articles 5 and 6 of the *SCM Agreement* is indeed different from that of prohibited subsidies. Simply put, the complainant must show adverse trade effects. It is not like demonstrating nullification or impairment elsewhere under the WTO Agreements where there is a presumption created if legal inconsistency is demonstrated. All but the most recent past practice will be of extremely limited legal and factual relevance especially when there is a qualitative distinction represented here by the financial crisis as a compared to the returning normality of the recent past.

Moreover, it is important to recall that under Article 7.8 the remedy is the withdrawal of the subsidy or its adverse trade effects. The negotiators, therefore, contemplated that adverse trade effects had to exist at the time of the dispute settlement. Korea has further submitted that the use of the present tense "is" in Article 6.3(c) contrasts with the wording of Article 15.2 of the *SCM Agreement* which refers to "whether there has been a significant price undercutting by the subsidized imports … or whether the effect of such imports is otherwise to depress prices to a significant degree or to prevent price increases, which otherwise would have occurred, to a significant degree". The provision of Article 15.2 contemplates a review over a reference period sufficiently long in order to provide a trend showing injury to the domestic industry. In the case of Article 6.3(c), Korea submits that price depression or suppression must be shown in a relatively recent period preceding the initiation of the dispute settlement. In support, it has referred to the conclusion of the Panel in *US – Wheat Gluten* in paragraph 543 of its First Written Submission.

Korea has noted that the EC in support of its allegation of price depression as regards LNGs, has provided a graph with newbuilding price developments up to January 2003 (Figure 30). However, Korea submits that the EC should show LNG price developments up until June 2003 taking into account prices submitted by Korea in the Annex V process and other prices as has become publicly available since January 2003. Similarly, in support of price suppression, the price data supplied by the EC are the same graph showing prices only up to January 2003 and for container vessels and chemical and product tankers up to the end of 2002 only (refer to Figures 39 and 42 of the EC's First Written Submission) whilst price data was obviously available to the EC in terms of the monthly reports prepared by its own expert, FMI, and particularly relevant as shown in Annex 5a of the EC responses to the Annex V process.

84. Is it your position that the outcome of all restructurings is *ipso facto* a market outcome, making the existence of subsidization impossible? Please explain. What is meant by your statement that every corporate restructuring was "market oriented"? Do you mean that its going concern value was higher than its liquidation value, or do you mean something else or something in addition?

Where an insolvency procedure can proceed only after it has been confirmed that the going concern value of the insolvent company is greater than the liquidation value and creditors can make a most market-oriented decision through mutual negotiations and a majority rule when adopting the restructuring plans, Korea considers that the insolvency procedure yields a market outcome. In particular, in the three cases at issue, each was market oriented in the sense that each creditor attempted to maximize the return on the debt it was holding. In these cases, it means that it was more profitable to continue operating the companies than winding them down and liquidating the assets. The existence of insolvency rules (corporate reorganization or workout) is the essence of a market economy; if the restructuring is made according to the insolvency rules on a market-oriented basis, then there is no subsidization.

85. You argue that the concept of "like product" applies in respect of price suppression/price depression, yet the relevant portion of SCM Article 6.3(c) does not

refer to "like product". What in your view is the significance of the fact that "like product" is not referred to in respect of price suppression/price depression or lost sales? Is your argument that this was an inadvertent omission by the negotiators? If so, is there any evidence to support this? Please explain.

Korea considers that the wording of Article 6.3(c) is consistent with a finding that the concept of "like product" applies with respect to price suppression/price depression. Article 6.3(c) states in this regard that serious prejudice may arise where:

> the effect of the subsidy is a significant price undercutting by the subsidized product as compared with the price of a like product of another Member in the same market or significant price suppression, price depression or lost sales in the same market…

The fact that the word "like product" is not repeated in the second part of the sentence after the disjunctive "or" is neither an omission on the part of the drafters, nor, in Korea's view, should it be interpreted to imply that the concept of "like product" does not apply in the context of price suppression/price depression. Read in context, Korea believes that the term "like product" in the first part of the sentence refers also to "price suppression, price depression or lost sales" in the second part of the sentence. The reason why the words "like product" are not repeated in the second part of the sentence, while the words "same market" are repeated, is that repetition of the former is superfluous while the latter is not. In this regard, throughout the subparagraphs of Article 6.3, the treaty specifies and differentiates the geographic boundaries of the market that is being referred to, i.e. the "market of the subsidizing Member" in subparagraph (a), a "third country market" in subparagraph (b) or a "world market" in subparagraph (d) etc. In the context of the contrasting geographic markets being juxtaposed in subparagraphs (a)-(c), it is therefore logical that the drafters would take care to specify the geographic boundaries within which the serious prejudice criteria (price undercutting, price depression etc.) should be examined.

In contrast, the term "like product" is not differentiated or redefined in each of subparagraphs (a)-(c) and consequently there is no need to again define or refer to this term in the second part of the sentence.

Indeed, comparable formulations are found elsewhere in the *Anti-Dumping and SCM Agreements*. In this regard, Article 3.2 of the *Anti-Dumping Agreement* states with respect to the injury analysis that:

> With regard to the effect of the dumped imports on prices, the investigating authorities shall consider whether there has been a significant price undercutting by the dumped imports as compared with the price of a like product of the importing Member, or whether the effect of such imports is otherwise to depress prices to a significant degree or prevent price increases, which otherwise would have occurred… (Emphasis added).

Article 15.2 of the *SCM Agreement* similarly provides:

> With regard to the effect of the subsidized imports on prices, the investigating authorities shall consider whether there has been a significant price undercutting by the subsidized imports as compared with the price of a like product of the importing Member, or whether the effect of such imports is otherwise to depress prices to a significant degree or to prevent price increases, which otherwise would have occurred… (Emphasis added)

In both the above formulations, the term "like product" is not repeated in the second part of the sentence after the disjunctive "or." Nonetheless, Korea considers that the drafters clearly intended

that depressed prices or lack of price increases in the context of the above-quoted Articles are to be analyzed by reference to the "like product" concerned and not by some novel undefined standard. There is no reason to interpret the use of the term "like product" in Article 6.3(c), and its applicability to the evaluation of price-suppression/depression, differently.

As Korea argued in its First Written Submission, Articles 6.3(a), (b) and (c) posit "like product" and "market" as different requirements (paragraph 506). Yet, the EC would have the Panel conclude that the words "in the same market" in the context of price suppression/depression suddenly comprises both a geographic and product dimension. This construction is illogical. It would require reading into the text of Article 6.3(c) a wholly undeclared and unexplained intent that the word "market" should comprise only a geographic dimension in some cases (e.g. subparagraph (a) and (b)) but in the context of subparagraph (c) the same word implies both a product and geographic dimension.

Moreover, to hold that "like product" does not apply in respect of price suppression/depression would mean that the absence of the word "like product" in the second part of the sentence under subparagraph (c) should be interpreted to mean – with no express words to that effect – that the *SCM Agreement* took the exceptional step introducing a new and undefined standard in the context of the subparagraph (c), despite that 'like product' is a cornerstone found throughout the *SCM Agreement* and indeed the *WTO Agreement*. Had the drafters intended such a result, Korea considers that they would have made this intent explicit and would moreover have defined or elaborated the alleged product dimension of the "same market" in the context of evaluating price suppression/depression. Korea notes in this regard that footnote 46 to the *SCM Agreement* provides that:

> Throughout this Agreement the term "like product" ("produit similaire") shall be interpreted to mean a product which is identical, i.e. alike in all respects to the product under consideration, or in the absence of such a product, another product which, although not alike in all respects, has characteristics closely resembling those of the product under consideration.

Had the drafters intended to introduce a special product dimension to the term "same market" in Article 6.3(c) the drafters would presumably have similarly defined this concept.

For these reasons, in addition to Korea's previously submitted arguments, Korea considers that under the ordinary meaning of the terms in Article 6.3(c), read in their context, the concept of "like product" applies to price suppression/depression under subparagraph (c).

Finally, the issue here is not simply a matter of what label ones applies. The real problem is that it is impossible to have a sensible discussion of the market unless one first defines that market. As noted above, the whole structure of the *SCM Agreement* is premised on defining that market in terms of "like product" and there is no indication of an exception for this one single portion of Article 6.3(c). But, even if one were to choose a different term, one still needs to define the market. Is there significant price depression in the market? But, what *market*, one must ask. The parameters must be rigorously defined or one is left with the situation demonstrated by the EC's arguments where they refer to some vague categories through which certain products sail at random such as the sudden exclusion of certain types of "pure" chemical tankers. At the next moment, the EC is endorsing the apparent Japanese view that there is a single product category and that every ship affects every other in a legally relevant manner. This vagueness renders it quite literally impossible for Korea to respond and the Panel to make a determination.

86. Do you think that footnote 46 of the SCM Agreement establishes a narrower definition of "like product" than that applicable under Article III, paragraphs 2 and 4 of the

GATT 1994? Could similarity of end-use be a criterion for determining "like product" as defined in footnote 46? Why or why not?

As explained more fully below, Korea is of the view that Article III provides a single analytical framework for determining "like product." However, Article III does not provide one single definition of "like product." The term "like product" under Article III can be broad in some instances and more narrow in others (the so-called accordion). Footnote 46, with its narrow definition focused on physical characteristics is similar to the narrow approach required by Article III:2 first sentence. As with Article III:2 first sentence, end-use can be a criterion incorporated into the like product analysis, but end-use cannot be used to broaden the scope of the like product away from the narrowness of the definition implied by the reference to physical characteristics.

The answer to this question and Question 87 have many overlaps. It is important to emphasize that Korea does not agree that the EC has adopted a "product segment" analysis like that suggested by the Panel in *Indonesia – Autos*. With its vague references and shifting product categories and the utter lack of any sort of proof of any sort, the EC has not followed any recognizable approach followed under any provision of the WTO Agreements.

In *Indonesia – Autos*, the Panel explicitly referred to the like product test as developed in the jurisprudence of Article III, explicitly citing the Appellate Body analysis in *Japan – Alcoholic Beverages*.[4] Indeed, the EC also endorsed this Article III-based analytical approach[5], but then completely abandoned any attempt to follow-through on the analysis. Instead, the EC tried to claim the right to make mere assertions of points that it subjectively considered "obvious" and hopes to shift the burden onto Korea to prove the negative of its assertions.

In contrast to the EC's approach, the Panel in *Indonesia – Autos* then went through the list of issues it would be examining including, physical characteristics, consumer perceptions, end-uses, price differences and tariff classifications. The Panel stated that it considered that, in the specific case before it, it found physical characteristics to be particularly important, but did not limit itself to that element of the like product analysis.

The term 'characteristics closely resembling' [as per footnote 46] in its ordinary meaning includes but is not limited to physical characteristics, and we see nothing in the context or object and purpose of the SCM Agreement that would dictate a different conclusion.[6]

Thus, it is clear that the Panel in *Indonesia – Autos* was not attempting to construct a new analytical approach to like product based on something outside the treaty language called "product segmentation" as proposed by the EC. Rather, the Panel was bringing the like product analysis of footnote 46 within the analytical context of the like product analysis used elsewhere in the WTO Agreements, including Article III of the GATT 1994.

By referring to Article III, the Panel in *Indonesia – Autos* was endorsing the analytical rigor of the Article III approach and certainly would not have approved the fuzziness and vagueness of the EC approach. According to the EC at times, there is a single product category of all ships. This was how it was described in parts of the EC's First Written Submission and certainly was the basis of the EC's endorsement of the Japanese approach in the First Substantive Meeting where any commercial vessel has a legally recognized impact on any other vessel regardless of type.[7] This is in contrast with

[4] *Indonesia – Autos* at para 14.174.

[5] EC First Written Submission at para. 39.

6 Indonesia – Autos at para. 14.173

[7] In this regard, Korea would like to draw the Panel's attention to the discussion in the Panel Report in Korea – Alcoholic Beverages wherein the Panel noted that, in the context of a discussion of the broad category of whether products are directly competitive or substitutable, at some general level all products and services are

other suggestions by the EC that there are three product categories rather than one. But even with three categories, the EC has failed to provide any sort of rigorous analysis of the parameters of such categories. Indeed, the parameters are so fluid that they apparently can permit certain types of ships to sail in and sail out of the categories depending on the complainant's supply side factors in isolation from any other sort of analysis.[8]

The key point to understand from the jurisprudence under Article III is that it defines an *analytical approach* to defineroduct categories. This analytical approach is essentially the same in Articles III:2 and III:4. There are three different *results* of the approach depending on whether a panel is making fact findings with respect to Article III:2, first sentence regarding "like product", Article III:2, second sentence, regarding "directly competitive products", or Article III:4, "like products". Thus, the *conclusion* will differ based on the breadth of the categories, but the *analytical approach* is basically the same.

Accordingly, the Appellate Body in *Japan – Alcoholic Beverages* found that the definition of "like product" was narrow and used an analogy to an accordion to denote how the term can be narrow or more expansive given the context.[9] Directly competitive products are a broader category, of which like products are essentially a subset. This was made very explicit in *Korea- Alcoholic Beverages* where the Panel applied essentially the same analytical tools to both analyses and found that the narrower like product categories had not been proved by the complainants.[10]

This approach was confirmed in *EC – Asbestos*, where the Appellate Body used the multi-element analytical approach and specifically criticized the Panel for looking at only one factor in making its like product analysis.[11] The Appellate Body then applied the tests but reached a conclusion based on a broader definition of like product than used for Article III:2, first sentence. In doing this, the Appellate Body expressly noted that it had not decided that the broader like product analysis of Article III:4 was coterminous with the directly competitive product analysis of Article III:2, second sentence, but it left open the possibility.[12] The conclusions of the Appellate Body in this regard necessarily mean that the analytical approach of the like product and directly competitive analyses of the different parts of Article III must be the same. The issue of narrowness of the product category becomes an issue of interpretation of the results of the analytical approaches, not any differences in the elements contained within such approaches.[13]

Footnote 46 of the SCM Agreement focuses on identical products or products with characteristics closely resembling each other. This is, on its face, a strong physical identicallity test. The Panel in *Indonesia - Autos* was applying this in a manner that found that physical characteristics could subsume some of the other issues such as end-uses, tariff classification and price relationships. That is, those other factors could also be taken into account within a like product analysis undertaken

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competitive with each other, but that the requirements of Article III meant that a more rigorous and specific analysis was required. Panel Report in Korea – Taxes on Alcoholic Beverages at paras. 10.39-10.43 (Panel Report approved without modification by the Appellate Body). If that was the case for the broad category, it certainly should be the case for the narrower category of like product.

8 The EC stated at the First Substantive Meeting that a certain type of specialty chemical tanker was no longer relevant because the EC yards do not construct such vessels. However, the question of whether the EC makes a particular product is irrelevant in answering the question as to whether such specialty chemical tankers are similar or dissimilar to the other chemical tankers, i.e., whether there are similarities in physical characteristics, end-uses, and demand side price relationships. The causal relationships cannot be analyzed unless these parameters are properly established.

[9] Appellate Body Report in *Japan – Taxes on Alcoholic Beverages* at p. 21.

[10] Panel Report in Korea – Taxes on Alcoholic Beverages at paras. 10.103-10.104 (Panel Report approved without modification by the Appellate Body).

[11] Appellate Body Report in *EC – Asbestos* at paras. 119-120.

[12] Ibid. at para. 99.

[13] Ibid. at paras 101-102.

pursuant to footnote 46. The language of footnote 46 clearly means that the conclusions drawn from such analyses must be taken on the basis of the "closed accordion" of like product definitions.

Korea considers this *Indonesia – Autos* approach, properly understood, as clearly within the jurisprudence that has developed under Article III which looks to these various elements of the like product/ directly competitive product test. However, the treaty text is quite clear in footnote 46 that the test for purposes of the SCM Agreement accords with the narrow approach adopted by the Appellate Body in Article III:2, first sentence, not the broader analyses of Article III:4 and Article III:2, second sentence.

In the present dispute, the problem has arisen that the EC has attempted to avoid the issue completely and claim that the Panel in *Indonesia – Autos* developed a whole new test of "product segmentation" that is not based on the treaty text and apparently is more vague, completely fluid and quite broad. This is contrary to the approach used by panels and the Appellate Body pursuant to Article III, as endorsed by the *Indonesia – Autos* panel. There simply is no way to read that panel report to imply a broadening of the interpretation of like products or a weakening of the analytical rigor needed to define the parameters of the categories.

In the absence of such rigorously defined product categories, it is simply impossible for the respondent or the Panel to address the complaint in any meaningful manner and the claims necessarily must fail as a matter of law. As Korea – supported by the US – has argued, the abdication by the EC of establishing the like product categories (regardless of whether the EC now tries to apply a different label) should end the Panel's inquiries because the EC has failed to carry its burden of proof. As the Appellate Body emphasized in *Japan – Agricultural Products II*,[14] the purpose of Panel questions asked pursuant to DSU Article 13 is to better understand the parties' arguments, not to make the complainant's case for it.

87. If the concept of "like product" does apply in respect of price suppression/price depression analysis, what in your view would be the appropriate "like product" categories to be used in this dispute? Do you agree with the EC on the general idea that like products could be defined on the basis of a market segmentation approach similar to that used by the *Indonesia – Autos* panel (even though the panel notes your disagreement with the particular market segments proposed by the EC)?

(a) At the outset, Korea is forced to note that it is deeply troubled by this question and wishes to reiterate its position that the burden of proof to demonstrate the existence of serious prejudice rests on the EC. If the Panel agrees with Korea (as supported on this issue by the US) that this requires an analysis based on like products, then the inquiry ends. The EC, to use its term, **"rejects"** the relevance of like product.

Korea recognizes the broad authority of Panels to ask questions for purposes of clarifying the parties' arguments and also recognizes that by merely asking a question, the Panel is not stating its position on a legal issue. Of course, therefore, Korea will do its best to answer this question in as full a manner as possible in the ten-day period allotted. However, Korea is concerned that when it answers this question, the EC will incorrectly try to shift the burden of carrying the argument to Korea. Therefore, Korea must note for the record its objection to being required to formulate *ab initio* a "like product" presentation in the face of the EC's rejection of its legal relevance.

The requirement of pursuing a like product analysis was confirmed by the Panel in *Indonesia – Autos*, the very case invoked by the EC itself in relation to the "like product" definition. That Panel observed:

[14] Appellate Body Report in *Japan – Agricultural Products II* at para. 129.

> In assessing the arguments of the parties, we are cognizant that the complainants are required to demonstrate the existence of serious prejudice by positive evidence. Thus, we agree with Indonesia that the complainants bear the burden of presenting argument and evidence with respect to each element of their serious prejudice claims – including the existence of effects on a "like product".[15] (Emphasis added)

The EC has failed to carry its burden of proof. In paragraph 393 of its First Written Submission, it has stated that the same product market in Article 6.3(c) requires showing that products are competing which can be done by using the factors used in the "like product" analysis developed in the case-law on Article III of GATT 1994. It proposes a "market segmentation" approach used by the Panel in *Indonesia – Autos* in relation to an assessment on the existence of price undercutting under Article 6.3(c). It has then proceeded to posit as three separate products, LNGs, container vessels and product and chemical tankers but without any argument or evidence as to why these products are separate like products from the point of view of the factors that were taken into account even by the Panel in *Indonesia – Autos*. The EC's Oral Statement only makes general references to cross-price elasticity and substitutability from the point of view of the shipyards and the shipowners, without any presentation of supporting evidence at all. It indicates that container vessels can be used on a variety of routes and that for a shipbuilder it is immaterial which ship it builds as every ship is an assembly of steel products. So far, however, there is no clear indication on the specific criteria based on which the EC considers that it can identify LNGs, all container vessels and all product and chemical tankers as separate like products. Hence, Korea considers that the EC has not carried its burden of proof and that this deficiency cannot be remedied at this stage of the proceeding. Nevertheless, as discussed above, despite its deep reservations about the appropriateness of requiring Korea to provide this like product analysis, in the face of the EC's rejection of its legal relevance, and in a spirit of co-operation, Korea *ab initio* submits herewith as Exhibit Korea – 66 its approaches regarding how it considers that "like product" should be established. In doing so, Korea reserves all of its rights.

(b) In referring explicitly to the Panel's analysis in *Indonesia – Autos* which, Korea repeats, relates to an assessment of price undercutting under Article 6.3(c), the EC has, in effect, admitted that the concept of "like product" applies or at least provides determining guidance for the purpose of the assessment on price depression or suppression under Article 6.3(c). When the EC then turns and "rejects" the legal relevance of the concept of "like product", it is admitting it has not carried the necessary burden in this dispute. Indeed, the so-called market segmentation used by the Panel in *Indonesia – Autos*, is not some new test created out of whole cloth totally apart from the treaty. If it were, it would not be useful as a reference. Rather market segmentation occurs within the concept of "like product" as set forth in Article 6.3(c) and explained in Footnote 46 to the *SCM Agreement*. Establishing market segments is none other than determining the "contours" – using the EC's own term – of the products that can be considered to be closely resembling in order to constitute a "like product". The core issue is nevertheless which criteria to use to determine the contours of what is a market segment or a like product. In this regard, Korea refers to the following statement by the Panel in *Indonesia – Autos*:

> Turning first to the argument of the European Communities that all passenger cars should be considered "like products" to the Timor, we consider that such a broad approach is not appropriate in this case. While it is true that all passenger cars "share the same basic physical characteristics and share an identical end-use", we agree with Indonesia that passenger cars are highly differentiated products. Although the European Communities have not provided the Panel with information regarding the range of physical characteristics of passenger cars, all drivers know that passenger cars may differ greatly in terms of size, weight, engine power, technology, and

[15] Panel Decision in *Indonesia – Autos*, para. 14.169.

> features. The significance of these extensive physical differences, both in terms of the cost of producing the cars and in consumer perceptions regarding them, is manifested in huge differences in price between brands and models. It is evidence that the differences, both physical and non-physical, between a Rolls Royce and a Timor are enormous, and that the degree of substitutability between them is very low. Viewed from the perspective of the SCM Agreement, it is almost inconceivable that a subsidy for Timors could displace or impede imports of Rolls Royces, or that any meaningful analysis of price undercutting could be performed between these two models. In short, we do not consider that a Rolls Royce can reasonably be considered to have "characteristics closely resembling" those of the Timor.[16] (Emphasis added)

As discussed in response to the previous question, these are the common criteria used in "like product analyses under Article III, as well. Therefore, in the present dispute, Korea proposes to make use of the indicators referred to by the Panel in *Indonesia – Autos* coinciding with the indicators frequently used for the definition of "like product", i.e., physical characteristics, customer perception and end-use.[17] This is no different from how the EC itself has assessed the shipbuilding market as is shown in several statements made by the EC and its expert FMI in various documents. These statements cannot simply be discarded by the EC as needed only "to follow developments in certain characteristic sub-types of most interest to EU yards for purely information purposes" (paragraph 106 of the EC's Oral Statement). Reference is made to the document in Exhibit EC-1 to the EC's First Written Submission entitled "Overview of the International Commercial Shipbuilding Industry, Background Report" (May 2003), i.e., an FMI report dated May 2003 in which the FMI states the following with regard to tankers, bulk carriers and container ships:

> The above three ship types make up by far the largest portion of the fleet and a significant proportion of the output from the shipbuilding industry. These main volume products are normally further sub-divided into distinct sub-classes, as described in table 3.2. The main ship types and sub types listed in this table are according to common industry usage and the terminology used will be found in any documentation relating to the fleet. The main ship type is defined by the function of the ship and the sub types are defined by size classifications demanded by operators of the ship. The sub-classifications have been developed to suit the economic conditions of the main trades in each sector and can largely be regarded as standard products. There is little material difference in operational terms between different ships within any class of sub-type, whoever the supplier may be. It should be note that the economic classes of ship represented by the sub-types listed below are not readily substitutable for other ship types. For example, it may be technically possible to adapt a bulk carrier to carry containers but in operational terms this would be unfeasible. Similarly, substitution is rarely possible on a size basis because of the economics of trade. One seventy thousand dwt ship, for example, is not operationally or economically equivalent to two thirty-five thousand dwt ships.

To this should be added the following FMI statement on container ships in particular indicating that container vessels have different uses depending on their size:

> There are a wide range of sizes of ships on a wide range of routes, typically following an established 'hub and feeder' pattern. Very large ships (the largest of which now rival the largest category of tankers in terms of physical dimensions) carry boxes on trans-oceanic routes servicing the main hub ports in the Far East, Europe, North America and Middle East. Smaller 'feeder' ships then distribute the boxes from the

[16] Panel Decision, *Indonesia – Autos*, para. 14.175.

[17] In the Indonesia – Autos case, the Panel considered that all cars had the same end-use to transport passengers. This is not the case of the commercial vessels subject of the dispute as is mentioned in (a) above.

main hub ports to local ports. The contents of the boxes is made up of 'general cargo', and may include such diverse items as machinery, white goods, clothing, electronic equipment, and so on.

88. To whose prices do the terms "price suppression" and "price depression" refer: the subsidizer's, the complainant's, or both?

Because the issue is serious prejudice to the interests of the complaining party, the price suppression must be of the complaining party, otherwise there cannot logically be serious prejudice to the interests of that Member, as required by Article 5(c). However, Korea would note that the significant price suppression or depression has to be caused by the subsidies. The EC has ignored the causation analysis. Please refer to the response in Question 91 below.

89. The panels in the GATT 1947 disputes on *EC – Sugar* brought by Australia and Brazil found that EC export refunds had contributed to depressed world prices for sugar, thus indirectly causing serious prejudice to Australia's and Brazil's interests. In other words, in those cases, the market in question was a world market, the prices in question were world market prices, and the finding of serious prejudice to Australia's and Brazil's interests was exclusively based on the depression of those (world market) prices.

You argue, by contrast, that the price suppression/depression provisions of the SCM Agreement neither contemplate nor permit an analysis based on a "world market". You also argue that price suppression/depression by itself does not constitute sufficient evidence of serious prejudice, but rather that a complaining party must (1) present evidence and analysis to establish that its own domestic industry is suffering significant overall impairment, i.e., something similar if not identical to "serious injury" such as for a safeguard investigation, and (2) must show as well that the survival of the industry in question is vital to the complaining party's overall interests.

(a) Is there anything in the text of the SCM Agreement to support your position that the domestic industry of the complaining party should suffer the equivalent of "serious injury", when SCM Article 5 clearly treats injury and serious prejudice as two separate concepts?

(i) The word "may" as used in the chapeau of Article 6.3 does not stand for "permitted", at least as that was used by the EC during the First Substantive Meeting. If the negotiators had meant to indicate that serious prejudice would exist any time only one of the factors stipulated in Article 6.3(a) to (d) were achieved, they would have used the word "shall" as was done in many of the provisions of the WTO Agreements. The word "may" indicates that serious prejudice does not automatically exist when any one or more of the factors in Articles 6.3(a) to (d) is found to exist.

(ii) The use "one or several" in the chapeau of Article 6.3 further confirms that the existence of any single factor does not *ipso facto* lead to an affirmative finding on the existence of serious prejudice.

(iii) Price suppression or depression are two indicators only of the existence of material injury of which Article 15.2 provides that "no one or several of these factors can necessarily give decisive guidance." If it were allowed pursuant to Article 6.3 to find serious prejudice if there was either price depression or price suppression, the standard to find serious prejudice under Article 5(c) would be substantially below that to find material injury under Article 5(a) and footnote 11. However, the Appellate Body in US – Lamb has concluded that the "word 'serious' connotes a much higher

standard of injury than the word 'material'".[18] The qualitative difference between "serious" and "material" does not change depending on whether it qualifies "injury" or "prejudice". It is inherent to the meaning of the words viewed in isolation.

(b) Is there anything in the text of the SCM Agreement to support your position that for serious prejudice to be present, the survival of the domestic industry of the complaining party must be vital to its overall interests?

Korea stated that it considered the term "prejudice" to be within the series of terms used in the WTO such as "injury", "damage" or resulting in "market disruption". Korea was noting that the whole phrase of "serious prejudice to the interests of another Member" connotes a standard that is not only higher than material injury (based on the considerable jurisprudence in this regard), but also broader, as the interests of a Member necessarily encompass something more than just the industry at question. The domestic industry is part of the interests of the Member but cannot automatically be equated to the broader interests of a WTO Member. Far from addressing this issue of "serious prejudice to the interests of another Member", the EC attempts to construct a case that would not even satisfy the requirements of *initiating* an investigation by a national investigating authority under Part V of the SCM Agreement. The "standards" proposed by the EC are so low and so vague that apparently they can be met by showing a "kink" on a graph.

(c) How do you square your arguments with the quite different approach and results of the prior GATT panels cited above?

The Sugar Panels cited examined the EC's export refunds for sugar under Article XVI:1 and XVI:3 of the GATT. Article XVI:1 imposes a notification and a consultation requirement for "any subsidy, including any form of income or price support, which operates directly or indirectly to increase exports of any product from, or to reduce imports of any product, into its territory". The operative section is Part B referring to "Export Subsidies" which are not relevant to the interpretation of Part III of the SCM Agreement. Specifically, Article XVI:3 provides that, for export subsidies, if a Member grants directly or indirectly any form of subsidy that operates to increase the export of any primary product from its territory "such subsidy shall not be applied in a manner which results in that contracting party having more than an equitable share of would export trade in that product". In that sense, to the extent that there is relevance under Part III of the *SCM Agreement* relating to export subsidies as actionable subsidies, the provisions are closer to (but still not the same as) Article 6.3(d) which considers the situation where the effect of subsidy is an increase in the world market share of the subsidizing Member in a particular subsidized primary product or commodity which is the only provision of Article 6.3 which explicitly provides that a "world market" may be taken into account.

The provisions of Article XVI:1 and XVI:3 indicate that the notification and consultation requirements must apply and that a subsidy cannot give a contracting party more than an equitable share of the world export trade as the word "shall" is used throughout these provisions. In this sense, the wording of the chapeau of Article 6.3 is different and, hence, it is not possible to derive any direct implications from the above Sugar Panels for the purpose of its interpretation.

(d) In this regard, what in your view is the significance of footnote 13 to SCM Article 5(c), which provides that the term "serious prejudice" in the SCM Agreement has the same meaning as in GATT Article XVI:1? We note that Article VI:1 of GATT 1994 contains no reference to injury to the domestic industry of the complainant. Is the purpose of this footnote to incorporate into the SCM Agreement the interpretations of the prior GATT panels on serious prejudice? If not, what is the purpose of this footnote?

[18] Appellate Body Report, *US – Lamb*, para. 124.

Given the explicit provisions of the chapeau of Article 6.3, the purpose of footnote 13 is to clarify that a threat of serious prejudice, as is explicitly provided in Article XVI:1 is also covered under Article 5(c) of the *SCM Agreement*. In addition, the reference can be interpreted to mean that a finding of price depression or suppression is not enough but must be accompanied by an increase in exports by the subsidizing Member from its territory or decrease in imports into its territory which must be shown to be result of the alleged subsidy. In response to both this and the previous sub-question, Korea would like to recall that the Appellate Body explicitly approved the following statement by the Panel in *Brazil – Desiccated Coconut* regarding the relationship between the *SCM Agreement* and Article VI, which applies equally with respect to Article XVI, particularly in light of footnote 13:

Article VI of the GATT 1994 and the SCM Agreement represent a new and different package of rights and obligations, as among WTO Members, regarding the use of countervailing duties. Thus, Article VI and the respective SCM Agreements impose obligations on a potential user of countervailing duties, in the form of conditions that have to be fulfilled in order to impose a duty, but they also confer the right to impose a countervailing duty when those conditions are satisfied. The SCM Agreements do not merely impose additional substantive and procedural obligations on a potential user of countervailing measures. Rather, the SCM Agreements and Article VI together define, clarify and in some cases modify the whole package of rights and obligations of a potential user of countervailing measures.[19]

There is nothing in Article XVI that detracts from the proposed interpretation of Articles 5 to 7 of the *SCM Agreement*. Indeed, when combined with an examination of Article VI and Part V of the *SCM Agreement*, it is quite evident that it is the EC's minimalist approach that is inconsistent with the overall scheme of the treaty language. The EC's approach is vague and standards-less with no like product analysis, no examination of the state of the complaining Member's industry, no examination of the broader scope of that Member's interests and only the most minimalist causation analysis that is not in harmony with the treaty. The EC's approach would render the standards of Part II of the *SCM Agreement* and Article XVI affecting markets in other Members at a much lower level than those required for examining imports into a Member's own market pursuant to Article VI and Part V of the *SCM Agreement*. This is both logically absurd and completely without support in the broader scheme of the treaty language.

90. In your view is the causation standard for serious prejudice the same as that in a countervailing duty investigation? If so, then what accounts for the very different drafting of the respective provisions of the SCM Agreement, and for the clear distinction in SCM Article 5 between injury and serious prejudice? If not, please explain the differences.

The causation standard for serious prejudice and in a countervailing duty investigation are different. Pursuant to Article 6.3(c), it must be shown that it is the challenged subsidy specifically that is causing the alleged price depression or suppression. Article 6.3(c) explicitly states: "the effect of the subsidy is a significant …" It is, therefore, not sufficient to show that the products that are being subsidized are causing price suppression or depression but it must be shown that the subsidy in isolation has caused significant price depression or suppression. As stated in Korea's First Written Submission (paragraph 532), where price depression or suppression significant enough to cause serious prejudice is not caused by the alleged subsidy but by other factors, the actionable subsidies cannot be prohibited. When price depression or suppression is caused by the alleged subsidy and by other factors, the actionable subsidies can only be prohibited when the alleged subsidy itself has caused significant price depression or suppression considered in isolation from other factors. This too requires a quantification of the alleged subsidy as explained in paragraph 536 of Korea's First Written

[19] Panel Report in Brazil – Desiccated Coconut at para. 246, as approved in the Appellate Body Report in Brazil – Desiccated Coconut, at p. 17.

Submission. As Korea noted at the First Substantive Meeting, it is possible to consider both the causation and injury standards for countervailing duty investigations as lesser standards subsumed within the standards of Articles 5 and 6. Thus, proving the elements of injury and causation under Part V could be considered as necessary, but not sufficient, elements of demonstrating serious prejudice under Articles 5 and 6.

91. In respect of causation, you argue that no matter what other factors may be present in the market, the subsidization independently of these other factors must itself cause serious prejudice.

(a) How could such an analysis be performed?

As discussed above in regard to the issue of "like product", Korea would like to note its concern about burden shifting. The EC has rejected any sort of conventional approach to causation, instead relying on a vague, mechanical approach that has a far lower standard than any trade remedy investigation or dispute under any of the WTO Agreements. Thus, if the Panel agrees that some sort of normal causation analysis should be pursued, the dispute should conclude at that point, for the complainant has rejected that approach and refused to provide any evidence or arguments of that sort.

As Korea has noted, the Appellate Body made it very clear in *Japan – Agricultural Products II* that the Panel has a broad mandate to gather information for purposes of clarifying the parties' arguments, but not making the complainant's case for it. Again, recognizing that questions are not statements of position, Korea provides the following discussion setting out its views. However, Korea must again reserve all of its rights so that its response cannot be interpreted as its agreement to assume a burden belonging to the complainant.

Subject to these reservations, Korea believes that, in order to establish the causation between the subsidy and the price depression or suppression, the analysis could be performed in accordance with the following order:

Step I: The alleged subsidy must be quantified with respect to each subsidized shipbuilder.

- If the quantity of the alleged subsidy is insignificant, the analysis must end there.

- If the quantity of the alleged subsidy is significant, the Panel should proceed to Step II.

Step II: The effect of the subsidy on the prices of the subsidized shipbuilder must be quantified.

- Logically, the chain of causation should begin with the effect of the subsidy on the prices of the subsidized shipbuilder. In a competitive market, it is generally assumed that prices are set at the level of the total production cost, even though actual prices may sometimes go below cost of production in the case of a highly capital-intensive, cyclical industry such as the shipbuilding industry. A subsidy would enable the subsidized shipbuilder to sell its products at prices below the competitive price level by either lowering the production cost or simply compensating the loss from sales below the production cost, depending on the nature of the subsidy in question. Therefore, the effect of the subsidy on the prices of the subsidized shipbuilder may be measured by (i) determining first the level of production cost not affected by the subsidy (e.g., the actual unit cost plus the prorated subsidy amount per unit of the subsidy that reduced the production cost (hereinafter the "non-subsidized production cost") and then (ii) comparing this non-subsidized production cost with the prices of the subsidized shipbuilder.

- If the prices of the subsidized shipbuilder still exceed the non-subsidized production cost, the subsidy has not affected the actual prices of the subsidized shipbuilder. Therefore, the subsidy has not had price depression or suppression for its effect.

- On the other hand, if the prices of the subsidized shipbuilder are below the non-subsidized production cost, the subsidy has affected the prices of the subsidized shipbuilder downward by an amount which is equivalent to the smaller of (i) the difference between the subsidized shipbuilder's prices and its non-subsidized production cost or (ii) the prorated subsidy margin included in the above production cost (this difference can be called the "subsidy effect margin" for convenience in the explanation).

- If the 'subsidy effect margin' is insignificant, there is no causal link and the serious prejudice analysis must be ended.

- If the 'subsidy effect margin' is found to be significant, the analysis should move to Step III.

Step III: The price depression and suppression margin must be quantified.

- This is a complex process of determining the percentage margin by which the prices of the like product produced by the shipbuilders of the complaining Member (i.e., the EC) have been depressed or suppressed.

- For this purpose, 'like products' produced by the shipbuilders of the complaining Member must first be identified.

- Then, it should be analyzed whether the prices of the shipbuilders of the complaining Member would have been significantly depressed or suppressed as a result of the subsidy granted to the subsidized shipbuilders (i.e., the 'subsidy effect margin'). In this regard, the causation analysis is an integral part of the process of determining the existence of a 'significant price depression or suppression'.

- The detailed analytical methods suggested will be explained in subsection (d) below. Any elements of fair competition leading to a decrease in the price of the allegedly subsidized products (economies of scale, cost advantages, etc.) must be assessed.

- The effects of competing non-subsidized products from other sources on the price levels must be considered. An allegation of the maintenance of capacity due to the alleged subsidy is insufficient to establish that the subsidy caused significant price depression or suppression is insufficient when there are significant other sources of like products that are not subsidized.

- For price suppression, all factual and economic elements, including economic factors relevant to the industry of the complaining member, affecting price levels must be determined in order to assess whether prices would have increased in the absence of the alleged subsidies.

Taking at least all of these elements into account, the effects in isolation of the alleged subsidies on price levels must be determined to assess whether the subsidies specifically caused significant price depression or suppression. Korea would like to emphasize that this question is difficult to answer in isolation from the complainant's arguments. The EC has explicitly rejected price undercutting. In this regard, the burden is on the complainant to demonstrate the market mechanism

transmitting the effect of the subsidy to the alleged price depression or suppression. To do this, the EC has relied almost exclusively on issues of capacity. When challenged on this point, the EC denied that they were looking at just capacity and stated that it necessarily includes a multi-faceted approach including a certain amount of price undercutting. Korea would agree with the complexity and subtlety needed, but in the EC's case it must be *explicitly* to the exclusion of price undercutting. Thus, in providing the above response, Korea notes that this is not necessarily the exclusive way to demonstrate causation if one were to take a more rational, broad based approach. It also still might not be applicable in this case to the extent that there remain elements of a prohibited price undercutting argument.

(b) You suggest that one part of the analysis would be to quantify the amount or degree of subsidization and to compare this to the degree of price suppression or depression that may exist. Please clarify this argument. In particular, would the degree of subsidization be compared with the alleged degree of suppression or depression of the subsidized product's price?

As mentioned in subsection (a) above, Korea submits that the subsidy must be quantified and pro-rated so as to determine its possible effect on the price of the allegedly subsidized product (i.e., the 'subsidy effect margin' to be calculated in Step II mentioned above). Then, as explained in subsection (d) below, at Step III this 'subsidy effect margin' will be added to the actual prices of the subsidized product to calculate the 'hypothetical non-subsidized prices' of the vessels produced by the subsidized shipbuilder. This "hypothetical non-subsidized prices" of the subsidized shipbuilder are necessary to assess whether the prices of the shipbuilders of the EC as the complaining Member would have been depressed or suppressed as the effect of the subsidy.

In light of the above analytical process, it would be inaccurate to state that the degree of subsidization must necessarily be compared with the alleged degree of suppression or depression. Korea refers to Section (d) below.

Again, Korea would like to note its reservations concerning the potential for incorrectly shifting the burden of proof and also the limitations of this proposed methodology which is constructed in the absence of direct price comparisons.

(c) Or would it be compared with the alleged degree of suppression or depression of the price of the complaining party's product? If the latter, what if anything is the logical connection between the specific amount by which a particular country may subsidize a given product and the degree to which the price of the same product produced by a producer in another country may be affected?

Korea considers that price suppression or depression must be shown to the prices of the complaining party's products but that the establishment of a causal link requires it to also investigate the price depression/suppression at the level of the products of the subsidizing party. As mentioned in subsections (b) above and (d) below, however, the alleged 'subsidy effect margin' would not be directly compared with the alleged degree of suppression or depression, but will be considered as a crucial factor in determining the degree of such suppression or depression.

A mere allegation as mentioned by the EC of the continued existence of capacity due to the coverage of debt-servicing cost through the subsidy without investigation into causal link as indicated in (a) above is insufficient.

Korea would like to refer again to the EC Commission's Third Report on World Shipbuilding where it outlines the massive amounts of subsidies provided to the EC shipyards over the decades. These were as high as 28 per cent direct operating subsidies as recent as 1988, only being phased down to a "mere" six percent at the present time. As the Commission noted, this was only one form

of subsidization. There also was export subsidization, research and development subsidization; equity injection subsidization; regional subsidization, research and development subsidization (now as high as 25 per cent), tied aid subsidization, etc. This is one of the anomalies of the EC's narrow focus on maintenance of capacity. The Commission itself noted that the EC had maintained too much capacity and had not made sufficient competitive adjustment due to this sustained high level of subsidization. If one is looking at the question of maintained capacity, as per the EC's argument, then the causal link lies much more firmly with the EC's subsidies than any other Member.

(d) How, in concrete terms, is the degree of price suppression or depression quantified and expressed?

Korea submits that the price suppression or depression means, with respect to each like product identified, the percentage margin by which the price of the products of the complaining Member's products have been suppressed or the percentage margin by which the price has been depressed, as the effect of the subsidy. In order to determine the degree of price suppression or depression, the Panel should analyze whether the prices of the shipbuilders of the complaining Member have been significantly suppressed or depressed as a result of the subsidy granted to the subsidized shipbuilders.

In order to determine whether there is any significant price depression or suppression; Korea believes that the Panel should consider all the factors that will determine the prices. In this regard, Korea considers that the Panel could take the following steps:

Step 1: The prices of 'like products' sold by all the shipbuilders that are believed to affect the prices of the 'like products' of the EC shipbuilders must be identified

- The prices of the non-subsidized EC shipbuilders' like products must be determined as from the period immediately preceding the granting of the subsidy throughout the most recent period preceding the initiation of the dispute settlement procedure

- The hypothetical non-subsidized prices of the like products sold by the allegedly subsidized shipbuilder in Korea must be determined for the same period. These hypothetical prices can be determined by increasing the actual prices of the allegedly subsidized shipbuilder by the 'subsidy effect margin' since the granting of the alleged subsidy

- The prices of non-subsidized like products from other WTO Members must also be determined for the period immediately preceding the granting of the alleged subsidy throughout the most recent period preceding the initiation of the dispute settlement procedure.

Step 2: All the factors that are believed to affect the prices of the non-subsidized EC shipbuilders must be assessed in respect of their possible effect on such prices.

(a) Demand and supply factors

- As the prices are determined by the interaction of supply and demand, those factors that constitute the demand and supply, respectively, should be identified and assessed.

- On the demand side, a main indicator may be the trend in new orders. If the demand has increased in excess to the capability of the shipbuilders in the market to supply products, prices would have increased while if the demand has decreased over the production capability, the prices would have decreased.

- An important supply side factor is the trend of major cost items. The ship prices are sensitive to cost movements. As demonstrated by Korea, the price decline as alleged by the EC coincides with the decline of steel and other cost items as well as devaluation of Korean won. In such case, the causation analysis should stop there. If the decline of production cost is not sufficient to the entire price movements, then the actual impact of the cost decline must be accurately quantified and should be compared with other causation factors.

(b) Effect of prices of other non-subsidized shipbuilders (whether Korean or third country shipbuilders)

- If, with respect to each like product, there are a number of non-subsidized shipbuilders which collectively have sufficient market shares to be able to lead or substantially influence setting of the market prices, then the prices charged by these non-subsidized shipbuilders will constitute the ceiling of the prices that can be charged by the EC shipyards, regardless of the effect of the alleged subsidy in question. Thus, the causation of the effect of the alleged subsidy is cut.

(c) Effect of the prices of the subsidized shipbuilders

- In the absence of any other causes mentioned above that are reasonably considered to disrupt the causal link between the alleged subsidy and the alleged price suppression and depression, the Panel can proceed to analyze the effect of the alleged subsidy;

- First, the Panel should look into whether the allegedly subsidized shipbuilder has the ability to lead or substantially influence the market prices of the like products, in terms of its market share or otherwise. If the market share is insufficient, or if the shipbuilder has not maintained a substantial market share consistently, it will be difficult to find a causal link as such.

- Only if the subsidized shipbuilder has maintained a sufficient market share to lead or substantially influence the market prices, should the Panel proceed to examine the effect of the subsidy on the prices of the shipbuilders of the EC. The Panel can compare the hypothetical non-subsidized prices of the allegedly subsidized shipbuilders (“Price A”) with the actual prices of the non-subsidized EC shipbuilders (“Price B”).

- If Price A is higher than Price B, it can be said that Price B, i.e., the prices of the non-subsidized EC shipbuilders were prevented from increasing up to the level of Price A. On the other hand, if Price B is equal to or below Price A, it can be assumed that, regardless of the effect of the alleged subsidy, the prices of the non-subsidized EC shipbuilders would have decreased (no price depression) or would not have increased (no price suppression) in any event.

- In such case, if the price difference is insignificant, the Panel should find that there was no “significant” price suppression or depression. On the other hand, if the difference is significant and the ‘subsidy effect margin’ is also significant, the Panel may find that there was “significant” price suppression or depression as the effect of the subsidy.

- In cases where the effect of the subsidy or the effect of other causes is not decisive or has equal force, then the quantity of the subsidy effect should be compared with the

aggregate quantities of all other factors, in order to determine whether "the effect of the subsidy" in isolation was the cause of significant price suppression or depression.

Korea would again like to note that it has answered this question the best that it can, but recalls that the EC has excluded price undercutting. In light of the EC's exclusion of such a critical element – which probably is present in the approach noted above – it is inequitable that Korea has been asked to construct an analytical approach *ab initio* to fit the skewed EC argument. This burden should be on the EC; thus, Korea reserves all of its rights even though it is attempting to be as responsive as possible to the Panel's questions in this regard.

92. What is the basis for your argument that the complaining Member must prove the effect of the alleged benefit from each alleged subsidy individually, rather than the combined effect of the alleged subsidies? How does this square with, for example, the approach to calculating the 5 per cent subsidization under the now-expired SCM Article 6.1, in respect of which paragraph 6 of Annex IV provided that "In determining the overall rate of subsidization in a given year, subsidies given under different programmes and by different authorities in the territory of a Member shall be aggregated", which seems to have implied that it was the overall impact of the subsidies in question that was relevant to the existence of serious prejudice? How in practice could a Panel conduct such a separate analysis of the effects of each subsidy individually?

The chapeau of Article 5 refers to "any subsidy". In addition, Article 7.8 provides that when a Panel or Appellate Body report is adopted in which it is determined that "any subsidy" has resulted in adverse effects to the interest of another Member, the subsidizing Member must either remove the adverse effects or withdraw the subsidy. The use of the term "any subsidy" confirmed by the multiple references to "the subsidy" in Article 6.3 confirms that the effects of a subsidy must be reviewed for each subsidy separately. In that regard, the wording of Article 6.1(a) and paragraph 6 of Annex IV is different from that in Article 6.3.

The analysis described in the response to question 91 above should be carried out for each subsidy individually.

As Korea noted during the First Substantive Meeting, this does not mean that after assessing each subsidy individually, a sum of the actionable subsidies cannot be aggregated for purposes of making the final causal assessment. But, unless they are broken down, the possibility of removing the adverse effects under Article 7.8 could not be done in any rational manner. Article 7.8 provides important context for understanding Articles 5 and 6 and is not a disembodied provision to only be looked at in isolation during implementation. To sever it in such a manner would be contrary to the provisions of Article 31 of the Vienna Convention. Rather, Article 7.8 serves as a useful illustration of the uniqueness of a trade effects dispute under the WTO. Because no other provision entails an adverse trade effects demonstration, no other provision allows for limiting the remedy to removing the adverse trade effects. Thus, in understanding what would need to be done to alleviate adverse trade effects later, a panel must build the case from the bottom up, one element at a time so that it is a comprehensible whole.

93. Is it your argument that, in a case involving multiple actionable subsidies, there would be double-counting of effects if somehow it could be demonstrated that in the absence of one of the subsidies, the remaining ones could not have caused adverse effects? What is the basis in the text of the SCM Agreement to such an approach to adverse effects?

No, there is not necessarily double-counting *per se*. In the question posed by the Panel, Korea is of the view that in the case of multiple actionable subsidies, the effect of the subsidies must be aggregated to determine whether in total they cause adverse effects. If one then removes one subsidy,

and the effect of the remaining subsidies is not adverse, then no remedy is required. The support for this conclusion comes from Article 7.8.

The double-counting issue only arises when there is a simultaneous claim regarding the same measure under Parts II and III of the SCM Agreement. The answer to the previous question shows why combining prohibited subsidies and actionable subsidies would result in double counting. To stack the prohibited subsidies on top of the actionable subsidies for purposes of the causation analysis would be including subsidies that as a *matter of law* under Article 4 will be removed. If they will be removed, then they should not be considered as part of the accumulated subsidies examined for purposes of causation in a trade effects case. For example, were they to be the subsidies that tipped the balance to an affirmative finding, then Article 7 becomes moot because the prohibited subsidies must be removed pursuant to Article 4. Thus, there would be no adverse trade effects to remedy and, therefore, no basis for the initial affirmative finding. The jurisprudence is quite clear that a treaty cannot be interpreted in a manner that renders part of *inutile*.

94. Please provide examples of recent bids for container ships, product/chemical tankers, and/or LNGs, which were won by Korean shipyards not alleged by the EC to have received subsidies, and for which bids you consider that at least one EC shipyard was a competitor.

As the Korean and EU shipyards focus on different product categories, the Korean yards, whether alleged by the EC to have been subsidized or not, did not compete with the EU shipyards with respect to many projects. One example of recent competition between Korean and EU yards would be the bids for a LNG Carrier order placed by Gaz de France (GDF). For this order, 5 shipyards (Mitsui, Chantiers de L'Atlantique, Daewoo-SME, Samsung and Hanjin) submitted bids, and Chantiers de L'Atlantique has won the order, thanks to the substantial amount of subsidies granted by the EC.

For details on this dubious transaction, please refer to the news articles, which are submitted herewith as Exhibit Korea – 67.

II. QUESTIONS TO BOTH PARTIES

95. Article 11-2 of the Guidelines for Interest and Fees (Amended) (Exhibit EC-13) provides that [BCI: Omitted from public version].

(a) To Korea: Does this suggest that KEXIM considers that foreign financial markets constitute an appropriate market benchmark? Please explain.

As stated in Korea's response to the Panel's question No. 77, KEXIM operates mainly in the Korean financial market in terms of its customers and competing financial institutions. Therefore, Korea is of the view that the appropriate market benchmark for KEXIM's interest rates is the Korean market. The fact that KEXIM may adjust the Base Rates by a marginal amount, taking into account the trends of domestic or foreign financial markets pursuant to Article 11-2, does not in and of itself support that KEXIM 's overall interest rates must be comparable to the interest rates charged by foreign financial institutions.

(b) To EC: What impact, if any, does this provision have on the EC's argument that KEXIM is not required to act on commercial principles? Please explain.

96. Can footnote 5 of the *SCM Agreement* be used to justify an *a contrario* reading of item (j) and the first paragraph of item (k) of the Illustrative List of Export Subsidies? Please explain.

Yes, in Korea's view so-called "safe harbors" do exist based on an reading of items (j) and (k) read in light of footnote 5 and the broader context of the SCM Agreement. While some have attempted to argue that the Appellate Body's statements in this regard in *Brazil – Aircraft (Article 21.5 – Canada)*[20] are mere dicta and do not mean anything, Korea is not of the view that the Appellate Body's views can be taken so lightly. Indeed, it is clear that any other reading risks rendering meaningless items (j) and (k), first paragraph.

In Korea's view a perfectly harmonious reading of the broader treaty text is achieved if there is an *a contrario* reading of these provisions. First, the language of items (j) and (k) both imply that the relevant issue is whether the programmes at issue cover the costs to the government of operating such programmes.[21] While some have expressed concerns that this reading in some way undermines the benefit to the recipient standard of Article 1.1(b), this is not the case at all. This is clear from the language of footnote 5 which provides that: "Measures referred to in Annex I as not constituting export subsidies shall not be *prohibited* under this or any other provision of this Agreement." (emphasis added). This language can be contrasted with the language of Article 8.1 which identified subsidies that "shall be considered as *non-actionable*" (emphasis added). Thus, it can be seen that all footnote 5 does is establish that measures that are not export subsidies under Annex I are not considered prohibited subsidies. It is a safe harbor with respect to Part II alone and is simply irrelevant to the analysis of benefit.

To put the issue another way, if benefit to the recipient is established pursuant to Article 1.1(b) and the other elements of the various tests are satisfied, then there is a subsidy. The question remains as to whether the subsidy is prohibited or actionable. All, footnote 5 – read in context with the language of items (j) and (k), first paragraph – does is provide that such subsidies are not prohibited. It is silent as to whether they may be actionable. If more were intended the drafters would have used the term "non-actionable" in footnote 5 as they did in Article 8.1. The harbors may be safe, but they are not all-encompassing.

Indeed, this point is illustrated in this very case. The EC has argued that the KEXIM measures are both prohibited and actionable. The safe harbors would render them immune form attack under Part II, but are not relevant to the analysis under Part III. Thus, even after the application of the safe harbors, the EC could still pursue its claims regarding alleged KEXIM subsidies under Part III. In this regard, it is worth recalling that Korea has not argued that the EC cannot claim that the KEXIM measures are actionable. Rather, Korea has only argued that they cannot be considered by the Panel as both prohibited and actionable simultaneously because that would result in double-counting in terms of considering serious prejudice.

97. What is the meaning of the term "material advantage" in the first paragraph of item (k) of the Illustrative List of Export Subsidies?

The term "material advantage" refers to whether the measure in question provides the exporter with some advantage relative to an appropriate "market benchmark".[22]

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[20] Appellate Body Repost in *Brazil – Aircraft(Article 21.5 – Canada)* at paras. 80-81.

[21] *Canada – Dairy (Article 21.5 – New Zealand and US)* at para.93.

[22] In Brazil – Aircraft, the Appellate Body noted that one example of a material advantage would be if the net interest rate was higher than the relevant CIRR.[22] However, the fact that the CIRR provided only one example and not the exclusive reference point for determining market benchmarks was re-emphasized by the Appellate Body in the Article 21.5 proceeding in that dispute. The Appellate Body noted that the CIRR reflects certain market conditions in one currency at one particular time and does not, in fact reflect the rates available in the marketplace. Thus the CIRR does not constitute the sole market benchmark. Brazil – Aircraft (Article 21.5 – Canada) at para. 64.

The Appellate Body stressed in *Brazil – Aircraft* that one cannot ignore the term "material" in item (k) first paragraph.[23] It logically must mean something more than the term benefit in Article 1.1. Of course, it must be observed that the issue of "advantage" requires a question of advantage relative to something. If it is merely an advantage relative to what would otherwise be available to the recipient, then it is simply redundant, as the Appellate Body noted. It, therefore, necessarily implies that it cannot be at a rate that gives the recipient a meaningful competitive advantage over other sellers, but must provide a competitive advantage as seen from the perspective of the buyer.

98. As a legal matter, does the definition of export credits used by the OECD in the context of the Export Credit Arrangement govern the meaning of this term in the first paragraph of item (k) of the Illustrative List of Export Subsidies? Why/why not?

The terms are not identical. The second paragraph of item (k) provides a very specific exception to the rule provided in the first paragraph. This exception effectively applies with respect to a very limited number of Members that are also OECD members and in a very specific circumstances described in the second paragraph. In this regard, it should be noted that the full term in the first paragraph is "export credits", while the full term in the second paragraph is "official export credits" which refers back to the very specific OECD agreements described further in the second paragraph. As is generally the case, exceptions should be construed narrowly and it follows that there is no reason for the term in the operative paragraph to be constrained by the definition of a specific narrow exception.

This conclusion also follows from the discussion in response to the previous question where it was demonstrated that the Appellate Body did not find that the language in the first paragraph was constrained by the OECD terms applied pursuant to the exception contained in the second. Thus, just as the CIRR does not provide the sole market benchmark relevant for determining material advantage in the first paragraph, so the reference to "official export credits" covered by the OECD arrangements in the second paragraph cannot be considered controlling on the definition of "export credits" in the first paragraph.

99. Would you provide us with the rationale behind your definition of export credits and export credit guarantees? Does an export credit have always to be a credit extended by the exporter or a financial institution to the buyer, and does an export credit guarantee always have to be a guarantee of such a credit? PSLs are loans extended by KEXIM to the shipbuilder, not to the buyer. APRGs are guarantees extended by KEXIM to the buyer, not to guarantee a credit given by the exporter or by a private financial institution to the buyer, but to guarantee that an advance payment by the buyer to the exporter shall be refunded in case of a contractual default. Does this exclude APRGs and PSLs from the realm of export credits/export credit guarantees?

Please refer to the Answers to questions 60, 97 and 98. With respect to item (j), it is clear that the definitions of the relevant terms should not be limited to guarantees provided to buyers only. The reference in the second sentence of item (j) to guarantees against increases in cost implies a reference to the seller, for that is the party that generally carries the risk of increases in cost, while the buyer generally carries the risk of increases in price. At the very least, the reference to costs implies that the guarantees at issue in item (j) can cover both ends of the transaction and are not limited to buyers only.

Regarding item (k), it would seem to follow that there is no reason to assume that the prohibition contained in the first paragraph of item (k) should be narrower than that contained in the first paragraph of item (j). As discussed in the previous two questions, the indirect reference to the OECD in the narrow and quite specific exception contained in the second paragraph of item (k)

[23] *Brazil – Aircraft* at para. 177.

cannot logically be taken to mean that terms used in the broader positive rules have the same narrow meanings. The manner in which the Appellate Body referred to the use of the CIRR - as but one possible market benchmark rather than the exclusive benchmark - supports this conclusion.

Moreover, the economic effect of credits and guarantees can be the same whether the extension of the guarantees or credits are to the buyer or the seller. There is nothing in the language of items (j) and (k) that implies such an economically non-sensical limitation to the language.

100. In the *Indonesia – Autos* dispute (the only circulated panel report to date addressing serious prejudice claims), the panel in analyzing the claims of displacement or impedance of imports into the Indonesian market applied a "but for" approach. In particular, the panel asked the question whether, "but for" the subsidies, the complaining parties' sales volumes and/or market shares in the Indonesian market either would not have declined, or would have increased by more than they in fact did.

(a) Would an analogous approach be appropriate here? That is, in assessing the price suppression/depression claims, should the Panel seek to answer the question whether, but for the subsidies, the prices in question either would not have declined, or would have increased more than they in fact did?

The Panel in *Indonesia – Autos* used a but/for test for a displacement or impedance case, with it being particularly relevant to impedance. In the present dispute, the Panel is examining what actually has happened in the market rather than what would have happened in the form of possible establishment or entry into the market. Thus, Korea is somewhat reluctant to endorse a test that has been applied in a different setting without knowing precisely what the Panel means in this setting. Korea believes that the approach that it has described in the response to Question 91 above is much more nuanced than a strict "but for" approach, but if that is what the Panel means by analogizing the test (as opposed to adopting it as applied), then perhaps the label could be used.

Obviously, no but/for test can be applied unless the subsidies in question have been precisely quantified and the EC has not only failed to do this, it has affirmatively refused to do it. The EC threw out some general numbers without any support and asserted that there was no burden on it to supply anything, even those assertions. Again, regardless of the label applied, Korea is of the view that the approach it suggests in the answer to Question 91 requires that the subsidy specifically must have caused significant price depression or suppression but also does not exclude an analysis of whether other factors may have caused significant price depression or suppression. Indeed, it is required that an assessment of such other factors be made.[24] The assessment in this regard will very much depend on a case-by-case assessment. Thus, for example, where non-subsidized like products have an important part of the like product market and prices for these non-subsidized products have decreased substantially over the period considered without it being possible to demonstrate that these prices followed the prices of the allegedly subsidized products, in Korea's opinion, it will not be possible to conclude that the price depression or suppression is the specific effect of the alleged subsidy.

(b) If so, what sorts of considerations should the Panel take into account in trying to determine what the price movements would have been in the absence of the alleged subsidies? If not, why not, and what other approach should be used?

[24] Korea notes that the EC claimed at the First Substantive Meeting that Korea agreed that there were no other such factors in this case. (See EC Oral Statement at para. 120) A review of the section of Korea's First Written Submission cited by the EC makes it clear that Korea was using the term "other factors" at that point to refer to the other elements listed in Article 6.3. The use of the term "factors" there in Korea's submission was not the best, although the broader context makes it clear that Korea in no manner agrees with the EC that other market factors than the alleged Korean subsidies are relevant to this dispute. Quite the contrary.

Korea refers to the approach which it has submitted in the response to Question 91 above.

101. Does the word "may" in the chapeau of Article 6.3 mean that a complainant of a "serious prejudice" must prove something more than the existence of price suppression/depression?

(a) If so, what is it that the complainant has to prove beyond price suppression/depression, and what is the basis in the text for any such additional requirements?

(b) If not, what is the significance of the word "may"?

The inclusion of the term "may" does not mean that something else *must* be shown. But, equally, it does not mean that demonstrating one element *automatically* leads to a finding of "serious prejudice," and by implication something more could be required to establish serious prejudice, is the use of word "may" in the chapeau of Article 6.3.

As discussed in Korea's response to question 89(a), the word "may" as used in the chapeau of Article 6.3 does not stand for "permitted" as was argued by the EC during the First Substantive Meeting. In Korea's view, this can be clearly established by a plain reading of the text of Article 6.3, according to the ordinary meaning of the terms used and in their context.

The word "may" is defined, inter alia, as "might…a possibility…"[25] In some case the word may indeed mean "permitted" as suggested by the EC. But the EC's interpretation does not apply in the context of Article 6.3. Article 6.3 chapeau states that:

> Serious prejudice … may arise in any case where one or several of the following apply…

If the word "may" is in this context interpreted as "permitted" rather than "might" or "possible," the sentence becomes nonsensical. One cannot logically say that serious prejudice is "permitted to arise." Rather, in the context of the chapeau, it seems that the drafters clearly intended the word "may" to read as "might" or "possibly" (e.g. "serious prejudice might arise…").

Further support for this interpretation is found by contrasting the word "may" in Article 6(3) with the word "shall" in the (expired) Article 6.1. Article 6.1 provides:

> Serious prejudice in the sense of paragraph (c) of Article 5 shall be deemed to exist...

Korea notes that in the context of Article 6.1, the word "shall" refers to the conclusion that serious prejudice shall be "deemed" or "determined" to exist in the circumstances described in subparagraphs (a)-(d). By contrast, the words "may arise" in Article 6.3 do not refer to a determination. Rather, they refer to the possibility that a situation might (or might not) arise if the circumstances described in subparagraphs (a)-(d) of that Article are established. Had the drafters intended the word "may" to mean "permitted" in this context, the provision should more properly have read that serious prejudice "may be deemed to exist" in the circumstances described in subparagraphs (a)-(d).

The conclusion therefore should be that while Article 6.1 referred to situations where serious prejudice is "deemed" automatically to exist, Article 6.3 chapeau makes clear that it refers to circumstances where serious prejudice "might" exist, or by implication, might not. The chapeau

[25] The New Shorter Oxford English Dictionary.

therefore makes it clear that a finding of serious prejudice is not automatic even if the existence of price suppression/depression is shown to exist. It should also be noted that as the word "may" is found in the chapeau of 6.3, this interpretation applies to all subparagraphs in Article 6.1.

The use "one or several" in the chapeau of Article 6.3 further confirms that the existence of any single factor does not *ipso facto* lead to an affirmative finding on the existence of serious prejudice.

Against this background, with respect to what else might need to be proved beyond price suppression/depression in order to establish serious prejudice, Korea would first recall that Article 5(c) refers to serious prejudice to the "interests" of a "Member." As Korea has noted, Presumably there was a reason the term "interests" was chosen rather than injury and it clearly implies something more than just the alleged damage to specific industry(ies) for a Member's "interests" are necessarily broader than just that. Against this background, the finding that alleged subsidies have resulted in price suppression or depression with respect to a particular like product may not, on its own, rise to the level of harm resulting in serious prejudice to the more broader "interests" of the Member concerned. Under this reading, the EC needs to demonstrate, and the Panel would need to find, not only the existence of price depression, but that the subsidies complained of have risen to the requisite degree of harm to the interests of the EC.

The EC has failed however to provide any basis for such a finding. The EC does not address the question of what EC interests have supposedly been seriously prejudiced and how that might have occurred. There is no evidence supplied about the state of the EC industry or "industries." Moreover, the EC did not provide any evidence on the level of the alleged subsidization. Without such evidence, it is impossible in Korea's view to make a determination that any subsidies, even if found to exist, would rise to the requisite level of harm to the interests of the EC. Korea would also recall that the EC has failed to establish a causal link between the alleged subsidies and the serious prejudice claimed. Korea considers that these are some of the additional factors that would be encompassed in proving serious prejudice. Korea believes that other factors could be taken into account and that this list may not be exhaustive. Korea would finally recall that price suppression or depression are only two indicators of the existence of material injury of which Article 15.2, which provides that "no one or several of these factors can necessarily give decisive guidance." It would seem to follow that the existence of price depression or suppression, if not dispositive on their own in the context of the lower standard of "material injury," should equally not be determinative in the context of the much higher threshold of "serious prejudice" in Article 6.3(c).

(b) Korea refers to its reply under part (a) above with respect to the significance of the word "may" in Article 6(3) chapeau.

102. In its arguments concerning price suppression/depression, the EC has focused on demand side factors. Korea, on the other hand, has focused on the supply side. Is it not more correct that the two aspects should be taken together. Please explain the impact of such an approach on your argument concerning price suppression/depression.

Korea disagrees with the premise of this question. In fact, the reverse appears to be the case. The EC has looked at the supply side almost exclusively to support its argument that there is no like product because virtually any yard can build any ship (which is, of course, inaccurate). Korea discussed the issue of capacity to a great extent because that necessarily is all that is left of the EC's causation analysis once they so dramatically narrowed their claims. Korea was emphasizing how extremely difficult it is to demonstrate causation on such a narrow basis, particularly when a great deal of the world capacity consists of inefficient and uneconomic EC yards that have been maintained for decades on the back of huge subsidies, as acknowledged by the Commission in its Third Report on World Shipbuilding. Indeed, the alleged difficulties of the EC industry bear an interesting correlation with the enforced decline of those subsidies from the early 1990's when the EC started reducing the

direct operating subsidies from the astronomical level of 28 per cent. This correlation is much stronger than any alleged relationship to the events arising out of the systemic financial crisis of the late 1990's. Korea's focus on the supply side was only to illustrate the lack of evidentiary and logical bases of the EC's approach.

In Korea's view, as far as the definition of "like product" used in the *SCM Agreement* is concerned, the EC's "competition market" approach based on supply side's substitutability is not acceptable. However, Korea agrees that, in conducting the causation analysis, all elements contributing to the setting of the vessel prices must be taken into account both from the supply and demand side. This is the purpose of its response to Question 91-(a) hereinabove as well as of paras 522 to 527 of its First Written Submission. In assessing the causal link between any alleged subsidy and significant price depression or suppression, all supply and demand factors should be taken into account including the increase in orders, freight rate or production costs as submitted by the EC. These alone are not, however, sufficient and factors such as overcapacity, building expertise, payment terms, slot availability, delivery time and changes in demand patterns must also be taken into account. The assessment of the causal link is fact-driven and must be done in a comprehensive manner and carried out on a case-by-case basis.

ANNEX D-4

RESPONSES OF KOREA TO QUESTIONS FROM THE EUROPEAN COMMUNITIES

(22 March 2004)

I. QUESTIONS TO KOREA

1. In paras 4-8 of its oral statement, Korea repeatedly invoked the "financial contagion". In which way did the "contagion" hit the three shipyards who went bankrupt differently than the ones who survived.

The impact of the "financial contagion" on the Korean shipyards varied according to the financial or business conditions of each shipyard. For instance, Daewoo was more heavily hit by the contagion than other major Korean shipyards as Daewoo held a substantial portion of non-operating assets as a result of investments in other Daewoo Group affiliates, such as Daewoo Motor. The difficulties Daewoo Motor ran into with various investments such as its Polish car plant are well known.

However, the real reason for Korea's reference to this financial contagion is set forth in paragraphs 8 and 9 of its Oral Statement. That is, Korea wished to highlight the following facts:

- the financial contagion first hit the banks, resulting in a serious credit crunch where money was not available for rolling over loans;

- the Government of Korea used the IMF funds to provide liquidity to the banks;

- there were conditions attached to this provision of funds, which required the banks to enhance financial soundness, reduce outstanding bad debts and meet BIS ratios; as a result, they needed to ensure that all corporate restructurings were done pursuant to market-oriented principles, including maximization of returns from their debts.

These facts as such negate the EC's allegation that the Korean banks somehow misbehaved in the restructuring process to subsidize the insolvent firms.

2. Korea points out that EC yards have recently produced smaller vessels than Korean yards (graph in para. 10 and the comments of Korea on the different sizes and types of EC and Korean ships in para. 13). Is this in line with the Korean presentation made during the last OECD meeting, where they explain that yards can easily switch from one ship to another?

At the last OECD meeting in early March 2004, competition law experts and government officials discussed whether a single shipbuilder can acquire a dominant position (or monopoly power) in the world shipbuilding market from the 'competition law' perspective. At that meeting, Korean experts explained that, in order to determine the possibility of a 'market dominance', one must first define the relevant 'product market' as well as the 'geographical market'. However, the context of those discussions was quite different and had nothing to do with WTO "like product" definitions.

As demonstrated in paragraphs 10 – 13 of Korea's First Written Submission, it is supported by empirical evidence that the Korean and EU shipbuilders operate in largely different product and

size segmentations. As a result, the area of competition between the Korean and EU shipbuilders is at best marginal. This divergence between the Korean and EU shipbuilders is not transient, but rather structural, as it has been due to the changes in patterns of demand and the differences in dock sizes and technical and cost advantages between the Korean and EU shipyards.

3. In its oral statement today, the EC hypothesized a scheme whereby the Minister for export promotion of a WTO Member would be empowered to award any sum he considered necessary to ensure that an exporter wins a contract against foreign competition where he considers this to be in the national interest. Would Korea consider such a scheme to be entirely compatible with Article 3 of the *SCM Agreement*?

Korea considers that a scheme allowing but not mandating the Minister to award an amount ensuring that an exporter obtains a specific contract would not necessarily be incompatible with Article 3 of the *SCM Agreement*. It would still be necessary to determine whether, in the individual circumstances of the recipient, it was granted in a form and under conditions that would constitute a financial contribution under Article 1.1(a)(1) of the *SCM Agreement* conferring a benefit under Article 1.1(b) thereof.

4. Does Korea believe that a body can not be considered a "public body", or a government agency can not be considered a "government" if it provides goods or services on competitive terms?

Korea submits that the mere shareholding or controlling interest by the government in a body and the pursuit of a public policy objective is not sufficient to qualify such body as a public body when it participates in the market together with private bodies on a market-oriented basis.

5. Does Korea believe that the same institution can be a "public body" for some of its activities, and a "private body" for other activities? If so, how is this view supported by Article 1.1 of the SCM Agreement?

Yes, Korea submits that this can be the case. Article 1.1(a) is aimed at covering all financial contributions whether conferred by a public body under Article 1.1(a)(1)(i) to (iii) or by private bodies acting under direction and entrustment of the government under Article 1.1(a)(1)(iv). Case-law has indicated that the provisions aim to be exhaustive and that the only difference lies with the actor of the financial contribution rather than with the functions. Hence, for those functions for which a body cannot qualify as "public body", it would still qualify as "private body" if it acted under direction or entrustment of the government.

6. In your opinion is KEXIM a "special institution controlled by" the Korean government within the meaning of items (j) and (k) of Annex I or a "special institution acting under the authority of" the Korean government within the meaning of item (k).

KEXIM is neither a "public body" nor a private body "entrusted or directed" by the Government of Korea as those terms are used in Article 1.1 of the *SCM Agreement*. Korea notes that the EC has made no claims that Korea has acted inconsistently with the terms of items (j) or (k) of Annex I. The issue of the applicability of these items only arises as a possible safe harbor under the *a contrario* reading implied by footnote 5 and the plain meaning of the language of items (j) and (k), first paragraph. As such, these constitute affirmative defenses that the Panel need only address if it has already reached conclusions contrary to Korea's arguments under Article 1.1. Article 1.1(a)(1) provides that for purposes "of this Agreement" both the government and public bodies shall be referred to as "government". Thus the reference to "government" in items (j) and (k) would cover KEXIM, if the Panel makes an affirmative finding with respect to KEXIM as a public body.

Thus, the questions of the applicability of these safe harbours only arises as *arguments in the alternative* made by Korea, a concept that should be quite familiar to the EC.

7. Korea states in para. 156 of its submission that Article 26 of the KEXIM Act requires KEXIM to operate with the goal of achieving a profit. Please refer to Article 26 (Exhibit EC - 10) and explain where there is any reference to profit?

Please refer to Korea's responses to Panel's question No. 55 addressed to Korea.

8. In para. 170 of its submission, Korea attempts to explain away Article 24 of the KEXIM Act (which states that it must not compete with commercial banks) by claiming that it must be read together with Article 25, para. 2 of the KEXIM Act. Please explain how you arrive at this construction since there is no cross-reference between these articles in the text of the Act?

Please refer to Korea's responses to Panel's question No. 53 addressed to Korea.

9. Korea provides, in para. 172 of its submission, an explanation of the function of the market adjustment rate provided in the KEXIM Interest Rate Guidelines. Please provide the source of this interpretation?

Please refer to Korea's responses to Panel's question No. 57 addressed to Korea.

10. Is the statement in para. 184 of Korea's submission that "foreign institutions were less equipped to monitor the collateral offered by the shipbuilders and, accordingly, insisted on APRGs without adequate collateral, but with higher premium rates" based on conjecture or on evidence? If the latter, what evidence?

The assessment by Korea is based on discussions with the shipyards and KEXIM. Korea has asked the shipyards and KEXIM for any further documentation and it will be submitted when provided to the Government of Korea. However, Korea notes that the EC is in a better position to make inquires of the foreign lenders than Korea. While the EC has developed a habit of attempting to shift the burden of proof to Korea, the EC is not relieved of the burden of establishing its case. The plain facts are that the foreign credit providers did not require the same level of collateral. Beyond this, the rationale of such lenders seems to be of no evidentiary value.

11. What is the value of "Yangdo Dambo" collateral[1] at the beginning of a project, when an APRG or pre-shipment loan is first granted?

[BCI: Omitted from public version.]

12. Korea states in para. 199 of its submission that the term of pre-shipment loans normally does not exceed period that it designates as [BCI: Omitted from public version]. How does this comport with Korea's argument in para. 170 of the submission that "KEXIM financing may be extended only 'when the term … is six (6) months or more", and with the fact that the KEXIM pre-shipment loans listed in paras. 175-179 of the EC's first written submission are for terms greater than 6 months (and some have terms up to 24 months)?

Article 9 of the KEXIM Interest Rate Guideline prescribes that the loan period applied for calculating the loan interests shall commence from the date of initial disbursement and end on the final repayment date. In other words, the loan period does not start until the loan disbursement is actually made.

[1] Defined by Korea in its reply to follow-up question 7 of the EC on 10 October 2003.

In the case of PSLs, the period between the "commitment date" and the "expiry date" ranges between **[BCI: Omitted from public version.]** Korea believes that such weighted average of actual disbursement periods must be used as the loan period of PSLs for the purpose of finding comparable benchmarks, because the KEXIM's Interest Rate Guideline calculates interests starting from the actual "disbursement" date, rather than the "commitment" date.

However, for the purpose of Article 25.2 of the KEXIM Act, the maturity of '6 months' referred to in that Article may be interpreted to mean the period from the "commitment date". In such case, the maturity of PSLs in general is not less than 6 months.

13. Please provide the (1) sales contract (2) the loan amount for the following preshipment loans granted to DSME:

- **Project Nr: 000110 P Commitment date 12 October 2000**
- **Project Nr: 000142 P Commitment date 21 December 2000**
- **Project Nr: 010008 P Commitment date 8 March 2001**

This is a request for new evidence that the EC has no legal basis to make. After the First Substantive Meeting, submission of new evidence is prohibited except for purposes of rebuttal, but not be asking questions. As for the loan amount, please refer to Korea's response to EC question No. 16 below.

14. Korea argues in para. 207 of its submission, without any citations or evidentiary support, that the collateral required by KEXIM was "stronger" than collateral required by foreign financial institutions. Please provide specific information regarding the valuation of the collateral involved in the transactions by Korean and foreign banks listed in pans. 170-173 of the EC's first submission to justify this statement.

It is the obligation of the EC to establish the comparability of the benchmarks it proposed. Moreover, Korea has no access to the information regarding the valuation of the collateral by foreign banks and other domestic banks as it is proprietary information in nature and is not publicly available. The EC is in a better position to obtain that information and has the responsibility to build its own case. Therefore, Korea provides only the information regarding whether any collateral was provided for the projects the EC enlisted and, if so, what type of collateral it was, as set forth below.

[BCI: Omitted from public version.]

15. In order to enable the panel to place values on the benefit of the KEXIM APRGs listed in paras. 170-173, please provide the actual values of the guarantees, or, alternatively, the monetary value of the APRG premiums.

The EC is assuming a legal conclusion in its question; there is no "benefit". Again, this is new evidence that the EC is attempting to derive to support its initial *prima facie* case. According to the *DSU* and the Panel's Working Procedures, the time is long past for the EC to attempt this. It was the legal obligation of the EC to calculate what it considered the "benefit". The Panel is not a domestic investigating authority. The Appellate Body opinion in *Japan – Agricultural Products II* makes it very clear that panels are prohibited from making the complainant's case for it. This question serves as an admission by the EC that it has not fulfilled its obligation to establish a *prima facie* case in this regard.

16. In order to enable the panel to place actual values on the benefit of the KEXIM pre-shipment loan transactions listed in paras. 175-179 of the EC's first submission, please provide the actual value of the loans for the transactions listed therein.

Please refer to Korea's responses to EC question No. 15 above.

17. Korea includes several charts in paragraphs 231, 233, and 236 of its submission purportedly showing the interest rates of corporate bonds issued by DSME, Samho, and STX. In order to allow the Panel to determine whether this is a relevant market benchmark, please provide all detailed information available related to the issuance of these bonds, including, but not limited to, (a) whether the bonds were issued below, above, or at par value, (b) the difference between the interest rates on the bonds and the yields, (c) the terms of the bonds, (d) guarantees by other entities (including KAMCO, Seoul Guarantee Insurance, etc.) of the bonds, (e) who underwrote the bond issue, and (f) the relationship between the yield/interest rate on the bonds and the corporate restructuring of the shipyards. Was there any guarantee between the underwriting bank and the yards to buy a certain percentage of the bonds if all bonds were not underwritten?

[BCI: Omitted from public version.]

18. Korea states in para. 348 of its First Written Submission that according to the Arthur Andersen Report the expected collection rate i.e. the total recoverable value compared to the creditors outstanding claims was:

[BCI: Omitted from public version] under the Liquidation value scenario.

[BCI: Omitted from public version] under the "going concern value" scenario.

Please explain why KAMCO bought NPLs at rates of [BCI: Omitted from public version] from foreign creditors and [BCI: Omitted from public version] from domestic creditors although the expected return under the going concern scenario was only [BCI: Omitted from public version].

The purchase prices for NPLs held by domestic and foreign creditors were determined through negotiations between the parties in **[BCI: Omitted from public version].** By the time that these negotiations took place, the business conditions of DHI and the external shipbuilding market environment had improved far more substantially than that assumed by Arthur Andersen when it assessed the value of DHI as of August 1999.

In contrast, as indicated in its workout report, Arthur Andersen made very conservative assumptions of various factors (such as growth rates) for its valuation, which resulted in the total recoverable value of **[BCI: Omitted from public version]** under the "going concern value" scenario. In other words, the price differential can be explained by the difference in timing and the difference between the assumed growth and the actual growth, as well as the fact that the KAMCO purchase prices were 'negotiated prices'.

19. Are the Pre-shipment loans provided as lump-sum payment, i.e., 100 per cent of the loan amount provided at the commitment date, as opposed to a credit line?

Has this been a consistent practice since 1997? If not please detail all changes in policies.

[BCI: Omitted from public version.]

20. Korea states in para. 308 of its submission that "Articles 31 and 23 of the KAMCO Act provide that KAMCO realizes profits". Please point to the text in these provisions that Korea believes justifies that statement (see Exhibit EC - 45).

Korea refers to the provisions of Articles 31 and 32 of the KAMCO Act and apologizes for the error in the reference in para. 308 of its written submission. Still, the KAMCO Act does provide for the realization of profits through the fees and sales margin in performing its services and the income arising from operation (Article 31) and provides for the settlement of dividends after reserves are made (Article 32).

21. Please provide the basis for Korea's statement in its submission (para. 323) that "circumstantial evidence" cannot be used to demonstrate entrustment or direction of a private body pursuant to Article 1.1(a)(1)(iv) of the SCM Agreement.

The Panel in *US – Export Restraints* stated the following:

> It follows from the ordinary meanings of the two words "entrust" and "direct" that the action of the government must contain a notion of delegation (in the case of entrustment) or command (in the case of direction). To our minds, both the act of entrusting and that of directing therefore necessarily carry with them the following three elements: (i) an explicit and affirmative action, be it delegation or command; (ii) addressed to a particular party; and (iii) the object of which action is a particular task or duty. In other words, the ordinary meanings of the verbs "entrust" and "direct" comprise these elements – something is necessarily delegated, and it is necessarily delegated to someone; and, by the same token, someone is necessarily commanded, and he is necessarily commanded to do something. We therefore do not believe that either entrustment or direction could be said to have occurred until all of these three elements are present.[2]

Korea agrees with the above analysis by the Panel and has, accordingly, stated in para. 323 that challenges cannot be made on the basis of vague circumstantial evidence that does not amount to an explicit and affirmative action. Thus, as Korea noted in response to the Panel in the First Substantive Meeting, while paragraph 323 may be too categorical, what is certainly the case is that very firm and persuasive evidence must be presented by the complainant to carry the substantial burden of proving the three elements necessary to demonstrate entrustment and direction. While circumstantial evidence may be legally recognized, a great deal of firm and persuasive circumstantial evidence must be presented in the face of a total lack of direct evidence. In paragraph 323, Korea was reacting to the utter lack of proof in the EC's submission – either direct or circumstantial – which has carried over into the First Substantive Meeting. Instead of offering real proof, whether circumstantial or direct, the EC has offered vague assertions based in large part on grotesque and discredited stereotyping.

22. If there is no subsidy where a creditor bank becomes owner of a company (as argued in para. 319) what is the purpose of the term "equity infusion" in Article 1.1(a)(1)(a) of the SCM Agreement?

This question does not make any sense as there is a logical disconnect in the middle of it. Equity infusions are legally distinct from debt-for-equity swaps. There are also differences in their practical effect. So called "equity infusions" often are covers for direct subsidies to cover operating losses. For example, over a long period of time the French government has made so called equity infusions into their aircraft engine company, SNECMA. The purported capital calls generally were mere shams reflected by the unwillingness of private minority shareholders to respond. Thus, the "purpose" of the term equity infusion is to cover such sham direct contributions of funds to cover operating losses.

The issue in a debt for equity swap is different. In such cases, where the company is insolvent and therefore in the hands of the creditors, the swap reflects a change in form of financial instrument.

[2] Panel Report, *US – Export Restraints*, para. 8.29.

The creditor financial institutions were holding debt and the issue was what they could do with the debt in order to maximize their return. More specifically, the creditors were holding debt in distressed companies in a country facing a financial crisis. The EC's odd diversion at the First Substantive Meeting into an elementary description of the different characteristics of the two forms of financial instruments (debt and equity) was completely beside the point. There is no logical relationship of debt-equity swaps to the term equity infusion.

23. In light of the same para. 319, is it Korea's position that a government can never subsidize a state-owned company?

No. As noted above, a government holding cash that makes an equity infusion into a state-owned company is making a financial contribution to the company. Whether the financial contribution is a subsidy depends on whether a benefit is conferred to the recipient.

24. In Annex V question Nr. 3.1(12), the EC asked Korea to provide a complete list of creditors in: (i) DHI as of August 1999; (DSME), DHIM, and DHI as of mid-October 2000 (i.e., before the debt-for-equity swap); and (iii) DSME, DHIM, and DHI as of December 2000 (i.e., following the debt for equity swap). In response, Korea refers to attachment 3.1(12). However, that attachment does not contain all the information. Thus, Korea did not provide the data on sub-questions (ii)-(iii). In response to a follow-up question Korea maintained that it had provided all the requested information. However, the EC has never received it. Please provide the missing information.

Korea's Annex V Attachment 3.1.2(12) contains all the information requested by the EC. In any event, Korea will provide again the data on sub-questions (ii) and (iii) requested by the EC. (*See* Korea's Annex V Attachment 3.1(12) attached hereto as Exhibit Korea - 69).

25. Please provide a breakdown for each DHI creditor between secured and unsecured claims. (Not just for DSME creditors so that the Panel can assess the interest of each creditor in restructuring or liquidation.)

Korea has already provided the data on DSME creditors. Beyond that, the "interest of each creditor in restructuring or liquidation" can be confirmed by the Arthur Andersen's workout report and the decisions of the CCFI to adopt the proposed workout plan.

26. Please provide the dates on which KAMCO purchased non-performing loans from each creditor. In your answer, please distinguish between the foreign and the domestic creditors.

[BCI: Omitted from public version.]

27. Please identify those creditors that refused to participate in the workout.

The question is not clear which "creditors" and which "workout" it refers to. If the EC meant the financial institutions which did not sign the Corporate Restructuring Agreement (CRA), a workout framework agreement, they were 231 mutual savings banks, 1,592 credit unions, and 47 branches of foreign banks.

28. What was the market value of the warrants issued to foreign creditors of Daewoo-HI, as described in para. 358 of Korea's submission?

No information is available to the Government of Korea. The EC is in a better position than the Government of Korea to develop that information from the foreign creditors. Korea notes again that the information the EC would develop in this regard would be new evidence and would be inadmissible absent good cause. Korea reserves its rights in this regard.

29. Korea states in para. 356 that foreign lenders were able to obstruct the workout procedure, even though they held a minority stake among creditors? Why did not {sic} domestic creditors also have this ability?

The domestic creditors did have the ability to obstruct the workout process within the creditor committee. And, indeed, the first Daewoo reorganization plan was rejected by a blocking minority of creditors during the early meetings of the creditor committee. Nevertheless, domestic creditors were also conscious that, if they pursued an obstructive path, the workout company's financial conditions would rapidly deteriorate and would always be thrown into the insolvency procedures. During the financial crisis, this would have inevitably led to the collapse of the whole national economy and there would be no financial institution that could survive. Therefore, they decided not to pursue legal means on their own or to seek individual repayment (i.e. outside of the process) by agreeing to the CRA workout process. From a commercial point of view, this was the best option for them to take to avoid their own demise.

30. Please provide citations or other evidentiary support, other than Korea's own Annex V answers, for the statement in para. 385 of Korea's first submission that the purchasing conditions for debts of foreign and local creditors were "slightly different."

For more detailed information on this question, please refer to Korea's response to the Panel's Question No. 80.

31. Korea argues that foreign banks do not understand the Korean system sufficiently to participate in a work-out proceeding and can therefore not be considered as benchmark.[3] Why does then the Corporate Restructuring Promotion Law of August 2001 which "replaced" the Corporate Restructuring Agreement by creating a statutory legal framework for workouts[4] – also include obligatorily foreign creditors in any future workouts. Have foreign creditors suddenly been considered more understanding?

Korea regrets that the EC continues to feel it necessary to inject such sarcasm into its questions. As stated in Article 1 (Purpose) of the Corporate Restructuring Promotion Act of August 2001 (the "CRPA"), the main purpose of this Act was to "*facilitate a continuous and market-oriented corporate restructuring by prescribing the matters necessary or required for implementing corporate restructuring in swift and orderly manner*". (See Korea's Annex V Attachment 2.2(16)). To achieve this purpose, the CRPA created a statutory legal framework for workouts which had been regulated by the CRA.

In line with the stated purpose of facilitating the corporate restructuring (workout) in a more orderly manner, the CRPA has included in the Council of Creditor Financial Institutions ("CCFI") all "financial institutions" which operate in Korea under Korean law, including domestic branches of foreign financial institutions and mutual savings banks which had not participated in the former CRA. However, the CRPA also allows financial institutions to withdraw from participation in the CCFI or individual workout procedures if they so wish: First, the CCFI can exclude from the CCFI membership small creditors which hold less than a certain percentage of the total loans, not exceeding 5 per cent of the total outstanding loans extended by all the CCFI members (CRPA, Article 25). Second, any creditor financial institutions that object to the proposed initiation of a particular workout procedure or to the proposed debt restructuring in the workout procedure, are entitled to exercise an appraisal right whereby such objecting creditors can request the CCFI (which approved the proposals)

[3] First Written Submission of Korea, para. 378.

[4] See response to question 16, page 39 of Korea's Annex V Response and Attachment 2.2(16) of Korea's Annex V Response.

to purchase the debt held by the objecting creditors at a certain negotiated or appraised value (CRPA, Article 29).

In sum, although the CRPA expanded the general scope of financial institutions participating in the workout framework, any foreign or domestic financial institutions which hold a small portion of debts or which are only interested in immediate collection of their loans at a reduced value, rather than long term recovery through workout, can still refuse to participate in the CCFI or in the particular workout plan. In this regard, it can be said that there is no substantial difference between the former CRA and the present CRPA.

32. Please clarify where the shipbuilding industry is accounted for in the table provided in para. 392 of Korea's first submission.

The shipbuilding industry is included in Machinery/Plants.

33. With respect to the Rothschild Report referred to in para. 413 of Korea's first submission, please provide the Rothschild valuation report, in its entirety. (So far Korea has provided the valuation for the shipbuilding division).

We understand that the "Rothschild Report" in the above question refers to both the 'Proposal of Restructuring of Halla Group' dated June 1998 (Korea's Annex V Attachment 3.2(47)-1; Exhibit EC - 81) and the 'Final Proposal for Restructuring of Halla Group' dated 8 September 1998 (Korea's Annex V Attachment 3.2(47)-2; Exhibit EC - 75). As these titles indicate, such Rothschild Report was in fact a compilation of the discrete reports relating to 4 independent Halla Group companies: Mando Machineries, Co., Halla Cement, Co., Halla Construction, Co., and Halla Heavy Industries ("Halla-HI").

Korea has provided all available reports of Rothschild to the extent that they relate to 'Halla-HI' which was the only Halla Group companies at issue in this dispute. **[BCI: Omitted from public version.]**

34. Please state whether other companies were given the opportunity to manage and take an option over Halla in the same way as Hyundai?

The Government of Korea has no information in this regard.

35. Please specify the price for the call option paid by Hyundai?

[BCI: Omitted from public version.]

36. According to para. 460 of Korea's submission, five companies submitted final offers to invest in Daedong. Were any of these companies foreign companies?

The KPMG carried out an international bidding for sale of Daedong. Therefore, foreign investors may have possibly been included in the five final bidders. However, it is impossible to confirm any further information. There was confidentiality agreement between KPMG and the bidders.

37. Korea states in paragraph 475 of its submission that it was fully responsive to the EC's questions regarding Daedong's unsecured creditors. The EC disagrees. Please provide specific information regarding the creditors that held 58.94 per cent of the unsecured debt Annex V attachment 3.3(54) (also Exhibit EC - 93) does not provide any information about these creditors, but simply lists them as "general commercial claims". Were any of these commercial

claims held by foreign creditors? If so, how did these foreign creditors vote with respect to the reorganization?

Korea has provided full information on Daedong's creditors, whether or not the EC agrees. **[BCI: Omitted from public version.]**

38. According to para. 458 of Korea's submission, one of the shareholders of Daedong, Mr. Do-Sang Lee, agreed to a complete reduction in his shareholding ownership. What were the terms of this agreement? Why did Mr. Do-Sang Lee agree to treatment less favourable than the other shareholders? How can Korea argue that he acted in his own self-interest, as it does in para. 476, when he agreed to take a total loss of his investment?

[BCI: Omitted from public version.] Article 221(4) provides that at least 2/3 of the shares held by the shareholder who influenced the directors in the mismanagement of the bankrupt company shall be written-off. **[BCI: Omitted from public version.]**

[BCI: Omitted from public version.] At least in Korea, registering an objection to the stock write-off may be viewed as a shameful behaviour for a controlling shareholder and CEO of the bankrupt company. In any event, Korea is not in a position to comment on Mr. Lee's personal motivation.

39. Can Korea confirm that the Korean Shipbuilders' Association uses a breakdown by ship types for categorizing the Korean shipbuilding production, which identifies four distinct ship types in the production of which Korean yards are particularly active, namely LNG carriers, tankers, containerships, bulk carriers?[5]

The Korean Shipbuilders' Association (KSA) uses different breakdowns of ships according to the diverse purposes of such breakdown. There is no reason for KSA to apply a WTO 'like product' definition when it generally describes the ship types in which the Korean yards are active. Moreover, as the Appellate Body found in *Japan – Alcoholic Beverages*, the definition of "like product" can differ according to the provision at issue. This was confirmed in *EC – Asbestos*.

40. Is it true that after the take-over of Halla/Samho by Hyundai the management tried to renegotiate contract prices as Halla's prices were seen as too low compared to Hyundai's?

[BCI: Omitted from public version.]

41. In para. 579 of its first submission, Korea lists the factors that it believes provide significant cost advantages for Korean shipyards, when compared with European shipyards. Notably missing from this analysis is the cost of debt servicing, and the cost of maintaining and constructing facilities. Why does Korea exclude these important factors from its analysis? Do prices charged by Korean shipyards not take account of these costs?

As mentioned in the Annex V process, debt servicing costs and the cost of maintaining and constructing facilities are taken into account when Korean shipbuilders determine their sales prices. The analysis provided by Korea in para. 579 aimed at listing those elements of costs in which Korea has a significant advantage over the EC; debt servicing and the cost of maintenance and construction of facilities is a cost that all shipyards overall need to incur in order to maintain efficient production.

42. Can Korea indicate to which extent the production value of Korean yards is hedged against currency exchange rate risks?

[5] http://www.koshipa.or.kr/upload/english/industry.pdf

Again, this is new evidence that the EC is attempting to derive to support its initial *prima facie* case. According to the DSU and the Panel's Working Procedures, the time is long past for the EC to attempt this. Nonetheless, Korea notes that some Korean yards do not hedge the currency exchange risk at all, while some others do hedge. For those who hedge against foreign exchange risks, the production values covered by the hedging vary from company to company and project to project.

43. Can Korea indicate the typical time period that elapses between first contacts with an owner or broker and the actual signing of a shipbuilding contract?

There is no typical time period. It ranges from several months to more than one year after receipt of inquiry, depending on the projects.

44. Can Korea confirm the exact price for the Nigerian LNG carriers from Hyundai mentioned in para 561 of the Korean submission (only a price range is indicated)?

Why does Korea claim that Hyundai is non-subsidized? It has taken over Halla and benefits from the subsidies granted through these transactions?

The Government of Korea does not know the exact price for the Nigerian LNG carriers from Hyundai. Moreover, Korea notes the EC has expressly rejected price undercutting arguments. The price on an individual sale is, therefore, not legally relevant to the EC's claims.

The EC again fails to apply the correct consequences of the WTO case-law indicating that "any analysis of whether a benefit exists should be on 'legal or natural persons' instead of productive operations."[6] As part of the Halla reorganization process, the stockholders lost their shares in Samho (first change in ownership); subsequently, the creditors who owned Samho sold all of their shares to Hyundai (second change of ownership). Therefore, Hyundai obtained no benefit.

This is the first time that the EC alleges Hyundai to have been "subsidized". Moreover, the EC has never alleged that the purchase of Samho by Hyundai was anything but an arm's-length transaction.

45. Is the market share analysis given in para. 595 based on number of ships, rather than tonnage or cargo carrying capacity? If so, why was this particular indicator chosen?

The market share analysis provided is based on CGT.

[6] Appellate Body Report, *US – Countervailing Measures on Certain Products from the EC*, para. 110.

ANNEX D-5

COMMENTS OF KOREA ON RESPONSES BY THE EUROPEAN COMMUNITIES TO QUESTIONS FROM THE PANEL

(22 March 2004)

I. QUESTIONS TO THE EC

A. GENERAL

1. What makes an entity a public body? Is the power to regulate and tax a necessary and sufficient condition to qualify an entity as a public body?

Korea would like to refer to the position which the EC itself took in *US – Export Restraints* in which it stated that:

> "Public bodies" are types of emanations of the government, without necessarily equalling the "government" proper. Their specific characteristic is the (at least occasional) exercise of public authority (imperium).[1]

2. Para. 83 of the EC's first written submission describes the purpose of permitting prospective challenges against mandatory legislation. What would be the purpose of prospective challenges against non-mandatory legal instruments? What would Members protect themselves against by bringing a prospective challenge against another Member's law that allows, but does not require, the grant of prohibited export subsidies?

Korea submits that in the case of discretionary legislation, the benefits accruing to WTO Members under the WTO Agreements are not impaired in the terms of Article 3.3 of the *DSU*. Challenging a discretionary legislation would be tantamount to be presuming bad faith on the part of a WTO Member. In practice, in cases of doubt on the implementation of the said discretionary legislation, Article 25.8 of the *SCM Agreement* provides a WTO Member with an instrument to seek information on the manner in which the legislation concerned is implemented and to discuss the matter in order to make certain that the implementation of the said legislation is WTO-compliant.

4. What is the basis for interpreting Article 3.2 in a manner that prohibits legislation containing a discretion to provide prohibited export subsidies?

Korea refers to and supports the position taken by the USA in para. 12 of the third-party submission which the USA entered on 9 February 2004 and which stated the following:

> With respect to Article 3.2 of the *SCM Agreement*, the EC emphasizes the phrase "neither grant nor maintain," asserting that the word "maintain" would have no meaning if legislation providing for the discretionary grant of subsidies was not

[1] Panel Report, *US – Export Restraints*, Annex B-3, para. 12.

prohibited.[2] Accepting for purposes of argument (1) the EC's definition of the word "maintain" as "cause to continue," and (2) the notion that "maintain" refers to subsidy legislation rather than a "subsidy" itself, the application of the mandatory/discretionary distinction to Article 3.2 does not render the word "maintain" meaningless. The word "grant" can be construed as applying to actual, discrete bestowals of subsidies under subsidy legislation – "as applied" situations – while the word "maintain" can be construed as applying to the enactment of legislation that mandates the "grant" of prohibited subsidies, thereby causing such subsidies to continue – "as such" situations. Under this approach, legislation that conferred discretion to bestow subsidies would not run afoul of either term insofar as an "as such" challenge is concerned.

B. KEXIM LEGAL REGIME

6. Is the EC of the view that finance / guarantee measures provided under the KEXIM legal regime would necessarily be inconsistent with Articles 3.1(a) and 3.2 of the SCM Agreement? Please explain.

Korea will await the position of the EC in this regard but, at this stage, wishes to point out that even if it were considered that the KEXIM legislation mandates giving export assistance (which Korea disputes), this still is not incompatible with Articles 3.1(a) and 3.2 as no benefit is afforded. Further, specific grants of financing and guarantee measures are not inconsistent necessarily with Articles 3.1(a) and 3.2. In fact, the EC did not and could not argue that all of the APRG/PSL grants were subsides although Korea provided data on these grants.

7. The KEXIM 2002 Annual report (Exhibit EC-14) contains a chapter entitled Bank Operations. That chapter refers to a decline in KEXIM's export credit business. It states that "[m]ajor Korean exporters were reluctant to use bank loans, instead they preferred raising funds from direct markets which was possible due to their successful corporate restructuring". Does this suggest that KEXIM's export credit terms are less attractive to Korean exporters than the terms for competing financing from other sources? Please explain.

Yes, KEXIM export credits are now less attractive. This is demonstrated by the fact that Korean shipbuilders are now using KEXIM preshipment loans for a small portion (approximately 20 per cent) of their shipbuilding projects. Moreover, some Korean shipbuilders are never using the KEXIM preshipment loans at all.

8. Para. 122 of the EC's first written submission states that the KEXIM legal regime, as "confirmed by KEXIM practice", provides for the grant of subsidies. Is the EC challenging "KEXIM practice" as well as the KEXIM legal regime as such, or does the EC rely on evidence regarding "KEXIM practice" in support of its claim against the KEXIM legal regime as such? If the latter, please explain how evidence regarding "KEXIM practice" is relevant to the Panel's assessment of whether the KEXIM legal regime as such is, or is not, in conformity with the SCM Agreement.

In the opinion of Korea, para. 131 of the EC's first written submission confirms that the EC's assertions are based both on the legal regime and the alleged practice and that the EC considers that it cannot rely on the legal regime alone. Indeed, the EC states that "[t]hese factors, <u>when considered together with the record of KEXIM financing detailed below</u>, establish that the KEXIM Act, Decree and Interest Rate Guidelines provide for WTO-inconsistent actions."

[2] EC's First Written Submission, paras. 79-80.

At a different level but based on the same argument, Korea reiterates that the EC has never defined the so-called KEXIM APRG and pre-shipment loans other than by the individual instances in which APRGs and PSLs were issued to shipbuilders.

C. APRG PROGRAMME

9. How does the EC's claim against the "APRG programme" as such differ from its claim against the KEXIM legal regime as such? Isn't the "APRG programme" based on the KEXIM legal regime? Is it conceivable to assess one of them differently from the other?

As mentioned above, Korea considers that the EC has never defined what the APRG programme really is in terms of statutory framework. Beyond that, however, the conditions at which APRGs can be afforded are set forth in the KEXIM Interest Rate Guidelines which, in accordance with the EC's own arguments, are part of the KEXIM legal regime that is challenged as such.

D. PSL PROGRAMME

11. How does the EC's claim against the "PSL programme" as such differ from its claim against the KEXIM legal regime as such? Isn't the "PSL programme" based on the KEXIM legal regime?

Korea refers to its comments in relation to Question 9 above which equally applies as regards the PSLs.

F. ACTIONABLE SUBSIDIES

16. In its third party submission in the *US – Export Restraints* case, the EC argued that there is no government entrustment or direction in a case where freedom of action is "limited", but not "curtailed", i.e., where "the producer can still make choices". Does the EC consider that the freedom of action of private financial institutions participating in the restructuring process was (i) "limited" or (ii) "curtailed"? Were those companies able to make choices regarding their participation in the restructuring process? Please explain.

In the same vein, Korea would like to mention the EC's response to a question raised by the Panel in *US – Export Restraints*:

> (b) Why would the "pre-determined conditions" have to exist in order for a private body to be carrying out a function normally vested in a government?
>
> As already explained by the EC in its Written Submission, the actions contemplated by Article 1.1(a)(1)(iv) of the *SCM Agreement* are not "expansive", but limited to those enshrined, for governments or public bodies, in subparagraphs (i) to (iii) of the same Article.
>
> Therefore, the determining factor for a private body carrying out the functions normally vested in the government and the practice differing, in no real sense, from practices normally followed by governments (which is the full text of the relevant part of Article 1.1(a)(1)(iv) of the *SCM Agreement*) is that the private body must, through government direction, perform materially the same function as would otherwise be carried out by the government itself – and caught by Article 1.1(a)(1)(i)(iii) of the *SCM Agreement*.
>
> Now, when a government decides to provide a subsidy to a certain industry or part of an industry, the government will decide in advance the kind of action it wishes to take, the class of beneficiaries it wishes to reach and the extent of the "benefit" it wishes to confer. The same standard must apply in the case of an 'indirect subsidy' with the government predetermining,

through regulatory means, essentially the same conduct for the private body, and the same result for the beneficiary industry, than the government would otherwise "directly" have implemented itself.

Only if such pre-determination exists, will the private body become a quasi-emanation of the government. Only then will it carry out a subsidizing function "normally vested in the government", and only then will the practice "in no real sense differ from practices normally followed by governments". In the EC's view, therefore, the existence of (government) "pre-determined conditions" is a *sine qua non* for the existence of an indirect financial contribution in the sense of Article 1.1(a)(1)(iv).

Korea submits that the Government of Korea has not predetermined the kind of action that private banks had to take when participating in corporate restructuring, which specific companies had to go in corporate restructuring or the extent of the benefit (if there were one, which Korea denies) to confer. The private creditors of DHI, Halla and Daedong freely determined whether to apply for workout or corporate reorganization and which measures to take in the corporate restructuring. The many creditor meetings and the opposition of private creditors to initial restructuring plans demonstrate that there were no pre-determined conditions of such a nature that there was direction or entrustment on the part of the Korean Government vis-à-vis the private creditors participating in the corporate restructuring.

17. Are you arguing in paragraph 73 of your oral statement that the banks that participated in the Corporate Restructuring Agreement thereby legally committed themselves up front to follow the direction of the government? Did such undertaking(s) by the banks affect <u>all</u> of the restructurings referred to in your complaint? Please elaborate and provide specific evidence.

The fact that creditors opted for a corporate reorganization in the case of Halla and Daedong rather than for a workout demonstrates that the banks that participate in the CRA did not commit "to the workout as the solution for bankruptcy" as is stated by the EC in para. 73 of its oral statement.

The CRA aims to achieve the promotion of workouts as an accelerated means for restructuring in accordance with Korea's negotiations with the IMF. Nevertheless, nothing in Articles 1, 2 and 20 referred to by the EC entails any waiver by the domestic banks from their rights to act independently. In particular, the penalty provided in Article 20 does not relate to a breach of the CRA itself but would apply if a creditor institution which freely entered into a workout plan failed to implement the workout plan. It is a penalty for a contractual default but not a penalty in case the financial institutions failed to participate in a workout.

20. The EC asserts (first written submission, para. 281) that KAMCO purchased non-secured loans held by foreign creditors of DHI on terms more favourable than those offered to domestic creditors. How is this relevant to the Panel's examination of the issues of whether or not there was a financial contribution and benefit to the restructured company?

Korea also refers to the response it provides to Question 80 of the questions addressed to it by the Panel.

24. Where a government entity is a creditor of an insolvent company being restructured, will the restructuring <u>always</u> result in a subsidy? Why or why not?

As long as the government – creditor behaved according to commercial standards, the restructuring does not constitute a subsidy.

G. SERIOUS PREJUDICE

27. Korea argues that there is considerable variation or diversity of products within each of the product segments proposed by you, meaning that these product segments are too broad and should be broken down, for example, at least into different size ranges. Please comment on the diversity of products within each of the product segments that you propose, and in this context please respond specifically to Korea's arguments on this point.

With regard to Questions 25, 26 and 27, Korea refers to the responses which it provided to questions 86 and 87 that were raised to it by the Panel.

29. You argue that there are three market "segments" relevant to your price suppression/depression claim: LNGs, chemical/product tankers, and container ships.

(a) Is the implication of this that in your view, price suppression/depression should be found in respect of each of these segments separately?

(b) If so, what is the relevance of figures 33-36 of your submission? That is, please explain what conclusions about price and cost trends in respect of the particular kinds of ships referred to in your claim can be drawn from these graphs, which appear to represent averages for <u>all</u> ships of <u>all</u> types.

Where there are different like products as stated by the EC or for like products as submitted by Korea, price depression or suppression must be established for each of those separately. Where no significant price depression or suppression is found for one or more of them, then no adverse effects can be found for that like product and no remedy should be adopted as regards that like product. Therefore, the burden of proof lies on the EC not only to determine, as is argued by Korea, the like product but also to prove the existence of price depression or price suppression for each like product separately. The graphs submitted by the EC reflect ship types as diverse as cruise ships, RoRos, bulk carriers, container vessels, LNGs, pure chemical tankers and product and chemical tankers, etc. without evidentiary nature for the price depression or suppression of each of the three ship types concerned.

(c) Do you agree with Japan's argument that a low price for any individual transaction will put downward pressure on <u>all</u> types of ships, whether substitutable or not? If so, why? Does a decline in the price of a ship of a certain type, for instance a container ship, cause a decline in the price of a ship of another type, e.g., a tanker or passenger ship? Is it not more defensible to argue that a decline in the price of one ship causes a decline in the price of another ship with the same end-use?

We do not agree with this statement from Japan for several reasons.

First, shipping markets, e.g., product tankers for carrying oil and containers vessels are discrete segments, which operate with no possibility of vessel substitution. It is also the case that each market will follow its own freight cycle, due to underlying movements in vessel supply and demand. Furthermore, it is rare for individual markets to be at the same stage in the development of the freight cycle (increasing or decreasing). The freight cycle is important, in that it influences the level of earnings for the ship owner and in turn this will have a bearing on new ordering levels. Normally, in a strong freight market new ordering will rise.

From the shipbuilders perspective it is not uncommon to witness a situation where new ordering for one type of ship is strong, but for another weak. As such, it does not follow that if new

ordering in one sector is weak and a builder accepts a "low" price, that price in other sectors (where ordering levels maybe stronger) would be under downward pressure.

In fact, there are examples of where ship prices by sector move in opposite directions, due in the main to differences in demand for individual ship types. For example, between 1998 and 1999 newbuilding prices for oil tankers of all types fell, while prices for bulk carriers of all types rose. Even in individual market sectors, e.g., oil tankers, there will be differences in price changes between one vessel type and another due to the existence of different specifications even within the same type of vessels as stipulated by Korea.

Second, most shipbuilders and owners are aware that a price for a ship will be determined by many factors, not least of which are the vessel's physical specifications, yard material, labour and production costs and exchange rates. One transaction in isolation does therefore not set a trend for the industry as a whole. Although it is true that the "last quoted price" will have a bearing on the next subsequent order for that particular ship type, provided the ship is of a similar specification. However, the influence of "last business" will not necessarily extend to all other ship types within a sector and certainly not across all fleet sectors.

Third, in a typical year between 1,500 and 2,000 new orders (for all commercial ship types) will be placed with the world's shipbuilders. There is no established mechanism for making the prices of these contracts known publicly; indeed many are concluded on private and confidential basis. In short, shipbuilders will not be aware of every price transaction, so it is illogical to argue that a single transaction can set a price trend for the whole industry.

(d) Is it not more defensible to argue that a decline in the price of one ship causes a decline in the price of another ship with the same end-use?

Within fleet sectors there is some crossover between individual segments. For example, a suezmax tanker at the low end of the suezmax size spectrum may at times compete with larger aframaxes for cargoes. However, a VLCC does not compete with a handy tanker.

Overall, if the newbuilding price for a VLCC is either falling or rising it will have a bearing on price trends in other adjacent oil tanker segments. Movements in newbuilding prices between ship types in a sector are not always uniform. Once again, the reason being that there will be differences in demand for individual ship types within a sector.

34. As a general matter, please describe the precise nature of the analysis that you believe is required to establish serious prejudice through price suppression/price depression, including the following issues:

(a) Must there be (at least *inter alia*) a demonstration that the prices for the complaining party's products have been suppressed or depressed, or is the focus of the analysis instead the prices for the allegedly subsidizing party's product? Or are both sets of prices relevant?

(b) How if at all should these two sets of prices be juxtaposed against or related to one another?

(c) How similar must the complaining party's and allegedly subsidizing party's products be?

Korea refers to the response it is submitting to Question 91 of the questions raised to it by the Panel.

38. In arguing, on the basis of *US – Norwegian Salmon CVD* and Article 15 of the SCM Agreement that an "*a* cause" standard is sufficient for a finding of serious prejudice, are you implying that the causation standard for serious prejudice is the same as that for a countervailing measure? If so, what is the textual basis for such an argument? If not, what is the relevance to this dispute of either SCM Article 15 or the standard applied by the *Salmon CVD* panel? In this context, please respond to the US comment pointing to the difference in drafting between SCM Article 6.3(c) and SCM Article 15 ("the effect of the *subsidy* [...]" versus "the effects of the *subsidized imports* [...]", respectively).

Korea refers to the response which it is submitting to Question 90 of the questions raised to it by the Panel.

41. Please respond to Korea's argument that the effect of any alleged subsidy must be "current", and thus that past subsidies should not be taken into account unless they can be shown to have such a current effect.

Korea refers to its response to Question 83 of the questions raised to it by the Panel.

45. Please comment on China's argument, in paragraph 46 of its written submission, that if the total amount of a subsidy is ten dollars only, it cannot be successfully demonstrated that the effect of such a subsidy is to *significantly* suppress or depress the price of a one-billion-dollar vessel.

With respect to questions 44 and 45, Korea refers to its response to Question 91 of the questions raised to it by the Panel.

ANNEX E

EXECUTIVE SUMMARIES OF THE SECOND WRITTEN SUBMISSIONS OF THE PARTIES

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ANNEX E-1

SECOND WRITTEN SUBMISSION OF THE EUROPEAN COMMUNITIES

(13 April 2004)

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I. INTRODUCTION

1. The Second Written Submission by the European Communities rebuts legal and factual assertions that have been made by Korea in its First Written Submission and at the First Substantive Meeting.

II. FACTUAL BACKGROUND

2. The European Communities discusses a number of inaccurate factual statements that Korea made in its First Written Submission, and shows that Korea attempted to mislead the Panel with respect to the nature of the commercial shipbuilding industry, the Korean economy, and the views of the International Monetary Fund (IMF).

III. BURDEN OF PROOF AND ADVERSE INFERENCES

3. Rather than respond to the EC's evidence, Korea hides behind unsubstantiated assertions that the European Communities has not established a *prima facie* claim. Korea has even argued that the European Communities does not understand the difference between the role of complainant and respondent, and is asking the Panel to make "the complainant's case for it." As discussed in the EC's Oral Statement, Korea misunderstands what is necessary to make a *prima facie* case. If complainants were obliged to set out a case in the excruciating detail demanded by Korea, any dispute settlement proceeding would become unworkable.

4. A *prima facie* case can be based on simple assertions of facts that do not need to be further proven if undisputed by the respondent. The complainant would then be obliged to provide further proof only if the defending party disputes such assertions in a substantiated way. Moreover, a *prima facie* case may be supported by certain presumptions from the WTO Agreements, or by adverse inferences.

5. In this way, during the course of dispute settlement proceedings, the burden of persuasion shifts between the complainant and the respondent. Once the complainant makes a *prima facie* case, the burden shifts to the respondent to rebut those claims. Once rebutted, the burden then shifts back to the complainant, and so on. In this way, WTO dispute settlement is an iterative process in which both the complainant and the respondent have a responsibility to assert and substantiate claims to support their respective positions.

6. In cases involving subsidies and in particular serious prejudice arising from subsidies, panels are asked to be particularly active in seeking information (*e.g.*, Article 6.8 of the *SCM Agreement*). This Panel has already used its power under Article 13 of the *DSU* and Article 6.8 of the *SCM Agreement* to request specific evidence from Korea. As Korea has not produced this evidence in its entirety, the Panel must draw adverse inferences. The European Communities recalls the authority vested in the Panel to request further information from the parties, where necessary.

IV. KOREA'S INTERPRETATIONS OF "PUBLIC BODY" AND ENTRUSTED AND DIRECTED "PRIVATE BODY" ARE CONTRARY TO THE TEXT, AND OBJECT AND PURPOSE OF THE *SCM AGREEMENT*

7. The European Communities demonstrates that Korea's narrow definition of "public body" and "private body" entrusted or directed by the government is not compatible with Article 1.1(a)(1) of the *SCM Agreement*. Article 1.1(a)(1) refers to financial contributions by a "government," a "public body," or a "private body" entrusted or directed by the government. Without the reference to "public body" and "private body," Members could entirely circumvent the disciplines of the *SCM Agreement* by using non-governmental entities to dispense subsidies.

8. To determine whether an entity is a public body or a private body entrusted or directed by the government, a Panel must consider all evidence, including circumstantial evidence. Korea wrongly interprets the terms "public body" and "government" as being synonymous and provides irrelevant context for the interpretation of "public body" from the *Agreement on Agriculture* and the *GATS Annex on Financial Services*.

9. There is no requirement in the *SCM Agreement* that the direction be "explicit and affirmative." Instead, the *SCM Agreement* refers only to instances in which a government "entrusts or directs a private body" without any such limiting qualifiers. Korea cannot rely on *US – Export Restraints* because the entrustment and direction in that case related to a general legislative measure, while in the present case it relates to *specific measures* taken to influence the policies and practices of private banks.

10. Just as Korea wrongly interpreted "government practice" in Article 1.1(a)(1)(i) of the *SCM Agreement*, Korea also wrongly interprets "functions . . . which would normally be vested in the government" or "practices normally followed by governments" in Article 1.1(a)(1)(iv). Korea erroneously argues these references are limited to functions and practices such as taxation and expenditure of revenue. This error arises again because Korea ignores the fact that "government" has been defined to include both "government" and "public body." The practices performed by public bodies are not limited in the same way as those of actual governments – i.e. regulatory function is not a necessary characteristic of "functions . . . which would normally be vested in the government" or "practices normally followed by governments."

11. The European Communities therefore repeats and amplifies its arguments that:

- KEXIM, KAMCO, KDB, IBK, KDIC, and BOK are public bodies, or, in the alternative, private bodies entrusted or directed by the Government of Korea; and

- The private creditors involved in the corporate restructuring of the Korean shipyards are private bodies entrusted or directed by the Government of Korea.

V. THE *SCM AGREEMENT* APPLIES TO PAST AS WELL AS PRESENT SUBSIDIES

12. Articles 3 and 5 of the *SCM Agreement* clearly prohibit certain behaviour – i.e. subsidisation contingent on export (or the use of domestic over imported goods), and subsidisation that causes adverse effects to the interests of other Members. As discussed in the EC's Oral Statement, there is no WTO rule that allows a violation to be forgiven once it is in the past. When Korea argues that subsidies granted in the past cannot be challenged under the *SCM Agreement*, it confuses the issue of whether a subsidy has been granted with countervailing duty principles, which only allow current benefits to be offset. It also confuses the issues before this Panel—whether a violation has occurred—with the appropriate remedy for violations. In this case, the Panel has not been asked to specify how Korea may bring itself into conformity with its WTO obligations.

13. The European Communities is entitled to a panel finding for all subsidies granted or maintained after the entry into force of the Uruguay Round. The Panel in *Indonesia – Autos* confirmed that past subsidies are subject to review. The Panel found that to exclude past (and future) subsidies from the scope of review would make it difficult for any complainant to demonstrate serious prejudice.

14. The same reasoning applies, *a fortiori*, to prohibited subsidies claims. It would be illogical for the scope of review of prohibited subsidies, which are illegal *per se*, to be narrower than the scope of review for subsidies that may be illegal depending on their trade effects.

15. While not required to demonstrate the current effects of subsidies, the European Communities has nevertheless done so in its Responses to the Panel's Questions with respect to the actionable subsidies granted to the shipyards through the corporate reorganisation and restructuring proceedings.

VI. PROHIBITED SUBSIDIES

16. The European Communities responds to numerous arguments raised by Korea claiming that (i) the KEXIM Act, KEXIM Decree, and KEXIM Interest Rate Guidelines as such, (ii) the KEXIM APRG and pre-shipment loan programmes as such, and (iii) specific grants of APRGs and pre-shipment loans do not constitute prohibited export subsidies under Article 3 of the *SCM Agreement*.

17. First, the European Communities demonstrates that that the mandatory/discretionary doctrine can not be used to shield the KEXIM Act, KEXIM Decree, KEXIM Interest Rate Guidelines, or APRG/pre-shipment loan programmes from the obligations of the *SCM Agreement*. In particular, the Appellate Body has confirmed that analysis of WTO consistency of a measure does not end with a finding that it is discretionary. Moreover, it is clear from the *SCM Agreement* that subsidy regimes like those of KEXIM are subject to prospective challenge.

18. The European Communities further explains that Korea has not rebutted the EC's evidence that the KEXIM Act, KEXIM Decree, and KEXIM Interest Rate Guidelines specifically envisage the provision of prohibited export subsidies. The European Communities reiterates its understanding that various provisions of the KEXIM Act, Decree, and Interest Rate Guidelines, including Articles 18, 19, 24, 36(2), and 37 of the KEXIM Act, and Articles 17(2) and 25(6) of the Interest Rate Guidelines, specifically envisage the grant of subsidies that violate Article 3 of the *SCM Agreement*. Korea's responses, including a request that the Panel virtually ignore Article 24 of the KEXIM Act based on an explanation that it should have been repealed, lack merit.

19. The European Communities next addresses Korea's counter-arguments regarding the specific grants of APRGs and pre-shipment loans, and confirms that these specific grants provide benefits to Korean shipyards. In particular, the European Communities demonstrates that transactions by foreign creditors provide a relevant market benchmark, and makes use of additional information provided by Korea to again demonstrate the benefit provided by KEXIM APRGs and pre-shipment loans. Additionally, the European Communities demonstrates that the alternative benchmarks proposed by Korea are not relevant benchmarks.

20. Finally, the European Communities reiterates that Korean APRGs and pre-shipment loans cannot be considered to fall within "safe havens" under the *SCM Agreement*. APRGs are neither export credit guarantees nor guarantee programmes against increases in costs under item (j) of the Illustrative List. Moreover, pre-shipment loans are not "export credits" within the meaning of item (k) of the Illustrative List.

VII. ACTIONABLE SUBSIDIES

A. RESTRUCTURING SUBSIDIES

21. Korea implies throughout its First Written Submission and Oral Statement that the European Communities believes that *all* bankruptcies and reorganisation proceedings constitute actionable subsidies within the meaning of the *SCM Agreement*. Moreover, Korea characterises the EC's arguments as indicating that a restructuring scheme requiring banks to act on market principles and to maximise returns results in the granting of an actionable subsidy. This is plainly an incorrect reading of the EC's submission. Indeed, as detailed previously, the European Communities fully accepts that bankruptcy law is a necessary part of a market economy, and that a bankruptcy proceeding does not generally give rise to a subsidy within the meaning of the *SCM Agreement*.

22. However, where the outcome of a bankruptcy proceeding or a corporate restructuring is determined by the Government, public bodies, or private bodies acting under the direction of the Government, and leads to a more beneficial outcome for the enterprise than would have arisen if the creditors had acted according to market principles, all of the components of a subsidy are present.

23. While the European Communities has already presented evidence demonstrating a *prima facie* case that the financial contributions granted pursuant to the restructuring/reorganisation of the three Korean shipyards have resulted in a benefit, and that these grants were specific, the European Communities responds to Korea's various arguments by explaining that:

- Daewoo-HI/Daewoo-SME, Samho-HI/Halla-HI, and Daedong/STX received financial contributions from public bodies and private bodies entrusted or directed by the Government of Korea that provided benefit to these shipyards, and are specific within the meaning of the *SCM Agreement*; and

- Korea failed to respond adequately to the claim relating to the tax concession, in particular 45-2 of the Corporate Tax Act, which was enacted on 21 October 2000 and extended tax incentives provided under Article 46 to spin-offs carried out under a workout program approved on or before 31 December 2000. This specifically tailored tax exemption provided a benefit to Daewoo-HI/Daewoo-SME of KRW 236 billion.

24. The European Communities details the manner in which private bodies were entrusted and directed by the Government of Korea and public bodies to participate in the corporate restructuring process. For example, the Government of Korea explained, in its Letter of Intent to the IMF, that public funds would be made available when a "bank is making adequate progress on implementation of sound corporate debt restructuring", at a time when Korean financial institutions depended on public funds for their own survival. The European Communities also details the instrumental role of KAMCO, a public body, in influencing the restructurings.

25. With respect to each of the three shipyards, the European Communities reiterates the appropriate market benchmark for analysing the corporate restructuring, and demonstrates the benefit accorded to the restructured shipyards. With specific respect to Daewoo-HI/Daewoo-SME, the European Communities demonstrates that the Arthur Andersen report does not rebut a *prima facie* case of benefit.

26. The European Communities details again the manner in which the restructuring subsidies are specific within the meaning of Article 2 of the *SCM Agreement*. They were all provided within the context of a specific restructuring of a single enterprise. Daewoo-HI/Daewoo-SME, in particular, was restructured under the specifically created framework of the Corporate Restructuring Agreement; Daewoo affiliates accounted for over half of the workout procedures under this framework in 1999, and two-thirds in 2000. The European Communities has also provided evidence that certain financial institutions were re-capitalised specifically for the purpose of ensuring payment of Daewoo bondholders.

27. With respect to Samho-HI/Halla-HI, and Daedong/STX, the European Communities reiterates its evidence that public bodies, including KEXIM and KDB, and entrusted/directed private creditors specifically selected these shipyards as recipients of restructuring on better-than-market terms. Korea can not prevail by arguing that any restructuring that takes place pursuant to an existing legal framework precludes a finding of specificity, as this would exempt all corporate reorganisations from the scope of the *SCM Agreement*.

B. KOREA'S SUBSIDIES HAVE CAUSED SERIOUS PREJUDICE TO THE INTERESTS OF THE EUROPEAN COMMUNITIES, WITHIN THE MEANING OF ARTICLES 5(C) AND 6.3(C) OF THE SCM AGREEMENT

28. The European Communities responds to Korea's various arguments, and reiterates that Korea's subsidies to its shipyards have caused serious prejudice to the interests of the European Communities within the meaning of Articles 5(c) and 6.3(c) of the *SCM Agreement*, as they resulted in significant price suppression and depression in the same market. Specifically, the European Communities demonstrates in the Second Written Submission that:

- Serious prejudice is not a separate legal element, and the European Communities has met its burden under Articles 5(c) and 6.3(c) by demonstrating that price depression or suppression in the same market was caused by the Korean subsidies;

- Korean and EC shipyards compete in the same geographic market (*i.e.*, the world market) and the same product markets (*i.e.*, liquid natural gas tankers (LNGs), container ships, and product/chemical tankers);

- Korean subsidies have caused significant price suppression and depression in these markets; and

- Korea fails to rebut the *prima facie* case of causation presented by the European Communities.

1. Significant Price Suppression or Depression

29. The European Communities responds to Korea's various arguments regarding price suppression and depression and demonstrates that:

- The assessment by the European Communities of prices of commercial vessels, and the dynamics affecting these prices, is well-supported by factual evidence;

- The European Communities has properly identified the general relationship between subsidies and prices of commercial vessels;

- KEXIM APRGs and pre-shipment loans have contributed to the price depression and suppression; and

- The Korean subsidies have caused price depression and suppression of LNGs, and price suppression of container ships and product/chemical tankers.

2. Causation

30. The European Communities replies to Korea's erroneous legal and factual assertions regarding causation of price depression and suppression by explaining as follows:

- Korea's proposed approach, including the vastly overcomplicated multi-step procedure to assess the effects of subsidies, has no basis in the text of the *SCM Agreement* and in WTO jurisprudence, which requires a 'but for' test;

- The evidence provided by the European Communities shows a clear coincidence in time between the subsidies and the price effects;

- The European Communities has presented *prima facie* evidence of causation, through use of relevant statistics and examples, including numerous facts and calculations showing the level of the subsidisation and the level of price depression and suppression;

- Korean subsidies allowed for maintenance of over-capacity, that significantly affected prices;

- The ability of subsidised Korean shipyards to affect the prices of LNGs, container ships, and product/chemical tankers is further supported by accurate market share data and information regarding individual transactions; and

- Korea's reference to additional factors does not cast doubt on the *prima facie* case of causation set forth by the European Communities.

VIII. CONCLUSION

31. The European Communities has shown that Korea has failed to rebut the *prima facie* case put forth by the European Communities demonstrating that the Government of Korea, public bodies, and private bodies entrusted or directed by the Government of Korea have provided enormous subsidies to Korean shipyards from 1 January 1997 to the present.

ANNEX E-2

SECOND WRITTEN SUBMISSION OF KOREA

(13 April 2004)

I. INTRODUCTION

1. In Korea's Second Written Submission, Korea rebuts the factual and legal allegations made by the EC in its Oral Statement of 9 March 2004 and in the responses submitted by the EC to the questions raised by the Panel and Korea on 22 March 2004. Korea addresses the core issues raised by the EC in terms of the subsidy allegations and sets forth the factual and legal grounds on which Korea relies to conclude that no prohibited or actionable subsidies were granted by Korea.

2. Korea notes from the outset that the EC's continued references to a centralized role of the Korean Government in the Korean economy are outdated and inappropriate. Ironically, to the extent that there was guidance from the Korean Government during the relevant period, it was to ensure that market principles and commercial considerations were paramount in the course of restructurings and more generally throughout the financial sector – a fact repeatedly confirmed by the IMF despite the EC's pressure on the IMF to say otherwise.

II. EVIDENTIARY ISSUES

3. The EC has utterly failed to carry its burden of establishing a *prima facie* case for each of its claims based on proven facts. The EC as complainant has the burden to establish every point necessary to demonstrate each claim. Failure on one point means failure on the claim as a whole. The EC has failed or refused to even argue critical issues underlying its claims.

4. Regarding prohibited subsidies, the EC does not have sufficient evidence and has been forced to demand that adverse inferences on APRGs be made against Korea based on law exclusively related to serious prejudice cases (i.e. Annex V), resulting in an abuse of the Annex V process.

5. With respect to pre-shipment loans, the EC relies on a totally unrelated benchmark (corporate bonds) that differs in terms, collateral and very nature from the measure at issue. Korea also showed that the corporate bond rates were inaccurate. Moreover, the EC did not make any adjustments for any of the differences in the critical factors such as terms of credit, collateral, etc. The EC's response that it was now up to Korea to prove the negative of the EC example must be rejected. The EC has failed to carry its burden of proof on this critical point. The EC cannot dodge its burden of establishing its own *prima facie* case. It cannot shift its burden to Korea nor to the Panel. The Appellate Body in *Japan – Apples* makes clear that the burden of establishing a *prima facie* case rests entirely with the complainant.

6. The EC demands from Korea further information at this late stage in the panel proceeding purportedly for the Panel to figure out how to use such information in calculating benefit. As Korea has pointed out a number of times, the Appellate Body in *Japan – Agricultural Products II* made it quite clear that panels are not to make the complainant's case for it. The EC's approach betrays that it has not presented sufficient evidence to satisfy its burden of proof.

7. The EC's arguments that the KEXIM Act, the APRG and pre-shipment loan programmes are inconsistent "as such" must be rejected. The EC is asking the Panel to reject an enormous amount of

GATT and WTO jurisprudence regarding the mandatory/discretionary distinction in evaluating legislation.

8. Regarding the EC's claim of serious prejudice, not a single element of the *prima facie* case has been proven. The EC did not establish that the banks identified were "public bodies". The EC cites to the fact that there is governmental ownership and public policies stated in the charter but these certainly do not suffice to be a 'public body'. A public policy or sectoral focus is also found in many privately owned companies. Further, Korea has identified the key issue in identifying a 'public body' as looking to the governmental function. With respect to "private bodies directed or entrusted by government" the EC has utterly failed to provide any explicit evidence at all.

9. The EC has for the first time actually identified the alleged beneficiaries. But its answers are mutually contradictory. On the one hand, the EC argues that the beneficiary of the Daewoo restructuring is Daewoo. Does the EC mean the old bankrupt Daewoo? If so, the EC has admitted that the new entity is not subsidized for the owners of the new entity want market returns on their assets and that motivation is completely detached from any earlier events under prior ownership. It may be that the EC actually means to refer to the new entity, DSME. But this would be similar to the losing arguments of the United States in the privatization cases. Moreover the EC argues that the subsidy occurs because the DHI creditors paid too much for the DSME stock they received in the restructuring. The contradictory nature of the EC's arguments is revealed when it turns to Hyundai and argues that the basis for the subsidy is that Hyundai paid too *little* for Samho.

10. Remarkably, the EC argues that "debt and equity do not have the same value".[1] This is not true. Debt and equity are different forms that may or may not have the same value at any given moment depending on the facts. The EC further claims that debt and equity swaps *per se* confer a benefit[2] and thereby proposes a sweeping rule that would render large swathes of Member countries' bankruptcy and insolvency codes as *per se* subsidies. Debt-for-equity exchanges are the base line manner of resolving insolvency. The EC is arguing that anything other than termination and winding up of insolvent companies is a *per se* subsidy. There is simply no basis for such a sweeping rule. Indeed, it would be inimical to the operation of any market economy including those of the EC .

11. Furthermore, in response to Question 20, the EC now wants to argue that the purchase of debt by KAMCO constituted a grant or equity infusion ignoring the inconsistency of this claim with its earlier statement that debt and equity cannot as a matter of law have the same value. This amounts to a new claim which was neither in the consultation request, request for Panel establishment, nor in any argument made so far and must be rejected at this stage.

12. Also, regarding the alleged restructuring subsidies, the EC has failed to carry its burden with respect to specificity, relying instead on repetitions of the benefit claims.

13. In response to Question 22, the EC again argues for a *per se* rule as a substitute for presenting the necessary evidence. The EC is reduced to arguing that unless every company in every country that ever went bankrupt has precisely the same circumstances or obtains different results from their debt workouts or restructurings, there is a *per se* subsidy.[3] Obviously, there cannot be any such *per se* rule regarding insolvency procedures.

14. With respect to serious prejudice the EC has not shown how the alleged subsidies affect the broader interests of the EC, much less seriously prejudice them.

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[1] Refer to para. 62 of the EC's response to the Panel's Question 17, at page 16 of the EC's responses.

[2] Refer to para. 75 of the EC's response to the Panel's Question 18, at page 19 of the EC's responses.

[3] Refer to paras 91 and 93 of the EC's response to the Panel's Question 22, at pages 24-25 of the EC's responses.

15. Like product has been left undefined. There is no information regarding how the products are physically similar or distinct in meaningful ways. More than that, the EC explicitly rejects that the notion is relevant and instead relies on some extra-treaty term of "market segmentation" but even then products seem to sail in and out of each pliable category depending on which passage of the EC's submissions one refers to. The EC continues to refuse to provide this essential evidence.[4] It is too late to do so now.

16. In question 30, the Panel asked for the EC to provide the capabilities and experience of each shipyard that produces vessels within the scope of the dispute. The EC refused to do so because the number of relevant shipyards is "too many". This is outrageous. The EC submitted about 600 questions to Korea in the short Annex V process and demanded that Korea translate thousands of resulting pages for the convenience of the EC. The EC then simultaneously shrank the size of its case, meaning much of that effort was wasted and then tried to claim adverse inferences liberally. Yet, when asked by the Panel for a relevant piece of information the EC refuses to answer the question because it allegedly is too hard. Korea requests that the Panel make adverse inferences against the EC in this regard.

17. With respect to causation, the EC rejects any need to quantify the alleged subsidy and rejects any need to link that subsidy to the alleged price suppression or depression. The EC has abandoned any attempt at identifying, much less explaining, the market mechanism that transmits the effects of the alleged subsidies, having abandoned every other element of proof contained in Article 6.3, including price undercutting.

18. The EC has failed to carry its burden of proof and indeed explicitly rejected it on element after element. Korea has been as forthcoming as it can be in supplying information; however, this cannot serve as a substitute for the EC's burden of establishing its own *prima facie* case on each claim.

III. ABSENCE OF PROHIBITED SUBSIDIES

19. KEXIM is not a public body. Korea has articulated a standard based on the one used in *Canada - Dairy* specifically that an entity is a public body only when it acts in an official capacity.[5] Conversely, if an entity is acting in a commercial manner consistent with market considerations and not in an official capacity, it is not a public body. The EC, by contrast has not even articulated a consistent theory on what constitutes a public body. KEXIM is required to operate on a commercial basis and does not have the authority to regulate and is thus not a public body under the definition espoused by Korea or under the definition used by the EC in its TBR report or in initial statements in its First Written Submission. Moreover, as explained in response to question 49 of the Panel's questions, KEXIM has minimal government borrowing and borrows nearly all its funds on the open market and must maintain a sound credit rating. Any capital injections made by the Korean Government were not for the purpose of covering losses but were for improving KEXIM's credit rating. Finally, KEXIM has been consistently profitable.

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[4] Indeed, in response to a question to provide further evidence, the EC responds by repeatedly citing its own Oral Statement. See paras 115-116 of the EC's response to the Panel's Question 27, at page 32 of the EC's responses that can hardly be considered convincing evidence. The EC also attempts to cite Korea's request for consultations. Refer to paras 118-121 of the EC's response to the Panel's Question 28, at page 33 of the EC's responses. Obviously, Korea does not present rigorous evidence in its request for consultations and it is odd that the EC would consider that to be the case since the EC has not done so in this dispute through the point of its "Answers" to Questions, much less the request for consultations. Korea would also make the observation that much of the contours of that case will depend on the Panel's interpretations in this case, not the other way around.

[5] Korea's First Written Submission at paras 146 and 147.

20. Not only do the individual APRG and PSL instances not confer a benefit but, in addition, the KEXIM legal regime, the APRG and PSL schemes cannot be challenged as such. The individual APRG and PSL transactions confer no benefit and the EC has failed to establish the appropriate market benchmark. Moreover, individual instances of APRGs and PSLs that have long since expired are not prohibited subsidies that are being 'granted' or 'maintained'.[6] Measures which provide a mere discretion to provide alleged subsidies are simply not challengeable as such under the SCM Agreement. The KEXIM Act, KEXIM Decree and Interest Rate Guidelines do not mandate the provision of any alleged export or other subsidies and therefore cannot, as such, be found in violation of the SCM Agreement. The EC argues that the traditional mandatory/discretionary distinction cannot be applied in the context of Article 3 subsidies under the SCM Agreement, but offers no support for this radical conclusion. In fact the Panels in *Brazil – Aircraft Article (21.5 II)* and *Canada – Aircraft* left no doubt that the distinction applies in Article 3 SCM cases. Moreover, the EC expressly admits that it is possible that measures taken by KEXIM would not be inconsistent with Article 3 SCM thereby confirming that the KEXIM regime cannot be said to mandate the provision of prohibited export subsidies.

21. The KEXIM APRG and PSL schemes and the individual instances in which APRGs and PSLs were conferred to shipbuilders benefit from the safe haven in items (j) and (k) of Annex I to the SCM Agreement. Footnote 5 of the SCM Agreement, read in the context of the language of items (j) and (k), first paragraph, of Annex I, as well as other provisions of the Agreement, clearly provides for so-called "safe harbours". Footnote 5 provides that excepted measures under Annex I are not "prohibited subsides"; it does not use the broader term "non-actionable subsidies" as is found in Article 8.1. Therefore, such subsidies could still be considered under Part III or Part V.

22. Both items (j) and (k), first paragraph, have affirmative provisions that must be met in order for them to identify prohibited export subsidies. Logically, if those provisos are not met, then there would not be an export subsidy. Otherwise, the provisions would have no meaning.

IV. ABSENCE OF ACTIONABLE SUBSIDIES

23. The EC has alleged that Daewoo Heavy Industries (DHI), Halla and Daedong were provided subsidies by virtue of undergoing corporate restructuring (DHI) and court supervised corporate reorganization (Halla and Daedong). However, the EC has failed to prove that a financial contribution was provided, articulated who the recipient of the financial contribution was, prove that a benefit was provided or that the corporate restructuring and corporate reorganization were specific to these companies or the shipbuilding industry. Therefore, the Panel should find that no subsidy was provided or in the alternative, if a subsidy was provided, it was not specific to these companies.

24. The EC failed to prove that either KDB, IBK, KAMCO, or KEXIM is a public body, under its definition or otherwise, and its analysis of what constitutes a public body is flawed. KDB and all of the creditors acted on commercial terms while participating in the corporate restructurings or reorganizations. KDB has no regulatory or taxation powers at all. The EC failed to show how government control goes beyond ownership. The KDB and all its creditors are not public bodies under either Korea's or even the EC's own criteria.

25. With regard to IBK, IBK acted only as a commercial creditor in the corporate restructurings and reorganizations and therefore did not meet Korea's definition of a public body.

26. With regard to KAMCO, KAMCO purchases and disposes of non-performing assets based on commercial considerations and does not have the authority to regulate any sector of the economy and its decisions are not enforceable in a court of law. It does not, for example, have the regulatory

[6] Korea's First Written Submission at paras 201 to 204, as challenged in para. 33 of the EC's Oral Statement.

authority of BOK. KAMCO just buys distressed loans on a commercial basis; it does not try to determine culpability. Therefore, KAMCO is not a public body.

27. With regard to KEXIM, Korea refers to its arguments above explaining why KEXIM is not a public body. The EC offered only vague or irrelevant evidence to support its claim. Korea referenced the test advocated by the Panel in *US - Export Restraints* that direction and entrustment requires three elements (i) an explicit and affirmative action be it delegation or command; (ii) addressed to a particular party; (iii) the object of which action is a particular task or duty. Something more than vague circumstantial evidence is required and the actions have to be specific to the subsidy alleged. Nothing suggests that the financial institutions were directed or entrusted to take specific actions in the corporate restructuring of DHI or the corporate reorganization or Halla or Daedong. Therefore, the EC's claims must fail.

28. With respect to the alleged corporate restructuring subsidies, the EC has clearly stated in its Oral Statement that if creditors behaved in a profit maximizing manner no benefit was conferred.[7] Korea believes in this regard that the information before the creditors at the time of the restructuring can be used to determine whether they acted based on market considerations. The Appellate Body has made clear that "the value of the 'benefit' under the SCM Agreement is to be assed using the marketplace as the basis for comparison".[8] Korea demonstrates that in each of the restructuring cases at issue, a market valuation was conducted and the companies were maintained as going concerns based on the market valuation and each was subsequently sold pursuant to arm's length transactions at fair market value.

29. The EC has failed to specify the correct benefit benchmark. In the present case, the appropriate benchmark is whether the creditors of an insolvent company in the same situation as that of the three Korean shipyards would have acted in the same way. Applying this benchmark, the evidence on the record supports the finding that the three proceedings were done on an arm's length basis and no benefit was provided.

30. The EC claims at paragraph 77 of its response to the Panel's questions that the creditors of Daewoo overpaid for the equity in the debt for equity swap on 14 December 2000 when compared to the price of the stock when it was first publicly traded on 2 February 2001. Amazingly, the EC proposes that the benefit amount be determined by comparing prices from December 2000 to prices weeks later, while in blatant contradiction, the EC claimed in its Oral Statement that Korea cannot invoke the fact that the share value of the restructured yards increased over time, because there is no room for an *ex post* analysis. The EC cannot have it both ways, relying on *ex post* analysis where convenient and rejecting it elsewhere. The EC's subsidy calculation for the debt to equity swap is meaningless because the calculation has to be done at the time of the transaction, based on information available to the creditor at the time, and there is no room for *ex post* analysis. Furthermore, the Appellate Body has clearly stated that if a sale of a company occurred in the context of an arm's length transaction, there was an irrebuttable presumption that the purchaser paid for what he got and thus did not get any advantage.[9] In each of the cases at issue, the creditors or the court decided that the companies were worth more as a going concern than in liquidation, based on the

[7] EC Oral Statement at paragraph 77, page 19.

[8] Appellate Body Report, *US - Countervailing Measures*, para. 102.

[9] Appellate Body Report, *US - Countervailing Measures*, para. 127. Moreover, the Panel and Appellate Body indicated that their concern, under the facts of that case, was whether there had been a *less* than arm's length purchase price, whereas here the EC is arguing that the DHI creditors did not get enough for their debt, i.e., that they *overpaid*. Ibid. at paras 103-104. It is difficult to see how an overpayment for the new equity could result in above market returns leading to the possibility of a pass-through of the subsidy. In Korea's view, the facts are clear in the present case that there was neither an overpayment nor an underpayment; the DHI creditors got fair market value for their debt.

market-based analysis the creditors exchanged debt for equity. In each of the cases, the stock was then sold on the open market for fair market value.

31. Remarkably, the EC claimed that the creditors paid too much for the stock in DSME but then complained that Hyundai-HI paid too little for Samho. These contradictions leave it unclear in which scenario the EC is arguing a benefit is conferred. Nonetheless, Hyundai-HI is an independent party that freely decided to purchase the stock in an arm's length transaction. Therefore, no benefit should be found to exist. The EC has also erred in calculating the benefit in a piecemeal fashion by wrongly considering the various portions of the debt restructuring in isolation.

32. For example, as explained at paragraph 411 of Korea's First Written Submission, Halla Heavy Industries filed for a corporate reorganization proceeding with the Court on 6 December 1997. The Court then determined that the going concern value was greater and appointed a receiver. The receiver submitted the first reorganization plan on 22 October 1998. The corporate reorganization was not concluded until 6 September 2000. Therefore, any payments made during the course of the corporate reorganization process have to be taken into consideration in the calculation of the debt. If the alleged subsidy is the corporate reorganization, then the entire process has to be taken into consideration in determining whether a benefit was provided. Therefore, this would not be an *ex post* analysis. Similarly for Daedong, if the EC is claiming that a subsidy was provided during the course of the corporate reorganization proceeding it must consider the entire proceeding. Consideration of the entire bankruptcy process would not be an *ex post* analysis.

33. The EC failed to use the correct benchmark in determining the alleged benefit and failed to rebut the evidence that the creditors acted in a commercial fashion.

34. The Arthur Andersen Report clearly shows that the creditors – based on reasonable assumptions and information available at the time – acted to maximize their return. The EC itself concedes that a primary criterion for keeping an insolvent company operating is "whether a market creditor/investor in similar circumstances, given probable market developments and the position of the undertaking would have acted in the same way."[10] Korea provided the valuation reports used by the creditors and the courts in each of the three restructuring cases as part of the Annex V process showing the EC's own criteria are met. Faced with the weakness of its case, the EC instead resorts to inventing an insurmountable and incorrect standard under which only companies whose going concern value "significantly exceeds" the liquidation value and those whose business plans do not have uncertainties would continue.

35. As confirmed by Anjin Deloitte LLC, the going concern value of DHI exceeded the liquidation value as reported in the original report.

36. The EC's specificity analysis is flawed and lacking in evidence. Korea believes that evidence of non-specificity and general availability is shown in two elements: First, assuming for the sake of argument that each of the creditor financial institutions of the three restructured Korean shipbuilders constitutes the "granting authority" as referred to in Articles 2.1(a) and (b) of the SCM Agreement, the granting authority, or the legislation pursuant to which the granting authority operates (i.e., the CRA and the Corporate Reorganization Act), did not explicitly limit access to an alleged subsidy to shipbuilders but is generally applicable to all companies irrespective of their industrial sectors. Second, the restructuring legislation or scheme established "objective criteria or conditions" governing eligibility for the alleged subsidy, establishing non-specificity by virtue of Article 2.1(b). The CRA and the Corporate Reorganization Act, authorized the creditor financial institutions or the Court to grant the restructuring measures to any corporation which was insolvent or suffering liquidity problems but whose going concern value is greater than liquidation value.

[10] Refer to para. 98 of the EC Response to Panel's Question 23, page 27.

37. The EC is incorrectly advocating benefit from the perspective of the physical assets of the company and not the legal entity. As discussed by Korea in response to Question 46 of the Panel's questions, the Appellate Body in *US - Countervailing Measures*, explained that "the focus of any analysis of whether a "benefit" exists should be on the "legal or natural persons" instead of on the productive operations,"[11] and that "once a fair market price is paid for the equipment, its market value is redeemed, regardless of the utility the firm may derive from the equipment. Accordingly, it is the market value of the equipment that is the focal point of the analysis, and not the equipment's utility value to the privatized firm."[12] This reasoning applies in the case of financial restructuring and in the case of Daedong, Halla and DHI, the transaction occurred at arm's length or market values.

38. Korea demonstrates in its submission why the purchase price paid by KAMCO for non-performing loans is irrelevant to the benefit analysis.

39. With respect to the EC's allegation of KEXIM measures as actionable subsidies, the EC failed to even allege specificity in relationship to the PSLs and APRGs' and without this element alone the EC's claim must fail.

40. The EC has failed to understand the value of debt and equity. The creditors in the case of DSME were not faced with the choice of debt or equity. They were faced first with the choice of liquidating the company or having it continue. Once the choice was made that it was more profitable to continue DHI as an operating concern, the creditors then considered the debt restructuring required that would allow them again to maximize their return. This included transferring a certain amount of debt into equity. Moreover, even assuming, *arguendo*, that the face value of the equity was worth less than the credit paid for it, no benefit would have been provided to DSME because 1) the company had been transferred to the creditors, 2) the creditors maximized their return which in turn means 3) the restructuring package received by DSME was market determined.

41. The EC has failed to show that the alleged subsidies have caused serious prejudice. The EC's arguments are characterized by a number of serious flaws. Among others, the assessment under Article 6.3(c) of the SCM Agreement cannot be made on the basis of the "world market," contrary to the EC's claims that the term "same market" in Article 6.3(c) of the SCM Agreement has no geographic qualification and that national boundaries have hardly any effect on the shipbuilding business.[13] In this regard, the EC itself in several documents has confirmed that, among others, the Japanese market is closed and the US cabotage provisions affect one third of the US' orders. It cannot be said that geographic or national boundaries are irrelevant. Also, contrary to the EC's assertion, the GATT Panel in *EC – Sugar* does not apply in the present circumstances because that case was concerned with export rather than actionable subsidies.

42. With respect to the like product issue, it is in law and in practice impossible to make an accurate assessment on the existence of price depression or suppression pursuant to Article 6.3(c) of the SCM Agreement without determining the "like product" first in accordance with the provisions of footnote 46 of the SCM Agreement. The EC instead relies on a vague and shifting extra-treaty concept of "market segmentation" which in any event is too broad to meet the requirement of footnote 46. Footnote 46 of the SCM Agreement focuses on identical products or products with characteristics closely resembling each other. Thus, footnote 46 rests on a strong physical identicallity test. The Panel in *Indonesia – Automobiles* was applying this in a manner that found that physical characteristics could subsume some of the other issues such as end-uses, tariff classification and price relationships. It is clear – and the EC also admits – that vessels are highly differentiated. It is ludicrous to then assert that all ships are like products. The like product definition must be sufficiently narrow in order to allow an accurate assessment of the price effects. The EC has failed to

[11] Appellate Body Report, *US- Countervailing Measures*, para. 110.
[12] Id. at paragraph 102.
[13] EC's Oral Statement, paras 93-95, pages 23-24.

provide any coherent product analysis to allow such an assessment and thus the EC cannot meet its burden of establishing serious prejudice.

43. Price suppression and depression must be demonstrated for each like product separately with separate supporting evidence. But the EC's so-called evidence in support of price depression (i.e., the decrease in newbuilding price index, the increase in order book volume, the alleged increase in freight rates and increase in cost of production) is based on data for the whole range of commercial vessels including vessels that are totally unrelated to the present dispute including cruise ships, bulk carriers, RoRos or LPGs. No finding of serious prejudice can be made on the basis of such wholly defective evidence.

44. The EC's claim that price suppression or depression does not require head-to-head competition but mere capability on the part of the EC shipyards to compete is legally unfounded and must be rejected. Article 6.3(c) of the SCM Agreement requires head-to-head competition as a pre-requirement to find price suppression or price depression.

45. The EC's mechanism to establish price suppression or depression is fatally flawed. The EC alleges that it is not required to show that the complainant's prices are actually depressed or suppressed. This is incorrect. Price depression or suppression must be established with regard to the prices of the EC vessels and the prices of the complaining party's products must therefore be shown to have declined or to have been suppressed.

46. In addition, the causal link between the price effects and the alleged subsidies must be demonstrated and the causal link requires a quantification of the alleged subsidies and their effect on the prices of the Korean vessels. The EC claims, among others, that alleged overcapacity suppresses or depresses prices, but the EC has nowhere established how this allegedly occurs. The EC has failed to carry its burden of proof.

47. The use of the term "any subsidy" in the *chapeau* of Article 5 of the SCM Agreement and in Article 7.8 confirmed by the multiple references to "the subsidy" in Article 6.3 confirms that the effects of a subsidy must be reviewed for each subsidy separately. The existence of price depression or suppression caused by the effects of the subsidies as outlined above must be carried out for each subsidy individually.

48. A finding of price depression or suppression caused by the alleged subsidies does not mean that a serious prejudice finding is automatic. Rather, a finding of serious prejudice must be made separately. This is clear, *inter alia*, from the use of the word "may" and the use of the words "one or several" in the *chapeau* of Article 6.3. Any other interpretation would mean that the standard to find serious prejudice under Article 5(c) is substantially lower than to find material injury under Article 5(a) and footnote 11, whereas the Appellate Body in *US – Lamb* has concluded that the word 'serious' connotes a much higher standard of injury. Thus, something more must be proven to establish serious prejudice. Article 5(c) of the SCM Agreement refers to serious prejudice to the "interests" of a "Member". There must have been a reason that the term "interests" (in plural) was chosen rather than injury and it clearly implies something more than just the alleged damage to specific industry(ies) for a Member's "interests" are necessarily broader than just that.

49. Nonetheless, the alleged subsidies have not caused significant price depression or suppression and the EC's claims fall far short of demonstrating serious prejudice. The EC provides in Attachment 2 to its responses to the Panel's questions a response to the Panel's question with regard to the existence of significant price depression or suppression caused by the alleged subsidies. But there is, among others, no indication of the like product vessel and hence the data is fatally flawed from the outset and cannot establish price depression or suppression for the like product vessels. Nor is there any serious attempt to establish a causal link. Among many other flaws, the price allegations

are also inaccurate. In sum, the EC has failed to establish any semblance of a *prima facie* case that would allow a finding of serious prejudice in this case, even assuming, arguendo, that alleged subsidization could be shown.

ANNEX F

EXECUTIVE SUMMARIES OF THE ORAL STATEMENTS OF THE PARTIES - SECOND MEETING

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ANNEX F-1

ORAL STATEMENT OF THE EUROPEAN COMMUNITIES

(25 June 2004)

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1. Korea makes increasingly reference to the "financial and economic turmoil" the "assistance of the IMF in resolving the financial crisis or the fact that other Members also subsidised their shipyards as an excuse for granting subsidies to its shipyards. Why does Korea invoke these circumstances although the *SCM Agreement* does not provide for justification on these issues?

I. PROHIBITED SUBSIDIES

A. MANDATORY/DISCRETIONARY ISSUES

2. Contrary to the suggestions of Korea, the European Communities attaches great importance to its claims against the KEXIM legal framework and its subsidy programmes "as such".

3. The European Communities does not accept that measures can be brought outside the scope of the *WTO Agreement* (or dispute settlement) simply by introducing an element of discretion.

4. Whether a measure is inconsistent with a WTO obligation must depend on the characteristics of the measure and the terms of the WTO obligation in question. A discretionary measure must surely be inconsistent with a provision that prohibits such discretion. For example, a discretion to impose antidumping duties at a level of treble the dumping margin is inconsistent with the obligation in Article 9.3 of the *Antidumping Agreement* that "the amount of the anti-dumping duty shall not exceed the margin of dumping" especially when interpreted in the light of the obligation in Article 18.1 that "no specific action against dumping of exports from another Member can be taken except in accordance with the provisions of GATT 1994, as interpreted by this Agreement." On the other hand, a power for a government body to grant subsidies, without more, does not violate the *SCM Agreement* because there is no prohibition on granting subsidies.

5. The so-called mandatory/discretionary doctrine cannot overrule the conclusion reached from an interpretation of the text in accordance with the principles of the Vienna Convention. The Appellate Body has already warned against the mechanistic application of this doctrine and expressly left open the possibility that "discretionary" measures may violate WTO obligations. It has also held that an assessment of the compatibility of a measure cannot end with the conclusion that it is discretionary but must continue with an examination of the effects of the measure.

6. It is true that there exists a presumption of good faith in international law and the so-called mandatory/discretionary doctrine may be a manifestation of it. However, there is by no means a presumption of bad faith when it is assumed that a government or public body will act in accordance with the directions addressed to it in its governing law. It does not matter that it has some discretion not to do so always or systematically, since this discretion must be exercised in accordance with the law

7. If one wants to try to establish a principle about what measures are subject to dispute settlement and which not, the relevant characteristic is, in the view of the European Communities, whether the measure is *normative* in relation to the behaviour covered by the WTO obligation in question. That is, does the measure set out the principles that govern or influence how the WTO Member will act in some situation? If the action of the WTO Member is determined according to principles that are inconsistent with those that it has agreed to follow in concluding the *WTO Agreement*, so that the action will at least in some cases be inconsistent with that agreement, then that measures will be inconsistent "as such" with the *WTO Agreement*.

8. The consistency of a programme with Article 3 of the *SCM Agreement* depends on the rules governing the programme and indeed the purpose that it is designed to achieve. It is not necessary that the programme should lead to an export subsidy in every single case (or even a "representative" number of cases), although the fact that there are some such cases is an important confirmatory element.

9. Whether or not every APRG and every pre-shipment loan will be an export subsidy is not determinative (although the European Communities has demonstrated many such cases). What is determinative is that the rules according to which the scheme operates may provide exporters with a benefit – indeed they are designed to do so. These schemes are only open to exporters and provide important advantages that are not available on the same terms on the market. They both provide exporters with important financing facilities for export contracts in the critical period before (properly so-called) export credits and export credit guarantees become available. Even if exporters do not always use these facilities (when alternative finance is more conveniently available), the availability of these programmes provides assurance that if market conditions were to change, finance from KEXIM would still be available at the pre-established conditions. In this respect, it is important to note that Article 3.2 of the *SCM Agreement* prohibits the *maintenance* of export subsidy programmes, even where they do not result in grants of export subsidies.

10. Turning now to the other "as such" claim – that against the legal framework of KEXIM – let me first say that the European Communities recognises the far-reaching nature of its claim but considers that it is justified in the circumstances. KEXIM is in reality a funding mechanism for directing state resources into the promotion of exports on better terms than commercial banks would offer. It is directed to do so on the basis of its interest rate guidelines rather than at market rates and at below cost rates when "inevitable for maintaining the international competitiveness to facilitate export".

B. BENEFIT

1. KEXIM as such

11. KEXIM as such is a benefit because exporters are provided with a bank that enjoys huge amounts of government money and unlimited state guarantee with a mandate to promote exports and the requirement to disregard market principles where necessary to support the export competitiveness of key Korean industries. The existence of such a body the work of which is not explicitly limited to either market principles or to OECD standards is a very significant advantage for exporters, in particular shipbuilding which is in Korea an export oriented industry.

2. APRG and PSL Programmes as such

12. The possibility of obtaining a preshipment loan involves a tremendous advantage for shipyards because they can then offer tail-heavy payment terms with the majority of the payment delayed until delivery. Contrary to what Korea and Drewry want to make the Panel believe, tail-end schemes have become common in recent years on the shipbuilding market. Tail-heavy payment implies that the payments to the shipyard are not sufficient to fund the cash flow during production and financing will therefore be required. Pre-shipment loans (in the form of credit-lines) enable Korean shipyards to accept tail-heavy payment terms. The provision of this "financial product" provided by KEXIM that is not offered by other commercial banks confers a very significant benefit. The existence of the APRG and pre-shipment loan programmes provide financial and thereby economic stability to shipyards.

3. Individual Grants

13. The European Communities noted that it had adequately rebutted Korea's argument in the second written submission, but wishes to draw the Panel's attention to a pattern that runs through them: Korea's non-cooperation in providing the necessary information to adjust the market benchmark in terms of duration and collateral. The European Communities asked about collaterals as early as the Annex V procedure. Korea did not respond. The Panel gave Korea a further opportunity to submit "internal documentation" concerning KEXIM's review/authorisation of a few transactions,

including worksheets and other documentation showing calculations of the interest rate and other terms, including consideration of collateral". Korea contented itself with providing the minutes of the Board of Director's meeting and noting that "it is not KEXIM's policy to keep and maintain worksheets and similar documents."

Another tactic of Korea to obstruct the European Communities' *prima facie* case on benefit regarding individual transactions is the frequent "clarification" of facts once it realised that it had mistakenly failed to withhold information that could be valuable to the European Communities' case. The European Communities considers that it has done more than making a *prima facie* case and fully rebutting Korea's defence on the issue of benefit by taking full account of any differences in duration and collateral. Korea has not rebutted the EC *prima faci*e case in a substantiated manner, e.g., by selecting some transactions and by providing independent expertise and supporting documents, e.g., on the value of the collateral - but as Korea admits, KEXIM does not keep such materials.

C. SAFE HAVEN

14. Korea does not respond to the EC argument that APRGs and preshipment loans are not export credit instruments envisaged by items (j) and (k).

15. In making APRGs and preshipment loans, KEXIM assumes a risk that relates to the creditworthiness of the domestic exporters. Export credit financing referred in items (j) and (k) however is different in a fundamental respect – it concerns foreign risk. The underlying rationale of these provisions is that domestic banks typically do not have the means of assessing overseas risks of a potential buyer of an export product (or of recovering money abroad). In order to ensure the functioning of a free world market it is essential that overseas buyers have access to financing.

16. The approach taken by the OECD (and WTO) was to harmonise the specific instruments for export financing (guarantees and credits) and to allow the activities of state agencies in this few particular market segment. Korea itself acknowledged that export financing within the meaning of the OECD Arrangement forms only a minor part KEXIM's financial services provided to promote exports.

17. Items (j) and (k) of Annex I to the *SCM Agreement* cannot justify the provision of export subsidies to the producer through additional financing instruments that cover the domestic risk of the producer as provided by KEXIM.

II. ACTIONABLE SUBSIDIES

18. The European Communities has presented *prima facie* evidence demonstrating that Korea has provided actionable subsidies to its shipbuilding industry, and has rebutted Korea's contentions to the contrary. In particular, the European Communities has demonstrated that public bodies and entrusted or directed private bodies have made financial contributions to three Korean shipyards that provide a benefit, and that these subsidies were specific within the meaning of the *SCM Agreement* and caused serious prejudice to the European Communities' interests.

A. FINANCIAL CONTRIBUTION

19. The European Communities has demonstrated that that KEXIM, KAMCO, KDB, IBK, KDIC, and BOK were public bodies that acted pursuant to government policy when participating in the corporate restructurings. We have explained that these bodies are subject to government control beyond ownership, pursue public policy objectives set by the Korean Government, and are entitled to unlimited governmental guarantees of losses. We have also shown that entrusted or directed private bodies involved in the restructuring provided financial contributions to the three Korean shipyards.

20. The European Communities has provided evidence that the financial institutions involved in restructuring of the shipyards were unable to act independently, including the following:

- letters from the Korean Government to the IMF indicating that public funds would be withheld from banks that did not participate in corporate restructuring;
- acknowledgement by a Korean bank that the Government's influence would cause it to make loans that it otherwise would not;
- a signed commitment by banks to participate in restructurings;
- Government decrees requiring bank participation in financial stabilisation;
- an explicit Government policy of supporting failing companies through debt for equity swaps; and
- statutory limits on the discretion of banks to make decisions relevant to the restructuring.

21. The EC has demonstrated that the Korean Government leveraged its multiple roles as decision-maker, legislator, executive, regulator, shareholder, capital injector, guarantor, and lender to ensure that credit was provided and debt was forgiven for the failing shipyards.

B. BENEFIT

22. The European Communities has presented reasonable market benchmarks to measure the benefit of these financial contributions to the Korean shipyards. This benchmark is based on the conduct of investors outside the reach of the Korean Government's tremendous influence. It showed that the Korean shipyards received a benefit because they paid less to be relieved of their debts to domestic creditors than they would have under fair market terms.

23. With respect to Daewoo, the European Communities logically compared the value of the debt with the value of the equity, which was based on the opening price of the Daewoo-SME stock on the first day of trading. This comparison, which is the closest market benchmark available, shows that creditors swapped debt for equity and did not receive market return. The European Communities has also provided additional evidence to reinforce the benchmark based on an Australian company's offer to purchase the company.

24. Daewoo's creditors (public bodies and entrusted or directed private bodies) conferred a benefit on Daewoo by paying too much for their equity. The change of ownership, therefore, was the subsidy. The creditors of Samho-HI/Halla-HI, on the other hand, once they became equity holders in the shipyard, conferred a benefit by accepting too little for their equity when they sold to Hyundai-HI. In addition to conferring a benefit, this transaction did not extinguish the benefits from the subsidies.

25. Korea erroneously asserts that the European Communities failed to account for debt repayments by the shipyards when calculating the net value of the benefit. With respect to Samho-HI/Halla-HI, for example, there was no debt repayment until the corporate reorganisation concluded in September 2000. As for Daewoo, the plan provided a grace period until the end of 2002. Indeed, because the benefit is composed primarily of the debt-for-equity swap and the negative net asset value of the remaining company, there was no reason to take into account the amount of debt repaid.

26. Korea erroneously argues that the actions of KAMCO, in purchasing non-performing loans of foreign creditors at higher prices than those of domestic creditors, are irrelevant to the benefit analysis. This disparate treatment shows that domestic creditors demanded less for loans than the

foreign banks because domestic banks were influenced by the Government. Moreover, the purchase and anticipated purchase of these loans from Daewoo's creditors, for example, cleansed the creditors' balance sheets in a manner that would not have been possible absent KAMCO's actions.

27. In addition, Korea has failed to rebut the EC's evidence that Daewoo benefited from a specifically targeted tax exemption valued at KRW 236 billion.

C. SERIOUS PREJUDICE

28. The European Communities has shown that the subsidies to the Korean shipyards have caused serious prejudice to the European Communities' interests by causing significant price suppression and price depression in the same markets. In response, Korea submitted a report by its consultant, Drewry Shipping Consultants ("Drewry report"), which attempts to prove that:

- Korean and EC yards do not compete;
- commercial ships are so different from each other that a meaningful economic comparison between products is not possible;
- price suppression and depression do not exist in the relevant product markets;
- past price developments are not related to Korean subsidisation; and
- Korean yards are more competitive than EC (and other) yards.

29. Careful scrutiny of the Drewry report, however, reveals that it:

- provides a large quantity of irrelevant information and data;
- represents the European Communities' positions in a subjective and biased manner;
- bases the like product analysis entirely on the end use of vessels, despite the fact that this end use frequently changes over the lifetime of a ship, and its like product analysis fails to appreciate the necessity for a supply side perspective;
- uses multiple contradictory analytical methodologies;
- basically denies that an analysis of real shipbuilding costs is possible; and
- contradicts itself and Drewry's own prior analysis of the shipbuilding market.

1. Same geographical and product market

30. The European Communities has demonstrated that the reference to "the same market" in Article 6.3(c) of the *SCM Agreement* refers to both the same geographic market (i.e. the world market in the case of shipbuilding), and the same product markets.

31. As for the geographic market, even Korea's own expert report acknowledges that ships are built "in a world market under open market competition."

32. With respect to product markets, the European Communities has presented evidence showing that (a) LNGs, (b) container ships, and (c) product/chemical tankers (not including pure chemical tankers) are three discrete product markets. Korea has failed to rebut the relevance of these

categories, but continues to argue that the existence of different sizes of ships necessitates a further subdivision of the product market.

33. As with the product definitions in the context of an anti-dumping or CVD investigation, claimants under Article 6.3(c) of the *SCM Agreement* must be accorded a certain degree of flexibility. As long as the complainant identifies markets or products that are reasonable and coherent, the Panel should accept that definition. The Panel should reject the complainant's proposed definition only if it would make a market analysis impossible. Far from impossible, the European Communities' product market definition is used by a number of market analysts, including Drewry itself.

34. Moreover, unlike lost sales claims, there is no need to demonstrate head-to-head competition in price depression or suppression claims. This is especially true in the shipbuilding industry, where the price is set at the time that a ship is ordered, rather than after a product has already been produced. As long as a company is capable of offering to produce a ship, it does not matter whether it has produced that ship in the past.

35. Korea's narrow product market definitions contradict reports from the leading experts in the commercial shipbuilding industry. It is obvious that ships, as made-to-order products, will show variations in size and specifications. But shipbuilders can easily accommodate these variations in the course of their normal business. From a technical point of view, all commercial vessels share the same key product characteristics. They have a welded steel hull and superstructure, they are powered by similar types of engines; they have to fulfil the same navigational and regulatory requirements; and they are subject to the same principal construction rules put forward by the classification societies.

36. Although it is not necessary to demonstrate the existence of head-to-head competition, the European Communities has shown, as do Korea's own tables, that EC and Korean shipyards often do sell ships in the same product markets.

37. Without justification, Korea has requested adverse inferences based on the European Communities' alleged failure to produce detailed information about the many EC shipyards that produce vessels within the scope of the dispute. The European Communities did in fact provide sufficient evidence to the panel, but, aside from this, the request for adverse inferences is inappropriate, because the claims do not require proof of head-to-head competition, but only that prices have been suppressed or depressed at the stage of bidding.

38. Drewry's attempt to support Korea's position that EC yards are concentrating on different vessels is undermined by the realities of the industry and by Korea's own arguments in this case. Indeed, the orderbooks of Korean yards show that they, like the major EC yards, are universal yards. Drewry's own tables and statistics thus reveal that Korean and EC shipyards build vessels in the same markets.

39. In addition, Drewry argues that the product market is highly segmented by exaggerating differences on the demand side of the market (i.e. end uses and ship specifications) and ignoring similarities on the supply side (i.e. the capability of modern shipyards to produce a wide variety of vessels). This argument, however, is contradicted elsewhere in the report where it speaks of standardised ship types with regard to container ships and LNG carriers, and ships built on market speculation or "commodity vessels". Ships cannot be commodities on the one hand and too specialised to compare on the other.

2. Price Depression/Suppression and Causation

40. The European Communities has already demonstrated that the Korean subsidies have caused significant price depression and suppression of LNGs, and significant price suppression of container ships and product/chemical tankers. Based on this evidence, the European Communities has shown

that, but for the massive subsidies, the tremendous overcapacity maintained by the Korean shipyards would have been significantly reduced. Such a reduction in capacity, given the large market share of the restructured Korean shipyards, would have had a significant effect on prices in the three product markets at issue.

41. Korea fails to acknowledge the common sense approach to finding adverse effects of subsidies, which is reflected in Articles 6.1 and 6.2 of the *SCM Agreement*. It is, for example, a basic principle of economics that the maintenance of capacity will lead to lower prices (all other variables being constant), or that direct forgiveness of large debts will affect prices by reducing the producer's costs. The *SCM Agreement* does not require the Panel to perform complex calculations that will yield obvious results.

(a) Korean shipyards have influenced world market prices

42. In order to conceal the true market share of the three Korean shipyards in question, Korea and Drewry assess market share according to the number of ships ordered and produced rather than the combination of physical size and work content (expressed in compensated gross tonnes (CGT)) of ships ordered and produced, which is the standard industry method. Because Korean yards tend to produce ships at the upper ends of the relevant size ranges, Korea's method understates their market share. The European Communities' use of CGT to measure market share follows the practice of the OECD, as well as the Korean Shipbuilders' Association and Drewry, themselves.

43. Measured according to size and work content, the three shipyards primarily at issue in this dispute together account for about one-third of the orderbook in Korea and twelve percent of the global orderbook. By way of comparison, the volume of orders in the three Korean shipyards alone is equivalent to ninety percent of the orderbook of all the Chinese shipyards and seventy-five percent of the orderbook of all EC shipyards. With this level of market share, there is little doubt that the three Korean yards exercise considerable influence over world prices.

44. The influence of the three Korean yards on world prices is even greater when viewed in the context of the specific product markets, which have a small number of suppliers. For example, Daewoo-HI/Daewoo-SME alone accounts for 32 per cent of the global orderbook for LNGs. Daewoo-HI/Daewoo-SME, Samho-HI/Halla-HI, and Daedong/STX are three of the five Korean shipyards that collectively control nearly two-thirds of the market for LNGs. Samho-HI/Halla-HI accounts for 7 per cent of the global orderbook for container ships, and, together with its parent, the Hyundai group, accounts for 33 per cent of the orderbook. Daedong/STX and Samho-HI/Halla-HI are two of four Korean shipyards that control 60 per cent of the market for product/chemical tankers. These statistics and other evidence provided by the European Communities demonstrate that the three Korean shipyards have a large enough market share to exercise significant influence over the world price of tankers, containership, and LNGs.

(b) Temporal link

45. Korea's arguments about the absence of a temporal link between the subsidies and the price effects ignore the fact that pressures on price in the shipbuilding industry are first felt when price offers are presented, and well before a contract is actually secured. This bidding usually takes place several months or even more than a year before the contract is signed. Moreover, there is generally a lag of some years between taking an order and building the ship. Many of the orders taken by Korean shipbuilding in 2003, for example, are for delivery in 2007 or 2008.

(c) Specific effects of the restructuring subsidies on prices

46. Simply stated, the subsidies enabled the shipyards to remain in operation and gave them economic stability in a particularly cyclical and unstable business. Drewry itself stated in a 1999

report that Korean yards were almost solely responsible for increases in capacity and that investments in these yards were viable only as long as the companies did not face the true cost of borrowing (the banks did instead).

47. Korea also confirms through Drewry's report that shipyards with overcapacity tend to offer low prices, a factor that lies at the base of the European Communities' assessment of the problems in the world shipbuilding market.

(d) Assessment of shipbuilding prices and costs

48. The European Communities has presented accurate and comprehensive information regarding the various factors that influence shipbuilding prices and costs. Korea, by contrast, fails to take account of overhead costs, or the depreciation and interest charges. The European Communities' evidence of the rising costs of ship production for the three Korean yards is based on consideration of all relevant costs, and accounts for the cost-advantages enjoyed by those yards. The European Communities and FMI stand by the results of their cost modelling and market and price analyses; all efforts by Korea to disprove these results have failed.

49. With respect to prices, Drewry fails to refute directly the price indices offered by the European Communities for each of the three product markets. Instead, Drewry argues that it is impossible to derive meaningful price indices for these product markets, even though Drewry uses these very same indices in chapter 8 of its report and in its own non-commissioned works. The European Communities has shown that a convergence of the following three factors should have caused shipbuilding prices to rise (in the case of product/chemical tankers, container ships, and LNGs) or not to fall (in the case of LNGs): increasing volume, increasing producer costs and high customer earnings.

(e) Valuation of subsidies

50. Although the *SCM Agreement* does not require a complainant to calculate the precise value of subsidies for purposes of demonstrating serious prejudice, the European Communities nonetheless has done so. Korea disputes the calculation of the benefit from the restructuring subsidies to Daewoo, arguing that it improperly looks beyond the liabilities of the core business of shipbuilding. The European Communities' point, however, is that the restructuring would not have occurred if the creditors had acted pursuant to market considerations, and the company would have retained *all* of its liabilities, whether or not related to its "core" operations.

51. With respect to the calculation of benefit to Samho-HI/Halla-HI, Korea disputes the European Communities' stock valuations. In fact, this valuation must be considered correct unless Korea admits that Rothschild made an incorrect valuation of Samho. The European Communities has already explained why Korea's proposed valuation based on net asset value is inadequate and further notes that no consultant has ever used this methodology to value shipyards.

52. Korea's reference to the long-term benefit of investments in facilities is a red herring, because Korean shipbuilders made no such investments after 1996. Based on investments in tools, machinery, and equipment for ships, it is reasonable to assume that the subsidies granted after 1997 had a useful life of about 10 years.

53. Korea fails to rebut the European Communities' argument that KEXIM pre-shipment loans and APRGs contribute to over-capacity, and therefore price suppression and depression. Korea states that KEXIM pre-shipment loans were granted for only "a limited number of shipbuilding projects" even though it supplied a list of hundreds of pre-shipment loan transactions in the Annex V process.

54. With respect to Korea's attack of the European Communities' attempt to quantify the value of a KEXIM pre-shipment loans and APRGs, the European Communities has already explained that it made reasonable estimates based on the limited evidence provided by Korea. Even on the basis of the new information on disbursement dates the quantified value remains high.

ANNEX F-2

ORAL STATEMENT OF KOREA

(28 June 2004)

I. INTRODUCTION AND EVIDENTIARY MATTERS

1. Korea is presented at this Second Meeting with a difficult task brought on by the litigation tactics of the EC claiming that it was not required to demonstrate the necessary facts to establish a *prima facie* case. The EC claims that a *prima facie* case can be based on simple assertions of facts that do not need to be proven if undisputed by the respondent. Hence, all a complainant would have to do is to make allegations which would shift the burden to the respondent to rebut them. Only then would the complainant need to adduce any evidence to support its claims. The EC further argued at the First Meeting that it need not demonstrate elements of its case that it considered "obvious", but then refused to identify just which elements those were.

2. The EC's position could not be more contrary to the jurisprudence of the WTO. This is summarized by the Appellate Body statement in *US – Wool Shirts and Blouses* to the effect that "[W]e find it difficult, indeed, to see how any system of judicial settlement could work if it incorporated the proposition that the mere assertion of a claim might amount to proof."

3. Following from its legal proposition regarding the burden of proof, the EC provided a virtually fact-free First Submission and oral presentation at the First Meeting. This forced Korea, arguing in the alternative and in response to Panel questions, to provide a considerable amount of argumentation and facts. Only then, did the EC submit a large number of new arguments and supporting "facts" in its Second Submission. This left Korea with the task of presenting rebuttal data at the Second Meeting in response to EC material that should have been provided at earlier stages of the dispute to support establishment of the EC's *prima facie* case in accordance with WTO rules and jurisprudence. Korea has responded as thoroughly as possible with arguments in the alternative, while reserving all of its rights regarding the burden of proof, due process and the Panel's Working Procedures. Korea specifically recalls the Appellate Body findings in *Japan – Agricultural Products II* and *Chile – Price Bands* to the effect that the Panel is not to use its investigatory powers to make the complainant's case for it nor to answer affirmatively claims that have not been effectively advanced by the complainant. Particularly in light of the difficulty of benchmarking during the period of the financial crisis, Korea also recalled the reasoning of the panel in the *US – Section 301* dispute to the effect that, if faced with a situation where the arguments of two parties left it in uncertainty or equipoise then, logically, the proper allocation of the burden of proof would mean that the benefit of the doubt would go to the respondent.

4. It is useful to step back and look at what is really going on in the shipbuilding markets -- recognizing, of course, that it plays out somewhat differently for each product. If there is indeed a problem with subsidies, it is with the EC that has splurged hundreds of millions of euros of subsidies of all forms. The EC Commission acknowledges in its periodic shipbuilding reports that EC subsidies have actually caused significant overall harm to the EC industries. In contrast, Korea has built a vibrant set of shipbuilding industries that compete fiercely but fairly based on efficient, flexible labour and a vastly lower cost structure. All of the trend lines the EC refers to concerning the competitiveness of the Korean industries are in existence from the late 1980's and early 1990's. There is nothing new and different about the period 1997-2001 except that the whole Korean economy went through a terrible financial crisis that spread out of Southeast Asia and nearly brought

the whole country to its knees. In this financial crisis, the EC has seen an opportunity to extract a competitive advantage that it could not through competition in the marketplace.

5. Regarding the issue of "public bodies", Korea agrees with the EC that the question of government ownership can be a good starting point. However, the EC has developed a non-treaty based test that is little more than variations on the theme of government ownership. In order to properly define the term, the obvious place to start is the treaty text itself. It sets up three categories of entities. At one end of the spectrum are the organs of government themselves. This would be something such as the Finance Ministry, for example. At the other end would be unarguably private entities. In between these poles exists something else referred to as a "public body" and the question becomes how to evaluate this term. The first point is that public bodies and the government are grouped together. Indeed, they are collectively referred to as "the government" in Articles after Article 1.1. As Korea has noted, the obvious implication of this is that it refers to actions that are essentially "governmental" in nature. Moreover, it also clearly implies that there are some actions that such entities can take which are not governmental action. That does not leave any gaps in the overall treaty scheme, despite what the EC alleges, for even if an entity is not considered a public body for purposes of the measure at issue, there is still the possibility of demonstrating that the government entrusted or directed the actions in question. Thus, while there is no gap in coverage, there is a distinction in the manner of proof. And this is where the EC ran into trouble for it has no evidence at all of entrustment or direction by the government.

6. For purposes of providing interpretative guidance, Korea refers the panel to Articles 4, 5 and 8 of the International Law Commission's Articles on State Responsibility that were commended in a December 2001 Resolution by the UN General Assembly to the membership for consideration. These three Articles provide a close parallel to the language of Article 1.1 of the SCM Agreement. In particular, Article 5 refers to entities empowered by a State's laws to exercise governmental authority; it further notes that a measure at issue will be considered state action only to the extent it was taken pursuant to such authority. The Commentaries to the Articles note that this was meant to cover para-statal entities that act in place of the organs of state. Thus, the Articles outline a two stage test that corresponds closely with the logic of the treaty language. Korea also noted again that this approach was consistent with the definitions provided in the GATS Annex on Financial Services. Korea also pointed out that the EC had presented its arguments against KEXIM and then applied them *mutatis mutandis* to the other government-owned banks, thereby improperly lumping everything together; this clearly did not satisfy the EC's burden of proof.

7. Regarding "private bodies" acting on entrustment or direction of the government, Korea noted that the EC continued to make a straw man argument regarding the admissibility of circumstantial evidence. Korea agrees that circumstantial evidence is admissible, but specifically noted that the legal probity of such evidence was suspect the further it got away from direct evidence. The real issue was whether the evidence of whatever type demonstrated conclusively that there was explicit and affirmative entrustment or direction by the government to the private entity in question to take the measure at issue. This is the logic of the findings by the panel in *US – Export Restraints*. Korea noted that the EC expressly rejected this idea and proposed a test based on what it referred to as "general direction." Korea further noted that even under this test, the EC's "evidence" was mere inference and stereotyping.

8. With respect to the issue of timing of alleged subsidization, Korea noted that the EC was once again setting up a straw man to knock down rather than addressing the real issues at hand. Korea was not arguing that older data was not admissible or that there was some sort of legal bar to discussing it. Rather, the issue was one of evaluating the evidence. In this regard, it was clear that the period of the financial crisis was *sui generis*. Korea's concern is that the EC was attempting to take advantage of the financial turmoil during this period to extract a competitive advantage that it could not in the marketplace. Specifically, the EC was comparing factors from outside that period with factors from that period. This was illogical and impermissible. Moreover, the EC was attempting to take

advantage of the difficulty of establishing benchmarks during such a period to argue that *any* governmental activity during the period was a subsidy. Korea recalled that the burden was on the EC as complainant to establish and demonstrate appropriate market benchmarks.

II. ALLEGATIONS OF PROHIBITED SUBSIDIZATION

9. The EC's arguments that the KEXIM Act and the two programmes are *per se* illegal would overturn decades of GATT and WTO jurisprudence regarding the distinction between mandatory and discretionary measures. There is no indication that the Appellate Body intended such a conclusion in the *US – Sunset Review* dispute cited by the EC. Korea again went through the various provisions of the KEXIM Act and described how they did not result in a mandatory requirement of export subsidization by KEXIM. Korea also reviewed the empirical evidence demonstrating how KEXIM always covered its operating costs (which is, in any event, an issue of cost to government and is not relevant at this juncture) and that KEXIM was in competition with other lenders throughout the period of the inquiry. Korea also reviewed KEXIM's methods for setting its rates and demonstrated how they could not be interpreted as requiring subsidies; indeed, they resulted in market-based rates.

10. With respect to the APRG programme, Korea noted that there was a general lack of APRG activity during the period of the financial crisis, and that, as detailed in Response 47 to the Panel Questions, while the APRG rates in Korea prior to the Asian financial crisis ranged from 0.1 per cent to 0.2 per cent, KEXIM doubled or more its overall rate to around 0.4 per cent during the crisis, which is composed of the base rate and the spreads. This increase in rates shows that KEXIM adjusted appropriately to reflect the changed circumstances. In contrast, the EC has cited a couple of isolated instances of APRGs from foreign banks that were not representative. There are two ways that APRGs are procured. The first is selection by the shipyard. In such cases, shipyards select the issuer considering, *inter alia*, the competitiveness of the premium rates proffered and the past transaction experiences with the issuer. In some other isolated cases, the buyer designates the provider of APRGs. Buyers designated a couple of foreign banks right after the onset of the 1997 financial crisis but this practice rapidly subsided as the Korean financial industry regained creditworthiness. These buyer-designated providers generally were not as familiar with the practice and charged higher rates reflecting their ignorance of the companies and the markets. They also followed the standard lending practice of charging country risk premiums which were relatively high during the financial crisis. There also was generally lesser collateral both quantitatively and qualitatively for the foreign banks. The EC admitted that it did not have adequate evidence to support its claims and asked for adverse inferences under the authority of Annex V which is exclusively limited to the issue of serious prejudice. Indeed, this request demonstrated again the abusive nature of the EC's demands during the Annex V process, a matter Korea still requested the Panel to address. In the meantime, the EC's request provided an admission against interest regarding the lack of a *prima facie* case.

11. Regarding the pre-shipment loan programme, Korea noted that the EC had introduced a large amount of new "evidence" regarding its proposed benchmarks. This evidence was not in rebuttal, but was part of the EC's initial *prima facie* case. Therefore, the requirements of due process, WTO precedent and the Panel's working procedures required that it be dismissed. Nonetheless, arguing in the alternative, Korea rebutted the EC's evidence which was based on bond indices. Korea noted that the bond indices were distinct in a number of ways.

- Despite the fact that the KSDA data for 6 month corporate bond yield rates are available, the EC has intentionally taken 1 year corporate bond yield rates and made distorted adjustments to make them allegedly comparable to the 6 month corporate bond yield rates;

- The EC misapplied the value of Yangdo Dambo collateral;

- The EC misapplied the credit rating for DHI/DSME;

- The EC failed to adjust Samho Heavy Industries' pre-shipment loan rates for the 100 per cent physical collateral provided; and

- The EC failed to consider the fair value of the other relevant factors that have substantial security value and mitigate the risk for KEXIM's pre-shipment loans.

12. Korea noted, moreover, that as the financial crisis ebbed, the instruments the EC offered and the pre-shipment loan rates converged as the underlying economic issues meant that they were more closely comparable.

13. Regarding the issue of safe havens, in Korea's view it was quite clear from the Appellate Body's statements in *Brazil – Aircraft (Recourse to Article 21.5)* that such safe havens existed. Unlike the EC, Korea does not consider it appropriate to disregard the Appellate Body's clear language. The EC has rejected the Appellate Body's argument with respect to item (k) first paragraph on the basis that Annex I is an Illustrative List and therefore a non-exhaustive list cannot provide a safe harbour. However, the EC then seems to forget this and argues that item (j) does provide a safe harbour. Purportedly, this is because item (j) contains a "proviso", but that distinction remained unexplained. The EC also contended that item (k) was exclusively in reference to the OECD. Aside from the fact that the OECD is not mentioned, its relevance was limited to the exception of the second paragraph of item (k) and could not be read as defining the broader rule of the first paragraph. In Korea's view, there is either an *a contrario* reading of footnote 5 that leads to safe harbours in both item (j) and item (k), first paragraph, or there is not an *a contrario* reading. There is no logical or treaty-based, linguistic way of splitting the interpretation between the two.

14. Korea also noted that there was no basis in logic for distinguishing between the legality based on who receives the benefit. While the EC has claimed that this was a settled matter in the OECD, that was not the case. Other OECD members had raised concerns about not being so formalistic as to create loopholes. Moreover, Korea noted that the EC was explicitly separating item (j) from the OECD. Furthermore, as noted above, there was no legitimate basis for reading OECD requirements into the first paragraph of item (k). Korea had presented ample evidence to demonstrate, as an argument in the alternative, that the APRG and pre-shipment loan programmes satisfied the requirements of item (j) and (k) in such manner as to qualify for the safe havens.

III. ALLEGATIONS OF ACTIONABLE SUBSIDIES

A. GENERAL MATTERS AND RESTRUCTURINGS

15. One of the issues of continued disagreement between Korea and the EC is whether or not a panel can make simultaneous findings that one set of measures are both prohibited and actionable subsidies. In Korea's view, the unique nature of actionable subsidies claims where actual adverse effects must be demonstrated requires a negative answer because otherwise there will be double-counting of subsidies. Korea notes that the EC asks the Panel to ignore Article 7 as the issue of remedies is not before the Panel. However, Article 7 is part of the context of Articles 5 and 6 and indicates the unique nature of Part III of the SCM Agreement. Article 7.8 states that the remedy can be either removal of the adverse effects or withdrawal of the subsidy. This possibility of removal of the adverse effects is unique in the sense that everywhere else the requirement is bringing the measure into conformity with WTO obligations.

16. In light of this, it is important to look at what happens when there is determination of prohibited subsidization. In such situations, if an export subsidy is found to exist under the terms of Part II of the SCM Agreement, then the only remedy, according to Article 4.7, is withdrawal without delay. Therefore, such subsidy would already be required to be removed by operation of law. If a

panel were, nonetheless, to consider the effects of such a subsidy under Part III, it raises the possibility of an affirmative finding with respect to the other subsidies which might not be, on their own, causing adverse effects. In effect, the remedy under Article 7.8 would already exist. So, this becomes an empty exercise and one that is contrary to the very nature of Part III where there is not to be an affirmative finding unless the subsidies at issue are causing adverse effects.

17. Regarding the restructurings themselves, Korea demonstrated the following:

- The EC has failed to show that the banks are public bodies for purposes of the subsidy analysis

- The EC has created a new standard for direction and entrustment and – by any standard – has failed to show how the Government of Korea directed or entrusted the banks to subsidize the shipyards.

- The EC has failed to show how a financial contribution was provided to the shipyards when debt was switched for equity.

- The EC has failed to show how a benefit is provided to a company through a bankruptcy or corporate restructuring proceeding.

- If there was a benefit, the EC has failed to show how this benefit carried through to the new owners of the companies.

- Finally, the EC has failed to show how the bankruptcy or corporate reorganization proceedings were specific to the three yards.

18. Regarding the issue of benefit in light of changes of ownership, Korea notes that there was nothing in the theory of changes in ownership that the Appellate Body and panels relied upon that limited the decisions in the previous cases to privatizations. Indeed, the Appellate Body was quite clear that privatization was only one example of the theory and, in fact, the one instance where change of ownership was least likely to result in extinguishment of the benefit. In the present case, the net debt was owned by the previous owners who were all wiped out, or virtually so. At that point, the creditors have control of the company. They have effectively written off that net debt and the loans are re-valued accordingly. This is why Korea has spoken about the change in form rather than a change in value. As a result, there can be no financial contribution when the instrument does not represent any change in value. Furthermore, even if this were considered a financial contribution, there is no benefit, because the creditors (i.e., the new owners) received nothing of greater value than what they had before. The EC's response here is to focus on the alleged benefit to the productive assets themselves, not the persons holding such assets. For example, the EC states that the assets would not have continued in existence but for the alleged subsidy. Of course, this is directly contrary to the findings of the Appellate Body in *US- Lead Bars* and *US -- Countervailing Mea*sures where the Appellate Body rejected this "but for" argument when it was presented by the United States in those cases.

19. Moreover, the EC in general has offered the Panel its own example of how to do workouts and insolvencies. The EC claims that they must be accompanied by permanent capacity reductions. This does not seem to be the case with the East German shipyards or those of the acceding EC countries. There have been no permanent facility shutdowns in those yards. Furthermore, there is no indication whatever of capacity or production constraints in the recent case of the Alstom bankruptcy. Indeed, all that is evident on the record is the continued generous subsidization of all of the EC shipyards.

20. **Regarding DSME**, the EC has alleged that the Korean government "controlled" the process. However, even if the panel were to agree that mere government ownership of several Korean banks made them public bodies, these entities did not control enough of the outstanding credit to control the process under the prevailing arrangements. The EC also refers to the alleged "control" that the Government of Korea had over all of the banks during the financial crisis. However, despite the EC's repeated attempts to get the IMF to support the EC's point, the evidence is conclusive that the restructuring of the financial sector pursuant to the agreement with the IMF was done on market principles and banks restructured their bad loans to maximize value. Thus, any influence of the government had exactly the opposite effect that the EC alleges. The sole piece of "evidence" the EC proposed regarding alleged improper influence was revealed by Korea's provision of the full quotation by a single Korean bank to be a reference to the real estate sector and even that was specifically noted by the bank's lawyer not to refer to even the general point the EC was alleging.

21. Regarding the issue of benefit in the DSME restructuring, the EC offered a report by its consultant, Price Waterhouse Coopers (PwC) critiquing the workout report done by Anjin, the former Korean affiliate of Arthur Andersen. A response by the authors of the Anjin Report as well as an independent retired senior British banker, Mr. William Lawes, confirmed that the Anjin Report was objective and fair; it was commissioned for the purpose of determining the best commercial, value-maximizing solution to the insolvency of DHI resulting from the credit crunch brought on by the Asian financial crisis. Anjin was required by the terms of its contract to act in an objective manner and there is absolutely no evidence of any sort that it did not do so. Anjin was not directed to come up with any particular answer, but provided an independent opinion as to the relative values of the available options. Mr. Lawes found that the Anjin Report was appropriately done, took into consideration all of the appropriate facts and was overall consistent with just the sort of evaluation that would be expected on the part of banks utilizing the "London Approach" to maximize value in situations of corporate insolvency. Mr. Lawes also confirmed the logical point that the foreign-owned banks were in a fundamentally different circumstance and had every incentive to take a better short term deal but with less long-term potential. Such a decision led to negotiations to sell their debt for as high an immediate payout as possible to those domestic banks, who had more at stake and more time and inclination to follow the workout route which could lead to a greater potential recovery over time. Again, the bargain for a residual amount of warrants demonstrates that the foreign banks recognized this trade-off.

22. The EC continued to argue that the debt-equity somehow "cleansed" the balance sheet of DSME despite the fact that the new owners were the old creditors making it impossible to see what exactly was cleansed. Any further debt could not have resulted in any changes in the debt equity swap as the players and the value were both the same under either scenario offered by the EC. The EC also pointed to the purchase of debt by KAMCO as cleansing the balance sheet. However, it was irrelevant to the balance sheet of DSME for it only resulted in a change of creditors, not a reduction of debt.

23. The EC also challenged the valuation done by Anjin given the allegedly low price offered for the stock of DSME by an objective foreign bidder. The EC referred to newspaper reports of a bid by an Australian company, Newcastle Heavy Industries. Korea rebutted this allegation by showing that NHI actually offered a substantial premium over what the EC alleged.

24. Regarding specificity, the EC's argument was little more than an allegation that the size of the Daewoo group meant that the restructuring was specific. However, the workout approach was broadly available and Korea had earlier submitted evidence demonstrating that a great number of companies availed themselves of the approach. Size alone does not render a procedure specific.

25. Regarding the alleged tax subsidies in the case of the DHI spin-off, there was no valuation gain or profit because the DHI assets were simply allocated at "book value" to the two spun-off companies and the remaining DHI. Therefore, because the assets were simply moved from one entity

to another there was no taxable event and no forgoing of any government revenue that was otherwise due. Therefore, Article 45-2 did not confer a benefit. Korea noted that the numbers the EC presented were taken exclusively from a newspaper report and that was not sufficient evidence. Moreover, the number the EC alleged was with respect to all of DHI and did not reflect any allocation between the divisions. Korea further demonstrated that the tax laws in question were not specific to the DSME transaction. If they had been, there would have been no reason to extend them for a further two years after the DHI spin-offs. As noted above, Article 46 of the Corporate Tax Act mandates specific tax treatment with respect to "gain" or "profit" realized to the spun-off company as a result of the "valuation" of assets conducted in the course of spin-off.

26. **Regarding the Samho restructuring**, Korea noted that the EC seemed to drop any reference at all to the role of the judges in the transaction. The reorganization proceeding cannot start unless the court determines that the going concern value of the subject company is greater than its liquidation value. If such is the case, the court has the power to order a receiver to submit a reorganization plan based on the continuation of business activities of the company concerned. If the plan submitted does not conform the provisions of the Corporate Reorganization Act or is unfair, unequal or not feasible, the court may decide not to refer the plan to the meeting of the interested parties for resolution. The court also has the authority to approve or reject the plan adopted by the interested parties. In sum, it is the court that decides whether to permit the subject company to continue its business operations. In order to establish that the court receivership, and any transaction done within the context of the court receivership, was not done at arm's length or conferred a benefit, the EC needs to show that the judge in this instance did not do his job, that he failed in his legal and fiduciary responsibility to maximize the return on the debt to the creditors. The EC has presented no such evidence. None exists.

27. The EC contradicted its approach to the DSME workout where the EC alleged that the new owners overpaid, by now arguing that the new owners of Samho underpaid. Of course, once again, the real answer is that facts do not support the EC's allegations regardless of which of their contradictory approaches they choose. In the case of Halla/Samho (as with Daedong/STX discussed later), the court determined that the going concern value was greater than the liquidation value and decided to proceed with the corporate reorganization. This court decision was based on the valuation by Rothschild, a financial advisor, and on Rothschild's corporate reorganization proposal which was drafted to maximize the debt repayment to the creditors. Moreover, among the many factual errors in the EC allegations was the basic point that the EC neglected to include the assumption of debt in the purchase price of Samho.

28. Regarding the issue of specificity, the EC argued that if Article 1.1(a) is satisfied because there was a financial contribution pursuant to government action and that Article 1.1(b) was satisfied in that a benefit has been demonstrated, then Articles 1.2 and 2 regarding specificity are *automatically* satisfied. That is, the EC reads Articles 1.2 and 2 completely out of the SCM Agreement. Obviously, the Panel cannot adopt an interpretation of the treaty that reads whole provisions as nullities.

29. **Regarding STX**, the EC argued that the sale of the company by the bankruptcy court was improper because it was sold to a Korean company. In an unfortunate instance of stereotyping, the EC claimed an "inherent defect" on the part of any Korean company. Korea demonstrated that the sale pursuant to a Recommendation Report by KPMG went to the highest bidder out of five. Of the five, two and perhaps three were non-Korean companies. The EC then reverted back to its unsupportable argument that *any* result from insolvency other than termination of the company and selling it for scrap was a benefit. Regarding specificity, the EC made the same incorrect arguments that it did with respect to Samho whereby the step of determining specificity was automatically satisfied by a finding of government involvement and benefit.

B. SERIOUS PREJUDICE

30. There is a basic disagreement between Korea and the EC on the issue of whether there is a need for the complainant to demonstrate serious prejudice. According to the EC the treaty contains a very mechanistic test. If any *one* of the elements of Articles 6.3 (a), (b) or (c) is shown, then the serious prejudice element of the case *automatically* is satisfied. The complainant need show nothing more. Essentially, the case is over. Of course, this approach requires reading out of the treaty some very important words. The chapeau of Article 6.3 provides that serious prejudice *may* exist when *one or several* of those elements are demonstrated. The EC reads the word "may" to mean "shall". Indeed, the EC really is replacing it with something more; it is really saying "shall be deemed to exist" because once again the EC is trying to create presumptions as substitutes for proof. It is worth noting that the EC interprets the term "may" in much the same way as it interprets the term "shall" from the now-expired presumption-creating provisions of Article 6.1. Next, the EC reads the "or several" out of the text. If any *one* element were enough to lead to an *automatic* and necessary conclusion of serious prejudice, why would there ever be a purpose in demonstrating others? Of course, there would not be. The words "or several" would be totally superfluous.

31. The EC attempts to eliminate the word "serious" from the treaty text. The EC's only attempt to respond to Korea's reference to the extensive jurisprudence that confirms that "serious" indeed connotes a higher standard than "material" is to jumble up Articles 5(a) and 6.3(c). Similarly, the EC attempts to read out of the treaty the term "prejudice". As Korea has noted there is no basis for reading the term prejudice as somehow lower than the term injury. In Korea's view, the term "interests" refers not only to the state of the complaining party's industry, but also to something more. The term "interests" is a broader term. Simply put, a complaining Member should not be permitted to potentially adversely affect the terms of sale in third country markets of other Members in this fashion unless it can show that its broader interests are seriously negatively affected.

32. Even more surprisingly, the EC maintains that it does not have to establish like product categories. Korea considers it fundamental to the treaty structure and plain logic that like product categories must be established by the complainant. Unless the complainant does so, there is simply no coherent manner of discussing the elements of the case. The EC argues that Korea's reference to like product in Article 15.2 of the SCM Agreement and Article 3.2 of the Antidumping Agreement is misplaced because those provisions refer to like products in *imported* markets. This argument seems to have been pulled from the air, for it is quite illogical and has no basis in the treaty. The EC fails to explain Articles 6.3(a), (b) and (c), as well as 6.4 and 6.5 which all refer to like products and none of which involve importation into the complaining Member's market.

33. The EC has built its whole case on an argument of price suppression or depression due to capacity issues. However, how can one discuss either capacity or price suppression or depression without rigorously defining markets? Capacity in what products causing price suppression or depression of what products? The EC only provides a bunch of charts of shifting product groups (for instance, at various times the EC has endorsed the Japanese suggestion that there is only one like product category) and even tried to sell the Panel on causation due to a "kink" in a price chart including apparently *all* commercial ships. Is the reason the EC suddenly decided in the middle of the case to exclude pure chemical tankers from the dispute because of the effect on their pricing charts of inclusion of this product? The EC claims that within the product types that it has distinguished (container ships, product and chemical tankers and LNGs) there is no need to further distinguish by size because vessels of all sizes can be substitutable in many instances on all routes. It thus not only contradicts the size differentiations that are commonly made in shipbuilding and shipping trade but also the statement of its own expert that substitution is rarely possible on a size basis because of the economics of trade and that one seventy thousand dwt ship, for example, is not operationally or economically equivalent to two thirty-five thousand dwt ships. The EC's reliance on supply substitutability -- claiming that vessels are merely an assembly of steel and that a shipyard can build any type of vessel -- is hardly understandable and is certainly contradictory with the EC's own

exclusion of all sorts of products from cruise ships to Ro-ro ferries to pure chemical tankers. First, what is a like product must be determined primarily from the demand side based on technical characteristics and their value added for the use of the products as perceived by the user. Second, no single yard in the world claims that it can build all vessels. In reality, EC yards intentionally - well before the corporate restructuring in Korea - concentrated on the smaller like products as well as on high value added niche vessels including cruise ships, ferries or roll-on roll-off vessels. It is equally an arbitrary and broad brush conclusion by the EC to refer to "Korea" in general when the participation of the restructured and non-restructured yards in different like product vessel markets is widely different. This is true all the more in that those like product vessels where there still is some competition between EC and Korean vessels, most, if not all of these Korean vessels were built by non-restructured yards that did not benefit from the alleged corporate restructuring subsidies.

34. Of course, the EC insists on calling it an *over*-capacity issue. This addition of "over" is nothing but an emotive term that the EC hopes will affect the way the Panel views the market. As the EC has itself acknowledged, there is not an agreed upon way of defining capacity in shipbuilding. In fact, there is general agreement the other way, i.e., that there is no universally applicable or unambiguous way of defining capacity. Any existence of capacity will affect the market whether it is from Estonia or Korea. And, of course, the larger the country's industry, the larger the impact of production from that country. Obviously, the EC is trying to direct the case away from the issue of the effect of the subsidies and get the Panel to focus on the effect of the products. If it can do that, then under the EC's approach, the sheer size of the Korean industry today (as should the size of the Japanese industry today or the Chinese industry tomorrow) will result in an affirmative decision without regard to the treaty requirement of linking significant price suppression to the effects of the alleged subsidy.

35. Regarding the EC's allegation of pricing matters, as Korea has pointed out and the EC cannot deny, Korean shipyards enjoy a significant cost advantage over the EC. This has been the case for a long time. This advantage has been accentuated in the past couple of years generally by a still weak Won and particularly by the relative strengthening of the Euro compared to the Won. In spite of this, the EC offered a speculative cost model based on unexplained and unproven assertions. Notwithstanding these estimations and assumptions, the EC is trying to make an *inference* of subsidization based on these speculative projected cost calculations. This would not be acceptable on the part of a domestic authority doing a constructed value determination in an antidumping case; it would be bizarre if used in a countervailing duty investigation and it is wholly unexplained why this Panel in a serious prejudice case should engage in such speculation based on cost modelling and inflation projections that it has not even seen.

36. The EC tries to reassert the abandoned claims of price undercutting. The "evidence" submitted by the EC is factually false. This is illustrated by the Hamburg Sud case where it is shown that the European yard Odense was the price leader. Moreover, it is impermissible for the EC to try to reintroduce previously abandoned claims at this stage. The EC tried to justify this by saying it is not claiming price undercutting as such, but only to support its price suppression arguments. This is mere sophistry. Normally cases are built on interlocking elements of evidence including "one or several" of the factors listed in Article 6.3. The EC rejected that approach and cannot change it, no matter how much it now regrets its earlier decision. Viewing the EC efforts of trying to establish this serious prejudice case on the narrow basis of price depression or suppression due to capacity issues to the exclusion of every other element of proof is like watching an elephant trying to balance on a pin.

37. Even considering that, if the EC's speculative cost modelling projects a uniform effect across the whole of Korean industry, it necessarily follows that the price effects are not from the alleged subsidies, but are instead from the pricing practices of the majority of shipyards that were not restructured. It is illustrative that the EC continues to claim price leadership by non-restructured yard Hyundai Mipo based on the allegation that Hyundai Mipo has benefited from the APRGs or PSLs. However, Hyundai Mipo had only a very limited number of PSLs and APRGs and the amounts of

benefits (if any) were minimal and certainly by far insufficient to explain the price difference of 15 per cent which the EC alleges with the competing Lindenau offer. (Korea also notes that the EC *ad valorem* subsidization across its shipyards is much higher and would need to be considered in any proper causation analysis.) That is, the EC's own approach of lumping everything together based on generic cost/price modelling actually leads to the opposite conclusion of what the EC wishes. Any price effect is not that of the alleged subsidies.

38. One of the many problems here is that the EC is collapsing distinct steps. The treaty text in each of the subparagraphs of Article 6.3 is that the "effect of the subsidy" is to cause one of the possible elements that can be a constituent of serious prejudice. That is, the causation *within* 6.3(c) is not of serious prejudice, but of the possible supporting factors. The treaty clearly states that the EC must demonstrate that the effect of the alleged subsidies is to cause significant price depression or suppression. There is no dancing around these words. Those specific identified subsidies must be actually having an effect themselves of significant price depression or suppression. Other factors may be at play and they may also have price depressive or suppressive effects, but such effects cannot be attributed to the alleged subsidies. Korea must point this out once again because the EC does not even get to the point of separating out the effect of the subsidies and, instead, tries to rely on the effect of the *products*. Only then after that element is established as an effect of the alleged subsidy can the complainant move on to show that that one element listed in 6.3 alone or along with others of the *several* identified elements may be causing serious prejudice. It is axiomatic that other factors causing the prejudice cannot be attributed to the alleged subsidies. This is not only required by the jurisprudence relating to all injury-type inquiries, but it is also mandated by the full contextual analysis of Part III which provides in Article 7.8 that one available remedy is to remove the injury. If there has not been a reliable analysis tracing through from the alleged subsidy having the effect of significant price suppression which, in turn causes serious prejudice, then this analysis is rendered literally impossible.

39. In conclusion, it is clear that the EC has failed to carry its burden of proof, indeed, has misconstrued that burden as a matter of law. Moreover, arguing in the alternative and at the request of the Panel, Korea has adduced substantial evidence on each legal point demonstrating that there is no basis for the EC's claims. Accordingly, Korea requests that the Panel reject the EC's claims under Parts II and III of the SCM Agreement.

ANNEX G

RESPONSES OF THE PARTIES TO QUESTIONS FOLLOWING THE SECOND MEETING AND COMMENTS THEREON

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ANNEX G-1

RESPONSES OF THE EUROPEAN COMMUNITIES TO QUESTIONS FROM THE PANEL

(2 July 2004)

I. TO THE EC

A. KEXIM LEGAL REGIME

Question 128

Does a government necessarily provide a subsidy if it makes a financial contribution outside the normal field of commercial behaviour? Assume a government creates a new special finance mechanism that has never been offered by private banks. Assume that private banks subsequently begin providing the same finance mechanism on the same terms as the government initially offered. Assuming that the finance mechanism constitutes a financial contribution, would the initial offer of that finance mechanism by the government confer a benefit? Please explain.

Response

1. The European Communities notes that the question requires an assumption that the finance mechanism constitutes a financial contribution.

2. In these circumstances, the European Communities believes that the hypothetical measure constitutes a subsidy since it is conferring a benefit in the form of a finance mechanism that is not available on the market. Whether it is a prohibited or an actionable subsidy will of course depend on whether it fulfils the other conditions for this in the agreement (and in particular specificity) and whether any exception or exclusion is available.

3. Once private banks begin providing the same finance mechanism on the same terms as the government, the benefit and hence the subsidy may well disappear. This does not however have any retroactive effect and does not change the fact that a subsidy was provided initially.

Question 129

The EC submits that KEXIM's website describes the PSL programme as designed "to encourage the export of capital goods such as . . . ships . . . involving larger credits and longer repayment terms than what suppliers or commercial banks would provide." Isn't this what any development bank does? Do development banks necessarily provide subsidies? Please explain.

Response

4. It is not clear to the European Communities what the term "development bank" refers to.

5. The first comment that the European Communities would make is that the issue of special and differential treatment of developing countries is not an issue in this case since Korea has not invoked, and could not invoke, developing country treatment.

6. In any event, if a public body of a WTO Member that is a "development bank" engages in *export contingent* lending at preferential rates, it will be providing export subsidies unless an exemption or exclusion under the *SCM Agreement* or another covered agreement is available.

B. APRG/PSL

Question 130

Please comment on Exhibit Korea-87, concerning country risk spreads.

Response

7. Korea submits *Anjin's Opinion on Country Risk Factor in determining APRG Premium Rate* **(Exhibit Korea-87)** to support its contention that "rates of APRGs issued by foreign banks must be higher than those by domestic banks due to the application of country risk premium".[1]

8. The European Communities strongly disagrees with Korea's argument and the opinion set out in **Exhibit Korea-87**. The European Communities submits in response **Exhibit EC-148** with an opinion from *PriceWaterhouseCoopers* which explains in detail that:

> As a consequence, **the risk of providing an APRG to a Korean company in a foreign currency**, as it is the case for most of the APRG's, **is the same regardless of where the bank is based** and thus the country risk of Korea needs to be taken into account in the price:
>
> - as an add-on to cover the transfer risk resulting from the company needing to find foreign currency in the case where a government wants to keep the "strong" foreign currencies;
>
> - as an add-on resulting from the bank's needs to obtain refinancing in the foreign currency.[2]

9. Hence, there is no basis for rejecting the APRG premium rates charged by foreign banks (CITI and ABN AMRO) as market-benchmarks.

10. Korea did not even attempt to provide recalculations of the numerous EC APRG benefit calculations. Indeed, even if Korea was right and 61 points (the "country risk premium" identified on p. 5 of Exhibit Korea-87) could be deducted (*quod non*), the KEXIM rates are still significantly below the foreign bank rates. This is illustrated in the tables below:

[BCI: Omitted from public version.]

11.

12. In short, the benefit demonstrated by the European Communities in comparing KEXIM APRG premiums to those charged by foreign banks and to those extended by domestic banks[3] remain intact.

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[1] Oral statement by Korea at the second substantive meeting with the Panel, para. 80.

[2] Report by PriceWaterhouseCoopers, June 2004 **(Exhibit EC-148)**, para. 3.2 at p. 10.

[3] First Written Submission by the European Communities, paras.170 to 173 and Oral statement by the European Communities at the second substantive meeting, para.36.

Question 131

Why, in its benefit calculations for KEXIM financing did the EC apply the S/M credit rating to DSME for the entire period for which calculations are presented, including in particular the post-restructuring period? Is it the position of the EC that DSME remained uncreditworthy even after the restructuring? Please explain.

Response

13. The European Communities has applied the credit ratings provided by the Korean credit agencies.[4] **[BCI: Omitted from public version.]**[5] In line with its calculation methodology[6], the European Communities, therefore, correctly applied the S/M rating for the entire period covered by its calculations and has never claimed that DSME remained uncreditworthy after the completion of the workout.

Question 132

Please comment on Korea's assertion that the collateral offered in respect of certain APRGs provided by foreign banks "covered only a small portion of the guarantee" (para. 81 of Korea's oral statement at the second substantive meeting).

Response

14. At the outset, it should be noted that Korea nowhere substantiated its assertion with supporting evidence showing the precise amount of the cash collaterals. Instead, Korea gave shifting indications as regards the percentage covered. Thus, in its first written submission, Korea stated that NHIC and CITI extended APRGs in return for bank deposits amounting **[BCI: Omitted from public version].**[7] In its Response to Question 14 raised by the EC, Korea stated that **[BCI:. Omitted from public version.]** In its second written submission, Korea reduced the bank deposit required by NHIC to **[BCI: Omitted from public version]** of the advance payments, again, without explaining the factual change and providing any supporting evidence.

15. In any event, Korea's assertion does not adequately respond to the EC argument that cash deposits offered as collaterals to foreign banks are stronger forms of collateral as compared to Yangdo Dambo.[8]

16. Therefore, the collateral value of the cash deposit must be considered to be at least equivalent with the Yangdo Dambo unless Korea had provided detailed materials and assessments of the respective value of the Yangdo Dambo. However, as Korea stated in response to Panel Questions, KEXIM does not keep such materials.

Question 133

At para. 105 of its second written submission, the EC states that only domestic banks with "government association" provided APRGs to Samho. Regarding Figure 12 of the EC's first written submission, is Chubb a domestic bank? If so, does it have a "government association"? If there is such an association, what is its nature? Please explain.

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[4] Koreas Response to Annex V questions, attachment 1.1(24)-1 **(Exhibit EC-30)**.
[5] First written submission of Korea, para. 362.
[6] **(Exhibit EC-125).**
[7] First written submission of Korea, para. 207.
[8] Price Waterhouse Coopers report on Pre-shipment loans and APRGs, p.15 **(Exhibit EC-118)**.

Response

17. The statement in para. 105 of our second submission refers to the period *before* Samho's restructuring which was completed (according to Korea, on 27 October 1999[9]).

18. Chubb was only referred to with respect to the period *after* Samho's restructuring. The evidence submitted by Korea[10] indicates that on at least four occasions APRGs were extended to Samho by Chubb. The European Communities understands that CHUBB is a global insurance company with no government associations. The European Communities compared the rates offered by Chubb to those provided by KEXIM in its oral statement at the second substantive meeting and demonstrated that KEXIM rates were 50 per cent lower than Chubb's.[11]

Question 134

In Exhibit EC-118, PWC asserts that "[t]he KSDA Bond Matrix is the accepted mark-to-market price for the domestic market". Does this mean that the EC disagrees with Korea's argument that the bond matrix represents hypothetical / projected rates, or does the EC accept Korea's argument but consider that the index nevertheless constitutes a reliable market benchmark? Please explain. What does "mark-to-market" in this context mean? In particular, who was marking what to which market?

Response

19. Yes, the European Communities disagrees with Korea. The KSDA Bond Matrix is not a hypothetical or projected rated, but a reliable market benchmark to assess interest rates for loans. "Mark-to-market" is "the act of assigning a value to a position held in a tradeable financial instrument based on the current market price for that instrument".[12] The KSDA bond matrix does this in the following way :

> Based on the definition provided by Bloomberg on KSDA Corporate Bond, "KSDA collects daily pricing for each sector from 10 major investment banks for tenors ranging from three months to five years. The indices are calculated daily and re-balanced weekly. All such changes are updated weekly in the Index Constituents so you can see the new underlying securities for each sector. Credit rating changes are updated monthly by the KSDA. […] The KSDA Bond Matrix is the **accepted mark-to-market price[6]** for the domestic market" .[13]

20. In short, the KSDA bond matrix is the accepted mark to market price, i.e. that it reflects the **current market price** of bonds, since bond prices and yields are updated daily based on data collected from a wide number of representative local securities houses. As reconfirmed by PriceWaterhouseCoopers:

> This is therefore, the best representation of the yield required by investors at a specific moment in time, on Korean obligations having a specific maturity and a specific rating.[14]

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[9] First written submission of Korea, para 422.
[10] List of APRGs to Korean Shipyards (Attachments 1.2(31)-1-1.2(31)-8) **(Exhibit EC-24)**.
[11] Oral statement by the European Communities at the second substantive meeting, para. 36.
[12] Report by PriceWaterhouseCoopers, June 2004 **(Exhibit EC-148)**, footnote 6.
[13] Report by PriceWaterhouseCoopers, June 2004 **(Exhibit EC-148)**, para. 4.1., p. 11.
[14] Report by PriceWaterhouseCoopers, June 2004 **(Exhibit EC-148)**, para. 4.1.

21. Korea appears to argue that the KSDA bond matrix is "hypothetical and projected" in comparison with interest rates of existing DHI obligations. However, as explained in detail before[15], the corporate bonds actually issued by the yards were not appropriate benchmarks as regards corporate bonds (i) because they were guaranteed by a bank, (ii) were not issued in the same currency or (iii) not issued at the same time as KEXIM's PSLs. As regards other sources of financing, they were not considered as an appropriate benchmark since their rate may depend on the particular relationship between the bank and the debtor.

Question 135

Korea criticizes the EC for having used in its benefit calculations the 1-year bond price index instead of the 6-month index. Why was the 1-year index used? What is the effect on the EC's calculations of using the 6-month index?

Response

22. The European Communities used the 1-year bond price index because it was not aware of the existence of the latter (the KSDA website is in Korean language). The 1-year bond price index was therefore the closest benchmark available to the European Communities, which was then duly adjusted by subtracting the spread between Korean Treasury Bonds 6 months /12 months as provided by Bloomberg and suggested by the Consultant[16] in order account for the difference in duration.

23. As is explained in more detail in our response to Panel Question 136, the European Communities has recalculated the benefit using the 6-months index (**Attachment EC–10**). The re-calculation demonstrates that the difference between the adjusted 1-year bond price index and the 6 months index is negligible and still results in a benefit.

Question 136

At para. 95 of its oral statement, Korea presents a number of points criticizing the EC calculation methodology, and states that further details are contained in Exhibits Korea 90-102. Please respond to Korea's criticism in detail, including with reference to the content of these exhibits.

Response

24. Korea provides five general criticisms of the EC calculation methodology.[17] These are further explained in two exhibits.[18] Korea then provides a "Corrigendum" to the EC calculation of benefit from pre-shipment loans for each of the seven shipyards concerned.[19]

25. The European Communities will first address Korea's general criticisms (Section 1). That section explains (supported by a Report from PriceWaterhouseCoopers) why three of these criticisms (misapplication of DHI/DSME credit rating, failure to consider Samho's collaterals and other factors mitigating Kexim's risks) must be rejected by the Panel. The European Communities will then provide a re-calculation (**Attachment EC-10**) taking account of

[15] Second written submission by the European Communities, paras. 122 and 123.
[16] Price Waterhouse Coopers report on Pre-shipment loans and APRGs, **(Exhibit EC-118)**, p.15.
[17] Oral statement by Korea at the second substantive meeting with the Panel, para. 95.
[18] Oral statement by Korea at the second substantive meeting with the Panel, **(Exhibits Korea 90-91).**
[19] Oral statement by Korea at the second substantive meeting with the Panel, **(Exhibits Korea – 94-100)**.

- the new information on KSDA 6-month bond yield rates;
- the new value of Yangdo Dambo for yards with investment grade ratings (above BBB-);
- a number of unavoidable calculation mistakes or otherwise clerical errors pointed to by Korea in its Corrigendums (Section 2).

26. Section 3 then further comments on Korea's corrigendum and notes that even under Korea's calculation there is benefit.

1. EC Response to Korea's General Criticisms

27. This Section responds to Korea's general criticisms that:

- Credit ratings of corporate bonds assigned by other credit agencies to shipyards are not comparable to the Kexim's credit ratings;
- The European Communities should have used KSDA 6-months rates;
- The European Communities misapplied the Yangdo Dambo;
- The European Communities misapplied the credit rating for DHI/DSME;
- The European Communities failed to adjust Samho's PSL for 100 per cent physical collateral;
- The European Communities failed to consider the fair value of the other relevant factors that have substantial security value

(a) Credit ratings of corporate bonds assigned by other credit agencies to shipyards **are** comparable to the Kexim's credit ratings

28. Korea states that the corporate bond rating and the KEXIM credit ratings are not directly comparable because:

- the levels of underlying credit risk within credit rating by KEXIM and corporate bond rating agencies are different and;
- factors for grading are not alike.

29. The European Communities contests these arguments.

30. One of Korea's main arguments for saying that the levels of underlying credit risk within credit ratings by KEXIM and corporate bond rating agencies are different is according to **Exhibit Korea – 91** that

> corporate bond rating [the rating of a bond issued by a company] in Korea could actually be considered same with issuer" [the rating of the company issuing the bond] whereas KEXIM ratings were taking into account all the characteristics of the credit facility.[20]

[20] **Korea Exhibit – 91**, para . 2 a).

31. As explained in our Second written submission and reconfirmed by PriceWaterhouseCoopers,

> Most if not all of the DSME bonds issued between 1997 and 1999 had either bonds collateral or bank and/or company guarantees. **Therefore, the ratings of these bonds CANNOT be considered the same as the rating of DSME**. The rating of the bonds reflects the collateral of the bond emissions just as KEXIM ratings reflect the collateral of the loans granted.[21]

32. With respect to Korea's argument looking at the performance of US privately placed bonds versus public bonds[22], and considering that "default rate for a bank credit rating is lower than for the corresponding corporate bond rating", the European Communities notes:

33.

> that credit exposure from investment grade and BB rated private placement loans are comparable to credit exposure of public debt with the same rating. It also appears that when discussion arises on specific rating, **the more pessimistic one is usually the one with the highest predictive power**. Consequently, the correlation between corporate bond ratings and KEXIM ratings, should exist at least for ratings better than or equal to BB (as shown by (Exhibit Korea – 93).[23]

34. Also Korea's argument regarding the specific collateral(s) and structure(s) of the loans that are supposed to be taken into account in the KEXIM rating and not in the CB rating[24] fails. The basic principle behind a rating is:

> A rating is issued to assess an exposure risk in terms of the repayment capacity of the obligor and will in the case of bond ratings (issue rating) take into account the existence of all possible collateral. As a result, a private loan and a bond having the same ratings will present the same obligor repayment capacity and the same credit exposure risk. Both should therefore be remunerated with the same interest rate.[25]

35. Korea argues in **Exhibit Korea - 91** that factors for grading are not alike. Specifically, Korea alleges:

> Banks generally employ so-called 'point in time' approach, under which the time period for validity of a risk assessment is generally one-year period from the date of assessment" and that "KEXIM is using this approach to evaluate the borrower's 'current' conditions" whereas Moody's and Standards & Poors (S&P) are rating corporate bonds based on through cycle approach and are looking at the worst case scenario.[26]

36. This is wrong. As explained in further detail in the Report by PriceWaterhouseCoopers:

> Nowhere in the definition of the rating [as reported by S&P] is mentioned that this rating is based on the worst-case scenario. It is based on the creditworthiness of the obligor and on the guarantees. Second, when determining a rating to set an interest rate on a loan, we suppose KEXIM looks at more than just the "current situation". **If**

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[21] Report by PriceWaterhouseCoopers, June 2004 **(Exhibit EC-148)**, para 2.1.1 p. 4
[22] **Exhibit Korea – 91**, para. 2 c).
[23] Report by PriceWaterhouseCoopers, June 2004 para. 2.1.1, p. 5 **(Exhibit EC-148)**.
[24] **Exhibit Korea 91**, para. 2a), b) and e).
[25] Report by PriceWaterhouseCoopers, June 2004, para 2.1.1, p.5 **(Exhibit EC-148)**
[26] **Exhibit Korea-91**, para. 3, d).

> **this were not the case, KEXIM wouldn't have carried on providing loans to DSME when it was bankrupt...** And if KEXIM looks at more than the "current situation" when a company is close to bankruptcy, we would expect that it also looks at the future when the company is presenting good results (just in case...). Would it not be the case, this would mean that the interest rate quoted on the loan does not reflect all the future risks of the loan and as such, would not represent a "normal" market rate.[27]

37. Moreover, the fact that there are differences between rating practices by banks does not mean that the ratings cannot be reconciled. PriceWaterhouseCoopers analyses and concludes:

> Where there is disagreement, the more pessimistic rating appears to have more predictive power for incidence rates, suggesting that investors be attentive to ratings assigned by others even when they disagree with such ratings.[28]

38. Finally, even using the data provided by Korea in **Exhibit Korea-92** – Table 1, and the spreads provided by independent credit rating agencies, PriceWaterhouseCoopers, confirms that KEXIM's P5 rating is comparable to a "BBB", i.e., investment rating.[29] KEXIM's use of "P5" credit ratings (and interest rates) for DSME where independent credit rating agencies assigned a rating of amounts to a benefit because it disregarded the actual credit risk of the company. The interest rates did not reflect commercial market rates.

(b) KSDA corporate bond yield rates: 1 year versus 6 months

39. The European Communities has explained in its response to Panel Question 135 why it was not aware of the existence of KSDA 6-months index and that it used in good faith the 1-year bond price while properly adjusting it. However, as demonstrated in the recalculation in **Attachment EC-10**, the use of the 6-months corporate bond yield rates does not lead to significantly different results.

(c) Misapplication of the Yangdo Dambo

40. Korea argues that the European Communities misapplied the value of the Yangdo Dambo.[30] The European Communities notes that this argument only applies to yards with "investment grades" above BBB- and that Korea has to date not provided the actual adjustments granted by KEXIM for the collateral in each case and supported this with evidence. Instead, Korea relies on values for the collaterals as provided by in KEXIM's interest rate guidelines. [31]

41. In consequence the benefit calculated for DSME and Samho is not affected since their ratings were below BBB-. As demonstrated in **Attachment EC-10**, even when adjusting its findings, the European Communities is still in a position to show benefit.

(d) No misapplication of the credit rating for DHI/DSME

42. Korea continues to deny that a corporate bond rating of "C" is the equivalent of KEXIM's credit rating "SM"[32] and presents in **Exhibit Korea-92** CB ratings and KEXIM's Credit rating for shipyards. This is untenable. KEXIM is free to use its own credit rating system. However, as

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[27] Report by PriceWaterhouseCoopers, June 2004, para. 2.1.2, p. 6 **(Exhibit EC-148)**.
[28] Report by PriceWaterhouseCoopers, June 2004, para. 2.1.2, p. 6 **(Exhibit EC-148)**.
[29] Report by PriceWaterhouseCoopers, June 2004 para., 2.2, p. 7 **(Exhibit EC-148)**.
[30] Exhibit Korea-90, para IV.
[31] Korea's Responses to Annex V questions, attachment 1.1(15).
[32] Korea's Responses to Annex V questions, attachment 1.1(15)

explained above and confirmed by PriceWaterhouseCoopers, each bank would take account of credit ratings provided otherwise on the market.

43. Korea Information Service is an **independent body** providing a C rating on some specific debt. KEXIM's rating of the shipyard should therefore have been worse than or equal to the rating of the bond (the latter being potentially covered by guarantees or collateral). On that basis, PriceWaterhouseCoopers concluded:

> We would therefore expect the rating of the shipyard to be SM or worse, based on Table 1 (from **Exhibit Korea–93**) and this until November 2001 (see **Exhibit Korea 92**).[33]

44. KEXIM did therefore not correctly assess the creditworthiness of DSME. While Korea Information service, an **independent body** provided a "C" rating equivalent to a KEXIM "SM rating", KEXIM provides loans provides under the P5 rating conditions. As explained and reconfirmed by PriceWaterhouseCoopers[34] according to the rating definition comparison, these are equivalent of a BBB (investment grade) rating.

45. The European Communities, therefore, maintains that it correctly applied the "C" rating to DSME as provided by the agencies, i.e. a "SM" rating in Kexim's own credit rating.

46. Korea cannot explain this glaring disregard of market conditions by pointing to the fact that KEXIM actively monitors the lenders.[35] As to the monitoring, in particular, of collaterals, KEXIM itself admitted that it does not even keep supporting documents and assessments of the collaterals which are essential for a monitoring.[36]

47. Korea also referred at the oral hearing to the "special relationship" between KEXIM and its creditors. That relationship is the core of the EC complaint against KEXIM. The special relationship between KEXIM and its clients (exporting industry) is laid down by the KEXIM statute itself. Because Korea's shipbuilding industry is more than 90 per cent export oriented, KEXIM has repeatedly identified the shipbuilding industry as its particular target. Thus, KEXIM stated, for example in its Operations Programme for 1999:

> In order to effectively overcome the Asian Economic Crisis [it shall] support the export of capital goods such as ships, industrial plant, machinery which creates high net export earnings and industrial backward-forward effect.[37]

48. Similar language was still found in the 2002 Operating Programme.[38]

(e) No failure to adjust Samho's PSL for the 100 per cent physical collateral

49. Korea never provided substantiated evidence of the existence and monitoring of collaterals and replied to the Panel[39] that it is not "Kexim's policy to keep and maintain any worksheet or similar documents" necessary for the consideration of collaterals. There is, therefore, no justified reason to consider "real property" as covering 100 per cent of the risk. On the basis of best information

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[33] Report by PriceWaterhouseCoopers, June 2004, **(Exhibit EC-148)**, para 2.2.
[34] Report by PriceWaterhouseCoopers, June 2004 **(Exhibit EC-148)**, para. 2.2.
[35] **Exhibit Korea-91** section e) and Second written submission by Korea, para. 56.
[36] Korea's Response to Panel Question 67 at the second substantive meeting.
[37] Responses to Annex V Questions (BCI) Attachment 1.1 (10), **(Exhibit EC-58)**, p. 3.
[38] *Ibid*.
[39] See Reply by Korea to Panel question 72 following the first substantive meeting.

available, the European Communities applied the same rule as for the Yangdo Dambo adjustment, i.e. a 50 per cent of the credit risk spread.

50. Moreover, Korea's criticism does not relate to the following two transactions showing benefit:

[BCI: Omitted from public version.]

(f) No failure to consider the fair value of the other relevant factors that have substantial security value

51. Korea argues that the PSL payment process allows Kexim to continuously monitor and review the financial conditions of shipyards whereas the bond holders cannot have such opportunity and this should mitigate Kexim's risks. This argument is to a certain extent valid but only if Kexim effectively adjusts the credit spread following the downgrading of a shipyard financial situation. However, this is not the case as already demonstrated in EC first written submission (para 181) where Kexim's Daewoo-SMI/Daewoo-HI risk spread did not change when the credit rating changed from BB+ before the workout to C after the workout (for transactions with similar collaterals and duration). Furthermore, even if Kexim was really monitoring and managing this situation, the impact on the credit spread at issuance of the credit would be very limited.

52. In addition, Korea argues that by virtue of the disbursement mechanism for PSL, Korea can promptly stop disbursing additional instalments and recover the outstanding loans by disposing collaterals and this should mitigate Kexim's risks. Two things should be noted here. First, the EC has no evidence that Kexim has ever stopped disbursing additional instalments when the credit situations degraded. Second, Kexim's credit spreads already took into account the existence of collaterals by adjusting downward the credit spread (without collateral); consequently, there is no reason why the above disbursement mechanism for PSL should further mitigate Kexim's risk. Furthermore, the argument itself is flawed. In the case of Yangdo Dambo, the collateral is supposed to increase in value as the total amount disbursed increases. The coverage is supposed to increase in line with the exposure. Stopping the disbursement will not increase the value of what will be recovered, just the opposite as the ship will not be finished and will be more difficult to sell.

53. Korea argues that the EC failed to consider the collateral value of joint and several personal liability guarantees. Contrary to what Korea says the EC has never considered that the collateral value of joint and several personal liability guarantees was worth nothing. On the contrary, and according to PWC's report[40] the EC considers that joint and several personal liability guarantees may have a certain value but should be carefully assessed as depending on the credit quality of the individual. This is why the value may vary from 0 to 8 (with 10 equal to the best collateral) similarly to the value of a Yangdo Dambo (value from 0 to 7). Needless to add that if the credit quality of the individual is poor or if the collateral is not carefully assessed, the collateral may be worth 0. In addition, as Korea confirms in exhibit Korea -90 that "Although KEXIM treated these personal guarantees as if no collateral were provided, it was only due to Kexim's policy of evaluating security interests in most conservative manner". In consequence, provided that Kexim itself treat these collaterals as if no collateral were provided and that Korea never provided any material evidence on the assessment of collaterals, the EC has no reason to consider that Kexim's' risk should be mitigated.

54. Again the EC would like to add that Korea critics the collaterals valuation done by the EC without being in a position to give details on Kexim's' own calculations or provide material evidence.

[40] Price Waterhouse Coppers report on pre-shipment loans and APRGs, p.15 and 16, **(Exhibit EC-118).**

2. Recalculation taking account of Korea's criticisms

55. The European Communities submits as Attachment EC-10 a recalculation of the PSL benefits taking account of the 6-months KSDA bond yield rates and the new application of the Yangdo Dambo value for yards with investment grade ratings. The recalculation also mends numerous minor errors detected by Korea in its Corrigendum[41] unless they are moot.[42]

56. These calculations reveal an important benefit.

3. Further note on Korea's corrigendum

57. Finally, the European Communities takes issue with Korea's assertion at para. 96 of its oral statement at the second substantive meeting that the evidence demonstrates that

> if these corrections are made, none of the seven Korea yards will be found to have received benefits from the KEXIM pre-shipment loans even under the EC's own methodology. According to Korea's calculations, the alleged benefit margins for all of the pre-shipment loan projects enumerated by the EC turn out to be negative or, at best, negligible ranging at far less than 1 per cent.[43]

58. What Korea describes as "benefit margins" is the actual difference between the interest rates and it implies that anything less than 1 per cent is negligible. First, it should be noted that contrary to what Korea alleges, there are numerous instances of benefit even under Korea's calculations and definition of "benefit margin" up to 2.61 per cent.[44] However, the European Communities considers that benefit is better appreciated when the difference is expressed as a proportion of the actual spread applied by KEXIM and not as such. The European Communities notes that even under Korea's own calculations (which it contests), there are numerous instances, where the difference between the market benchmark and the KEXIM rate is more than 30 per cent when expressed as a proportion to the KEXIM actual spread rate.[45]

Question 137

Korea submitted evidence (in response to Question 74 from the Panel) that KEXIM reduced the credit risk spread for HHI to [BCI: Omitted from public version]. Did the EC apply this [BCI: Omitted from public version] credit risk spread in the relevant part of its PSL analysis? Please refer to the relevant calculations where this adjustment was made.

Response

59. Yes, the EC applied the reduced credit spread for HHI of **[BCI: Omitted from public version]**.[46]

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[41] **[BCI: Omitted from public version.]**

[42] Moot errors concern all errors concerning the yields for corporate bonds 1 year since the adjusted benchmark is yields for corporate bonds 6 months. Korea exhibit 94 for Hanjin in which (CB1Y,BBB+) yield on 19/07/2001 is 7.24 per cent and not 7.76 per cent or Korea exhibit 95 for HHI in which (CB1Y,A-) yield on 12/12/2002 is 5.69 per cent and not 5.91 per cent.

[43] Oral statement by Korea at the second substantive meeting with the Panel, para. 96.

[44] **[BCI: Omitted from public version.]**

[45] **[BCI: Omitted from public version.]**

[46] Table concerning HHI pre-shipment loans project number 000107P **(Exhibit EC-125).**

Question 138

The EC does not appear to have answered Questions 9 and 11 from the Panel. The EC's replies referred the Panel to the EC's reply to Question 8. That reply, however, focuses on Kexim's "practice" of providing APRGs and PSLs, without identifying the APRG and PSL programmes "as such", and without explaining how (if at all) they differ from the KEXIM legal regime "as such". Please provide full answers to Questions 9 and 11.

Response

60. In Questions 9 and 11, the Panel asked how the EC's claims against the APRG programme and PSL programme as such differ from its claims against the KEXIM legal regime as such, specifically whether the APRG programme is not based on the KEXIM legal regime and whether it is conceivable to assess them differently from each other.

61. The European Communities agrees that although the KEXIM legal regime and the two programmes are distinguishable they are also linked.

62. The two export credit programmes and the benefits they provide are a consequence of the KEXIM legal regime and its requirement to promote exports and to lend below cost if necessary.

63. The state guarantee, dispensation from paying dividends and the requirement to promote exports confer a benefit as such to exporters because they specifically envisage the provision by KEXIM of financial services under conditions not offered by the market. The existence of such a bank is a benefit as it provides economic stability or a safety valve to exporters.

64. However, these financial services do not necessarily need to be the APRG and pre-shipment loan programmes. KEXIM could provide export assistance to exporters in another form. It is in this sense that the KEXIM legal regime is a separate violation from the two programmes.

65. The individual export subsidy transactions are similarly a consequence of the existence of the programmes (and thus of the KEXIM legal regime) but are nonetheless separate, even if linked, violations.

Question 139

The Panel refers to Attachment 5 to the EC's replies to the Panel's questions after the first substantive meeting, which contains transaction-specific alleged benefit calculations for one PSL and one APRG. Please make the same calculation for each of the APRGs and PSLs at issue in these proceedings. In other words, for each shipyard, specify which APRG / PSL relates to either LNG, product / chemical tankers, or container ships, and specify the amount of the alleged benefit as a % of the ship price. Please attach detailed worksheets.

Response

66. In **Attachment EC 5** to the Replies by the European Communities to the Panel's questions after the first substantive meeting, the European Communities produced a calculation of the impact of an APRG and a pre-shipment loan in two transactions. These calculations were based on the best information available to the European Communities (ship price, PSL ceiling, commitment date, payment terms, expiry date, base rate and spread applied) from which it reconstructed the amount of the advance payments.

67. Korea criticised these calculations for not taking account of certain additional features of these financing transactions.[47] Korea provided in **Attachment Korea-4** to its second written submission, a recalculation of the impacts of these transactions, including for the first time information about disbursement date and amount.

68. However, Korea never provided the following information for all pre-shipment loans and APRGs:

69. dates and amounts of disbursements under the pre-shipment loan and exact dates and amounts of advance payments benefiting from the APRG or at least ship prices and payment terms;

70. completion date (repayment of pre-shipment loan and end of APRG).

71. Since for most transactions, the information on the record is not sufficient to even reasonably reconstruct the amounts of the advance payments, the EC could only make the requested calculations for a limited number of transactions. The European Communities provides these re-calculations in **Attachments EC – 11 and 12**. However, it remains the understanding of the European Communities that there is no obligation or otherwise need to quantify the amount of subsidies, in particular under the export subsidy claims.

Question 140

Please comment on Korea's argument that KEXIM PSLs are made "at rates far higher than those the government has to pay for the funds so employed" (para. 277, Korea's first written submission).

Response

72. This statement by Korea implicitly admits that Kexim's loans are made from government funds.

73. The fact that they are made at rates higher than those the government has to pay for the funds (assuming it to be true) does not demonstrate that there is no subsidy. There are costs involved in making pre-shipment loans – administrative costs and in particular the costs implicit in the risks undertaken.

74. In any event, Korea made the above assertion to invoke the first paragraph of item (k) of the *SCM Agreement* as a safe haven. Yet, PSL's do not fall under the term "export credits" in item (k) and the first paragraph of item (k) is not open to an *a contrario* reading as its second paragraph explicitly sets forth a safe haven.

C. ALLEGED ACTIONABLE SUBSIDIES

Question 141

Para. 215 of the EC's first written submission states that "Daewoo" benefited from a 236 bn tax exemption alleged to be a subsidy. Para. 226 then refers to alleged benefit to "Daewoo-SME". Para. 232, however, refers to benefit to "Daewoo-HI/Daewoo-SME". Please indicate precisely which legal entity received / benefited from the alleged tax concession.

[47] Second written submission by Korea, para. 283.

Response

75. Pursuant to the available evidence, the EC understands that the new tax provisions at issue "exempt[ed] a workout company from taxes related to corporate splitting."[48] Furthermore, Korea has confirmed that these provisions exempted the spun-off companies from taxes that they otherwise would have been required to pay.[49] Thus, the benefit of the tax concession was received by the two spun-off companies -- Daewoo-SME and Daewoo-HIM.

76. Please note that the paragraphs mentioned in the Panel's question refer to the EC's *second* written submission, not the first written submission as indicated.

Question 142

In percentage terms, how much of the alleged benefit resulting form the "Daewoo" tax concession should be attributed to DSME's production of (i) LNGs, (ii) product / chemical tankers, and (iii) container ships? Please attached detailed worksheets.

Response

77. As the tax concession subsidy to Daewoo-SME was not tied to any particular ship type, it should be allocated over Daewoo-SME's overall sales.

78. In Attachment-13[50], the EC has re-quantified the subsidies received by Daewoo-SME by taking into account the tax subsidy, which was before erroneously omitted (in Attachment 1 to the EC's response to the Panel questions of 22 March 2004).

Question 143

Is it the EC's argument that the tax exemption was determinative in the decision to maintain Daewoo's shipbuilding operations as a going concern, rather than liquidating them? If so, where is this reflected in the Arthur Andersen/Anjin report or in other documentation before the Panel?

Response

79. In any restructuring review, the tax impact should be carefully assessed. However, as confirmed by PriceWaterhouseCoopers[51], the Arthur Andersen Daewoo-HI workout report made no reference to the fiscal effects of the restructuring. The report should have calculated the tax to be paid following the spin-off without the exemption because the report was issued in November 1999[52], eleven months before the tax exemption was approved.[53] If the report had properly calculated the tax consequences of the restructuring, it would have reduced Daewoo-HI's going concern value by KRW 236 billion, which is the amount that spin-off companies would have owed but for the tax exemption, according to Daewoo officials.[54]

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[48] See **Exhibits EC-137 & EC-138**.
[49] Oral statement by Korea of 17 June 2004, paras. 206-208.
[50] Quantification of Subsidies to Daewoo, Including Tax Concession (Attachment EC-13).
[51] PriceWaterhouseCoopers June 2004 Report, at Chapter 5 ("Tax Impact on DSME Restructuring") **(Exhibit EC-148)**.
[52] Second Written Submission by the European Communities, para. 197.
[53] Second Written Submission by the European Communities, para. 221.
[54] Second Written Submission by the European Communities, para. 223.

80. The EC maintains that the tax exemption was a determinative factor in the decision to maintain Daewoo's shipbuilding operations as a going concern, rather than liquidating them. Without the exemption, Daewoo's value as a going concern would have been dramatically reduced. The EC also notes that a prudent creditor would have taken into account the tax consequences in making its decision whether to opt for liquidation or restructuring. If the tax exemption were in preparation but not yet approved, prudent creditors would have taken into account the risk that the law would not pass or at least would not pass expeditiously.

Question 144

Para. 162 of Korea's second oral statement refers to creditors rejecting the initial DHI workout proposal. Were such creditors included in the EC's claim of government entrustment or direction? If they were entrusted or directed by GOK, why / how did they reject the initial workout proposal?

Response

81. Korea's second oral statement refers to an article from Seoul Economic Daily News, but this article does *not* identify the group of creditors that allegedly objected to Daewoo-HI's workout.[55] In fact, Daewoo-HI's workout is referred to only once in the article (p. 2, 3rd paragraph), without providing any specific information. The reference to investment trust companies relates to the restructuring of *Daewoo Electronics Co Ltd* (p. 1, para. 3). The EC does not, therefore, believe that the article supports Korea's contention.

82. Korea explained in its first written submission, however, that objections by the investment trust companies at the third meeting of the Council of Creditor Financial Institutions (CCFI) related to the treatment of a specific loan from 19 July 1999.[56] Indeed, these objection were not linked to the more general issue of whether or not to save Daewoo-HI from liquidation, as this issue was pre-determined by the Government's entrustment/direction of the financial institutions.

83. In other words, the general plan to restructure Daewoo-HI had been agreed to at the third CCFI meeting, and the objections at issue related only to specific details that were sorted out at the fourth CCFI meeting. This was confirmed by Korea in its reply to the EC during the TBR investigation.[57]

84. As detailed herein, KAMCO eventually purchased the 19 July loan at a rate **[BCI: Omitted from public version]** that was not justified by the circumstances (i.e. non-secured Daewoo-HI loans were otherwise purchased at **[BCI: Omitted from public version]**.[58] In this way, the Government of Korea, KAMCO, and the private creditors worked together to agree on the details of a plan that would ultimately save Daewoo-HI from liquidation, regardless of market considerations.

85. In fact, financial institutions were originally directed/entrusted by the GOK to provide the 19 July loan at issue. The World Bank reported as follows:

> When the Daewoo group faced a severe liquidity problem last summer, **the government put strong pressure on domestic financial institutions** to purchase 4 trillion Won of Daewoo CP, backed by collateral worth 10 trillion Won. With falling securities prices, **the value of collateral has dropped to one trillion Won**.

[55] See Exhibit Korea-104.
[56] First written submission by Korea, para. 351.
[57] See Daewoo-SME's February 2001 Response to the Questionnaire intended for the Exporter/Producer for Investigation under the Trade Barrier Regulation, **(Exhibit-EC 55)**, at p. 29.
[58] See reply to question 30 of Korea's Annex V main response at page 80 **(Exhibit-EC 39)**.

> KAMCO has offered to pay domestic financial institutions 80 per cent of the face value of the CP, but the financial institutions strongly oppose the 20 per cent discount. Because of their weak financial conditions, many of the financial institutions are not in a position to absorb these additional losses and would require government help. (emphasis added)[59]

86. **[BCI: Omitted from public version.]**[60] Thus, investment trusts were directed/entrusted to provide a loan on the basis of security of questionable value. When the investment trusts realised that the security was reduced to a quarter of the original value and that the loan became unsecured, they raised a specific objection at the third CCFI meeting. **[BCI: Omitted from public version.]**

87. In particular, Korea confirmed[61] that at the 4th CCFI meeting held on 26 November 1999 (NB: merely 2 days after the 3rd CCFI meeting), the investment trusts

> **[BCI: Omitted from public version.][62]**

88. Consequently, the loan was purchased by KAMCO at **[BCI: Omitted from public version]** its face value, just as would a fully secured loan.[63] Interestingly, following KAMCO's purchase of the loan from investment trusts[64], its fate changed once more and it was eventually (1 year later at the 17th CCFI meeting of 6 December 2000) swapped as non-secured.[65]

Question 145

The EC requests an adverse inference regarding Korea's alleged failure to provide a copy of the workout plan / report submitted by KDB on 24 November 1999. Please comment on the explanation set forth at paras 194 and 195 of Korea's second oral statement. If the EC still maintains its request, what is the legal basis for that request? Why does the EC consider that Korea should have made this report available to the EC / Panel earlier?

Response

89. Korea contests the use of adverse inferences regarding its failure to produce KDB's workout plan, alleging that it was presented to the EC during the TBR investigation, and that the EC has used this information in Exhibits **EC-55 to EC-57**.

90. Korea is incorrect. The exhibits in question contain only the Memorandum of Understanding signed by financial institutions on 20 January 2000, but do not include the KDB workout plan of 24 November 1999. This plan has never been submitted to the EC.

91. Adverse inferences are justified in this case, as Korea revealed the existence of the KDB workout plan only after the EC had highlighted that the Arthur Andersen report was issued on the very same day (24 November 1999) as the restructuring decision. Korea argued that Arthur Andersen had supplied KDB with a preliminary report on 30 October 1999, and that creditors were therefore aware of the essence of the report in advance of the 24 November meeting. However, Korea has now

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[59] See World Bank report on Korea (18 September 2000). **(Exhibit-EC-149).**
[60] See reply to question 2 of Korea's Annex V main response, at p. 59 **(Exhibit-EC 39)**.
[61] See reply to question 25 of Korea's Annex V main response, at p. 76 **(Exhibit-EC 39)**.
[62] See reply to question 25 of Korea's Annex V main response, at p. 77 **(Exhibit-EC 39)**.
[63] See reply to question 2 of Korea's Annex V main response, at p. 60 **(Exhibit-EC 39)**.
[64] KAMCO purchased the loan from the investment trusts before the spin-off of Daewoo-SME and the completion of the debt-to-equity swap which was completed on 14 December 2000. See First written submission by Korea, at para 360, and Attachment 3.1(2) of Korea's Annex V response **(Exhibit-EC 150)**.
[65] See reply to question 25 of Korea's Annex V main response, at p. 78 **(Exhibit-EC 39)**.

made clear that the Arthur Andersen report was not the actual workout plan voted upon by the creditors. Paragraph 194 of Korea's second oral statement confirms that KDB proposed a "workout plan to the 3rd CCFI meeting for deliberation and adoption by the creditor financial institutions, and that this Daewoo-HI workout proposal was, of course, based on the Arthur Andersen report".

92. Independent of any adverse inferences, the EC wishes to emphasise the implication that the creditors did not seriously consider rejecting the reorganisation, given that they were required to decide upon Daewoo-HI's workout plan after having been presented with the plan (as opposed to the Arthur Andersen report) on the same day that they voted on the plan.

93. By contrast, as confirmed by Korea, independent investors that considered whether to obtain a stake in Daewoo-HI prior to its collapse (February - August 1999) "needed considerable time to negotiate for sale of such a big business as DHI's shipbuilding division" and "could not have completed their due diligence investigations by the time that the Daewoo-HI workout commenced."[66] Consequently, Korea's explained that "all negotiations for the sale of the shipbuilding division was halted since no investor would invest in the shipbuilding division in light of the financial uncertainty during the workout procedures".[67]

94. This difference in approach casts heavy doubt upon Korea's statements that (with or without a KDB plan) Korean creditors took important restructuring decisions during this short period (24 to 26 November) pursuant to market considerations.

Question 146

In response to Question 23 from the Panel, the EC asserts that "[t]he existence of a going concern analysis can be an indicia that a hypothetical private creditor would have acted in the same manner." Does the EC accept that the individual components of the Daewoo workout can be assessed on the basis of the Arthur Andersen report? If the Panel rejects the EC's argument that the Arthur Andersen report incorrectly determined that the going concern value of DHI exceeded its liquidation value, does this necessarily mean that the Panel should reject the EC's claims regarding the individual components of the workout? Please explain.

Response

95. The individual components of the Daewoo workout (i.e. debt-to-equity swap, debt rescheduling, and spin-offs) were simply the vehicles proposed by Arthur Andersen for ensuring the viability of the spun-off companies Daewoo-SME and Daewoo-HIM after the report established that a restructured Daewoo-HI would not be viable as such.

96. However, the EC has submitted evidence[68] that shows that the Arthur Andersen Report contained important "uncertainties" which cast doubt upon the finding that, under normal market conditions, the going concern value of Daewoo-HI was higher than its liquidation value. In particular, as stated in the report by PriceWaterhouseCoopers, "a bank faced with the decision to go either for the liquidation scenario or the going concern scenario, would require more in depth understanding of the competitive positioning of the respective companies and impact thereof on the various cash flow scenarios before taking a final decision. That information is not provided by the Arthur Andersen report".[69] Thus, a prudent creditor, even before addressing the individual components of the Daewoo workout, would have questioned the premise that the going concern value of Daewoo-HI was higher than its liquidation value.

[66] See reply to question 9 of Korea's Annex V main response, at p. 68 **(Exhibit-EC 39)**.
[67] See reply to question 9 of Korea's Annex V main response, at p. 68 **(Exhibit-EC 39)**.
[68] See PriceWaterhouseCoopers Analysis of the Arthur Andersen Report **(Exhibit EC-112)**, at p. 2.
[69] See PriceWaterhouseCoopers Analysis of the Arthur Andersen Report **(Exhibit EC-112)**, at p. 3.

97. Nevertheless, even if the Panel rejects the EC's argument that the Arthur Andersen report incorrectly determined that the going concern value of Daewoo-HI exceeded its liquidation value, this does not mean that the Panel should reject the EC's claims regarding the individual components of the workout. Indeed, a subsidy can still be granted to a company even where the decision to restructure is market-based. The terms of the restructuring, such as the amount of debt remaining in the shell company, the amount of debt in the spin-off companies and the price at which debt is to be converted to equity are decisions that can lead to a benefit for the recipient if they are more favourable than what would be obtained on the market.

Question 147

The EC asserted at the second meeting that creditors should have got more out of the Daewoo debt/equity swap. How could creditors have got more? Who / what benefited from the fact that they did not?

Response

98. The creditors of Daewoo could have recovered more of the debt owed to them if they had not agreed to go along with the restructuring in the first place. As the EC's consultant, PriceWaterhouseCoopers, has determined, that under scenarios, the liquidation option was economically preferable to reorganisation.[70] The fact that the creditors did not demand liquidation conferred a benefit on Daewoo, which was able to stay in business.

99. In addition, once the creditors accepted restructuring, they failed to demand terms that would maximise their recovery, as creditors normally would in a free-market system. As the EC has explained, these creditors, which are public bodies and entrusted or directed private bodies, participated in the debt for equity swap on non-market terms. As detailed in Attachment 1 to the EC's response to the Panel's questions following the first meeting of the Panel, the value of the debt forgiven by the creditors significantly exceeded the value of the equity received by them in exchange.

100. The creditors could have minimised their losses by either refusing to accept restructuring or, once they accepted restructuring, by refusing to swap their debt for less valuable equity. The two spun-off companies -- Daewoo-SME and Daewoo-HIM – benefited from the creditors' losses, without which they would not have survived or would have had a high level of debt.

Question 148

The EC proposes an outside investor standard when challenging the reorganization of Samho. This contrasts with the position taken by the EC in the GATT case concerning United States - Imposition of a Definitive Countervailing Duty on Imports of Certain Steel Products Originating In France, Germany, and the United Kingdom. Why has the EC changed its position on this issue? Why does the EC now consider that the outside investor standard is preferable to the inside investor standard? Please explain.

Response

101. The concepts "outside investor" and "inside investor" are not used in the *SCM Agreement*. The European Communities considers that the appropriate benchmarks for assessing the presence of a subsidy is market-based or commercial behaviour, whatever that may be in relation to the facts of the case.

[70]Second written submission by the European Communities, para. 194, citing **Exhibit EC-133** at p. 3.

102. As the European Communities explained at para 245 of its second written submission, there were, in relation to Samho, no "inside investors" that were free form government control and so the question does not in fact arise.

103. In that respect, the European Communities wishes to respond to Korea's second oral statement[71] that it has failed to identify which creditors of Halla were under government control. The European Communities has relied on the information provided by Korea in the Annex V procedure[72] which showed that government owned or controlled secured creditors[73] had a ratio exceeding by far the required 75 per cent [74] and could effectively decide on the restructuring as they saw fit. Considering that these creditors were also the creditors which participated at the DHI restructuring there was no need for repeat statements; the European Communities has submitted extensive information showing government control over these entities.[75] [76]

104. The European Communities comments on the relevance of the GATT case referred to in response to Question 172 below.

Question 149

If the Panel were to reject the EC's claim of government entrustment / direction of private creditors, would this mean that those private creditors provide a reliable market benchmark for determining whether or not the restructurings at issue conferred a benefit? Please explain. Did the EC address this issue in its previous written and oral submissions to the Panel. If yes, please indicate precisely where it did so.

Response

105. As summarised in paragraphs 49-50 of the EC's Oral Statement of 17 June 2004, the EC has presented powerful evidence to demonstrate that the private creditors were entrusted/directed by the Government of Korea.

106. If the Panel were to disagree with the European Communities on this point, this would not mean that the actions of the private creditors could be considered a "reliable market benchmark."

107. Article 1 of the *SCM Agreement* does not make "directed or entrusted" by the government equivalent to non-commercial. Therefore, even it cannot be demonstrated that private bodies were not "directed or entrusted", it may still be that their actions do not constitute a reliable market benchmark. The question of whether there has been a financial contribution by an entrusted/directed private body in Article 1.1(a) is distinct from the issue of whether a benefit has been conferred pursuant to Article 1.1(b).

108. The tremendous government influence over the actions of private creditors (even if the Panel were to find that it does not rise to the level of entrustment/direction), certainly raises strong doubts as to their ability to act according to market considerations (as is required for a valid benchmark). Thus, the Panel would still be required to look elsewhere for a market benchmark -- either to foreign investors, outside investors, or another reliable source.

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[71] At para 211

[72] See Korea Annex V response to question 42 at page 85 **(Exhibit EC 39)**.

[73] KEB, Kexim, KDB, Seoul Bank, CHB, Kamco had jointly 87.81 per cent of the secured loans.

[74] See Korea Annex V response to question 45 at page 88 **(Exhibit EC 39)**.

[75] See Attachment 3 to EC's Answers to Panel question 17 of 22 March 2004

[76] Unsecured creditors were obviously not an obstacle to the restructuring as most of the unsecured loans were held by other Halla group companies, See Korea Annex V response to question 42 at page 85 **(Exhibit EC 39)**.

Question 150

Regarding the EC's Question 33 to Korea after the first substantive meeting, please explain why, if at all, the value of Samho's construction business is relevant to the present proceedings.

Response

109. Up until now, Korea has provided discounted cash flow valuation or going-concern value for the shipbuilding business of Halla-HI, but has provided only the *liquidation value* for Halla-HI's other businesses divisions (plants and construction heavy equipment). In order to further assess whether the restructuring plan was made pursuant to market considerations (i.e. whether the going-concern value exceeded the liquidation value), the EC wanted to compare liquidation and going-concern value for the same entities. This is why the EC asked Korea to provide the valuation report in its entirety.

Question 151

Korea asserts that the share of debt held by the foreign creditors who failed to participate in the Daewoo workout was around [BCI: Omitted from public version]. Is it reasonable to expect a panel to condemn a restructuring on the basis of the behaviour of creditors holding only [BCI: Omitted from public version] of the debt?

Response

110. Under ordinary market conditions, the fact that foreign creditors had rights to only approximately 3 per cent of the debt would result in the Government of Korea being little concerned with their reaction, given that foreign creditors did not have sufficient interest to block a vote on reorganisation – i.e. more than 25 per cent of the votes. Yet, as detailed in paragraphs 189-191 of the EC's second written submission, the Government realised that it had to pay special attention to the foreign creditors because -- being outside the scope of the Government's influence -- they might vigorously attempt to disrupt the pre-determined progression to reorganisation. In fact, the EC has provided evidence that the *Government of Korea* and the foreign creditor banks entered into negotiations to avoid this situation.[77]

111. Accordingly, the foreign creditors are the best available benchmark against which to judge whether the restructuring was market based and the level of the resulting benefit.

Question 152

Regarding the Daewoo workout, the EC makes various arguments regarding the purchase of debt and bonds by KAMCO. It is unclear whether these arguments support a separate claim regarding the KAMCO rates, or whether those arguments are made in support of the more general claim concerning the use of foreign creditors as the market benchmark. Please explain.

Response

112. The EC has made these arguments in support of the more general claim concerning the use of foreign creditors as the appropriate market benchmark.

[77] Second written submission by the European Communities, para. 189, quoting **(Exhibit EC-132)**.

113. The EC has explained the multiple roles played by KAMCO in the restructuring process, serving as a vehicle for providing funds to cash-hungry creditors of Daewoo-HI, and as a Daewoo-HI creditor, itself.

114. In its answer to question 14 by the Panel, the EC explained that, in the Letters of Intent dated on or after 13 November 1998, the Government of Korea stated as follows:

> In order to enhance the incentives for banks to participate fully in the corporate restructuring process, no public funds, **whether by way of KAMCO purchases** or capital injections or other means, shall be made available to banks which are not certified by the FSC to be performing their role in the corporate sector restructuring process."[78] (emphasis added)

115. Moreover, in its reply to question 20 of the Panel, the EC summarised KAMCO's role as follows:

> KAMCO's purchase of more than **[BCI: Omitted from public version]** of DHI non-performing loans provided a benefit to the restructured Daewoo Shipbuilding Company, because:
>
> - it cleansed the balance sheets of DHI creditors which could not otherwise have agreed to proceed to a debt/equity swap given their precarious situation;
> - it enabled a public body (KAMCO) to swap debt for up to **[BCI: Omitted from public version]** of DSME's capital; and
> - it allowed a substantial amount of DHI debt to remain idle in the hands of KAMCO until it is resold as opposed to remaining in the hands of creditors which would have pursued all available legal means to obtain repayment including through the liquidation of troubled borrowers.
>
> (footnotes deleted)

116. These arguments support the claims of direction and entrustment of private creditors, as KAMCO's purchase of non-performing loans by Daewoo-HI creditors, and its participation in the Daewoo-HI restructuring were clearly mandated by the Government of Korea.

Question 153

Please comment on Korea's argument (at para. 191 of Korea's second written submission) that the EC, in its response to Question 22 of the Panel (which concerned the "alleged specificity of the corporate restructuring" <u>generally</u>), allegedly concedes that the Court supervised corporate reorganizations undertaken by Halla and Daedong were not specific "because these companies seemed to have disappeared and the EC answers the question only in regards to DHI".

<u>Response</u>

117. The EC continues to maintain the reasoning presented in its (1) First Written Submission (paras 350-354 and paras. 380-384), and (2) Second Written Submission (paras. 248-252 and paras. 268-269) demonstrating that the corporate reorganisations of Halla and Daedong were specific within the meaning of Article 2 of the *SCM Agreement*.

[78] **(Exhibit EC-36)**.

118. The specific references to Daewoo in response to Question 22 were made by way of example, and the EC was careful to include "e.g." to reflect this throughout its response. If the EC had decided to take the dramatic change of position alleged by Korea, it would have certainly made this clear through an affirmative statement to that effect.

Question 154

Regarding the STX reorganization, we note that the debt rescheduling / exemption from interest is the sole element identified by the EC when calculating the amount of alleged benefit in Annex 3 of Attachment 1 to its replies to questions from the Panel after the first substantive meeting. We further note that the EC's rebuttal submission does not refer to the other elements of the restructuring identified in its first written submission, such as the issuance of bonds by Daedong. Does the EC still claim that the other elements of the restructuring, including the bond issuance by Daedong, constituted a subsidy? If so, why were they not included in the abovementioned Attachment 3?

Response

119. The EC maintains that the sole element identified as a benefit is the debt rescheduling and exemption from interest, as provided in Annex 3 of Attachment 1 of EC's reply to questions from the Panel after the first substantive meeting.

D. SERIOUS PREJUDICE

Question 155

The EC has indicated that the Panel should determine the existence of price suppression/depression separately for LNGs, product/chemical tankers, and container ships.

(a) Does this mean that the EC is asking the Panel to issue three separate serious prejudice rulings, on LNGs, product/chemical tankers, and container ships, respectively?

(b) If not, please explain.

Response

120. Serious prejudice must be to the interest of a WTO Member and there is not therefore any need for three separate serious prejudice findings.

121. The serious prejudice finding that is requested should be based on price suppression and/or depression in the three product markets each of which is a global geographical market. Article 6.3 of the *SCM Agreement* refers to "serious prejudice . . . where *one or several* of the following apply".[79] Just as serious prejudice can be determined based on various combinations of Article 6.3(a), (b), (c), and (d) – serious prejudice may also be based on multiple findings of price depression and/or suppression in the global market (albeit in three different sub-markets of commercial vessels). Moreover, Article 6.3(c) refers to the "effect of the subsidy," where subsidy is singular. The subsidies at issue in this case were granted to shipyards that produce a variety of commercial vessels. In this way, the same subsidy caused price suppression and/or depression in the three product markets at issue. Thus, there is no need for three separate serious prejudice findings in this dispute.

[79] Emphasis added.

Question 156

In the information before the Panel, including the Annex V information, are there additional examples (beyond those already referred to in the EC submissions) of bids by Korean shipyards, for which EC shipyards also are bidding, and where in the view of the EC the Korean yards have led prices downward.

Response

122. The EC submitted, in the framework of the Annex V proceedings, various examples of instances when EC yards offered a price, but the order was ultimately secured by a Korean shipyard at depressed prices.

123. The relevant documents are included in the EC's responses to question 7 by Korea (and relevant annexes 7.1 to 7.17) from the Annex V procedure.

124. The EC particularly wishes to point out the example in annex 7.3, in which the broker clearly explained that the guideline in terms of prices consists of the newbuilding price in Korea.

125. More specifically, with respect to price depression in the LNG segment, see bullet point C (and relevant annexes 7.13 to 7.17) of the EC's replies to question 7, as well as the annex 8.C, which includes an explanation as to how prices were led downwards by Korean yards in that segment.

Question 157

(a) In the information before the Panel, including the Annex V information, are there examples/evidence of instances in which EC shipyards have considered, but declined to, bid due to low prevailing prices? For example, can the EC provide records of instances in which an EC yard was contacted by a ship broker concerning the possibility of bidding, but decided not to do so because of low prices.

(b) In any such instances, does the information before the Panel contain evidence of Korean pricing/bidding for the same sale?

Response

126. As previously explained by the EC, the major part of the correspondence between ship owners, brokers and shipyards takes place on an informal basis. Therefore, documentary evidence in many cases does not exist. In addition, most shipyards usually do not keep faxes or other correspondence received from brokers concerning the possibility of bidding for projects on which they eventually decided not to submit an offer (whether for price reasons or otherwise). Finally, no such examples/evidence were requested in the framework of the Annex V procedure, and thus they were not submitted at that time.

127. For those reasons, the EC is not in a position to provide examples other than those referred to in the reply to Question 156, above.

Question 158

(a) Is it the view of the EC that excess shipbuilding capacity exists only in Korea, or is there also excess capacity in other countries?

(b) If your view that excess capacity exists only in Korea, please explain.

(c) If your view is that there is excess capacity also outside of Korea, where and how much is the excess?

(d) Is there any excess shipbuilding capacity in the EC? If not, what is the basis for this conclusion?

Response

(a)-(c):

128. The development of capacity is discussed in "Overview of the International Commercial Shipbuilding Industry", section 5.2, page 14 (**Exhibit EC-1**), which also provides estimates of shipbuilding capacity by region, based on OECD report C/WP6/2001/6.[80]

129. As shipbuilding is an integrated world market, i.e. any owner can buy at any yard, and sales are determined by market considerations (with the exception of the US Jones Act), the world shipbuilding capacity also must be seen in this way. As with the shipbuilding market, shipbuilding capacity can be regarded as something of a continuum, and it is therefore meaningless to say that shipbuilding overcapacity exists only in Korea. However, as described in **Exhibit EC-1** and the OECD report referred to therein, the problem of overcapacity has long been known, but this has not stopped the Korean shipyards from massive expansion in recent years. Indeed, the OECD found that shipbuilding capacity in the 1990s had been increased primarily by Korean shipyards.[81] This expansion has been aimed at the pursuit of volume with the aim of reducing unit costs. It is this expansion that is at the core of the accusations that Korea is responsible for global overcapacity, not only by the EC and FMI, but also by most industry analysts. This was detailed in Attachment EC-8 to the EC's second oral statement.[82] For example, a January 1999 report by Drewry explained as follows:

> Economic growth in South Korea until recently was based on an open understanding between the Government, which planned which industrial sectors should be entered, and the banks, which would provide capital for investment at rates more favourable than the financial markets would warrant to a small group of very powerful conglomerates (the chaebols). As with the Japanese, the chaebols' main objective was to increase market share in their chosen sectors, rather than to ensure profitability and returns to shareholders. This formula led to a massive increase in shipbuilding capacity as well as in car manufacturing, and micro chip plants (it is notable that all these industries are now faced with oversupply of capacity, and ensuing low prices, and low profitability world wide).[83]

130. In an integrated market, capacity reductions in one region cannot have a positive effect on the world market if additional capacity is created at the same time in another region. If the new additional capacity in Korea exceeds the reductions in the EC (as it did), the new EC shipbuilding capacity would also appear to exceed actual world-wide demand, although the market distortion originated in

[80] OECD, Evaluation of World Shipbuilding Capacity (2000 Revision), C/WP6(2001)6 (29 May 2001) **(Exhibit EC-151)**.

[81] OECD, Evaluation of World Shipbuilding Capacity (2000 Revision), C/WP6(2001)6 (29 May 2001), at para. 55**. (Exhibit EC-151)**.

[82] "Detailed Rebuttal of Exhibit Korea-70", p. 3 at para. 16, & page 4, at para. 23 – Attachment EC-8 to EC's second oral statement.

[83] "Detailed Rebuttal of Exhibit Korea-70", p. 3 at para. 18 -- Attachment EC-8 to EC's second oral statement.

Korea. Consequently, the EC views the reduction of non-viable capacity (i.e. the capacity of failed yards) as the only meaningful way to address the problem.

131. In the EC, this has led to a series of yard closures and company restructurings (typically going along with capacity reductions) since 1975. In Japan, shipbuilding facilities have been mothballed. Contrary to these developments, Korea has expanded shipbuilding capacity since the early 1990's.

132. Capacity control measures enforced by the main shipbuilding blocks have included the following:

- In the EU, shipbuilding directives in force from the mid-1980's until the end of 2000, in particular the fifth, sixth and seventh directives, limited the level of assistance that governments could offer to shipyards, while at the same time strictly controlling capacity development. Ailing shipyards could not be rescued, and new shipyard facilities had to demonstrate that they did no more than replace existing capacity that had to be removed from the market as the new facilities came on stream.

- In Korea, the shipbuilding industry had been previously regulated by the Shipbuilding Industry Rationalisation Law, implemented in 1988 by the Ministry of Trade and Industry. This law froze the development of new facilities and banned low-priced bookings. The overall aim was to improve competitive conditions. The law was repealed in December 1993, followed by unrestrained capacity expansion.

- Japan has been controlling capacity since 1950, through the "Zosen Ho" shipbuilding law which restricts construction of ships over 500GT or 50m length. Other legislation enacted in 1953 enables the government to monitor and control production volume before the commencement of work, applying to ships of over 2,500 GT or 90m length, regardless of whether they are domestic or export contracts. These legislative controls remain in force today, to be exercised when market and economic conditions dictate.

(d):

133. In addition, the EC would like to emphasise that Europe has experienced capacity reductions, with 90 per cent of the workforce being shed since 1975. Shipyards continue to be forced into bankruptcy, leading to their permanent closure. This market mechanism regulates capacity in the EC. By contrast, no shipyard has ever closed due to market forces in South Korea without being re-opened.

Question 159

The Panel's written question 30 following the first meeting was as follows:

"In general, how much flexibility does a typical shipyard have to produce all or a broad range of ship types? What are the physical and other constraints on any given shipyard's potential product range? How important is prior experience to a shipyard's production cost and capability to build a particular type of ship? With reference to the above considerations, please describe the capabilities and experience of each EC shipyard that produces or is capable of producing some or all of the kinds of commercial vessels cited in your serious prejudice claim."

Please present a summary of any information already before the Panel, including the Annex V information, that is relevant to this point but was not referred to in the EC's original answer to this question.

Response

134. The flexibility of shipyards and the nature of constraints is discussed in section 4 of the "Overview of the International Commercial Shipbuilding Industry", **Exhibit EC-1**.

135. The order books of the major shipyards show a wide range of ship types under production (*see, e.g.*, Clarkson World Shipyard Monitor).[84] Within the constraints described in the EC's answer to Question 30 by the Panel and in **Exhibit EC-1**, yards maintain the capability to design and build all kinds of sea-going vessels. Exhibit Korea-70 (the "Drewry Report") provides a wealth of statistical information that shows that EC yards are active in all contested market segments (see, in particular, chapters 5-7). Section II(C) of the EC's First Written Submission describes the portfolios of the major EC yards, demonstrating that these yards produce a wide range of ship types.

Question 160

Concerning the composite ship newbuilding price index furnished by the EC, the EC indicates that major shipbuilding consultants also maintain "more specific price information for particular ship types". In Attachment 2 to its answers to questions, the EC provides price information for two sizes of tankers and for eight sizes of container ships.

(a) Is this the "more specific" information to which the EC refers?

(b) Why does the EC show the particular breakouts that it does? Do other breakouts exist for these products? Please explain.

Response

(a):

136. The most commonly used source of newbuilding prices is "Clarkson World Shipyard Monitor".[85] The section of that publication entitled "Shipbuilding Price Trends", at page 8, provides the most comprehensive overview of prices available, and is the source of price data presented in the EC's attachments. A more detailed time series of prices reported by this publication can be found in **Exhibit EC-146**, "FMI June 2004 Report, technical support to the WTO hearings", submitted with the second oral statement, at page 5.

(b):

137. The specific breakouts were chosen by the EC because they corresponded to the available information on Korean costs from the cost monitoring exercises, which enabled cost and price indices to be shown together for Korea. The cost information is ship-type specific, and cost/price indices have not been created for the full range of products.

Question 161

The EC presents indices of estimated Korean production costs versus prices in support of its argument that there is price suppression/depression. The EC indicates that its consultant, FMI, prepared the cost estimates, taking into account various known cost trends and cost advantages of the Korean yards. The EC in its answers to questions following the first meeting provided a description of the methodology used by FMI to prepare these estimates. The EC also

[84] Clarkson World Shipyard Monitor **(Exhibit EC-152)**.
[85] Clarkson World Shipyard Monitor **(Exhibit EC-152)**.

indicated that, should the Panel so request, it would furnish the detailed underlying data. Is it the view of the EC that a graphical presentation of price indices, along with a description of methodology, constitutes prima facie evidence of evolution in Korean shipbuilding costs? Please explain.

Response

138. The EC has provided a graphical presentation of price and cost indices to provide, in an easily-viewed form, a summary of the detailed data that its consultant, FMI, has collected during years of intensive research and investigation. In particular, the EC has monitored prices and costs in Korean yards for almost 5 years, leading to seven shipbuilding market reports that have been presented to the Panel.[86]

139. The cost analyses by FMI, which are project-specific, take account of all relevant cost factors in shipbuilding, and are regularly updated. Naturally, these forward cost estimations are complex and require a sound understanding of the shipbuilding process with its numerous intermediate steps.

140. The EC encloses a sample of such a detailed cost estimation, concerning a LNG carrier order at Daewoo.[87] The spreadsheet shows the various cost categories and the details of the estimations made. In total more than 60 such cost estimations have been made for orders placed in Korean yards, and each analysis would concern a number of vessels as typically ships are ordered in short series. The EC took great care to investigate orders that are typical for the production of Korean yards, in order to arrive at a conclusive picture. More detailed cost estimations can be made available to the Panel upon request.

141. The analyses undertaken have led the EC to conclude that prices offered by Korean yards are not in line with costs of production, and that this gap is widening.

142. It is not the EC's assumption that cost developments can be derived from price indices. Rather, the EC sees prices and costs in Korean shipbuilding as being disconnected, as Korean yards tend to offer the price that gets them the order and fills their shipbuilding capacity, but that does not necessarily reflect the full costs of production. Consistently low prices at a time of rising costs are a clear indication of behaviour that leads to price suppression and price depression.

Question 162

What specific evidence/examples are contained in the information before the Panel in support of the EC argument that prices at one end of the product spectrum for a particular kind of ship influence prices along the entire spectrum? (For example, is there specific evidence in the information before the Panel that a downward movement in very large container ships brings about commensurate downward movement in all smaller sizes of container ships?)

Response

143. The best evidence for this can be seen in **Exhibit EC-146**, "FMI June 2004 Report, technical support to the WTO hearings", submitted with the second oral statement (Figure 1, page 5). Shipbuilding prices tend to move in unison, with some variation. This can also be seen in the graph

[86] Responses by the European Communities to Annex V Questions, Annex 10c containing the seven Commission reports to the Council on the situation in world shipbuilding.

[87] Cost Moedelling Details Angelicousis LNG Tanker at Daewoo **(Exhibit EC-156)**.

on page 8 of the Clarkson World Shipyard Monitor, clearly showing tanker prices moving together, regardless of the size of the ship.[88] This is discussed further in response to Question 163 below.

144. Moreover, a recent document from the OECD Secretariat emphasises the contagious effect of specific behaviour in the shipbuilding market:

> [S]hipbuilding is, from a geographical point of view, a single, integrated global market. This imparts shipbuilding with unique characteristics, as this integration would suggest that an impact in one part of the market would be readily felt in the rest of the market. It is further suggested that the effect would be quite different in sectors that were not so closely integrated.[89]

Question 163

(a) For each ship category, in practical terms how substitutable are different sizes/configurations (containment systems, in the case of LNGs)? Are there specific evidence/examples in the information before the Panel? In addition, please furnish relevant portions of the industry publications discussed at the second meeting. (For example, one industry expert referred at the meeting to one of the industry publications that contains information relevant to cross-price elasticities).

(b) Can the EC cite specific instances/situations in the information before the Panel where a shipowner has purchased and used a larger-than-usual ship for a particular run, due to a relatively low price for the larger ship?

Response

(a):

145. The best evidence of the supply-side substitutability of products is found by browsing through the orderbooks reported in Clarkson World Shipyard Monitor.[90] Further information on this matter can be found in **Exhibit EC-1**, "Overview of the International Commercial Shipbuilding Industry", including chapters 4, 6 and 7. Most products within a shipyard are substitutable, with the exception of LNG tankers and cruise ships. LNG tankers are exceptional because of the difficulty and cost of obtaining licenses, and the initial investment cost. Cruise ships involve brand-conscious and conservative buyers, and require high costs of entry. These are the only two exceptions to supply-side substitutability. On the demand side, the two LNG containment systems are fully substitutable. They both do the same job. On the supply side, the substitution is more difficult because it requires a change in licences, but the switch by Hyundai Heavy Industries between the two types illustrates that it is possible.

146. The data regarding relevant cross-price elasticity appears in the graph on page 8 of the Clarkson World Shipyard Monitor, which shows prices of different sizes of ship moving together.[91] The difficulty in doing a true cross price elasticity analysis for the shipbuilding industry is that, in recent years, demand has been disconnected from prices due to the overcapacity problem. Analysing price against demand has therefore had little relevance and is inconclusive. From the information

[88] Clarkson World Shipyard Monitor **(Exhibit EC-152)**. Detailed descriptions of the ship types shown in that graph can be found in **(Exhibit EC-1)**, "Overview of the International Commercial Shipbuilding Industry", at section 3.2.

[89] OECD document C/WP6/SNG(2004) **(Exhibit EC-153)**.

[90] Clarkson World Shipyard Monitor **(Exhibit EC-152)**.

[91] Clarkson World Shipyard Monitor **(Exhibit EC-152)**, p. 8.

presented on prices in figure 1 of **Exhibit EC-146** and information on demand (represented by total contracting activity, as reported on page 4 of the Clarkson World Shipyard Monitor[92]) it is possible to illustrate the effects by looking at a specific case.

147. A specific sub-type has been chosen because it provides a good example of a market where there has been little change in demand over the past year, but a significant movement in price. Figure 1 below presents the movement in price of Panamax tankers over the past year (this is one of the lines included in figure 1, page 5, of **Exhibit EC-146**) and figure 2 below presents the volume of ordering over the same period.

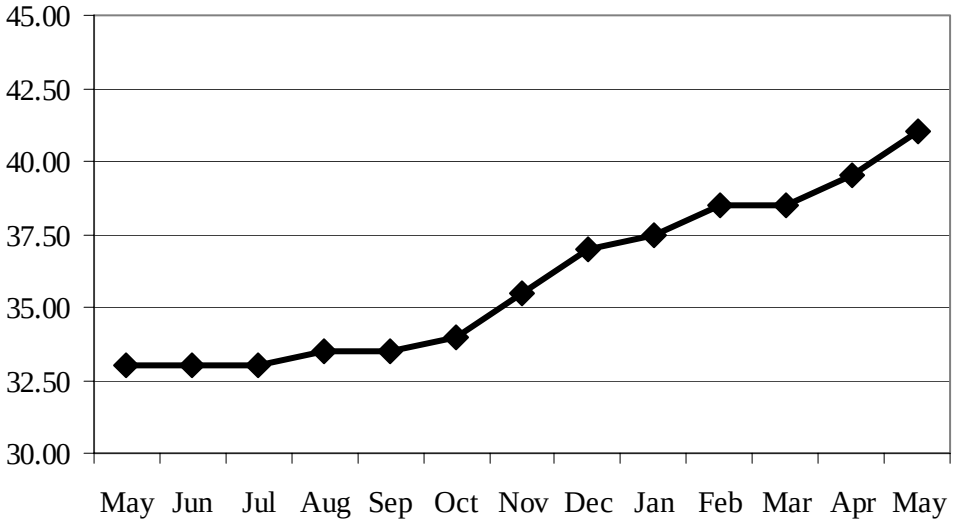


Figure 1 – Movement in Panamax tanker prices in 2003 / 2004 ($ million)

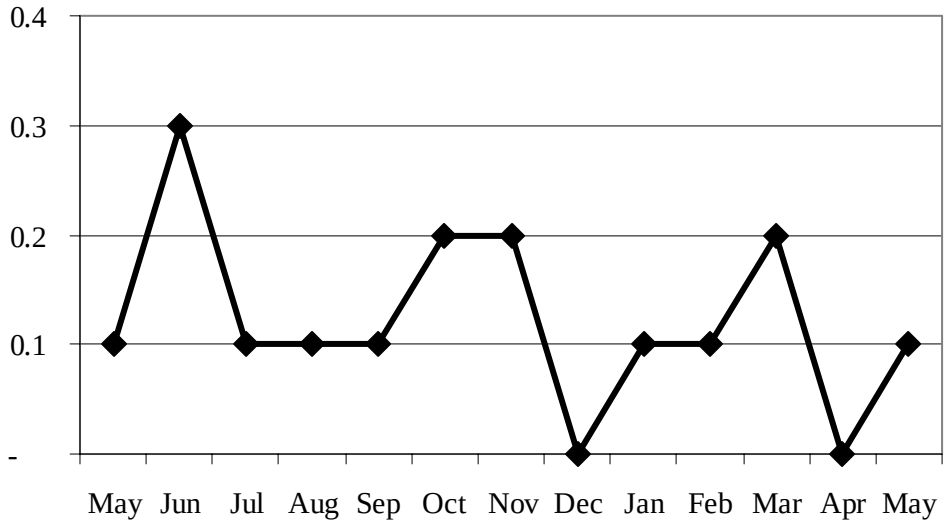


Figure 2 – Volume of Panamax tanker orders placed per month in 2003 / 2004 (million CGT)

[92] Clarkson World Shipyard Monitor **(Exhibit EC-152)**.

148. It is clear that there has been no correlation between price and demand in this sector over this period. If the price is correlated against the overall FMI newbuilding price index, however, a strong correlation is seen. This is shown in figure 3 below.

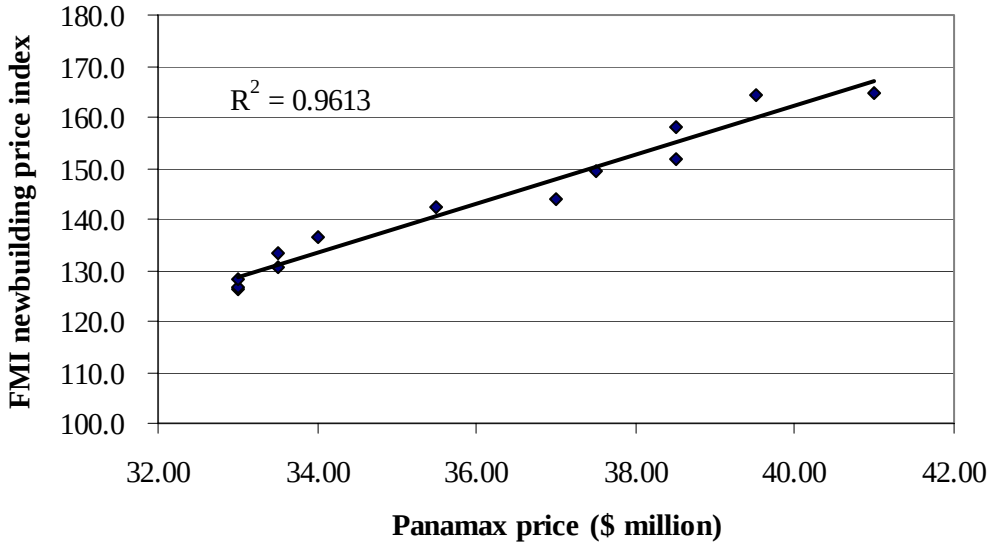


Figure 3 – The relationship between Panamax tanker prices and the newbuilding price index between May 2003 and May 2004

149. Thus, the price of Panamax tankers has followed the general trend in newbuilding prices, but has no apparent relationship to demand in this specific sector. Likewise, the general trend in prices has not followed the overall trend in demand. Figure 4, below, shows the total volume of contracting reported by Clarkson over the past year, which has remained largely level. Newbuilding prices, by contrast, have increased as shown in the newbuilding price index for the period in figure 5.

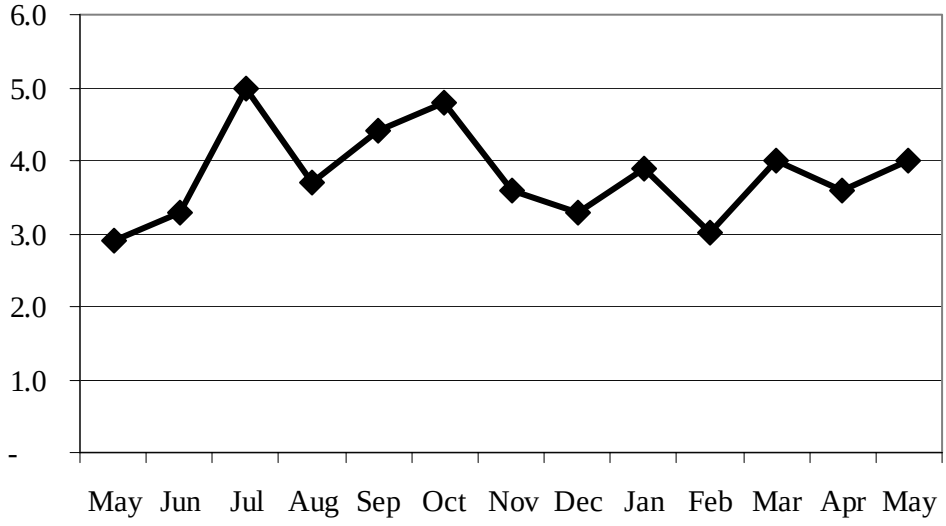


Figure 4 - Volume of all orders placed per month in 2003 / 2004 (million CGT)

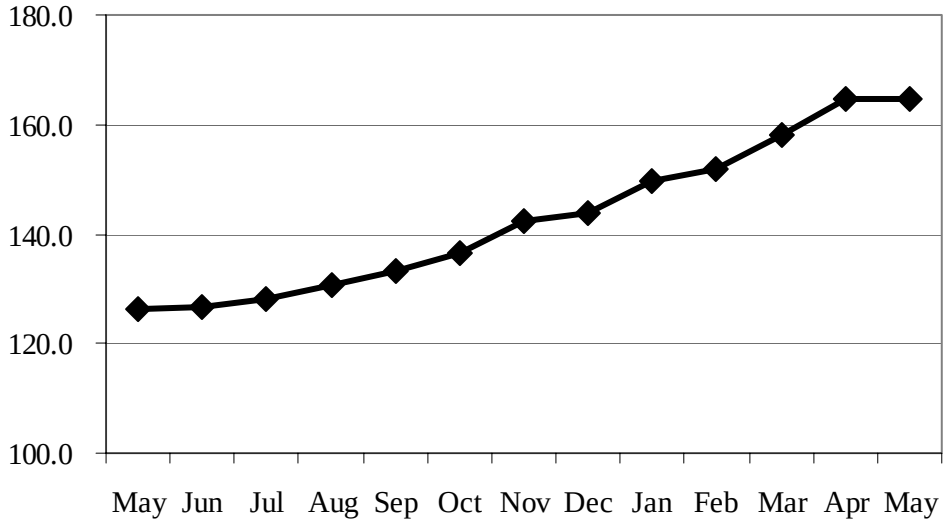


Figure 5 – FMI newbuilding price index in 2003 / 2004 (1987 = 100)

150. Price has not always been de-coupled from supply and demand. Economist Dr Martin Stopford, author of the definitive text "Maritime Economics" and managing director of Clarkson Research, has theorised that shipbuilding prices are determined through supply and demand, but that the supply and demand functions shift over time.[93] Long term analysis of the market shows this is true, with shifts caused, for example, by increasing costs in price-leading countries or changes in capacity. The relationship between price, on the one hand, and supply and demand, on the other, normally reasserts itself following a shift. For example, this happened from 1999 to 2001, following the shift in the supply function that accompanied the Asian financial crisis, and in particular the collapse of the Won. The link with the market disappeared thereafter in the dash for orders and is only now starting to reassert itself.

151.

(b):

152. The concept of customers purchasing a larger-than-usual ship for a particular run, due to a relatively low price for the larger ship, was raised by Korea. The EC is not aware of such incidents in the market. Typically, an owner has a clear idea about the market in which its new ship will be used. His key parameters will be cargo carrying capacity and vessel speed. While he may accept variations in the ship's specification (*e.g.*, a higher or lower speed), he will not see any benefit in buying a larger vessel for the same price if the available cargo remains limited. Where available cargo is unlimited, he will opt for the largest design possible, as currently seen with container ships. However, he will also take account of market volatility and operating costs, assessing whether the larger ship can actually be filled throughout its useful life. This has, for example, limited the growth of crude oil tankers, as the largest designs today are around 300.000 dwt, while designs of up to 1.000.000 dwt were discussed and planned before the oil crisis of 1973.

153. The important relationship between ship size and trading can be found in **Exhibit EC-1**, "Overview of the International Commercial Shipbuilding Industry", at Section 3.

154.

[93] Martin Stopford, "Maritime Economics" (Second Edition) 1997. pp 472-473.

Question 164

What specific evidence is there in the information before the Panel that APRGs and PSLs around the time of the restructuring helped the shipyards in question to remain in operation, whether by improving their balance sheets/cash flow or otherwise?

Response

155. It is obvious that access to pre-shipment loans and APRGs at a time when private creditors either would not have provided such facilities, or, if they had, would have charged higher rates or fees based on market conditions, improved the shipyards' cash flows and profitability. This self-evident conclusion is supported by the following general statement from KEXIM itself, as quoted in paragraph 160 of the EC's first written submission:

> The 1998 KEXIM Annual Report explained that KEXIM, "as an export credit agency, played a rescue-operation role, transfusing emergency loans to Korean exporters and importers at the onset of the crisis *when the banking sector in Korea was nearly paralyzed*." As KEXIM's Chairman stated in the 1999 KEXIM Annual Report, KEXIM "contributed to the economic recovery by providing a variety of financing programmes to exporters . . . who *experienced difficulty in obtaining adequate trade-related financing from commercial financial institutions*, due to the government-initiated restructuring plan in the financial and corporate sectors."

156. In addition, as explained in paragraph 489 of the EC's first written submission, APRGs caused orders to be placed with these yards, which led to full orderbooks, which in turn led to optimistic sales projections for the purposes of establishing going concern value.

Question 165

For each category of ship, what has been the evolution in prices versus costs in other major shipbuilding countries since the mid-1990s, and how does this compare with the trends in Korean prices versus costs?

Response

157. With respect to prices, the world market does not distinguish among countries of production. Any yard can set a price level that will be noted in the world market, and that will be the relevant benchmark, as long as production capacity exceeds demand. A yard can set such a price level even if it does not reflect its cost of production, as the losses will not occur until the vessel's delivery a couple of years later.

158. In the shipbuilding industry, it is not conceivable that a yard can ask a higher price for the same or similar vessel design, unless the buyer is somehow constrained to purchase at a competing yard. Such constraints do not exist for the large majority of ship owners. They exist only in particular cases, such as for US owners operating between US ports (thus being subject to the Jones Act), Japanese owners operating on domestic routes (who must obtain licenses from regional authorities that may indicate their preference for a domestically built vessel) or cruise ship operators who need vessels of such sophistication that Korean and Chinese yards are not considered experienced enough to deliver an acceptable ship.

159. Regarding costs, reference is made to the answer to question 161. The analysis of shipbuilding costs is a complex undertaking requiring significant resources. The EC has had no reason to investigate shipbuilding costs in Japan, as EC yards do not consider the business practices of Japanese yards as injurious. There has also been no reason to monitor shipbuilding costs in EC yards,

as these yards operate in a free market environment, and losses from extremely low prices would put the company into financial difficulties. If such losses would be compensated through subsidies, the EC competition law would apply. Recently, the EC has started to monitor shipbuilding costs in China, but no results are available at this time.

160. In general, certain costs would not be country-specific or only on a limited scale. For example, steel is more or less a global commodity, and major equipment such as engines, cranes, etc., are procured by yards on a global scale. The main cost differences between countries result from labour costs, productivity levels, exchange rates and financial instruments.

Question 166

(a) For each of the three ship types, what specific evidence/examples are there in the information before the Panel (in addition to the domestic complaint by Samsung against Daewoo) that the restructured shipyards were the price leaders among the Korean producers?

(b) What evidence is there in the information before the Panel in support of the EC argument that the alleged restructuring subsidies enabled the restructured yards to drive down the prices charged by all other Korean shipyards?

(c) What has been the annual financial performance of the other (non-structured) Korean shipyards since the restructuring?

Response

(a) – (b):

161. The price leadership is dependent on the capacity exercised in the market and on market share. It is also related to the dynamics within small groups of dominant shipyards, amongst which are the disputed yards. This is discussed in **Exhibit EC-146** at Section 3, page 4. Additional information on the strength of the restructured Korean shipyards can be found in Clarkson World Shipyard Monitor, including section "Shipyard Capacity", page 16, and in the detailed sections showing the distributions of orders by type.[94]

162. As explained in response to question 162, the low prices in the shipbuilding market have a contagious effect in the shipbuilding market. Furthermore, the WTO Secretariat itself recognised that Korean shipyards are the price leaders when it pointed out the strong market position of the five big chaebols, with about 95 per cent of the Korea output, three of which are restructured shipyards:

> Since 1999, Korea has been the world's leading shipbuilder (second in 1998) and thus a **price leader** for many types of ships; its share in global ship production attained 30 per cent-35 per cent (1999). Shipbuilding, a capital-intensive industry strongly linked to, inter alia, the cargo handling, steel and electronics industries, is among the few sectors that emerged virtually unscathed from the recent recession. The depreciation of the won (as well as high wage levels in Japan and the bilateral strength of the yen) helped boost the export competitiveness of Korean shipyards (vis-à-vis China and Japan), which rely heavily on the building of large-sized ships. Between 1995 and 1998, the output of the shipyards, which are dominated by five chaebols (Hyundai, Daewoo, Samsung, Hanjin, and Halla account for about 95 per cent of output), grew steadily by more than 17 per cent. Between 1995 and 1998, Korea virtually doubled its trade surplus in ships (US$7.6 billion), as imports fell by

[94] Clarkson World Shipyard Monitor **(Exhibit EC-152)**.

> 75 per cent and exports grew by 45 per cent; in 1998, ships accounted for 6 per cent of Korean exports.[95]

(c):

163. The EC does not possess information regarding the annual financial performance of the other (non-structured) Korean shipyards since the restructuring.

Question 167

If, as the EC argues, shipyards have near-total flexibility to produce any kind of ship, and the Korean yards are heavily subsidized, why are Korean shipyards not more-or-less equally active in all kinds of ships (including cruise ships, ferries, etc.)?

Response

164. The Korean shipyards have been pursuing sectors that they anticipate provide the greatest economic benefits, either through volume or value. This does not mean to say that they will not shift into other sectors as they perceive changing conditions.

165. For example, Daewoo, Hyundai Heavy, Hyundai Mipo and Samsung have begun to build ferries, and Samsung has committed significant investment to pursue the cruise ship sector. Korean yards cherry pick the contracts and sectors that they see as having the greatest advantage at the time. The ferry and cruise ship sectors are generally considered as "niche market" where the volume of orders is more cyclical, and relatively low in terms of number of ships. In recent times, volume has dictated order intakes, with the Korean yards targeting the greatest volume sectors. Not all sectors generate the same amount of work. This is discussed in **Exhibit EC-1**, "Overview of the International Commercial Shipbuilding Industry", at Sections 4 and 5.

II. TO BOTH PARTIES

A. ITEM (J) / ITEM (K), FIRST PARA.

Question 168

The parties disagree as to whether APRGs constitute export credit guarantees and whether PSLs constitute export credits. Please provide any documentation (either from the shipbuilding industry, the OECD, or any other source) that you consider supports your position on these issues.

Response

166. The European Communities has already provided documentation supporting that APRGs and pre-shipment loans do not constitute export credits because they assume a risk that relates to the creditworthiness of the domestic exporters.[96]

167. This is further confirmed by the *Knaepen Package* agreed between OECD Members in 1997.[97] The *OECD Arrangement on Export Credits* did not address premia at the time of the Uruguay

[95] WTO Trade Policy Review Mechanism of 2000, WT/TP/S/73 **(Exhibit EC-82)** (footnotes omitted).

[96] Oral Statement by the European Communities to the first meeting with the Panel, paras. 56-64 and **Exhibits EC-98 and EC-99**.

Round. The *Knaepen Package* contains rules on calculating the premia drafted solely with the creditworthiness of the *buyer-country* in mind. The *Knaepen Package* states that the guiding principles for setting premia fees under the *Arrangement on Guidelines for Officially Supported Export Credits* set minimum premium rates for sovereign and country credit risks irrespective of whether the buyer/borrower is a private or public entity. Principles for the *commercial risk* on the *buyer* are still outstanding for negotiation.

168. There is no suggestion in the *Knaepen Package*, nor indeed was there during the negotiations that led to its adoption, that premia should be set according to the risk of the exporting country or of the seller, exporter or producer. Any loans or guarantees which involve risks incurred within the exporting country would be subject to the same considerations as normal domestic loans and guarantees.

Question 169

Item (j) refers to the provision of various "programmes". Assuming that an a contrario interpretation of item (j) is permissible, could it operate as a defence for individual APRG transactions, as opposed to the APRG programme per se? Please explain. In particular, if the focus of item (j) is on the long-term operating costs of the programme, how could item (j) determine whether or not individual transactions under the programme constitute export subsidies?

Response

169. Assuming that an "*a contrario"* interpretation of item (j) is permissible, it could not operate as a defence for individual APRG transactions but only for the APRG programme *per se*.

170. The existence of an export subsidy programme and an individual export subsidy transaction are two separate questions.

171. Item (j) clarifies that certain export credit programmes are not WTO incompatible if they cover long-term operating costs. However, item (j) is not relevant for the determination (under Article 1 of the *SCM Agreement*) whether an individual transaction was market based or a subsidy. Even if a programme is set to cover long-term operating cost, it may be that an individual transaction confers a benefit because the guarantee is granted without regard to market principles, e.g., the corporate risk of the shipyard.

B. APRG/PSL

Question 170

Korea asserts that KEXIM PSL rates have been above certain DSME bond rates since 1999 (para. 231, Korea's first written submission). The EC asserts that certain DHI bonds were guaranteed (para. 124, EC's second written submission). Are the parties referring to the same bonds, or were the DSME bonds referred to by Korea different from the DHI bonds referred to by the EC? Please explain.

Response

172. The DSME bond rates shown in Para 231 of Korea's first written submission reflect quarterly summaries of outstanding borrowings in corporate bonds and *not* the interest rates at which

[97] *The Knaepen Package: Guiding Principles for Setting Premia Fees under the Arrangement on Guidelines for Officially Supported Export Credits*, entry into force by 1 April 1999 **(Exhibit EC-154)**.

DHI/DSME bonds were issued. In consequence, one cannot compare directly the bonds rates as provided in para 231 of Korea's first written submission and the bonds rates to which the European Communities refers in para 124, of its second written submission.

173. The EC's assertion that most DHI and DSME bonds were guaranteed is supported by **Exhibit EC-129**, which contains a table listing lists all DHI issues of corporate bonds from 1986 until December 1998. It demonstrates that most of the DHI bonds issues were guaranteed during this period.

174. The EC in Question 17 at the first hearing asked Korea to provide details on corporate bond issues referred to by Korea in para 231 of its first written submission.[98] Korea provided a table limited to only *6* issues from 1997 to 1998 whereas the issues amounted to *39* in that period (**see Exhibit - 129**). In consequence, the EC can only reply for the 6 issues provided by Korea, which are the same as the ones provided by the EC. Out of these 6 issues, 3 issues were guaranteed.

175. However, it should be noted that as regards the remaining corporate bond issues, Korea failed to provide the required information. The EC in question 17 to Korea specifically asked for detailed information, including on "d) guarantees by other entities". Korea replied that this information was not available. The European Communities considers that Korea failed to cooperate because the requested information is not confidential, available for any investor[99] and Korea has therefore not rebutted the EC *prima facie* case on this point.

176.

Question 171

Regarding Exhibit Korea – 16, are "KEB", "CHB" and Hanil Bank public bodies? If not, are they "entrusted or directed" private bodies? Please explain.

Response

177. In this case the EC has not argued that KEB (Korea Exchange Bank), CHB (Chohung Bank) and Hanil bank are public bodies but that they were "entrusted or directed" private bodies. These Banks were in a weak financial condition and were helped by GOK through capital injections. GOK has substantial shareholdings in all three of them.

178. In particular, with regard to KEB the EC has explained[100] that KEB was established as a fully government-owned bank in 1967 to specialise in the foreign exchange and trade business. For a decade it had the exclusive right of offering trade financing and foreign exchange services. In 1997 trade financing and foreign exchange services were liberalised and KEB ventured into commercial banking. Still in 1997 GOK was the major shareholder (47.88 per cent); as of 31 December 2000 it is owned by the State 43.17 per cent (KEXIM 32.50 per cent, Bank of Korea 10.67 per cent) and Commerzbank (32.55 per cent)[101]. **Still after its partial privatisation (Commerzbank acquired its share in July 1998), the Korean Government as the major shareholder continued to exercise its influence and provided substantial support to the Bank through capital injections : 336 Billion Won in April 1999 and 400 Billion Won in December 2000.**[102]

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[98] Korea's response to the question 17 by the EC following the first substantive meeting.

[99] See unredeemed Corporate bonds of DHI Source : DHI marketable Securities Statement for offering the 229th Non-Guaranteed Corporate Bonds, submitted to Financial Supervisory Service (FSS) on 25 May 1999 **(Exhibit EC-129).**

[100] See Attachment 3 to EC's Answers to Panel question 17 of 22 March 2004

[101] See Korea's Annex V main response, reply to question 5 at page 26, **(Exhibit-EC 39)**.

[102] See Korea's Annex V main response, reply to question 5 at page 27, **(Exhibit-EC 39)**.

179. With regard to **Chohung Bank**, the EC has explained[103] that it was established in 1943 to engage in commercial banking. Soon after the financial crisis erupted Chohung went into financial dire straights so that in 1999 the Korean Government stepped in and acquired **80 per cent of stock** (which it still holds). In its Annex V response Korea states that Chohung received a capital injection of 2.7 trillion Won[104].

180. With regard to **Hanil** in its Annex V response Korea states that Hanil received a capital injection of 1.6 trillion Won.[105] Korea has not reported the shareholding obtained by GOK through this capital injection.

C. ALLEGED ACTIONABLE SUBSIDIES

Question 172

Please comment on paras 504 – 509 of the report of the GATT panel in United States - Imposition of a Definitive Countervailing Duty on Imports of Certain Steel Products Originating In France, Germany, and the United Kingdom.

Response

181. The panel report referred to related to a dispute under the 1979 GATT subsidies code and was never adopted. Its pertinence is already for that reason limited.

182. That said, the European Communities would note that the Panel did not express any absolute preference for one or the other standard. It contented itself with concluding that the rejection of the "inside investor" standard was not an error in the light of the facts of the case at hand, in the light of the reasoning provided by the US agency involved (DOC). In fact it concluded that:

> 507. The Panel was aware that there might be circumstances under which inside and outside investors might behave differently because of factors such as differences in the availability of relevant information to inside and outside investors and the presence of barriers to exit and entry. However, the Panel did not consider that the arguments of the EC showed that such factors were relevant under the facts of the cases at hand.
>
> 508. In sum, the Panel found that the DOC had expressly addressed the issue of the alleged need to distinguish between inside and outside investors and that the explanation provided by the DOC for its decision not to make such a distinction could not be said to be inadequately supported by rational analysis. The arguments of the EC at best indicated that an alternative approach was possible. The Panel therefore could not find on the basis of these arguments that the DOC, by not making a distinction between inside investors and outside investors, had failed to consider a relevant fact.
>
> 509. In the light of the considerations above, the Panel saw no merit in the argument of the EC that the United States acted inconsistently with the Agreement when, in the countervailing duty investigations of imports of certain hot-rolled lead and bismuth carbon steel products from France and the United Kingdom, the DOC did not make a distinction between the perspectives of inside investors and outside investors in its

[103] See Attachment 3 to EC's Answers to Panel question 17 of 22 March 2004
[104] See Korea's Annex V main response, reply to question 5 , table d) at page 26, **(Exhibit-EC 39)**.
[105] idem

analysis of whether or not subsidies arose from the provision of equity capital by the Governments of France and the United Kingdom.

183. In any event, as the explained in response to question 148 above, the European Communities does not believe that this is an issue in the present case. The only case where Korea invokes this concept (Samho) is one where there was no "inside investor" that was free from government control.

D. SERIOUS PREJUDICE

Question 173

(a) For each of the three ship types at issue in this dispute, how are ship data normally maintained by the industry, and by industry analysts?

(b) In particular, are these three categories of ships recognized and used routinely for purposes of industry analysis?

(c) If so, how are they defined, and for what purposes are these categories used?

(d) When analysts report on pricing trends, do they normally refer to prices for each category as a whole, or for subcategories thereof, broken out, for example, by size and/or other characteristics.

(e) If they provide a range of pricing information at different levels of aggregation, how are these different data series used?

(f) Please provide documentation (including in particular relevant excerpts from the published industry reports discussed at the second meeting) showing examples of the various breakouts to which you refer.

Response

(a):

184. There are numerous sources of information on the industry. FMI, in particular, maintains subscriptions with those analysts that have shown the greatest consistency and accuracy, including publications from Lloyd's Register and Clarkson Research. A note on these sources is given in **Exhibit EC-1**, "Overview of the International Commercial Shipbuilding Industry", at Section 1.3, page 2. The two most important publications from the point of view of the shipbuilding industry are provided herein as exhibits, i.e. Clarkson's monthly World Shipyard Monitor[106] and Lloyd's Register's quarterly World Shipbuilding Statistics.[107] Many other consultancy reports and analyses, including much of FMI's work, are derivatives of these sources. The main advantage of the Clarkson publication is that it examines prices, not considered by Lloyd's, and it looks at the shipyard level, where Lloyd's only looks to the country level. The main advantage of the Lloyd's publication is the level of completeness of the data, which is based on Lloyd's Register. Virtually all ships will appear in Lloyd's Register, while Clarkson concentrates on the mainstream market sectors. FMI also subscribes to Lloyd's Register's database, to enable more detailed analysis of the statistics presented in the publication, including at the shipyard level.

[106] Clarkson World Shipyard Monitor **(Exhibit EC-152)**.
[107] Lloyd's Register's "World Shipbuilding Statistics" **(Exhibit EC-155)**.

(b) and (c):

185. A good illustration of the grouping and hierarchy of ship types is given on pages 6 and 7 of the Lloyd's Register publication "World Shipbuilding Statistics".[108] It is broadly this taxonomy that is used by FMI in its analyses. The three ship types can be clearly seen within this table. The use of these groupings is fundamental to the analysis of shipping and all related industries, including shipbuilding. Definitions of the ship types concerned are given in **Exhibit EC-1**, "Overview of the International Commercial Shipbuilding Industry", at Section 3.

(d), (e) and (f):

186. The most complete source of price information and trends is Clarkson's World Shipyard Monitor.[109] The "Shipbuilding Price Trends" description on page 8 thereof presents prices for various classes of ships. For example, one price index is given based on the average movement of tankers (both crude and products) and dry bulk carriers. This index clearly groups together ships of different types and sizes to look at the average movement of prices. See also **Exhibit EC-1**, "Overview of the International Commercial Shipbuilding Industry", at Section 3, for a description of the meaning and implications of bulk ship types included in this index.

Question 174

Korea argues that demand should be measured in numbers of vessels, and/or workload years (i.e., order backlog) rather than compensated gross tons of new orders. The EC responds that CGT is more accurate as a measure of supply and demand, and that even measured in workload years, demand trends are as represented by the EC.

(a) Could each party explain the technical differences between the two measures, and provide further detail as to why it believes its preferred measure represents a more accurate picture of demand than the other.

(b) Which measure is used by industry analysts and the industry when analyzing demand trends?

(c) If both are routinely used, please explain the circumstances in which they are used, and provide examples from independently prepared sources (the published industry reports discussed at the meeting, OECD documents, etc.).

Response

(a):

187. A description of CGT and other measurements is presented in **Exhibit EC-1**, "Overview of the International Commercial Shipbuilding Industry", at Section 2, page 3. The EC has used CGT because it measures the amount of work involved in building ships, and therefore the amount of *capacity* required. A shipyard has the capacity to undertake a certain amount of work in a given period. Because of the nature of the product, this is not necessarily related to the number of ships produced or their physical size. At the extremes, for example, constructing a single VLCC will provide more work than constructing two handy-size tankers. Constructing a single cruise ship will provide more work than the construction of several very large tankers. CGT is the unit that connects supply and demand, and is therefore the key to price behaviour.

[108] Lloyd's Register's "World Shipbuilding Statistics" **(Exhibit EC-155)**.
[109] Clarkson World Shipyard Monitor **(Exhibit EC-152)**.

(b) and (c):

188. The measure used by analysts depends on the analysis being undertaken. Both the Clarkson and Lloyd's publications provide a range of units to enable a proper analysis to be performed.[110] For example, a tanker owner will be interested in the total deadweight of tankers on order[111] because it measures the cargo carrying capacity of the ship, and that is what interests the owner. Gross tonnage measures the physical size of ships and is the "official" (i.e. registered) measure of the size of the fleet. It also has significance for owners of ships that are "volume carriers" (i.e. that carry low density cargoes) where it better represents cargo-carrying capacity than deadweight. Passenger ships are a good example of such a ship type.

189. CGT is almost solely used in relation to the shipbuilding industry. For example, the OECD uses CGT when assessing production capacities, and their relationship to demand.[112] The number of ships is of limited significance in statistical analysis of either the shipping or the shipbuilding industry, although it is reported in the statistical sources and it is sometimes used for very specific and narrow analyses. FMI has used the number of ships, for example, to examine product focuses of specific shipyards, in terms of the internal distribution of their order books. This has been necessary because of data lags in information provided by Lloyd's Register. At the early stage of a contract, the register may not have complete tonnage information, and the number of ships provides a temporary guide. If the information were available, the distribution by CGT would be more appropriate for the analysis.

Question 175

In response to EC arguments concerning market share as a factor in price leadership, Korea variously states that market share does not demonstrate price leadership, but also that Korean yards' market shares are too small for them to be able to influence prices. Both sides thus seem to view market share as somehow relevant to the question of price leadership.

(a) How (on the basis of what sort of concrete data and analysis) can price leadership be determined/established?

(b) What role in such an analysis would levels and trends in market shares play?

(c) How large a market share would a given market participant need to be able to exercise price leadership.

Response

(a), (b) and (c):

190. The determination of price is fundamentally related to the exercise of capacity in the market. The positioning of the Korean shipyards in this respect can be seen in Clarkson World Shipyard Monitor.[113] Over the past two to three years, because of the seemingly inexhaustible availability of capacity, the dynamics between small groups of leading shipyards have been determining prices. (This is discussed in **Exhibit EC-146**, "FMI June 2004 Report, technical support to the WTO

[110] Clarkson World Shipyard Monitor **(Exhibit EC-152)**; Lloyd's Register's "World Shipbuilding Statistics" **(Exhibit EC-155)**.

[111] See **(Exhibit EC-1)**, "Overview of the International Commercial Shipbuilding Industry", at Section 2, page 3, for the definition of tonnage measures.

[112] OECD, Evaluation of World Shipbuilding Capacity (2000 Revision), C/WP6(2001)6 (29 May 2001) **(Exhibit EC-151)**.

[113] Clarkson World Shipyard Monitor **(Exhibit EC-152)**, p. 16.

hearings", at Section 3, page 4, and the prices in general are discussed in **Exhibit EC-1**, "Overview of the International Commercial Shipbuilding Industry", at Section 8, page 25). Because of the dynamics between these groups, the amount of capacity exercised does not have to be large. Every order will be contested on the basis that if a matching price is not offered, there is other capacity available that will snap it up.

191. Furthermore, two reference documents, one issued by the **WTO Secretariat**[114] and one issued by the **OECD Secretariat**[115] confirm that **Korean Shipyards are the price leader** on the world wide market. As already indicated in our response to Panel question 163, three of the five Korean leading shipyards are restructured shipyards, exercising a strong pressure on the other Korean shipyards preventing prices to increase when the demand increases. The OECD Secretariat notes that under normal economic theory:

> high demand would drag up prices, as the market sought some kind of equilibrium. The combination of high demand and lower input costs should also signal a period of high profits for all manufacturers, but this has not happened. The fact that this has not happened, and does not show any signs of happening, would reinforce the view that the industry is still affected by considerable excess capacity.[116]

192. Then, the OECD notes as well that the explanation of low prices cannot be found through a strong decrease in material/metal cost. The conclusion of the OECD "*is that the market is being interfered with, which prevents prices from responding to steeply increasing demand*".[117] The two factors identified to explain such a situation are (i) the Korean shipyards overcapacity resulting from restructuring subsidies and (ii) the price depression and suppression leadership by Korean shipyards.

[114] TPRM Korea (**Exhibit EC-82**).
[115] OECD Document "Recent Newbuilding Price Developments" C/WP6/SG(2003)10 **(Exhibit EC-157)**, paragraph 10.
[116] *Ibid*., para. 9.
[117] Ibid, para. 13.

LIST OF ATTACHMENTS

Attachment EC-10	**EC – Calculation for Benefit PSL**
Attachment EC-11	**EC – Calculation for AdValorem Benefit PSL**
Attachment EC-12	**EC – Calculation for AdValorem Benefit APRG**
Attachment EC-13	**EC – Calculation Subsidies to Daewoo, including Tax Concession**

LIST OF EXHIBITS

Exhibit EC-148	**Report by PriceWaterhouseCoopers, June 2004**
Exhibit EC-149	World Bank Report on Korea (18 September 2000).
Exhibit EC-150	**Details of 19 July 1999 Loan to Daewoo-HI (Attachment 3.1(2) of Korea's Annex V response)**
Exhibit EC-151	OECD Evaluation of World Shipbuilding Capacity (2000 Revision), C/WP6(2001)6 (29 May 2001)
Exhibit EC-152	Clarkson World Shipyard Monitor
Exhibit EC-153	OECD Document C/WP6/SNG(2004)
Exhibit EC-154	The Knaepen Package: Guiding Principles for Setting Premia Fees under the Arrangement on Guidelines for Officially Supported Export Credits, entry into force by 1 April 1999
Exhibit EC-155	Lloyd's Register's "World Shipbuilding Statistics"
Exhibit EC-156	**Cost Modelling Details Angelicousis LNG at Daewoo**
Exhibit EC-157	OECD Document "Recent Newbuilding Price Develoments" C/WP6/SG(2003)10

Note: Attachments and Exhibits in bold contain BCI.

ANNEX G-2

COMMENTS OF THE EUROPEAN COMMUNITIES ON NEW FACTUAL INFORMATION PROVIDED BY KOREA

(9 July 2004)

I. INTRODUCTION

1. The European Communities thanks the Panel for providing it with an opportunity to comment on any new factual information to submitted by Korea in conjunction with the 2 July answers to the Questions from the Panel.

2. The invitation by the Panel to comment, as the European Communities understands it, is strictly confined to new factual information submitted by Korea in its Responses to the Panel Questions following the second substantive meeting with parties. Therefore, the European Communities will not comment, again, on any facts reiterated by Korea in that context, appreciation of old and new facts or otherwise legal arguments. Therefore, the fact that the European Communities does not comment on the latter does not mean that they are no longer disputed by the European Communities. The European Communities refers the Panel to its positions on facts and legal arguments as previously expressed. In addition, the European Communities has sought to limit its comments to new factual elements that appear relevant to the Panel's deliberations.

3. For the convenience of the Panel, where the European Communities has a comment to make on new factual information introduced by Korea, the European Communities first repeats the question and the response by Korea before setting out its comment.

II. KOREA'S RESPONSES TO QUESTIONS BY THE EC

4. Paragraph 209 of Korea's Oral Statement: If the tax breaks pursuant to Article 45-2 of the Corporate Tax Act referred to were not intended to apply only to the Daewoo workout why were they introduced in conjunction with that workout and granted for only three months – enough time to allow Daewoo to capture them? How may other companies have benefited? Is it still in force?

Korea's Response

Article 45-2 of the STTCL was intended to extend the tax provision to workout companies as well as companies undergoing corporate reorganization. When the law was deliberated at the National Assembly, every company which could be affected by the proposed law was interested and waited for the law to be passed. The law has a broad base of application in terms of the companies to which it could apply.

The law was extended twice so that workouts and corporate reorganizations carried out until the end of 2002 could be covered. It is normal for tax laws in Korea to be adopted on an annual basis. No records have been kept either in court or by the tax administration to identify the companies that made use of this tax provision.

EC Comment

Korea claims that it has not kept any records that it would allow it to identify companies using the tax break. The European Communities would note that Article 46(3) of the Corporate Tax Act, which is applicable to Article 46(1) of the Corporate Tax Act referred to in Article 45-2 STTLC and therefore to this tax break requires, companies that request its application to submit "a detailed statement on corporate division to the competent district tax office".

In view of Korea's statement that there are no records, the European Communities considers that the Panel can only assume that there are no other cases of application of Article 45-2 STTLC.

III. KOREA'S RESPONSES TO QUESTIONS FROM THE PANEL

110. Please comment on the EC's assertion (at part 107 of its Second Written Submission) that Korea failed to provide details of the rates of five of the APRGs issued for Samsung by commercial banks in 1997.

Korea's Response

Korea provided the best information available at the time of the Annex V procedure. Korea notes that much of the information requested in Annex V and subsequently has not been in the hands of the Government of Korea. Having confirmed with Samsung, Korea understands that the rates of the five APRGs referred to by the EC were not available as the required preservation period of the relevant documents had expired. Where information for some of the APRGs issued in 1997 was still available, such information was submitted.

EC Comment

The European Communities does not find it credible that a company like Samsung would not keep documents for more than five years or, indeed, that it would do for some APRG documentation but not for others.

The European Communities considers that the Panel should infer that the missing documentation was not provided because it would have shown the existence of a subsidy.

113. In respect of Koreas reply to Question 71 from the Panel, please provide supporting evidence for Korea's assertion that the Kookmin and Woori Bank rates for Samsung APRGs were [BCI: Omitted from public version] instead of [BCI: Omitted from public version].

Korea hereby confirms that the Kookmin Bank and Woori Bank rates for Samsung APRGs were **[BCI: Omitted from public version]**. Korea's prior statement that is not consistent with this information was inadvertently made due to clerical mistake by the company in pulling together the response. Korea regrets any confusion.

EC Comment

*Korea re-confirms the original EC assertion (based on Annex V information provided by Korea) that the Kookmin Bank and Woori Bank rates for Samsung APRGs were **[BCI: Omitted from public version]**. The EC calculations on APRGs are based on this assumption and therefore remain valid.*

116. Korea asserts that Article 45-2 of the Corporate Tax Act does not constitute revenue forgone, and did not confer a benefit. According to the news report in Exhibit EC-136, however, a Daewoo company official stated that Daewoo would "be exempted from taxes totaling 236 billion won'. Please comment, and explain how a 236 billion won tax exemption is not revenue forgone and did not confer a benefit

Korea's Response

Under the *SCM Agreement*, the EC has the burden to prove specifically what government revenue was otherwise due and how such revenue was foregone or not collected (Article 1.1(a)(1)(ii)). The EC has failed to carry this burden of proof. Moreover, it appears that the EC still has no clear understanding of the Korean tax scheme. As a result, Korea still can not determine specifically what the EC's allegations on tax concessions are about.

The news report in Exhibit EC - 136, which quoted the alleged statement by a Daewoo official, establishes nothing about the types of taxes concerned, applicable provisions of tax laws, tax rates, calculations of the tax amount involved, how they were foregone, etc. Given the complication and technicalities of the tax issues, no Panel would make an affirmative finding of financial contribution and benefit on the basis of such a very questionable newspaper article. Moreover, the amount of KRW 236 billion allegedly mentioned by a Daewoo official does not distinguish what portion of this total amount is attributable to DSME as distinguished from the portions attributable to the machinery company and to the remaining DHI. In short, the EC has not established a *prima facie* case of the tax concession as required by Article 1.1(a)(1)(ii) of the *SCM Agreement*.

Under these circumstances, Korea is placed in an awkward position when it is asked by the Panel to "explain how a 236 billion won tax exemption is not revenue foregone and did not confer a benefit". This question assumes that there was a tax exemption of KRW 236 billion, but Korea disagrees that a 236 billion won tax exemption has ever been established by the EC. Unless the EC first explains how KRW 236 billion or whatever amount has been calculated and under what provisions of tax laws, it is impossible for Korea to explain how this amount is not revenue forgone. Nonetheless, Korea would like to comply with the request of the Panel by providing further explanations on the tax issue, while again reserving its rights regarding the burden of proof.

First of all, Korea refers the Panel to paragraphs 221 and 222 of the EC's Second Written Submission, in which the EC made clear that its "core claim" was the "temporary tax exemptions" granted under Article 45-2 of the Special Tax Treatment Control Law ("STTCL") which extended tax incentives under Article 46 of the Corporate Tax Act. It appears that the EC believes that Exhibit EC - 136 provides evidence of the size of tax incentives under the above Article 46 of the Corporate Tax Act which had been "extended" by Article 45-2 of the STTCL.

However, as Korea has repeatedly explained (see, e.g., paras. 206 – 208 of Korea's Oral Statement at the Second Panel Meeting), the special tax treatment under Article 46 applies only when "valuation gains" have arisen to a spun-off company as a result of the "valuation" of assets carried out at the time of the spin-off. In the case of the DHI workout, the assets of the original DHI were spun-off to DSME and the machinery company at book value (i.e., without "valuation" of those assets). Therefore, DSME could not obtain any tax incentives under Article 46 of the Corporate Tax Act as extended by Article 45-2 of the STTCL.

The fact that the DHI assets were transferred at book value to the spun-off companies is clearly demonstrated by **Exhibit Korea – 120** (1999 Anjin's Workout Report, excerpted pages, Appendix 10), as well as by Exhibit EC-55 (DHI Workout Plan), Appendix D-11 (balance sheet) and Exhibit EC-56 (Structure of spin-off). Also, the EC has never disputed this fact.

Therefore, contrary to the allegation by the EC, there was no tax exemption granted to DSME under Article 45-2 of the STTCL and Article 46 of the Corporate Tax Act. Thus, the EC's "core claim" fails, and the questionable statement by a Daewoo official in Exhibit EC-136 cannot prove anything when what the EC proposes to prove on the basis of hearsay cannot "legally" make sense. For the avoidance of any doubt, Korea hereby submits the text of Article 46 of the Corporate Tax Act (both the Korean original and English translation) as **Exhibit Korea – 121**.

In this situation, it is questionable that a Daewoo official could really have made the statement about KRW 236 billion as was written by the journalist or whether the journalist misunderstood. If a Daewoo official really made that statement, it may well be that he misunderstood the facts and the applicable tax law. The other plausible answer might be that the Daewoo official may have referred to a totally different type of tax incentive. A possible candidate is the "special additional tax" which could have been levied if there were gains from the transfer of certain assets from DHI to the spun-off companies. However, this tax was to be levied on DHI (remaining after the spin-off) under Article 99 of the Corporate Tax Act.

Prior to 31 December 2001, the Corporate Tax Act provided that, if a company realized capital gains from the transfer of certain assets (e.g., land, building and other real property rights), the transferring company was required to pay, in addition to ordinary corporate income tax, the so-called "special additional tax" at the rate of 16.5 per cent of the capital gains so realized (*See* **Exhibit Korea – 121,** Articles 2 and 99 of the Corporate Tax Act). For the purpose of this tax, the 'capital gains' meant the amount of the transfer price of the assets concerned, minus their original acquisition price and acquisition costs. In the context of the DHI spin-off, DHI may have been required to pay a substantial amount of such special additional tax if capital gains had been realized through the transfer of assets to DSME and the machinery company. Even if the transfer of assets was made at book value, the book value of those assets could have been higher than their acquisition prices and costs as a result of, among others, re-valuation made prior to the spin-off pursuant to the Asset Re-valuation Act.

Again, it should be noted that the payer of such special additional tax was the transferor of the assets subject of the special additional tax (i.e., the remaining DHI). However, by virtue of a special provision of Article 99(11) of the Corporate Tax Act, the transferor's payment of special additional tax could be deferred if the transfer of assets took place as a result of, among others, a spin-off that satisfies the requirements of Article 46 of the Corporate Tax Act. (*See* **Exhibit Korea – 121,** Article 99(11)). In the case of companies in restructuring, a problem arose due to the technical issue of not having precisely equal shareholding ratios due to the normal rules of share allocations in such situations. If a provision such as Article 45-2 had been included in the STTCL, thereby treating a spin-off made on unequal shareholding ratios as satisfying the requirement of Article 46 of the Corporate Tax Act, then, the remaining DHI's liability for special additional tax could have been deferred (not exempted) pursuant to Article 99(11) of the Corporate Tax Act and the remaining DHI would have been relieved of the burden to pay special additional tax immediately upon the spin-off.

However, by virtue of a subsequent legislation, the "special additional tax" was repealed as of 1 January 2002 (*See* **Exhibit Korea – 121**, Law No.6558 of 31 December 2001). As a result, any special additional tax liability of the remaining DHI (the provisions were only relevant to the transferor, not a transferee such as DSME) was completely extinguished.[1] This repeal was made mainly because the special additional tax was controversial as it operated as a double taxation in addition to ordinary corporate income tax which would also be assessed on the same capital gains as those subject to special additional tax.

[1] Korea also notes that this was generally available for any and all Korean corporations involved in any "asset transfer" transactions because the "special additional tax" itself was withdrawn in its entirety from the Korean tax system by virtue of the law of 31 December 2001.

EC Comment

The European Communities cannot hide its amazement that Korea is now claiming for the first time (without providing, however, any supporting documentation) that Article 45-2 was not applicable to the Daewoo restructuring and that any benefit would have allegedly been to DHI under Article 99 of the Corporate Tax Act.

The European Communities is unable at this time to obtain the tax advice necessary fully comment on the plausibility of these claims. Such tax advice would not however appear necessary in the light of the following facts:

- *Korea does not deny the fundamental point in the Newspaper article that the Daewoo restructuring would not have gone ahead without the tax exemption (whatever the precise legal basis);*

- *Korea confirms that the Arthur Andersen Report did not analyse the tax consequences of the restructuring plan (this is stated even more clearly stated in reply to question 123). This fact either adds to the flaws of the Arthur Andersen Report already identified by the European Communities and further reduces the going concern value or it shows that the entire restructuring was precooked from the beginning with Arthur Andersen knowing about the tax exemption well before it was adopted.*

125. (a) The list of factors identified in the *Drewry Report* as determinants of ship price includes freight rates, delivery date/build time (which would seem to be related to capacity and thus supply and demand), and payment terms (which would seem to be related to financing). Drewry does not refer to any measure of the aggregate level of demand as such. Please explain.

Korea's Response

Drewry considers that the trend in demand for each like product separately is one of the factors that contribute to the relevant price level for the product considered. However, as mentioned in Section 1.2.2 of the Drewry report, considering only that price will vary directly in line with demand does not go far enough as there are many other demand and supply-related factors that contribute to determining the price level for any like product. In Section 1.2 of Exhibit Korea – 70, Drewry identifies a range of factors that are considered to have an impact on ship price, i.e.:

- External factors (para 1.2.1)
  - Freight rates
  - Exchange rates
  - Metals prices index
- Supply side (para 1.2.2)
  - Workload shortage or overcapacity
- Demand side (paras 1.2.3 and 1.2.1)
  - Size
  - Delivery date
  - Payment terms
  - Build time
  - Shipbuilding orderbook
- Demand side – technical factors (para 1.2.3)
  - Speed and manoeuvrability
  - Hull strengthening

- Equipment specification
- Paint & coatings
- Innovative design
- Regulatory: Class and Ship Register

While the aggregated supply-demand balance is, therefore, clearly a factor which affects price in the shipbuilding industry, Drewry considers that it is not the only or dominant factor. Applying the simple economic concept of supply-demand balance, however, encounters some problems in shipbuilding, primarily:

- the difficulty in quantifying shipbuilding capacity (as opposed to historical output levels)

- the fact that this capacity is not all dedicated to merchant shipbuilding and may also be in used for naval shipbuilding, ship repair and conversion and offshore structure construction in particular

- the lack of homogeneity in aggregate demand (primarily due to different ship types and sizes)

- the lack of homogeneity in aggregated supply due to the size capability of yards' facilities and the experience base regarding ship types that they have experience in building.

The result is that whilst demand may be able to be categorized according to size and type of vessels, supply cannot rigorously be divided on the same basis and so there is considerable non-homogeneity within the supply-demand balance.

EC Comment

Contrary to what Korea states, there is no significant non-homogeneity within the supply-demand balance. CGT is the factor designed to iron out non-homogeneity. This is acknowledged by Korea, e.g., in its response to Panel Question 173(b) at p. 73, last paragraph.

(b) Also, in discussing Korean cost advantages on the supply side, Korea does not refer to cost of debt service/interest expenses. Please explain.

Korea's Response

Debt service costs tend to be specific to a particular yard's situation, both in terms of the structure of its financing of capital assets and also its working capital requirements. It is, therefore, not possible to take general economic indicators to estimate the relative cost advantages or otherwise of different yards in this respect. For example, in the EC there are many long established yards whose capital cost of facilities has long since been amortized and any interest on debt related to this will also have gone. Debt service costs related to facilities are, therefore, likely to be those associated with improvements and modernizations. In general terms, there has been a lower level of modernization at EC yards, but exceptions to this are to be found in the passenger shipbuilding yards and most particularly in the former East German yards like Aker MTW and Kvaerner Warnow Werft. In these yards the modernizations were state funded and then when the yards were privatized the new owners inherited the new facilities at a fraction of the investment costs – in this situation, the debt levels and hence debt service costs are driven by very specific circumstances which does not make for easy comparisons.

However, the area where Korea has significant cost advantages for such costs is in terms of the scale factor of its production. Firstly, debt service costs are supported by high workload volume

throughputs and as such on a basis of output units the cost per unit will be lower than for smaller yards.

This is particularly relevant in the case of financing of facilities and capacity where the capital cost of providing 1,000 cgt of capacity will be far lower than in smaller capacity yards. The Figure 8.1 in Exhibit – Korea 70 gives an indication of the throughput scale differences between EC and Korean yards, particularly recognizing that most of the bigger EC entries are in fact groups comprising more than one yard.

A good example of the economies of scale is evident from the example of LNG-specific investment. As highlighted in the KPMG report submitted as Exhibit Korea – 108, FMI assessed that a European yard would need to cover the investment burden of LNG specific investment over a series of 3 LNG ships but subsequently changed its estimates for Daewoo to recovery over 10 ships, to reflect the higher throughput volumes of such vessels at the Korean yard. By the end of 2002, Daewoo had in fact received orders for 21 LNG vessels and so its capital expenditure and any debt service cost associated with this is likely to be much lower than any European yard with only short series builds.

In respect of working capital requirements and the debt service costs of these, the Korean yards are considered to operate at an advantage to EC yards in this respect in view of the generally better cash flows achieved by their more front-end loaded contract payment installments.

Therefore, Korea submits that the EC has not shown that debt service costs/interest expenses of the allegedly subsidized Korean yards have incurred such an increase over the years as to offset the decrease in costs that was shown in the Drewry report in Exhibit – Korea 70. And, in fact, as mentioned above, the debt service costs and interest expenses, as confirmed by the EC's expert, FMI, have shown a decreasing effect due to their spread over a greater throughput. Thus, Drewry's conclusion stands: the decrease in Korean costs of production is clearly greater than the decrease in prices of the vessels concerned.

EC Comment

Of course, debt service costs are specific to particular shipyards. Their analysis is straightforward based on information available in company accounts and documents such as work-out plans. The cost modeling undertaken by FMI takes this into account: The level of debts for each yard is analysed and a contribution is calculated pro rata for each project of the yard during the period in question. If a yard has received a high number of orders, debt service costs would of course be spread over all orders, but a reasonable estimation of the costs of production, which have to be at the base of the final offer price, cannot take into account future orders which have not yet materialized. That is to say that e.g. Daewoo could not have assumed in 2000, when estimating its costs of production for a LNG carrier, that by the end of 2002 there would be a total of 21 orders and debt service costs would therefore be lower for each individual project. Concerning Drewry's conclusion, the EC notes that Drewry only made qualitative assessments of the cost advantages in Korean yards and claims that costs of production are extremely difficult to estimate. It is therefore not clear how Drewry can come to such a specific conclusion.

126. Korea seems to imply that shipyards specialize in producing certain kinds of ships. If a given Korean shipyard has no history of producing, for example, ferryboats, could this be the basis for concluding that that shipyard cannot produce them? Please explain.

Korea's Response

The fact that a national industry or individual shipyard does not produce a particular type of ship, does not necessarily mean that it is physically or technically *incapable* of building that type of

vessel. The reality is that there is a range of factors which places limitations (physical, economic and technical) on the shipyard such that it is either not economically viable for the yard to build them or that it does not have credibility as a competent builder in the customers' eyes.

The following are the main factors imposing limitations:

- ship size – the shipyard has to have building locations big enough to build the ship in question, this includes the height of lift for cranage and or headroom clearance in covered building berths for ships with very high superstructures;

- specialist facilities or skills – for certain types of vessels specialist facilities are required which must be provided in the shipyard or sometimes from a supplier or sub-contractor. Ship types that are generally recognised to have such requirements include:

    - Cruise ships: skills for the installation of glass atriums and interior decoration; high volume of modular cabins, highly complex interaction of specialist sub-contractors;

    - Ro-Ro ships: skills to install the watertight bow and stern doors and associated ramps;

    - Chemical tankers: some chemical tankers include tanks made of stainless steel which requires special welding equipment and welding skills;

    - LNG ships: ability to construct the special containment gas containment tanks or to lift in and install such tanks made by sub-contractors; high levels of insulation 'boxes' required to insulate the tanks; skills in the installation of steam turbine engines which are rarely used in other merchant ship types; and most recently gas turbines and dual fuel engine arrangements;

    - FPSO and drill ships: skills in the installation of what is referred to as the 'topside' equipment for these vessels involved in seabed oil extraction and storage; specialist mooring and pipeline connections for loading and unloading cargo;

    - Fast ferries: skills and facilities for construction of the aluminium hull and superstructure which requires specialised welding facilities and skills and sometimes hull jigs;

    - Tankers: although less dramatic, tankers of most kinds have much higher levels of pipework and valves so a shipyard building tankers must have superior pipeshop capabilities and facilities in-house or by sub-contract than those building other ship types.

Shipyards tend to have a range of ship types and sizes which they produce and for which they gain a reputation in the marketplace with customers and hence they will focus their marketing efforts on these ship types and sizes. These are ship types and sizes in which they can be most cost competitive and where they have good customer credibility in terms of design, price, and delivery. Through a combination of self-selection and customer selection they focus on market sectors where they can maximise their competitive advantage.

This is not to say that they cannot move into other markets that are within their physical capability but to do this they will have to be able to hone their productivity; offer good designs and will need to build customer awareness in their competence and competitiveness in this market. They will recognize that yards already well established and active in these markets will have an advantage over them initially.

The fact that yards specialize in specific like product vessels can be shown for yards all over the world including for Japanese and Chinese yards but also for the EC yards as is demonstrated below. The data covers the same timescale of deliveries or orders from 1990 and records the involvement of 290 EC yards across all ship types over that time:

- **General Cargo and Multi-purpose ships**: 75 EC shipyards (or shipyard groups if not reported at yard level) have been involved in this sector so there has been plenty of participation with 771 vessels involved. But there has been no involvement by any the IZAR yards in Spain; any of the Fincantieri yards in Italy, Chantiers de l'Atlantique, Odense, Aker MTW, HDW, Lindenau, Kvaerner Masa Yards. The major yards involved have been Damen group, Peters Scheepswerf, Ferus Smit, Bodewes and Vollharding of Holland and JJ Sietas of Germany which have built 347 of the 771 ships.

- **Bulk Carriers:** 39 EC shipyards have been involved in this sector involving 154 ships but there has been no involvement from Chantiers de l'Atlantique, Odense, Aker MTW, Kvaerner Warnow Werft, Volkswerft, HDW, Lindenau, Kvaerner Masa Yards and only two built at IZAR group yards. Fincantieri yards however were involved with 16 of the 154 vessels. The market leader in this sector is Japan where 2,152 ships were involved followed by China with 454 ships. So any lack of involvement seems unlikely to be connected to Korean yards.

- **Container Ships:** 51 EC shipyards have been involved in this sector involving 693 ships but participation has varied dramatically by size of vessel. Whilst 39 yards were involved in building container ships of <1,000 teu, only 5 yards were involved in building container ships of 3,500 teu and above; 21 yards were involved with building mid range vessels of 1,000<3,500 teu. Kvaerner Masa Yards and Aker Finnyards of Finland and Chantiers de l'Atlantique of France did not participate in this market at all, whilst in Spain, IZAR groups yards built just 10 and Union Naval Valencia built another 2; and in Italy Fincantieri yards were the only ones to participate with 9 vessels. The concentration of containership building within EC lies with the German yards, Dutch yards (for ships on less than 1,000 teu only) and with Odense of Denmark.

It is evident that the shipyard supply market within the EC is far from homogenous and some shipyards have a particularly strong focus on certain size or types of vessels, i.e.:

- **Damen Shipyards** group of Holland built 251 ships during the period of which 194 were either Tugs, General Cargo or Multi-purpose Cargo ships.

- **Lindenau Shipyard** in Germany where 21 of the 24 vessels with which it was involved during this period were Chemical Tankers.

- **Odense Shipyard** in Denmark, where 59 of the 76 vessels were container ships.

- **Chantiers de l'Atlantique** in France, where 32 of the 47 ships were Cruise Ships.

- **Kvaerner Masa Yards** where out of 54 ships, 25 were Cruise Ships, 9 were Ferries and 8 were Offshore.

- **Aker Finnyards** where out of 41 ships, 20 were either Cruise, Ferry or Passenger ships and another 4 were Reefers ships and 3 were RoRos.

- **Smaller Italian Yards**: Morini where 13 out of 20 ships were chemical tankers; Orlando where 10 out of 14 ships were chemical tankers; de Poli where 10 out of 20 were chemical

tankers and another 7 were LPG ships; Rodriquez where 18 out of 29 were ferries and 6 were passenger ships; SEC where 16 out 24 were chemical tankers and 5 were Ro-Ros; Visentini where 14 out of 25 were Ro-Ro and 11 were ferries.

- **Smaller Spanish Yards**: Armon group where 47 out of 91 were fishing vessels and 43 were Tugs; Zamacona where out of 55 ships 36 were Tugs and 9 were fishing vessels; UN Valencia where out of 45 ships 23 were Tugs and 9 were chemical tankers; Freire where 21 out 27 ships were fishing vessels; Gijon Naval where out of 14 ships, 7 were fishing vessels and 7 were chemical tankers; Cies where 10 out of 11 were fishing vessels; Barreras where 11 out of 31 were fishing vessels, 9 were Vehicle Carriers and 6 were Ferries; Balenciaga where out of 16 ships 7 were fishing vessels and 6 were Tugs; de Huelva where 23 out of 35 were fishing vessels.

- **Small Dutch Yards**: Peters Scheepswerf where 57 out of 60 ships were General Cargo; Bodewes were 26 were General Cargo and 22 were Multi-purpose Cargo (MP Cargo); Vollharding where 25 were MP Cargo and 17 were General Cargo out of 63 ships; Tille where out of 22 ships 10 were Containers and 9 were MP Cargo; IHC Holland where 48 out of 51 ships were Dredgers; K Damen where 13 out of 20 were chemical carriers;

We believe that the above demonstrates that the supply side of the shipbuilding market is far from homogenous and that yards do tend to specialize in certain types and sizes of vessels. The reasons for this may relate to facility limitations, but may also be driven by the yards own appreciation of the sectors that it has the best competitive advantage in or by customers' views on technical competence and competitiveness for certain ship types.

EC Comment

The EC is pleased to note that Korea is revising its previous untenable position. While it claimed in para 294 of its second written submission that "Korean shipbuilders and the EC shipyards operate to a large extent in different like products markets", Korea now acknowledges that some EC yards are active in each segment where Korean yards operate, in particular, container ships.

Korea's attempt to argue that smaller and bigger EC yards are not active in the same segments is irrelevant. In the view of the European Communities it is sufficient that at least one yard of the EC shipbuilding industry is capable of producing ships in the same market segment.

IV. KOREA'S COMMENTS TO QUESTIONS FROM THE PANEL TO THE EC

158. (a) Is it the view of the EC that excess shipbuilding capacity exists only in Korea, or is there also excess capacity in other countries?

(b) If your view that excess capacity exists only in Korea, please explain.

(c) If your view is that there is excess capacity also outside of Korea, where and how much is the excess?

(d) Is there any excess shipbuilding capacity in the EC? If not, what is the basis for this conclusion?

Korea's Comments

It is recognized within the industry that there is no easy way to rigorously measure shipbuilding capacity. However, significant attempts have been made over recent years, under the auspices of the OECD Working Party on Shipbuilding, to improve the estimation of shipbuilding capacity.

The latest estimates of capacity from OECD sources are an estimated figure for actual capacity in 2000 and a figure for anticipated capacity in 2005 which was also made and agreed in 2001[2] from estimates provided by the Japanese, EC, USA and Korean shipbuilding associations expressed in cgt. The following table shows an assessment of capacity utilization for the major shipbuilding regions based on these capacity assessments and shipbuilding output statistics from LR Shipbuilding returns.

	Versus 2000 capacity			**Versus projected 2005 capacity**		
	2001	**2002**	**2003**	**2001**	**2002**	**2003**
Japan	90%	93%	95%	84%	86%	88%
South Korea	94%	104%	111%	77%	84%	90%
EU countries	87%	84%	76%	78%	76%	68%
AWES non EC [1]	86%	83%	74%	78%	76%	68%
Other European	61%	80%	87%	54%	71%	77%
China, PR of	96%	110%	180%	63%	72%	118%
Asia & Pacific	43%	63%	48%	39%	58%	44%
NIS Countries [2]	29%	83%	64%	27%	77%	59%
North & South America	32%	44%	58%	29%	39%	52%
Africa & Middle East	8%	8%	8%	8%	8%	8%
Others	0%	0%	0%	0%	0%	0%
WORLD TOTAL	85%	91%	96%	74%	79%	83%

[1] AWES non EC = Norway, Poland and Romania
[2] NIS = Russia, Ukraine, Latvia, Lithuania, Georgia, Azerbaijan

While Korea is not endorsing this extremely general overview as an appropriate measure for the multiple industries examined in this WTO dispute, nonetheless, the table helps to indicate the situation regarding estimated excess capacity in the main shipbuilding regions in spite of the difficulty in defining shipbuilding capacity and the fact that the 2005 figure is a projection which is now some 3 years old.

Against both the 2000 capacity estimate and the 2005 capacity projection it can be seen that excess capacity exists all around the world. Regarding the major shipbuilding regions, it is noted that there is significant excess capacity within the EC yards and some overcapacity in Japan. The table below shows a country level breakdown for the EC's main shipbuilding countries.

[2] OECD Document C/WP6(2001)16 of 'Present Market Conditions and Future Outlook for the World Shipbuilding Industry' dated November 14, 2001 and prepared by the Secretariat of which an excerpt is attached in **Exhibit Korea – 123.**

	Versus 2000 capacity			Versus projected 2005 capacity		
	2001	**2002**	**2003**	**2001**	**2002**	**2003**
Denmark	68%	82%	72%	61%	73%	65%
Finland	116%	88%	69%	116%	88%	69%
France	165%	107%	139%	147%	95%	124%
Germany	102%	106%	79%	90%	93%	70%
Italy	80%	89%	88%	69%	77%	76%
Netherlands	77%	72%	43%	69%	64%	38%
Spain	59%	67%	88%	54%	62%	81%
United Kingdom	19%	21%	28%	19%	21%	28%
EU countries	**87%**	**84%**	**76%**	**78%**	**76%**	**68%**

Of particular note is the situation regarding China, where it is shown that output has exceeded the projected 2005 assessment. At the time of the 2001 projection, unlike the other major shipbuilding regions of Japan, Korea and the EC, China did not supply its own estimate nor has it done so subsequently. The OECD capacity estimates show that output has exceeded the estimated 2000 capacity figure in both 2002 and 2003 and exceeded the 2005 projected capacity in 2003.

However, there has been considerable growth in capacity in China since 2000 both through improved performance[3] and additional or enhanced facilities. Drewry Shipbuilding Consultants believes that there has been excess capacity within China during this period. Over the period 1999-2001 it is estimated that the top 20 shipbuilding yards in China (which represented approximately three quarters of the country capacity) were working at 55 per cent of their capacity. Drewry undertook a detailed estimate of capacity in China, based on the agreed OECD guidelines which reflects the type of ships built and performance over the period 1999-2001, which was published in its (non-commissioned) report on China's Shipyards issued in July 2003. This assessed Chinese capacity to be 3.187million cgt at the end of 2002 which taken in conjunction with the reported output for China in 2002 and 2003 would indicate utilization levels of 49 per cent and 81 per cent respectively. Furthermore, Drewry calculated that a projected additional 0.353 million cgt was scheduled to come on line by 2005/6. This estimated 2005/6 capacity of 3.54 million cgt contrasts with the earlier OECD estimate for 2005 of 2.18 million cgt.

EC Comment

Korea provides two OECD tables in order to argue that there is overcapacity in the European Communities and otherwise in the world. However, this evidence is irrelevant, since it the tables concern capacity utilization and not capacity. The reason for lowered capacity utilization in the European Communities is the consequence of the serious prejudice caused by Korean subsidies. Moreover, utilization rates of Korean yards are misleading as they have filled their capacities through low-price offers. Korea seems to argue that a yard brimming with orders cannot contribute to shipbuilding overcapacity although that yard is maintained only due to subsidization.

*Exhibit **Korea -123** actually confirms Korean capacity expansion through the 1990s while EC and Japan remained flat. Korea nowhere contested the fact that capacity of EC shipyards has been reduced significantly over the last 20 years (Second written submission by the European Communities, para. 395).*

[3] One of the great difficulties in this area is that potential capacity is profoundly influenced by efficiency of production, not just by nominal physical capacity. This explains in part why China with its great potential is such a "wild card" in the projections.

161. The EC presents indices of estimated Korean production costs versus prices in support of its argument that there is price suppression/depression The EC indicates that its consultant, FMI, prepared the cost estimates, taking into account various known cost trends and cost advantages of the Korean yards. The EC in its answers to questions following the first meeting provided a description of the methodology used by FMI to prepare these estimates. The EC also indicated that, should the Panel so request, it would furnish the detailed underlying data. Is it the view of the EC that a graphical presentation of price indices, along with a description of methodology, constitutes prima facie evidence of evolution in Korean shipbuilding costs? Please explain.

Korea's Comments

Korea observes that the EC has not even provided production cost versus price indices for each of the vessel segments that the EC itself has identified. In the Second Substantive Meeting, upon a request of the Panel, the EC has confirmed that a serious prejudice assessment should be made for each of the three product segments identified by the EC separately. While the same question is now addressed in writing to the EC, having clearly separated the three product segments, in the EC's rationale, there is no reason why the EC should respond differently in writing. Thus, when the EC alleges that price suppression must exist because in the absence of price pressure due to Korean subsidies, the increase in demand, freight rates and cost of production would have led to price increases, the EC should have made a *prima facie* case in support of its allegations already in its First Written Submission for each of its own product segments separately.

The EC failed to do so and even further weakened the strength of its allegations in Attachments 2 and 6 of its responses to the Panel's questions as well as in its Second Written Submission. The following will clarify this:

	First Written Submission		**Attachment 2 of the EC's responses to the Panel's questions**	
	Price developments	**Price and cost index**	**Price developments**	**Price and cost index**
LNGs	Newbuilding price developments (Figure 30 at page 164)	Cost and price indices for Korean LNGs (Figure 38 at page 165) *No explanation on how these cost indices were obtained and which LNGs are reflected in these LNGs.*	Year-end prices of LNGs (Figure 1.3 at page 3)	Cost and price indices for Korean LNGs (Figure 1.5 at page 4 *Half of one page explanation on the "estimation" of cost indices (Section 4 at page 16) but still no clear explanation on how these costs were calculated or which LNGs are reflected in these indices.*
Container vessels	A graph with world market prices for 3,500 teu and for 1,100 teu container vessels taken from Clarkson Research Studies	Cost and price indices for Korean 3,500 teu container vessels (Figure 40 at page 166 of the EC's First Written Submission)	A graph is shown with price developments for 8 different sizes of containers based on Clarkson research.	Cost and price indices are shown for a Korean panamax container ship (Figure 3.7 at page 15.

	First Written Submission		Attachment 2 of the EC's responses to the Panel's questions	
	Price developments	**Price and cost index**	**Price developments**	**Price and cost index**
	(Figure 41 in the EC's First Written Submission, at page 167)	*Price indices presumably calculated based on Figure 41.* *No explanation on how these cost indices were obtained and which container vessels are reflected.* *No explanation as to why conclusions for all container vessels are drawn on the basis of a specific size range only.*		*The comments with regard to the data in the First Written Submission remain. In addition, it is questioned whether the cost and price indices shown in Figure 3.7 can be reconciled with those in the First Written Submission. The latter reflected those of 3,500 teu container vessels while Attachment 6 to the EC's responses to the Panel questions indicates that Panamax container vessels which are reflected in Figure 3.7 cover vessels between about 4,000 and 5,000 teu (item 7. at page 1.) There seems to be an inconsistency in the EC's demonstration.*
Product and chemical tankers	No price developments shown at all.	Cost and price indices for Korean handysize product and chemical tankers (Figure 43 at page 169 of the EC's First Written Submission) *No indication on how the price indices were determined.* *No explanation on how these cost indices were obtained and which container vessels are reflected.* *No explanation as to why conclusions for all product and chemical tankers*	Price developments for handymax and panamax products tankers taken from Clarkson's (Figure 2.3 at page 8) *The data is shown for "product tankers" while the EC has constantly indicated that "product and chemical tankers" are concerned by the present dispute and has indicated in the Second Substantive Meeting that it is concerned with tankers that transport both oil and chemical*	No cost and price indices are shown and there is no indication as to whether the EC maintains those shown in Figure 43 of its First Written Submission. *There is total uncertainty as to the allegations. If the EC meant to maintain Figure 43, the questions/observations in the third column of this table remain valid.*

	First Written Submission		Attachment 2 of the EC's responses to the Panel's questions	
	Price developments	**Price and cost index**	**Price developments**	**Price and cost index**
		are drawn on the basis of a specific size range only.	*products. It is, therefore, not clear whether these prices reflect sown in Figure 2.3 reflect those of the products concerned by this dispute.*	

As mentioned, it is not clear how the cost indices used were arrived at or whether the cost reports of FMI submitted in Annex 10a of the documents supplied by the EC in the Annex V process were taken into account. However, if they were, in addition to the criticism already mentioned by Korea in its Second Written Submission (at page 124) or in the Drewry Report (Exhibit Korea – 70 at page 8.22), Korea submits that the cost calculations are not sufficiently representative as to be conclusive. Indeed, cost calculations were made for the following vessels subject to the present dispute:

- Hanjin 4,900 teu container;
- Daewoo 5,100 teu container
- STX 51,000 dwt tanker (which may be a product tanker not concerned by this dispute)
- Hyundai Mipo handymax tanker[4]
- Daewoo LNG for Exmar
- Hyundai LNG for Golar
- Hyundai 2,500 teu
- Samsung 5,500 teu container
- Samsung LNG for British Gas
- STX panamax products tanker (which may not be concerned by this dispute that concerns combined product and chemicals tankers)
- STX product and chemicals tankers[5]
- Hyundai 7,200 teu container vessel,
- Daewoo LNG for Bergesen
- Samho Aframax tankers (which may not be concerned by this dispute that concerns combined product and chemicals tankers)
- Samsung 7,200 teu container ship
- Daedong 2,500 teu container ship
- Hyundai Mipo handysize products tanker (which, as mentioned above, may not be concerned)
- Shin-A handysize products tankers (which as mentioned above, may not be concerned)[6]
- Daedong 35,000 dwt tanker (if a product tanker, this product may not be concerned)
- Hanjin 5,608 teu container ship
- Hanjin 1,200 teu container ship

[4] For details on this vessel and the preceding three, refer to Section 6 of the FMI Mid-term report, Shipbuilding Marketing Report – Phase 4, March 2003, Annex 10a of the documents submitted by the EC in the Annex V process.

[5] For details on this vessel and the preceding five, refer to Section 6 of the FMI Final report, Shipbuilding Market Monitoring – Phase 3, August 2002, Annex 10a of the documents submitted by the EC in the Annex V process.

[6] For details on this vessel and the preceding six, refer to Section 6 of the FMI Final report, Shipbuilding Market Monitoring, Phase 2, May 2001, Annex 10a of the documents submitted by the EC in the Annex V process.

- Hanjin 6,250 teu container ship
- Halla 3,500 teu container ship
- Hyundai 6,800 teu container ship
- Hyundai 5,600 teu container ship
- Hyundai LNG for Bonny Gas Transport
- Hyundai 5,500 teu container ship
- Samsung 5,500 teu container ship
- Samsung 3,400 teu container ship[7]

Thus, it would seem that cost calculations have been made at best for around 25 vessels out of the hundreds of Korean vessels sold that are vessel types concerned by the dispute. Not even half of these cost calculations concern vessels built by restructured yards.

Korea, therefore, submits that if this were the basis for the cost indices set forth by the EC in relation to price indices, these cost indices are not representative compared with the total sales of the vessels concerned by the restructured yards in terms of the number of vessels sold or in terms of like product coverage. If these are not the basis for the cost indices, the indices relied upon by the EC constitute all the less *prima facie* evidence sufficient to demonstrate the existence of price suppression as they are assertions only without any substantiating evidence. In any event, Korea submits that the EC has not carried the burden of proof that rested on it.

162. What specific evidence/examples are contained in the information before the Panel in support of the EC argument that prices at one end of the product spectrum for a particular kind of ship influence prices along the entire spectrum? (For example, is there specific evidence in the information before the Panel that a downward movement in very large container ships brings about commensurate downward movement in all smaller sizes of container ships?)

EC Comment

The cost investigations listed by Korea are indeed those undertaken by the EC which fall into the disputed product categories. However, Korea's cannot dismiss the EC cost calculations as not being representative. Each of these cost calculations concerns a number of ships due to series building, and the EC has made great efforts to select orders for cost analysis that can be considered representative for the production of Korean yards. Moreover, as of May 2003 another 17 cost investigations had been made which are not listed by Korea as they do not concern the disputed product categories. Nevertheless, these cost estimations have helped the EC to understand better the cost structures and pricing behaviour of Korean yards.

173. (a) For each of the three ship types at issue in this dispute, how are ship data normally maintained by the industry, and by industry analysts?

(b) In particular, are these three categories of ships recognized and used routinely for purposes of industry analysis?

Korea's Comments

The basis of most analysis is the electronic databases referred to earlier together with market intelligence and detailed market knowledge and these are used to prepare certain regularly issued reports.

[7] For details on this vessel and the preceding five, refer to Section 2.2.2 of the FMI Final summary report, Shipbuilding Market Monitoring, April 2000, Annex 10a of the documents submitted by the EC in the Annex V process.

These reports routinely provide information based on ship types but do not necessarily coincide with the categorization of containerships, product and chemical tankers and LNGs proposed by the EC which explains why it is, in particular, so difficult to identify the EC's product category for product and chemical tankers.

The product chemical and LNG ship types covered by this dispute fall within the category of tankers (as shown in the ship type classification table in the response to Question 173 – (a) above), which is a broad grouping which includes, crude oil tankers, product tankers, chemical tankers, gas carriers as well as specialist types (again, without any category for product and chemical tankers). In the LR Fairplay Register of Ships, for example, this includes the following tanker types: Beer, Bitumen, Chemical/Oil Products, Chemical, Crude Oil, Edible Oil, Fish Oil, Fruit Juice, Latex, LNG, LPG, Molasses, Oil Products, Oil Sludge, Vegetable Oil, Water, Wine.

General type classification are, however, sometimes inconsistent with detailed technical fields as a result of data input or reporting inconsistencies, and as such data must be looked at taking into account the context in which information is required to avoid misleading, inaccurate or incomplete data.[8]

In general terms, the following classifications of tankers are generally widely observed:

- Crude oil
- Oil Products
- Chemical[9]
- Gas Carriers – which consistently identify LPG and LNG as separate types

As far as containerships are concerned, these are usually referred to separately to other ship types.

Size bands are used for almost all in-sector analyses and also for some cross sector analyses. **Exhibit Korea – 131** shows the use of size bands within ship types on a regular basis in various industry publications. *See* the response to Question 173(c), (d) and (f) for examples of those commonly used for reporting and analysis purposes. Common statistics are the numbers of ships/orders, GT (gross tonnage) and dwt (deadweight tonnage for cargo carrying ships only) and in the case of containerships teu capacity - this information is used by shipyards and shipowners alike and covers both new orders, orderbook and deliveries. Orderbook information is generally shown both in aggregate terms and phased by year of delivery.

Cgt (compensated gross tonnage) is of no interest to shipowners or brokers, but is regularly used for certain shipbuilding purposes, namely shipbuilding capacity, aggregated shipbuilding demand and shipbuilding output. The choice of which parameter to use is determined by the purpose for which the analysis is to be undertaken.

Other characteristics of the vessels such as whether they are equipped with gearing or have reefer capacity may also be taken into account in a number of industry reports.

[8] For example, in the preparation of the Drewry reports in Exhibit Korea – 70, 109 and 110, Drewry established through inspection of the above sources that ships with IMO chemical classes were listed as oil product tankers and *vice-versa*. Thus, there was considerable inaccuracy and incompleteness in this respect. Drewry therefore made use of various sources to maximize the accuracy and completeness of the products/chemical tanker category.

[9] Note that in **Exhibit Korea – 130**, LR Fairplay include chemical/oil tankers under the category of chemicals and not oil products which contrasts with how the EC has used this data.

EC Comment

Drewry's own taxonomy example provided in exhibit Korea 131 gives size bands for containerships (500, 1000, 1500, 2000 TEU) that are entirely inconsistent with Drewry's report (Exhibit Korea-70) which uses <1000, 1000-2500, 2500-3500, 3500-5000 and >5000 TEU. This contrasts with size bands previously referred to by Korea. As noted in the Response by the European Communities to Panel Question 27 at the first substantive meeting, Korea itself refers to the market in "container vessels up to 1,999 TEU" and the "market in container vessels from 2,000 to 3,999 TEU" in para. 19 of Korea's first written submission while then citing with approval to the vessel categories used in an analysis of FMI which looked at "container feeder vessels (up to about 3,500 TEU)" in para. 515 of Korea's first written submission.

The shifting size bands used by Korea and other industry analysts are evidence against Korea's own argument that size bands can be used to sub-divide the product.

173. *(e) If they provide a range of pricing information at different levels of aggregation, how are these different data series used?*

Korea's Comments

The main level of aggregation is from a range of price series into a single newbuilding index. This is usually done as a mathematical average (or price per dwt average) and not a weighted average reflecting the overall composition of the fleet. A single newbuilding index is a basic way of looking at what is happening overall to shipbuilding prices as opposed to sector or size band specific trends. So if a broad range of price series is used and prices are rising in some and dropping in others, the newbuilding index trend will be moderated by this. However, as the price indices do not cover all ship types and because it is not weighted by the composition of the demand across different types and sizes, it has to be used with extreme caution and interpreted in the light of industry knowledge.

Price series are not generally aggregated to provide a single trend for a particular broad ship category because it is recognized that the differing trends between different size bands is a significant factor. Whilst these trend differences may seem small in relation to overall market price movements, they are highly significant to industry players because they demonstrate different underpinning factors for different ship sizes. For example, there may be a particular shortage of smaller vessels affecting freight rates and hence ordering trends for these vessels and not larger ones.

Price series are therefore only indicators of what is happening for sample ship types which will be chosen to reflect commonly used types or sizes of vessels. Where a range of sizes are given, they are useful to see that trends can be varying differently within the same ship type. When only a single price trend is given for a particular type this generally means that this is the most popular size of vessel in use or that there is not a consistent enough stream of data for another size to construct and maintain a price series.

Industry players are generally fully aware that price series data must always be used with caution and care.

EC Comment

The discussion with respect of price indices is misleading. FMI produces a price index covering a wide spectrum of ship types, and Clarksons covers a wide spectrum of differing bulk ship types. The concept of weighting in this respect is incorrect and displays a lack of understanding of the monitoring of the market. The aim of the price indices (none of which are weighted, including Drewry's when they publish it) is to monitor price levels, not shipyard revenues. The use of weighting would shift this to monitor ordering value, not price levels.

ANNEX G-3

RESPONSES OF THE EUROPEAN COMMUNITIES TO SUPPLEMENTAL QUESTIONS FROM THE PANEL

(16 July 2004)

Question 187

Please comment on Korea's recalculations of benefit in Exhibits KOR-91-102

Response

1. Please see EC reply to question 136 of the 2 July submission for extensive comments on Korean Exhibits 91-102.

Question 188

Concerning the question of whether the restructuring of Daewoo was subsidized, please provide a summary based on all of the submissions of Arthur Andersen/Anijn and PWC, of the EC's analysis and conclusions in respect of whether DHI should have been liquidated instead of restructured. In this summary, all relevant figures should be shown in tabular form, with cities and cross-references to the original Arthur Andersen report of November 1999 assessing the value of DHI under various scenarios.

Response

2. Please see Section 3 of Exhibit EC-158 (PWC Report) for the information in tabular form with references as requested.

Question 189

Concerning the Daewoo restructuring

(a) Concerning the most recent PWC submission (Exhibit EC-145), please explain in detail the statement at page 3 that the Anijn analysis indicated "that the Enterprise Value of the restructured company is lower than the Enterprise Value of the company computed without debt restructuring".

(b) What is "enterprise value" and how does it differ from "going concern value"?

(c) What is the significance of the fact that the "enterprise value" was lower under one set of calculations than under another? How if all does it affect the central issue raised by the EC, namely the decision to restructure instead of liquidate Daewoo?

(d) What is the significance of Anijn's reply in Exhibit KOR-70 that enterprise value was reduced under the analysis of the restructuring scenario from what it had been under the valuation of the non-restructured company? What if

anything is the significance that enterprise value calculations differed under two scenarios for the central issue posed by the EC, namely whether it was better to liquidate or to restructure Daewoo?

Response

3. Please see Section 4 of Exhibit EC-158 (PWC Report) for a reply to sub-questions (a) to (d).

4. As explained in that section, the enterprise value of a company having too much financial debt is lower than the enterprise value of a company that generates the same cash flows but which bears a reasonable amount of debt. As a result, one would expect that the enterprise value of a company having undergone financial restructuring is higher than the enterprise value of the same company before its restructuring. This was not the case in the analysis performed by Arthur Andersen.

5. Consequently, either the pre-restructuring enterprise value of DHI was over-estimated or the post-restructuring enterprise value was underestimated. To come up with a post-restructuring value that is higher than the pre-restructuring value, Arthur Andersen suddenly took into account factors excluded from their analysis up to that stage (assets recoverable from DHI). Considering that these elements were suddenly introduced without any explanation and based on estimates without any supporting evidence, under normal circumstances, creditors would certainly have demanded more information on that aspect.

6. The above is simply an additional question raised by the AA report, which along with all other open questions (EBIT margin, lack of analysis of tax consequences of the restructuring, enterprise value being lower after restructuring, investment level for the residual value, etc.) demonstrates that no prudent creditor would have taken such an important decision on restructuring on the basis of such a question-ridden report. To the contrary, prudent creditors would not have agreed to any solution other than liquidation without requiring much more in-depth analysis.

7. It is now clear that the Arthur Andersen Report could at best be considered as a very first and rudimentary analysis of the DHI situation at the time, on the basis of which no prudent creditor would have acted. Under normal circumstances, prudent creditors would have required a lot more in-depth information and would have questioned a number of elements and assertions of the Report. Please see Section 5 of Exhibit EC-158 (PWC report) for further comments regarding the EBIT margin (page 10 of Exhibit Korea-141) and the recovery value of DHI (pages 7 and 8 of Exhibit Korea-141) used in the Arthur Andersen report.

8. Moreover, the European Communities would like to point out a major new fact presented by Korea in Exhibit Korea-141 (pages 5, 8, and 9). In particular, Korea has stated that the liquidation value of DHI was **[BCI: Omitted from public version]** as opposed to the figure of **[BCI: Omitted from public version]** used previously in the Arthur Andersen Report. It seems, therefore, that a different liquidation value is used depending on the desired outcome. This new higher liquidation value would make it clearer that DHI ought to have been liquidated. See Section 3 of Exhibit EC-158 (PWC report).

Question 190

The data presented in Exhibit KOR-108 show interest and depreciation expense in the cost/profitability analysis for Daewoo. Please comment. How can this be reconciled with the EC's assertion that these costs have not been adequately reflected in Daewoo's prices?

Response

9. The European Communities notes that the KPMG analysis of production costs for three LNG carriers (Exhibit Korea-108) is based on DSME figures and not on audited facts. Thus, it is not independent. KPMG confirms only that the figures presented correspond with the figures held in the Daewoo cost accounting system. The inclusion of costs has not been audited, as indicated in the letter accompanying this exhibit, and no opinion has been given by KPMG as to whether all costs are included.

10. We also note that the ship prices given by KPMG in chapter 2.5.2 **[BCI: Omitted from public version]**. The summary of cost analysis on page 3 gives yet another set of figures: dividing the indicated sales prices in Won by the indicated sales prices in USD (on page 2) yields exchange rates of **[BCI: Omitted from public version]**. None of these exchange rates corresponds to the exchange rates allegedly applied by KPMG as indicated on page 7. If KPMG is not even clear on this basic parameter, one must wonder about the rest of the assessment.

11. For the Bergesen LNG carrier the price difference is significant **[BCI: Omitted from public version].**

12. KPMG undertakes to compare cost estimates made by FMI at the time of contracting the vessel with real costs incurred. In the case of the Bergesen LNG carrier the cost estimate by FMI was made in July 2000 (2 months after the conclusion of the contract), including (mostly) figures provided by Daewoo during the bilateral discussions with the European Communities. At this time, DHI continued to have a significant amount of debt, and FMI calculated the debt service accordingly as the shipyard should have done when preparing its bid (unless the shipyard knew already in July 2000 that its debts would be forgiven in December 2000). It is not conceivable that DHI could have arrived at the offer price of **[BCI: Omitted from public version]** if it had taken into account the actual debt situation at the time.

13. It should also be noted that DHI could not have known in 2000 how many LNG carriers it would contract in the mid-term, and how the depreciation of LNG related investment costs would thus be allocated per vessel. FMI had to base its analysis on the actual order situation (as any reasonable shipyard estimator would have done) and not on some speculative market prospect. Again, it is not conceivable that DHI could have arrived at the offer price if it had taken into account the very limited number of confirmed orders for LNG carriers at the time.

14. There remains a difference primarily relating to costs of development of both the product and the processes to build the product. FMI's model includes an assessment of what they believe these costs may be, based on the known costs of others entering this sector. It is likely that Daewoo would want to contest these costs in terms of their magnitude, but it is difficult to understand the claim that the costs do not exist at all. If they do not exist, they must have been written off at some point because it is not possible to enter this market, let alone become the global market leader, without incurring significant expense.

15. Further information to back up this point of view is given below, by reviewing the contribution to overhead indicated for the three ships analysed in Exhibit Korea-108 against the total workload of the business and the total depreciation cost.

16. Table 1 presents information taken from DSME's audited accounts published on the web site www.DSME.co.kr, showing depreciation in million Won. For the purposes of comparison, the table also shows the value of depreciation for the shipbuilding portion of DHI in 1999, prior to the bankruptcy and restructuring of the company, using information from DHI's published audited accounts for that year.

Year	Depreciation (million Won)
1999 (DHI)[1]	115,116
2000	20,636
2001	80,027
2002	85,563
2003	101,148

Table 1 – Depreciation at DSME (and DHI shipbuilding operations for 1999)

17. It can immediately be seen that the depreciation carried by shipbuilding operations at DSME is considerably lower than that carried by the shipbuilding operations of DHI. The difference is even more marked when it is noted that the DHI figure for 1999 includes only depreciation attributed to shipbuilding operations while the DSME figures cover shipbuilding and other operations. The proportion of sales attributed to shipbuilding (excluding offshore and other business) and the proportion attributed to LNG tankers alone are presented in Table 2, using information from DSME's published accounts.

Year	Proportion of sales attributable to shipbuilding	Proportion of sales attributable to LNG tankers alone
2001	75%	15%
2002	84%	30%
2003	70%	32%

Table 2 – Proportion of sales at DSME attributable to pure shipbuilding operations

18. Table 3 below presents data from Exhibit Korea-108 indicating the amount of overhead recovered from each of the three contracts evaluated. This has been proportioned over the work content of the ship according to its CGT value noted in Lloyd's Register. This gives the amount of overhead recovered per unit of work on these ships, which can be compared to the values per unit of work in the shipyard as a whole. **[BCI: Omitted from public version.]**

19. For comparison, Table 4 summarises the average cost of depreciation per unit of work in the shipyard as a whole. The assumptions made in this table are that the total depreciation cost is distributed across the company according to sales value and that this is evenly distributed across the output of the shipyard – i.e. with an average cost of depreciation for each unit of work (CGT) produced.

[BCI: Omitted from public version.]

20. This allocation of depreciation to shipbuilding through sales is a little simplistic, as some of the offshore business will involve shipbuilding operations.[2] In the absence of detailed audited accounting information, however, these percentages are used in the following analysis with the note that the results will err on the side of caution.

21. Comparison of the right hand column of Table 4 with the right hand column of Table 3 indicates how the actual contribution per unit of work from the three LNG tankers discussed in

[1] Depreciation allocated to shipbuilding only.
[2] *E.g.*, the fabrication of hulls for offshore storage and processing vessels.

Exhibit Korea-108 compares to the average. On average, the contribution from LNG tankers to depreciation is around the average level per unit of work for the shipyard as a whole over the period shown.

22. These results are hard to understand, given that LNG tankers would be expected to contribute greater than the average level to depreciation given the cost of product and facilities developments for this very complex type of ship. The development of the capability to build LNG tankers is a lengthy business. The extreme potential hazard represented by these ships, which carry around 75,000 tonnes of liquid methane at around -160^{o}C, requires a high level of certification and approval, including a license to build from the developers of the cargo containment systems. This requires the development of the design of the ship, development and approval of special production procedures, training of personnel, and development of specialised facilities and equipment. The specialised facilities include support structures for the tanks, in particular special staging for construction inside the tanks, facilities for production of insulation boxes, robotic welding machinery and robotic machinery for the application of separating materials, facilities for clean working, facilities for atmospheric control, etc.

23. KPMG points out on page 13 of Exhibit Korea-108 that "FMI failed to explain why the cost model of European shipyards applicable to these 'other direct costs' should apply to Korean shipyards that are generally known to be the most efficient yards in the world." This is misleading, however, because efficiency does not relieve the shipyard of costs associated with capital expenditure to gain the capability to build this ship type, and the efficiency of the building process does nothing to lower the investment cost. Pursuit of efficiency may actually raise this cost as was the case, for example, when DSME in 2002 constructed a new outfitting pier for LNG tanker construction to improve workflow in the shipyard (reported cost 40 Mio USD).

24. FMI's estimates were based on a cost estimate made for a series of LNG tankers by a European shipyard. This includes a cost of 15.5 Mio USD per ship for capital investment directly related to the ships' construction. It does not include provision for the training and market entry costs discussed above. As discussed above, it would be expected that DSME may argue that this provision is too high. During the bilateral discussions in 2000, however, it was claimed that these costs do not exist at all, a view also put forward by KPMG in Exhibit Korea-108. The potential argument that greater throughput means that costs are depreciated over a greater number of ships is limited, because more investment has to be made to enable this greater throughput to be accommodated.

25. Finally, profit margins of **[BCI: Omitted from public version]** are virtually unheard of in shipbuilding as any analyst will confirm. It is not realistic to think that DHI could have offered, for example, the Exmar LNG carrier (hull number 2213) at a price of **[BCI: Omitted from public version]** and still broken even.

Question 191

Exhibit KOR-107 sets forth the results of the court-ordered/supervised restructuring of Daedong. Presumably, such a restructuring had to proceed in accordance with Korean bankruptcy law. On what basis does the EC allege that nevertheless it involved a subsidy?

Response

26. As the European Communities stated in its response to Question 23:

> The EC fully accepts that bankruptcy law is a necessary part of a market economy and that a properly conducted bankruptcy proceeding would normally not give rise to a subsidy. However, where the outcome of a bankruptcy proceeding or a corporate restructuring is determined by public bodies – or private bodies acting under their direction – and leads to a more beneficial outcome for the enterprise than would have

> arisen if the creditors had acted according to market principles, all of the components of a subsidy are present. There is no basis in the *SCM Agreement* to allow insolvency to be a loophole in the subsidy disciplines.[3]

27. Moreover, the fact that a restructuring proceeded in accordance with Korean bankruptcy law says nothing about whether creditors or investors did or did not provide a subsidy. The terms of the restructuring, such as the amount of debt to be forgiven, are decisions that can lead to a benefit for the recipient if they are more favourable than what would be obtained on the market even within a bankruptcy proceeding.

Question 192

One conclusion that might be drawn from Exhibits KOR-91-102 is that Korea accepts that there is a benefit from the KEXIM financing at issue, but that the benefit in a number of cases is quite small (0.5 per cent or less). If one accepts that the benefit is of the magnitude reflected in these Korean exhibits, what would be the implications for the EC's serious prejudice analysis and conclusions?

Response

28. First, it is important to note that even a small percentage of the value of a multi-million dollar vessel provides a considerable and significant benefit. Moreover, the ability of Korean shipyards to make use of the benefits from KEXIM financing, whether in the form of pre-shipment loans or APRGs, can often be the deciding factor in their ability to offer a lower price than competing shipyards or to otherwise provide the most attractive contract terms for the buyer. Thus, even in those instances where KEXIM subsidies constitute a relatively small benefit in terms of percentage, they significantly strengthen the ability of KEXIM-subsidised shipyards to maintain their capacity (and the low prices in the market) when they would otherwise exit the market or reduce capacity.

Question 193

Exhibit KOR-112, concerning MOCIE's intervention at the request of Samsung, could be viewed as indicating that the government takes action if prices are too low. If this is the case, what are the implications for the EC's serious prejudice claim?

Response

29. As MOCIE does *not* take actions against low prices based on the standards of "significant price suppression" or "significant price depression" within the meaning of Part III of the *SCM Agreement*, MOCIE's actions do not have any implications for the EC's serious prejudice claim. Moreover, there is certainly no indication that MOCIE takes actions in a systematic way for every situation in which it considers that prices are too low.

Question 194

If the Panel were to accept the product subdivisions set forth in Exhibit KOR-109, how would this affect the EC's analysis of price suppression/depression? Please respond in detail.

[3] Responses to Questions from the Panel following the First Substantive Meeting by the European Communities, 22 March 2004, question 23, para. 97.

Response

30. Drewry, in Exhibit Korea-109, argues that ship size needs to be taken into account when comparing price developments. Of course, no one would argue that a larger ship does not cost more than a smaller ship. However, the analysis presented in Exhibit Korea-109 inevitably leads to a skewed result because it analyses price against cargo carrying capacity (TEU and dwt) and not against work content. The price analysis should, correctly, be undertaken on the basis of CGT because that is the unit that measures work content and its relationship to capacity in shipbuilding. The analysis is intended to look at the situation with respect to the shipbuilding industry, not the shipping industry, and the appropriate denominator must therefore be used.

31. The weighting of prices according to product mix in the graph on page 4 is particularly misleading. The use of weighting factors in this situation is incorrect because the analysis is intended to reveal trends in ship prices and not the value of the orderbook. The use of weighting in a ship price index demonstrates a lack of understanding of the economics of shipbuilding prices.

32. The remainder of Exhibit Korea-109 primarily repeats previous arguments regarding differences between and within ship types. Its relevance is questionable. This portion culminates in section III starting on page 13, with misleading assertions about the non-substitutability of shipyard capacity. Complex passenger vessels ("cruise ferries") have recently been built in both South Korea (by Hyundai, Samsung, and Daewoo) and China. The breadth of shipbuilding orderbooks in South Korea (as can be seen from the Clarkson Monitor, Exhibit EC-152) gives ample demonstration of the broad potential for substitution, with passenger ships, offshore vessels, container ships, tankers, LNG carriers, etc., all proceeding through the same facilities.

33. As ships are made-to-order products, certain differences between individual vessels can always be found. Taking this specific feature of the shipbuilding industry to the limit would make it impossible to undertake a price suppression/depression analysis, as product markets would contain only a handful of vessels or even just one ship. Korea is obviously attempting to avoid the SCM disciplines by creating an unlimited number of categories of products. As the European Communities has set out in its oral statement of 17 June (paragraphs 66-67), such an approach cannot be correct.

34. Exhibit Korea-109 makes little reference to price depression and suppression apart from trying to suggest that it does not exist because like products are too difficult to identify. The European Communities stands by the model of price suppression and depression and the mechanisms previously explained, at the broad product level. Detailed explanation of the mechanisms can be found in attachment 2 ("Estimation of price suppression and depression prepared by FMI") to the EC's responses to questions from the Panel following the first substantive meeting. Clearly, it follows from this that if the mechanism is active at the broad product level it is also active at any sub-category level. This is amply demonstrated by the graph on page 5 of Exhibit EC-146 (FMI June 2004 report, "Technical Support to the WTO Hearings"), which shows prices of sub-classes of ships moving broadly in unison.

35. Consequently, the European Communities does not see the subdivisions put forward in Exhibit Korea-109 affecting the price suppression/depression analysis. More detailed analyses would reveal the same mechanisms and would give the same result.

36. In fact, if the Korean analysis of sub-types were to be accepted, the mechanism whereby dominating capacity has a suppressive effect on the market is more clearly seen. The European Communities has argued that price suppression is led by intense competition between concentrations of capacity in a limited number of very large shipyards. In the handymax products tanker sector, for example, South Korean shipyards have a share of the orderbook of 53.3 per cent, shared between three shipyards: STX, Hyundai Mipo, and Shin A. The top four shipyards, including Shin Kurishima in Japan, control about two-thirds of the market. In the panamax products tanker sector, South

Korean shipyards account for 63.7 per cent of the orderbook, spread between four shipyards: Hyundai Heavy, STX, Samsung, and Daewoo. In the LNG tanker sector, Daewoo and Samsung together account for 47 per cent of all orders. In the panamax container sector, Hyundai, Hanjin, and Samho together account for 70 per cent of all orders, and in the post-panamax sector, Hyundai Heavy, Samsung, and Daewoo account for two-thirds of all orders. The disputed shipyards regularly appear among the small concentrations of shipyards whose capacity is leading prices.

Question 195

Please comment on Exhibit KOR-115.

Response

37. Regarding Exhibit Korea-115, a table compiled from a 19-page August 2003 FMI report on key price movements (originally submitted as Annex 5a-2, submitted by Korea as Exhibit Korea-142), the European Communities first notes that Korea finds it useful to monitor new shipbuilding prices in USD/CGT.

38. Korea referred to this exhibit in its oral statement of 17 June 2004 in paragraph 293, indicating that Korean offer prices were not always the lowest for a number of ship types. The indicated price levels are the average of reported contract prices for the ship types in question for a seven-year period (1997-2003), adjusted by CGT. These averages are a very minor part of the FMI report and are meaningless without the time series graphs that accompany them. The graphs showing the relative movement in prices over time between the different nationalities are of particular importance, and this analysis in no way supports the contentions made in paragraph 293 of the Korean oral statement. The Korean presentation oversimplifies the price setting mechanism in the shipbuilding market. Price competition is based on shipyards' bids for individual shipbuilding contracts, not on long-term averages for a large group of shipyards in a specific shipbuilding region. Long-term averages are only meaningful for a trend analysis, which was the purpose of the August 2003 FMI report. Additional quotes from the report can help to make the situation more transparent and provide the trend information that is missing from Exhibit Korea-115:

From the conclusions

> In all cases a significant fall in prices can be seen in South Korea in 1998. As a general comment, other builders followed suit with price reductions but at a slower rate than was seen in South Korea.
>
> Price leadership in the product/chemical tanker sector is varied. China appears to be the price leader for panamax tankers and South Korea for the smaller ship types. Croatian shipyards had a significant presence in the handymax sector although with prices generally higher than those offered in the Far East. Chemical tanker prices have been led by China since 2001.
>
> In the feeder container sector, prices appear to have been led in recent years by South Korea and China but with strong competition from Poland, Singapore and Taiwan. In the panamax and post panamax container ship sectors, South Korea has a strong lead. In the post panamax sector, China and Japan appear to have been trying to undercut South Korean prices to increase market share although with only limited success.

Concerning handysize products tankers

> Competition is predominantly between China and South Korea, with South Korea dominating.

South Korea reduced prices for this class of ship significantly in 1998 from a level of around $1,500 to $1,600 per CGT to a level of around $1,200. Prices in general have risen since then. Prices in China fell more slowly than in South Korea and have been competitive with South Korean prices since 2001.

Concerning handymax products tankers

Orders in this sector are competed by South Korea, Japan and China, with South Korea dominating.

As with handysize products tankers, South Korea appears to have been the price leader in this sector with prices falling over 1998 from a level of around $1,400 per CGT to around $1,100. Prices from other countries also showed a declining trend but less sharp than in South Korea and without falling to such a low point. Since 2001 prices have been competed at around $1,200 to $1,400 per CGT. Since the start of 2000, prices from Croatian shipyards have been generally higher than those from Far East shipyards.

Concerning panamax products tankers

The market for panamax products tankers was quiet in the period up to 2001 and increased after that time. The market is competed by China, Japan and South Korea, with South Korea being the market leader in recent years.

China has remained the price leader in this sector over the period examined, with prices falling over the past three years from around the $1,350 per CGT level to around $1,200. South Korea reduced prices in 2001 and 2002 and market share correspondingly increased, taking share from Chinese builders. Japan also saw a fall in prices in 2001, in competition with China and South Korea.

Concerning chemical tankers

The analysis of chemical tankers is made difficult by variations in specification. Not all records in the data set indicate the IMO classification of the ship. The majority of ships where the IMO class is indicated are either class II or class II/III. A small number were indicated as class I/II, with a correspondingly higher price. Class I/II ships were indicated only in Poland and the EU, although this does not mean to say that none of the ships from other countries where no class is indicated are class I/II. Even where class is indicated, there is no clear trend in price between classes in the same country. It has not therefore been possible to subdivide the data set any further on this basis.

Japan, South Korea and China have offered the lowest prices and in the past two years China appears to have been the price leader. Prices from EU shipyards are generally significantly higher than those from the Far East. It is not possible to say how much of this higher price is due to differences in specification.

Concerning container feeder vessels

The market has been competed primarily by China, EU, South Korea and Other countries. “Other” refers in particular to Singapore, Taiwan and Poland.

The pricing situation in this sector is complex and difficult to summarise. South Korea reduced prices over 1997 and 1998 from around $1,700 per CGT to

around $1,300. Competitors in other countries followed suit but were unable to match the price level achieved in South Korea. When South Korean prices increased in late 1999 and 2000, relative competitiveness returned to China, EU and other countries. Subsequent significant falls in price in South Korea and other countries in 2001, to below $1,200 per CGT, were not matched by Chinese and EU builders. EU shipyards have been losing ground through increasing prices since 2001.

Concerning panamax container vessels

South Korea has dominated the market with intermittent orders taken by Other countries. "Other" in this table refers to Taiwan and Poland.

Prices from South Korean shipyards fell in 1998 from around $1,500 per CGT to around $1,300. Prices increased again in 2000 but have fallen fairly steadily since that time, remaining at around the $1,300 per CGT level in 2002 and 2003. There has been limited competition from elsewhere over this period with other countries apparently struggling to compete with the price level set by South Korean shipbuilders.

Concerning post-panamax container vessels

As with panamax ships, the market is dominated by South Korea.

Both China and Japan appear to have been offering prices to undercut South Korea in a bid to gain market share, although with only limited success.

LIST OF EXHIBITS

Exhibit EC-158 **Report by PriceWaterhouseCoopers, July 2004**

Note: Exhibits in bold contain BCI.

ANNEX G-4

RESPONSES AND COMMENTS OF KOREA TO QUESTIONS FROM THE EUROPEAN COMMUNITIES AND FROM THE PANEL

(2 July 2004)

RESPONSES OF KOREA TO QUESTIONS ADDRESSED BY THE EUROPEAN COMMUNITIES TO KOREA FOLLOWING THE SECOND MEETING OF THE PANEL

1. Question

In paragraph 69 of its Oral Statement, Korea states that government funds constitute less than 3 per cent of the total requirement funds.

(a) Please explain what this means. Is it not true that KEXIM has received capital injections every year since 1997-2001?

Response

The "less than 3 per cent" in the Oral Statement represents the ratio of the outstanding borrowings from the Government of Korea to the total outstanding borrowings of KEXIM in 2002. More specifically, the KEXIM borrowing from the Government at the end of 2002 was **[BCI: Omitted from public version]** of the total borrowing. The ratios of borrowings from the Government of Korea have continuously decreased as shown in the table below. **[BCI: Omitted from public version.]**

This is distinct from the question of paid-in capital. The EC is mixing apples and oranges.

(b) Please explain the statement in Moody's opinion of August 2002 (Exhibit EC-120):

KEXIM A3 senior debt rating and Prime-2-short-term rating reflect its government ownership, and the governments' responsibility under the KEXIM act to cover the bank's annual losses beyond its reserves

Wholly owned by the Korean government, KEXIM issued debt shares the same A3 investment grade rating as a government bond

Response

Korea will not speculate on Moody's opinion. The EC could have solicited a further explanation from Moody's in a timely fashion had it so wished. As Korea has stated, KEXIM does not borrow with a sovereign guarantee.

Why would KEXIM need to borrow from the state under these conditions?

Response

KEXIM borrows funds because it is a financial institution independent of the Government. Article 19 of the KEXIM Act specifically allows KEXIM to borrow such funds from Korean and foreign governments, international financial organizations as well as commercial financial institutions. As with any financial institution, KEXIM borrows from a variety of sources.

(**c) Please comment on page 14 of the KEXIM brochure (Exhibit EC – 97) indicating that the government was KEXIM's main funding source in the period 1998-2000 (42.1 per cent in 1998, 45.6 per cent in 1999 and 47.1 per cent in 2000). How does this tie in with the statement made in paragraph 69 of the oral statement that the government funds constitute less than 3 per cent?**

Response

The percentages indicated in the KEXIM brochure represent the ratios of borrowings from public sectors to the total KEXIM borrowings in the respective years. The public sectors include the Government of Korea and international financial organizations such as the IBRD. For example, 47.1 per cent in 2000 means the percentage of the borrowings from **[BCI: Omitted from public version]** to the total KEXIM borrowings.

(d) Please explain the statement on page 3 of the KEXIM brochure that "the Government shall provide funds to cover any net loss beyond the Banks' reserve which implies pre-emptive and sufficient support"

Response

The statement is simply reiterating Article 37 of the KEXIM Act which requires the Government of Korea to cover net loss beyond reserves as the major shareholder. This is merely an indication that it is unlikely that KEXIM would go into bankruptcy. This is a characteristic of all government-owned corporations, whether financial or otherwise, in all Member states. However, KEXIM has never incurred any losses since its establishment.

(e) Please explain the statement (page 4) that the "continuous capital injections [by the government] reaffirm KEXIM to be a valid sovereign entity".

Response

Again, this is describing the participations by the Government of Korea in the capital increases of KEXIM. KEXIM increased its capital in 1998, 1999 and 2000 to meet BIS requirements. As to the details of KEXIM capital increases, please refer to Korea Response 1.1(11) to Annex V Questions. There is no disagreement that KEXIM is government-owned.

2. Question

In paragraph 106 of its Oral Statement Korea states that Korean domestic banks' returns on equity (ROE) were negative 17.2 per cent during this critical period. Please confirm that the critical period referred to is 1997-2001 and that Korea has not included the KDB and IBK in that calculation?

Response

As clarified by Korea during the Second Substantive Meeting, the period concerned is 1997-2001 and the ROE does not include KDB and IBK.

3. Question

Korea is correct that one of the key elements in the dispute is the relationship between the Korea and the IMF and the degree to which bailout funds may be shielded from SCM disciplines. Could Korea please explain why the Letter of Intent between Korea and the IMF contained the following statement:

> **In order to enhance the incentives for banks to participate fully in the corporate restructuring process, no public funds, whether by way of KAMCO (NPA Fund) purchases or capital injections or other means, shall be made available to banks which are not certified by the FSC to be performing their role in the corporate sector restructuring process.[1]**

Why was this statement repeated in all subsequent Letters of Intent to the IMF until July 2000?[2]

Response

The above statement in the LOI was incorporated into the LOI at the initiative of the IMF. As a matter of fact, the provisions of the LOIs required the Government of Korea to do, or refrain from doing, something that had been proposed by the IMF. As the borrower under the IMF stand-by arrangement, Korea had to accept the proposals of the IMF in most cases.

What the IMF was aiming at with the above-quoted LOI provision was to restore the soundness of the Korean financial sector. In order to achieve this objective, the IMF thought that banks should provide some impetus for corporate restructuring as it was essential to reduce their exposure to corporations (*See* Exhibit Korea - 2, Carl-Johan Lindgren *et al*, Financial Sector Crisis and Restructuring – Lessons from Asia (IMF Occasional Paper 188, 1999), p. 76).

The LOI statement quoted above refers to banks "performing their role in the corporate sector restructuring processes." This is a very general statement. In fact, the "corporate sector restructuring", as used in the LOIs, was a generic term that covers a variety of objectives, including, without limitation, reducing cross guarantees, improving corporate governance, strengthening the role of the Fair Trade Commission to enforce antitrust laws, and strengthening the legal framework for creditors' rights by improving the insolvency system.[3] Furthermore, as demonstrated by these LOIs, the specific contents and focus of the corporate sector restructuring have continuously changed.

Despite all of these ambiguities, however, the LOIs laid down certain rules for the Korean Government and banks to abide by in connection with such corporate sector restructuring. First, "*[t]o strengthen market discipline, bankruptcy provisions according to Korean law will be allowed to*

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[1] Korea Letter of Intent and Memorandum of Economic Policies, 13 November 1998, (Exhibit EC-36) and Annex to Korea Letter of Intent and Memorandum of Economic Policies, 13 November 1998, p. 7 (Exhibit EC-117).

[2] See for example : Korea Letter of Intent and Memorandum of Economic Policies, 24 November 1999, at 6 ; Korea Letter of Intent and Memorandum of Economic Policies for 2000, 12 July 2000, at 7 (Exhibit EC-36).

[3] *See* Exhibit EC - 34, e.g., 24 July 1998 LOI (World Bank SAL II, Policy Matrix on Corporate Restructuring), 10 March 1999 LOI (Corporate Restructuring part), 24 November 1999 LOI (World Bank CFSRL – Policy Matrix II. Corporate Sector Reform).

operate without government interference. No government subsidized support or tax privileges will be provided to bail out individual corporations" (Exhibit EC-36, 3 December 1997 LOI, para. 35).

Second, "*[a]ll corporate restructuring should be voluntary (i.e. not government directed) and market oriented; and public funds will not be used to bail out corporations*" (Exhibit EC - 36, 2 May 1998 LOI, section on "Corporate Governance and Restructuring").

Thus, although it is unclear what "roles" the LOIs expected Korean banks to perform in connection with the corporate sector restructuring, the LOIs clearly circumscribed such "roles" to be performed by the banks. In no event had the banks been directed to bail out corporations and act against the market principles. In this regard, the EC's allegation to the contrary is refuted by the LOIs as such.

As Korea has noted, the IMF was apparently concerned with the example of some other countries experiencing financial stress where banks did not move expeditiously to clear up problem loans and instead left unrestructured loans on their books. The results in some places were unfavourable. The IMF made clear that it was interested in seeing a rapid and market-based restructuring of bad loans. The IMF made clear to the EC a number of times that it considered that Korea banks were quite successful in pursuing market-based results from this process.

4. Question

Paragraph 209 of Korea's Oral Statement: If the tax breaks pursuant to Article 45-2 of the Corporate Tax Act referred to were not intended to apply only to the Daewoo workout why were they introduced in conjunction with that workout and granted for only three months – enough time to allow Daewoo to capture them? How may other companies have benefited? Is it still in force?

Response

Article 45-2 of the STTCL was intended to extend the tax provision to workout companies as well as companies undergoing corporate reorganization. When the law was deliberated at the National Assembly, every company which could be affected by the proposed law was interested and waited for the law to be passed. The law has a broad base of application in terms of the companies to which it could apply.

The law was extended twice so that workouts and corporate reorganizations carried out until the end of 2002 could be covered. It is normal for tax laws in Korea to be adopted on an annual basis. No records have been kept either in court or by the tax administration to identify the companies that made use of this tax provision.

5. Question

Paragraph 291 of Korea's Oral Statement: Does Korea agree that Exhibits Korea-113 and 114 do not relate to the Hamburg Süd/MOCIE case that is referred to?

The ship subject to the DSME offer (Exhibit Korea – 114) is a 5.600 teu container ship (Ref. No. BPT-HAM-101-001) for USD 53 Mio while the MOCIE letter to DSME and SHI (Exhibit Korea – 112) concerned a 4.100 teu container ship (Ref. No. HAM-100-001) for a contract price of USD 58 Mio. Exhibit Korea – 113 also refers to a ship priced at 53 Mio. USD, with payment terms different from those listed in the MOCIE letter.

Response

Korea reconfirms that both Exhibits Korea -113 and 114 are indeed related to the Hamburg Süd containership contract.

The EC fails to recognize that the shipbuilding industry uses two standards of measurement for the loading capacity of a containership, i.e. teu and '14 tonne homogenised' teu value.[4] This is reflected in the seemingly different descriptions between the MOCIE letter (Exhibit Korea – 112) and the DSME offer (Exhibit Korea – 114) which nevertheless designate the same vessel. In the Hamburg Süd case, the buyer initially specified the containership with a capacity of 5,600 teu by using the first method. But, at the later stage of negotiations, the buyer began to use the second method, i.e. the 14 tonne homogenised teu measurement, thereby converting the capacity into 4,100 teu. This is the reason why the initial DSME offer referred to a 5,600 teu containership while the MOCIE letter referred to 4,100 teu, quoting it from the final contract. Therefore, Korea again confirms that Exhibits Korea -113 and 114 are addressing the same Hamburg Süd project in question which the EC has been taking issue in the present proceeding.

Also, "HAM-100-001' and "BPT-HAM-101-001" were only the reference numbers of the subject vessel specifications. DSME initially used reference number "BPT-HAM101-001" to refer to "outline specification". But, as the specifications have been finalized as a result of negotiations with Hamburg Süd, DSME assigned the final reference number "HAM-100-001". However, these numbers referred to the same project. Designating different specification reference numbers at different stages of the negotiation process is a normal practice in the shipbuilding industry. Such a practice is the result of the fact that shipbuilders and buyers need to identify the agreements reached at different levels due to the sheer length of the negotiations for a shipbuilding contract.

In addition, as the EC well knows, it is not uncommon for a shipyard to make different price quotations depending on the payment term that the buyer will ultimately select. As is clearly stated in Exhibit Korea – 114, DSME quoted two different prices for the same vessel based on different payment terms. Thus, USD 53 million was offered based on a "top heavy" payment term whereby 90 per cent of the price would be settled at the time of the signing of the contract and 10 per cent at the time of the delivery of the ship. At the same time and in the same written offer, a price of USD 58 million was also offered based on a rather "tail heavy" payment term, i.e, 10 per cent at contract signing, 10 per cent six months after the contract, 10 per cent at keel-laying, 10 per cent at launching, and 60 per cent at delivery. DSME gave this offer verbally to the broker (Water J. Hinneberg) on 30 August 2002 and then confirmed it by sending a written offer (Exhibit Korea – 114) on 2 September 2002. The price offered of USD 53 million mentioned in the broker's letter (Exhibit Korea – 113) meant the "top heavy" price offered by DSME, which was equivalent to USD 58 million on a "tail heavy" basis.

As stated by Korea in its Oral Statement and response to the EC's question at the Second Substantive Meeting, the buyer, Hamburg Süd, unreasonably forced DSME to reduce the offer price to the level of USD 55 million on a "tail heavy" basis, which was the price level offered by a European shipyard, Odense (Exhibit EC-88). At that time, the Korean shipyards, DSME and Samsung, had already offered prices at the level of USD 58 million.

[4] Teu stands for twenty-foot equivalent unit and measures a vessel's capacity to load containers. The accuracy of this measurement depends on the method of calculation, whether the ship capacity for only loaded containers is taken into account, and whether the deadweight capacity allows a full load of containers. The industry has therefore developed a measure (known as '14 tonne homogenised' teu value) which is the deadweight (payload) of the container ship divided by 14. This gives the number of containers (1 standard container = 1 teu) that a ship can carry within its deadweight payload if each one weighted 14 tonnes. This figure can be significantly different to the stated teu values of some ships. This value represents a 'nominal container capacity' calculated on a standard basis.

Does Korea admit that MOCIE intervened and asked Daewoo to raise the price by USD 3 Mio which is supported by the clear language in Exhibit Korea – 112. Does this not contradict what Korea responded in its Response to Question 82 from the Panel where you stated that MOCIE was not concerned with the price level?

Response

In Korea's opinion, there is no difference between the language in Exhibit Korea – 112 and the response to Question 82. It is clear from both that MOCIE was not concerned with the price level as such but with the anticompetitive behaviour.

6. Question

Regarding paragraph 292 of Korea's Oral Statement, explain what USD 10 million vessel you are referring to and what intimation by the EC this refers to.

Response

As was clarified by Korea during the Second Substantive Meeting as well as in the final text of the Oral Statement filed on 14 June 2004, this refers to paragraph 331 of the EC's Second Written Submission.

RESPONSES OF KOREA TO QUESTIONS FROM THE PANEL AT THE SECOND MEETING AND COMMENTS OF KOREA TO SOME OF THE QUESTIONS ADDRESSED BY THE PANEL TO THE EUROPEAN COMMUNITIES

I. TO KOREA

A. KEXIM LEGAL REGIME

103. What is the precise legal basis for Korea's assertion (at para. 99 of its rebuttal submission) that KEXIM is explicitly required by law to operate on a market-oriented basis?

Response

Korea considers that the following criteria must be reviewed for determining whether a financial institution is operating on a market-oriented basis: (i) whether to appropriately assess the credit risks of the borrower; (ii) whether to apply interest rates or guarantee premia commensurate to credit rating of the borrower/applicant; (iii) whether to take into account market situations when setting up interest rates/premium; (iv) whether to properly manage risks associated with the KEXIM business and (v) how to ensure soundness of management.

(i) Assessment of the credit risks of the borrower

Already in the period preceding 2000, KEXIM compared the credit ratings made by outside credit rating agencies, and for any given borrower (applicant) KEXIM used the lowest credit rating found with respect to the borrower (applicant). In fact, in order to effectively manage credit risks, KEXIM established the Risk Management Committee as early as in 1998 to set up policies and guidelines (e.g., Regulations for Credit Rating Evaluation) regarding risk management in KEXIM. In addition, the Risk Management Department and the Credit Evaluation Office have been set up under the Committee for implementing and administering the policies and guidelines by the Committee. These two departments have been in operation independently from the financing departments in order to ensure a transparent and effective risk management.

As from 2000, as noted in Exhibit Korea – 91, KEXIM implemented its own credit rating system pursuant to the recommendations by the Bank for International Settlement (through Basel II) and the Financial Supervisory Service of Korea, and has since then evaluated credit ratings of the borrowers (applicants) in accordance with the enhanced credit risk management. Currently, KEXIM classifies the credit ratings into 14 grades and evaluates credit ratings of borrowers (applicants) after assessing five factors of credit risks (i.e. industry risk, business risk, management risk, financial risk and future cash flow risk) associated with borrowers/applicants. For the details of KEXIM's credit rating system, please refer to **Exhibit Korea – 117** (Korea Annex V Attachment 1.1(24)-2) submitted herewith.

(ii) Application of credit risk spreads commensurate to credit ratings

Pursuant to Articles 8, 14 and 25 of the KEXIM Guidelines for Interest Rates and Fees (Exhibit EC - 13), it is required to add credit risk spreads onto the base rates (whether it be an interest rate for loans or a premium for guarantees). These credit risk spreads to be added are varying depending on the credit ratings of borrowers/applicants. This may in turn result in different overall interest rates or premia applied to the borrowers/applicants. As to the structures of KEXIM interest rates and guarantee premia, please refer to Korea's Response 47 to the Panel Questions and Exhibits Korea - 12 & 14.

(iii) Taking into account market situations

As detailed in Korea's Response 47 to the Panel Questions, the base rates for KEXIM loans, which are determined pursuant to Articles 10 & 11 of the KEXIM Guidelines for Interest Rates and Fees, are by themselves designed to properly reflect the prevailing level of interest rates in the financial market at the relevant time. In addition, the "market adjustment rates" which are to be applied pursuant to Articles 14 & 25 of said Guidelines also ensure the interest rates and guarantee premium to fully reflect the current market situations (for details of market adjustment rates, please refer to Korea Response 57 to Panel Questions).

(iv) Proper management of business risks

In order to properly manage business risks of KEXIM, Article 17-10 of the KEXIM Decree (the Enforcement Decree of KEXIM Act, Exhibit EC-11) requires KEXIM to establish and operate a risk control system, and currently the above-mentioned Risk Management Committee is in charge of such risk control tasks. For administering these tasks, the Committee has set forth and enforced the Regulation for Risk Management whereby all risks associated with KEXIM business including the credit risk, market risks and the liquidity risk are being closely watched. Further, pursuant to Article 29 of the KEXIM Act (Exhibit EC - 10) and Article 17-10 of the KEXIM Decree, KEXIM has established the standards and procedures for business conducts (one of which is the Operating Manual submitted in the Annex V process as Attachment 1.1(9)), which are to reduce potential risks related to day-to-day business practices of KEXIM.

(v) Ensuring sound management of KEXIM

Articles 17-5 through 17-9 of the KEXIM Decree specifically set limitations and restrictions to KEXIM practices for the purpose of ensuring the sound management of KEXIM. Such limitations and restrictions pertain to credit extension ceilings, restrictions on investment activities or holding securities and disposals of non-business assets. These limitations and restrictions safeguard KEXIM against potential business risks. Further, KEXIM is subject to supervision by the Financial Supervisory Commission ("FSC") as well as the Ministry of Finance and Economy pursuant to Article 39 of the KEXIM Act and Articles 17-12 & 17-13 of the KEXIM Decree. The Ministry and the FSC regularly review KEXIM's compliance with the limitations and restrictions as mentioned above. In addition, KEXIM is required to regularly check the soundness of its holding assets and to maintain an appropriate level of reserves for bad debts. KEXIM is also required to follow FSC regulations regarding the BIS adequacy ratio and the ratio for the foreign currency assets/liabilities. The limitations, restrictions and requirements related to the sound management are corresponding and similar to those imposed onto the other commercial banks under the Banking Act. The FSC may issue an order to KEXIM to take the necessary measures (which are equivalent to "Prompt Corrective Measures" by the FSC against other commercial banks) in cases where it finds that KEXIM's management is insufficiently sound due to its non-compliance with the FSC regulations (*See* Article 39 of the KEXIM Act and Article 17-13 of the KEXIM Decree).

Legal requirement for operating on a market-oriented basis

As shown above, the KEXIM Act, the Decree and other internal regulations, which can be collectively referred to as the KEXIM legal regime, aim at making certain that KEXIM operates on a market-oriented basis. In other words, the systemic safeguards, all of which are based on the KEXIM legal regime, require and enable KEXIM to secure its operations on a market-oriented basis. Korea reiterates that KEXIM has continuously earned operating profits since its establishment (as to KEXIM's operating profit, please refer to the Korea Response 49 to the Panel Questions).

104. Korea states (in response to Question 53 from the Panel) that Article 24 of the KEXIM Act should have been repealed, and that in fact "KEXIM has been contemplating proposing the

repeal or amendment of Article 24". Please provide proof or supporting evidence (minutes of meetings, for example) for this assertion?

Response

Korea hereby submits **Exhibit Korea – 118** which proves that KEXIM contemplated the repeal of the provision of Article 24 of the KEXIM Act already in 1999/2000. As explained in the Korea's response to the Panel's Question 53, the restriction on KEXIM's business scope had already been eliminated by amending Article 18 of the KEXIM Act in 1998. This amendment was enacted in order to fully and appropriately reflect financial market realities which had materially changed since the enactment of the KEXIM Act. While this amendment officially allowed KEXIM to fully participate in the financial market, even prior to this amendment, KEXIM had already been active in the market where other commercial banks were prevalent, therefore entailing increased competition. Thus far, the repeal of the provision has not been proceeded with because of the burdensome legislative procedures required for the amendment. In practice, in light of Article 18 of the KEXIM Act and because KEXIM has had no restrictions for competing with other commercial financial institutions notwithstanding Article 24, KEXIM has not been constrained by the anachronistic "non-competition" provision in the KEXIM Act. Further, Korea notes that it already has provided considerable empirical evidence of competition between KEXIM and other financial institutions.

105. Until what date was Article 24 applied, and in which specific instances? Please explain and describe in full.

Response

As submitted, after the incorporation of KEXIM, the Korean financial market developed and commercial financial institutions began to provide the specialized financing services in which KEXIM had been involved. This resulted in competition with other financial institutions in virtually all areas of the KEXIM financial services (as to the types of KEXIM financial services, please refer to Korea's Response to the Panel's Question 53). Korea reiterates that none of the relevant provisions in the KEXIM Act are intended to prohibit other financial institutions to participate in financial services extended by KEXIM or, conversely, to require KEXIM to exit the market as soon as other financial institutions entered into the market. As submitted, as for the APRG, KEXIM took only a small portion of the market share (less than 20 per cent) prior to the Asian financial crisis, which shows that there was a fierce competition in the market. Virtually all financial institutions have provided overseas investment credits since the restrictions on foreign currency business were lifted in the late '90s. Also, KEXIM has been competing with other financial institutions in the area of the import credit market. Having extended such financial services, KEXIM has never been sanctioned by the supervisory authorities or challenged by other commercial financial institutions by claiming the existence of Article 24 of the KEXIM Act.

106. At para. 45 of Korea's second oral statement, you argue that if lending is provided on commercial terms the lending entity is not a public body. Would this reasoning apply in the case where the Finance Ministry has a general practice of lending on a commercial basis? That is, would the Finance Ministry be a private body (or in any event not be a public body)? Would the analysis be the same if one day, exceptionally, the Finance Minister instructs his/her employees to provide a loan to his/her friend's company at one third of the market rate? Would that loan constitute a financial contribution? Why, or why not?

Response

Korea stated in paragraph 24 of its Oral Statement that it considers there to be three distinct categories: (1) governmental organs; (2) public bodies; and (3) private bodies. Korea offered the Finance Ministry as an example of a governmental organ that would be included in category (1). In

contrast, with respect to para-statal entities that are not organs of government, under the treaty language as well as the interpretative guidance of the Articles on State Responsibility and Commentaries, they are *prima facie* not considered as acting with governmental authority.

Paragraph 45 was not referring to an organ of government, but to a situation involving a para-statal or government-owned entity. The EC has never alleged that any of the banks in question were organs of government, only that they were public bodies. Thus, the second half of the question does not really apply in the context of the Finance Ministry. On the other hand, if a para-statal entity were operating a commercial programme (and therefore would not be considered a public body), the sort of intervention noted in the question could constitute entrustment of the para-statal entity as a private body depending on the facts. As Korea has noted in paragraphs 43-44, there is no loophole in the treaty scheme; the difference is in the type of proof that must be presented depending on whether it is a private or public body. The utter lack of evidence regarding entrustment or direction is what has compelled the EC to try to construct a novel and sweeping definition of "public body".

107. At para. 56 of Korea's second oral statement, Korea states that so-called "market window" financing falls outside the coverage of the OECD) export credit arrangement Is Korea thereby arguing that such financing falls outside the coverage of the SCM Agreement? If so, is this because Korea considers that such financing does not constitute a financial contribution? Please explain your reasoning.

Response

The Panel's characterization of Korea's comment in paragraph 56 is, perhaps, somewhat too categorical. Korea purposely used a passive grammatical construct: "They are considered market-based commercial activities in competition with other banks." The reason for this construct is that because there is a lack of reporting, there is a certain amount of self-definition as to what is included in the concept of "market-window". Nonetheless, irrespective of what is included as a practical matter, Korea does consider that the concept provides a valid distinction.

In order to answer the Panel's question, one must once again refer to the different categories of entities as discussed in the answer to the previous question. Therefore, if an organ of government is offering the financing, it may be a subsidy depending on whether or not there is a benefit. On the other hand, if the financing is being offered as part of a *commercial programme* by a para-statal entity, it is presumptively not "governmental" and therefore would not be considered a financial contribution by a government unless specifically demonstrated as such. There are two points to note here. First, the issue of whether or not it is a commercial programme is one for the complainant to establish as an initial matter. Merely alleging that the programme is not commercial because the entity is government-owned as the EC has done collapses two distinct analytical steps into one. Second, as also discussed, even if the overall programme is on a commercial basis and, therefore, the entity is not considered as a public body for purposes of a dispute, it is still the case that the complainant has the possibility of demonstrating that there was governmental entrustment or direction in a particular case. Of course, the EC has been unable to do this (because the evidence does not exist), which is why it is trying to build its whole case on the fact of government ownership.

B. PAST SUBSIDIES

108. Korea has made various comments regarding the EC's claims concerning so-called "past" subsidies. In particular, Korea referred to this issue in its reply to Question 83 from the Panel, and at paras. 62, 63 and 93 of its second oral statement. We understand that Korea is not seeking a ruling that the EC is precluded from challenging "past" subsidies. Is this a correct understanding? If not, why not?

Response

It is correct that Korea is not making a general argument that the EC cannot challenge alleged past subsidies as a matter of principle. However, to be clear, there are two different aspects to this issue depending on whether one is referring to Part II or Part III of the *SCM Agreement*. Allegations of prohibited subsidization are much more of the nature of "standard" GATT/WTO dispute settlement cases where the complainant is generally considered to have a general right to request a ruling regarding the imposition of a measure by another Member that it considers is inconsistent with the other Member's treaty obligations. It may be the case, of course, that such a ruling is of only historical interest if the facts are that the respondent is no longer implementing measures that are inconsistent with its obligations. This would be the case if there were no longer benefits being provided within the meaning of Article 1.1(b) of the *SCM Agreement*. Of course, it does raise a question as to the meaningfulness of such a ruling or recommendation by the DSB for a Member to withdraw the subsidy as required by Article 4.7 if in fact there is no longer any subsidy. In light of this point, the Panel must take into consideration within the full context of Part II of the *SCM Agreement* whether it considers that there actually are prohibited subsidies being provided.

Regarding claims under Part III with respect to allegations of Adverse Effects, the Panel must recognize the *sui generis* nature of its inquiry in this regard. In no other area of WTO dispute settlement must a complainant demonstrate that a measure has caused adverse effects. To put it another way, subsidies are considered illegal only if they cause adverse effects. Moreover, Article 7.8 provides that they are illegal only *to the extent* of such an adverse effect. Thus, there is the unique situation of a measure only being "partially" inconsistent with a Member's WTO obligations. One can assume that, in determining whether the alleged subsidies in question have caused adverse effects, a panel will look at such alleged effects over a period of time. It is axiomatic that in any injury-type inquiry, the most recent period is the most relevant. Thus, the probative value of evidence of subsidization in earlier periods is highly questionable if the evidence is that there was no subsidization or no adverse effect in the most recent period. Thus, it is not a question of a legal bar to looking at earlier periods; rather, it is a question of the relevance and probative value of such evidence. In light of the requirements that there be a demonstration of actual adverse effects and that the subsidies are only illegal to the extent of such causation, a panel would need to explain in detail why it considered that a subsidy that was no longer causing adverse effects would be actionable. Thus, Korea is not saying that historical evidence is irrelevant in analyzing trends that lead to present adverse effects; it can have an impact on the overall analysis. However, in the case where the evidence is that such adverse effects are no longer being caused or there is no longer a subsidy, it is unclear what the basis of such a determination would be.

C. APRG/PSL

109. Korea argues at para. 80 of its second oral statement that foreign APRG providers include a country-risk spread for APRGs extended to Korean shipyards, which accounts for the higher rates charged by the foreign APRG issuers than those charged by KEXIM. Should not KEXIM have applied a similar country-risk spread, or otherwise have taken into account the risk factor of investing in Korea? Please explain. Why should foreign APRG providers, including those based in Korea (See Exhibit Korea – 87, page 5, which indicates that both foreign banks A and B issue APRGs though their Korean branches) incur more risk in investing in Korea than Korean banks?

Response

As detailed in Exhibits Korea - 84 through 87 and stated by Korea during the Second Substantive Meeting, the country risk premium (or county risk spread) is to be applied to the financial transactions between companies established in different countries. In general, the term "country risk" typically covers the risk that economic, social, and political conditions and events in a foreign country

may adversely affect an institution's financial interest. The country risk factor is not understood in financial markets to cover risks in transactions between parties established in the same country. Rather, in these instances, the lenders or providers focus on the general credit risks of their counter-parties.

For the better understanding of the Panel and for illustrative purposes, Korea submits the elements of country risk assessed under the OECD Arrangement on Officially Supported Export Credits (*See* Article 24.a) of the OECD Arrangement). These are:

- general moratorium on repayments decreed by the buyer's/borrower's/guarantor's government or by that agency of a country through which repayment is effected;

- political events and/or economic difficulties arising outside the country of the notifying Participant or legislative/administrative measures taken outside the country of the notifying Participant which prevent or delay the transfer of funds paid in respect of the credit;

- legal provisions adopted in the buyer's/borrower's country declaring repayments made in local currency to be a valid discharge of the debt, notwithstanding that, as a result of fluctuations in exchange rates, such repayments, when converted into the currency of the credit, no longer cover the amount of the debt at the date of the transfer of funds;

- any other measure or decision of the government of a foreign country which prevents repayment under a credit; and

- cases of *force majeure* occurring outside the country of the notifying Participant, i.e. war (including civil war), expropriation, revolution, riot, civil disturbances, cyclones, floods, earthquakes, eruptions, tidal waves and nuclear accidents.

When KEXIM extends APRGs to Korean shipyards, the transactions involve parties in the same country of establishment and there is, as a result, no need for KEXIM to consider a "country risk." Rather, as explained in Response 103 above, KEXIM is looking at the general credit risks of the applicant by factoring in all relevant risks such as industry risk, business risk, management risk, financial risk and future cash flow risk of the applicant. In contrast with KEXIM, on top of considering the usual expected risks, foreign APRG providers needed to take into account a risk of a different dimension, i.e. the country risk, as they are located outside Korea. The additional risk notwithstanding, foreign providers extended APRGs to Korean shipyards when they were so designated by the buyers and, in fact, earned, high guarantee premia.

Further, Korean branches of foreign APRG providers need to factor in such country risk, as the foreign APRG providers themselves, not the branches of such foreign providers, will bear the ultimate and final legal liability (this is evident by the operation of law) of having to settle the advance payments to the buyer of the vessels in case of a contractual default by a Korean shipbuilder. As a result, the country risks have been factored into the premium for guarantees issued by Korean branches of foreign APRG providers.

110. Please comment on the EC's assertion (at part 107 of its Second Written Submission) that Korea failed to provide details of the rates of five of the APRGs issued for Samsung by commercial banks in 1997.

Response

Korea provided the best information available at the time of the Annex V procedure. Korea notes that much of the information requested in Annex V and subsequently has not been in the hands of the Government of Korea. Having confirmed with Samsung, Korea understands that the rates of the five APRGs referred to by the EC were not available as the required preservation period of the relevant documents had expired. Where information for some of the APRGs issued in 1997 was still available, such information was submitted.

111. In response to Question 72 from the Panel, Korea submitted certain documents containing redactions. What is the reason for those redactions?

Response

In Question 72, the Panel requested Korea to provide internal documents related to a certain project specifically identified by the Panel. As the original document (of which the version with redactions was submitted by Korea as Exhibit Korea – 60) contained information on other projects (which were not requested by the Panel) which is by nature business confidential information, Korea deleted the information not related to the project identified by the Panel.

112. Were any APRGs issued to Korean shipyards by independent financial institutions after 28 May 2001? If so, why weren't these included in Korea's reply to the Facilitator's questionnaire under the Annex V procedure?

Response

Korea would like to note that it considers KEXIM to be an "independent financial institution."

Notwithstanding this, Korea confirms that it provided all information in Attachments 1.2(31)-1 through 1.2(31)-8 of the documents submitted during the Annex V process as to APRGs issued by Korean financial institutions (except some information related to foreign APRGs) to Korean shipyards up until the Annex V procedure was initiated. Information as to APRGs issued after 28 May 2001 was included therein also. Please refer to Attachment 1.2(31)-1 through 1.2(31)-8 (Exhibit EC-24) as regards the information on such APRGs.

113. In respect of Koreas reply to Question 71 from the Panel, please provide supporting evidence for Korea's assertion that the Kookmin and Woori Bank rates for Samsung APRGs were [BCI: Omitted from public version] instead of [BCI: Omitted from public version].

Response

Korea hereby confirms that the Kookmin Bank and Woori Bank rates for Samsung APRGs were **[BCI: Omitted from public version]**. Korea's prior statement that is not consistent with this information was inadvertently made due to clerical mistake by the company in pulling together the response. Korea regrets any confusion.

114. Regarding Exhibit Korea – 99, why did KEXIM continue to apply the same credit spread after DSME entered financial difficulties?

Response

As clarified during the Second Substantive Meeting, Korea did not, and could not, endorse the EC's benchmark as suggested in Exhibit EC - 125 or EC Attachment - 9. Korea merely submitted

Exhibits Korea - 93 through 100 (i) to illustrate that there are critical fallacies in the EC's calculations due to its misunderstanding regarding the interest rate structure of the KEXIM PSLs and (ii) to show that no benefit exists even under the EC's own hypothetical and inaccurate methodology. Thus, Exhibit Korea – 99 is the basis for an argument in the alternative and is also a hypothetical one based on various assumptions, not reflecting actual transactions. In particular, it was prepared to show that even if DSME had the worst credit rating during the period of the workout, no benefit was afforded.

As evidenced in Exhibit Korea – 92, DSME was rated as P5 by KEXIM during the workout period when DSME was under the worst financial situation. Hence, despite the fact that KEXIM did not retain its current credit rating system before the Asian Financial Crisis and DSME workout, it is a logical speculation that DSME's credit rating prior to the workout would have been better off compared to its rating when DSME was going through the workout process. This can be substantiated by the fact that the credit rating of DSME was adjusted upward to P4 right after the graduation out of the workout (s*ee* Exhibit Korea – 92). Nonetheless, Exhibit Korea – 99 was submitted to show that during the entire period the EC indicated in its Exhibit EC – 125, no benefit was afforded to DSME. And, of course, if the better credit rating were to be assigned in Exhibit Korea – 99 for the period preceding the workout, it would be shown that the negative benefit margins would even become larger.

D. ALLEGED ACTIONABLE SUBSIDIES

115. Please comment on para. 259 of the EC's Second Written Submission, concerning the fate of Mr. Do-Sang Lee's [BCI: Omitted from public version] shareholding in Daedong. Under what legal previsions did the complete cancellation of Mr. Lee's shareholding take place? Please explain fully.

Response

In the context of "corporate reorganization" (court receivership) under Korean law, the fate of shareholders of the subject company is prescribed by the Corporate Reorganization Act (*See* Exhibit EC - 43). Articles 221(3) and (4) of the Corporate Reorganization Act provide as follows:

> (3) In cases where the total liabilities of the company at the time of commencement of the reorganization proceeding exceed its total assets, the reduction of capital shall be provided for [in the reorganization plan] on such terms that no less than a half of the company's issued stock is written off.
>
> (4) In cases where the commencement of the reorganization proceeding has been caused by acts for which directors or equivalent persons, or managers of the subject company are seriously responsible, the reduction of capital shall be provided for [in the reorganization plan] on such terms that no less than two thirds of the shares of stock held by a shareholder who has exercised considerable influences on such acts, his relatives, and other shareholders who have a special relationship with him as set forth in the Supreme Court Regulations, are written off.[5]

As clearly indicated in the above provisions, the thresholds of a "half" or "two thirds" mentioned in the above provisions constitute a minimum level for the stock write-off. Therefore, Article 221 of the Corporate Reorganization Act requires that the reorganization plan provide for a stock write-off that should not be less than these levels but may even achieve the complete cancellation of the stock. Based on these legal requirements, the bankruptcy courts in most cases

[5] This is more accurate translation. The unofficial translation of the Corporate Reorganization Act submitted by the EC to the Panel as Exhibit EC - 43, is not entirely accurate. For verification purposes, Korea submits the Korean version of Article 221 of the Act as **Exhibit Korea – 119.**

completely cancelled the shares held by a controlling shareholder particularly when the shares had no value due to insolvency.

In the case of Daedong, it was determined that the total liabilities of Daedong exceeded the total assets (Exhibit EC - 78, Final Corporate Reorganization Plan for Daedong, Attachment 1, Balance Sheet). As such, the receiver was required by law to write-off the shares by not less than 50 per cent. Therefore, the receiver proposed a reorganization plan whereby the shares held by all the shareholders of Daedong, except Mr. Do-Sang Lee, were reduced by 80 per cent (i.e. 5:1 ratio). In addition, the shares of Mr. Do-Sang Lee, who, as the major shareholder, had exercised a considerable influence over the acts of directors and managers, were required by the Corporate Reorganization Act to be reduced by at least two thirds. Ultimately, taking into account the fact that the Daedong shares had no value and that Mr. Lee was fully responsible for the failure of Daedong, the receiver proposed the complete cancellation of Mr. Lee's shares. Ultimately, however, the acceptance of this proposal was Mr. Lee's choice. Korea considers that the EC's highly personal, disparaging remarks about Mr. Lee's motivation are regrettable.

116. Korea asserts that Article 45-2 of the Corporate Tax Act does not constitute revenue forgone, and did not confer a benefit. According to the news report in Exhibit EC-136, however, a Daewoo company official stated that Daewoo would "be exempted from taxes totalling 236 billion won'. Please comment, and explain how a 236 billion won tax exemption is not revenue forgone and did not confer a benefit

Response

Under the *SCM Agreement*, the EC has the burden to prove specifically what government revenue was otherwise due and how such revenue was foregone or not collected (Article 1.1(a)(1)(ii)). The EC has failed to carry this burden of proof. Moreover, it appears that the EC still has no clear understanding of the Korean tax scheme. As a result, Korea still can not determine specifically what the EC's allegations on tax concessions are about.

The news report in Exhibit EC - 136, which quoted the alleged statement by a Daewoo official, establishes nothing about the types of taxes concerned, applicable provisions of tax laws, tax rates, calculations of the tax amount involved, how they were foregone, etc. Given the complication and technicalities of the tax issues, no Panel would make an affirmative finding of financial contribution and benefit on the basis of such a very questionable newspaper article. Moreover, the amount of KRW 236 billion allegedly mentioned by a Daewoo official does not distinguish what portion of this total amount is attributable to DSME as distinguished from the portions attributable to the machinery company and to the remaining DHI. In short, the EC has not established a *prima facie* case of the tax concession as required by Article 1.1(a)(1)(ii) of the *SCM Agreement*.

Under these circumstances, Korea is placed in an awkward position when it is asked by the Panel to "explain how a 236 billion won tax exemption is not revenue foregone and did not confer a benefit". This question assumes that there was a tax exemption of KRW 236 billion, but Korea disagrees that a 236 billion won tax exemption has ever been established by the EC. Unless the EC first explains how KRW 236 billion or whatever amount has been calculated and under what provisions of tax laws, it is impossible for Korea to explain how this amount is not revenue forgone. Nonetheless, Korea would like to comply with the request of the Panel by providing further explanations on the tax issue, while again reserving its rights regarding the burden of proof.

First of all, Korea refers the Panel to paragraphs 221 and 222 of the EC's Second Written Submission, in which the EC made clear that its "core claim" was the "temporary tax exemptions" granted under Article 45-2 of the Special Tax Treatment Control Law ("STTCL") which extended tax incentives under Article 46 of the Corporate Tax Act. It appears that the EC believes that Exhibit EC -

136 provides evidence of the size of tax incentives under the above Article 46 of the Corporate Tax Act which had been "extended" by Article 45-2 of the STTCL.

However, as Korea has repeatedly explained (see, e.g., paras. 206 – 208 of Korea's Oral Statement at the Second Panel Meeting), the special tax treatment under Article 46 applies only when "valuation gains" have arisen to a spun-off company as a result of the "valuation" of assets carried out at the time of the spin-off. In the case of the DHI workout, the assets of the original DHI were spun-off to DSME and the machinery company at book value (i.e. without "valuation" of those assets). Therefore, DSME could not obtain any tax incentives under Article 46 of the Corporate Tax Act as extended by Article 45-2 of the STTCL.

The fact that the DHI assets were transferred at book value to the spun-off companies is clearly demonstrated by **Exhibit Korea – 120** (1999 Anjin's Workout Report, excerpted pages, Appendix 10), as well as by Exhibit EC-55 (DHI Workout Plan), Appendix D-11 (balance sheet) and Exhibit EC-56 (Structure of spin-off). Also, the EC has never disputed this fact.

Therefore, contrary to the allegation by the EC, there was no tax exemption granted to DSME under Article 45-2 of the STTCL and Article 46 of the Corporate Tax Act. Thus, the EC's "core claim" fails, and the questionable statement by a Daewoo official in Exhibit EC-136 cannot prove anything when what the EC proposes to prove on the basis of hearsay cannot "legally" make sense. For the avoidance of any doubt, Korea hereby submits the text of Article 46 of the Corporate Tax Act (both the Korean original and English translation) as **Exhibit Korea – 121**.

In this situation, it is questionable that a Daewoo official could really have made the statement about KRW 236 billion as was written by the journalist or whether the journalist misunderstood. If a Daewoo official really made that statement, it may well be that he misunderstood the facts and the applicable tax law. The other plausible answer might be that the Daewoo official may have referred to a totally different type of tax incentive. A possible candidate is the "special additional tax" which could have been levied if there were gains from the transfer of certain assets from DHI to the spun-off companies. However, this tax was to be levied on DHI (remaining after the spin-off) under Article 99 of the Corporate Tax Act.

Prior to 31 December 2001, the Corporate Tax Act provided that, if a company realized capital gains from the transfer of certain assets (e.g., land, building and other real property rights), the transferring company was required to pay, in addition to ordinary corporate income tax, the so-called "special additional tax" at the rate of 16.5 per cent of the capital gains so realized (*See* **Exhibit Korea – 121**, Articles 2 and 99 of the Corporate Tax Act). For the purpose of this tax, the 'capital gains' meant the amount of the transfer price of the assets concerned, minus their original acquisition price and acquisition costs. In the context of the DHI spin-off, DHI may have been required to pay a substantial amount of such special additional tax if capital gains had been realized through the transfer of assets to DSME and the machinery company. Even if the transfer of assets was made at book value, the book value of those assets could have been higher than their acquisition prices and costs as a result of, among others, re-valuation made prior to the spin-off pursuant to the Asset Re-valuation Act.

Again, it should be noted that the payer of such special additional tax was the transferor of the assets subject of the special additional tax (i.e. the remaining DHI). However, by virtue of a special provision of Article 99(11) of the Corporate Tax Act, the transferor's payment of special additional tax could be deferred if the transfer of assets took place as a result of, among others, a spin-off that satisfies the requirements of Article 46 of the Corporate Tax Act. (*See* **Exhibit Korea – 121**, Article 99(11)). In the case of companies in restructuring, a problem arose due to the technical issue of not having precisely equal shareholding ratios due to the normal rules of share allocations in such situations. If a provision such as Article 45-2 had been included in the STTCL, thereby treating a spin-off made on unequal shareholding ratios as satisfying the requirement of Article 46 of the Corporate Tax Act, then, the remaining DHI's liability for special additional tax could have been

deferred (not exempted) pursuant to Article 99(11) of the Corporate Tax Act and the remaining DHI would have been relieved of the burden to pay special additional tax immediately upon the spin-off.

However, by virtue of a subsequent legislation, the "special additional tax" was repealed as of 1 January 2002 (*See* **Exhibit Korea – 121**, Law No.6558 of 31 December 2001). As a result, any special additional tax liability of the remaining DHI (the provisions were only relevant to the transferor, not a transferee such as DSME) was completely extinguished.[6] This repeal was made mainly because the special additional tax was controversial as it operated as a double taxation in addition to ordinary corporate income tax which would also be assessed on the same capital gains as those subject to special additional tax.

117. Korea argues that the Daewoo workout was good for both domestic and foreign creditors, and that the fact that foreign creditors took warrants is an indication of their support for the workout. Could the foreign creditors ever have prevented the workout? Since they held only [BCI: Omitted from the pubic version] per cent of the debt, were they ever in a position to force liquidation / court receivership? Please explain.

Response

Under Korean law, the foreign creditors were able to obstruct DHI's workout by filing a petition for a straightforward bankruptcy proceeding. The Bankruptcy Act of Korea authorizes "any creditor" (regardless of the percentage of debt held by it to the total debt) to file a bankruptcy petition when there is a cause of bankruptcy (*See* **Exhibit Korea – 122**, excerpted Articles, Article 122(1)). The cause of bankruptcy exists when the debtor is not able to pay debts (Article 116) or its total debt exceeds the total assets (Article 117). Once the bankruptcy court adjudicates a bankruptcy, the court-appointed receiver liquidates assets and distributes the proceeds from liquidation to the creditors.

Through a due diligence investigation, Arthur Andersen (Anjin) found that, as of August 1999, DHI was not able to pay its total debts and the creditors would recover only 28.4 per cent of their total debts (*See* **Exhibit Korea – 120**, 1999 Arthur Andersen Report, excerpted pages, page 38). Therefore, any foreign creditor was able to file a petition for a bankruptcy proceeding against DHI.

Despite a petition for bankruptcy proceeding, a court-receivership proceeding can be initiated. Thus, if a petition for court-receivership (corporate reorganization) proceeding is filed with respect to a debtor which is under a bankruptcy proceeding, the latter can be suspended by the court order (Exhibit EC - 43, Corporate Reorganization Act, Article 37). However, the fact that the debtor company was going through a creditors-led "workout" procedure under the Corporate Restructuring Agreement cannot stop the bankruptcy proceeding.

In the case of DHI, the foreign creditors were also in a position to petition for a court receivership as their total debt (**[BCI: Omitted from public version]**, *See* Korea's Annex V response Attachment 3.1(12)) accounted for approximately 17 per cent of the DHI's total shareholders' equity (**[BCI: Omitted from public version]**). Under the Corporate Reorganization Act, any creditor can petition for a corporate reorganization only if their debt accounts for not less than 10 per cent of the debtor company's "capital" (shareholder equity), not of the total debt (*See* Exhibit EC - 43, Corporate Reorganization Act, Article 30(2)).

Of course, the foreign creditors, holding less than 3 per cent of the total debt, would not have been able to "force" DHI into court-receivership, as it was the court that ultimately decides on

[6] Korea also notes that this was generally available for any and all Korean corporations involved in any "asset transfer" transactions because the "special additional tax" itself was withdrawn in its entirety from the Korean tax system by virtue of the law of 31 December 2001.

whether to put the debtor into court-receivership and, also, the reorganization plan had to be approved by the three groups of interested parties (i.e. 4/5 secured creditors, 2/3 of non-secured creditors, and a majority of shareholders). Nonetheless, it is true under the Korean law that, as long as the foreign creditors wanted to obstruct the creditors-led workout procedure for DHI, they could do so by simply filing a petition for bankruptcy or court receivership.

However, it should be noted that the foreign creditors of DHI were all non-secured creditors which might have ended up recovering only a minimal amount of their debt if DHI had undergone a bankruptcy or court-receivership proceeding. Therefore, it is inconceivable that the foreign creditors would have ever considered petitioning for such a – for them - unfavourable proceeding.

118. According to para. 139 of Korea's rebuttal submission, "Article 18 [of the Special Act on the Management of Public Funds" strictly controls provision of new loans by the receiving banks. Thus, this Article provides that '[i]f a financial institution which received Public Funds pursuant to the provision of Article 17(1) intends to provide new funds to an unsound company as prescribed by the Presidential Decree', it will be subject to a requirement that it shall enter into a restructuring agreement with that unsound company" Does Article 18 only impose restrictions on publicly-funded financial institutions that intend to provide new funds to unsound companies? Are restrictions also imposed if a publicly-funded financial institution chooses to do something other than provide new funds to unsound companies? If the latter question is answered in the negative, please give an example of something that a publicly-funded financial institution could do without incurring obligations under the Special Act on the Management of Public Funds.

Response

The purpose of Article 18 is to minimize the loss of public funds by restricting the banks that received public funds from lavishly providing new loans to unsound companies. This provision does not affect the discretion of the institutions that obtained public funds to decide whether or not to extend new loans, but it applies only when a publicly-funded bank intends to provide new loans to "unsound" companies.

Moreover, as clearly indicated by the provision of Article 18 itself (see Exhibit EC - 103), this provision applies to a publicly-funded bank's individual lending activity. In other words, the restriction applies only when a publicly-funded financial institution decides to extend a new loan to an unsound company in an individual transaction between that particular bank and the unsound company as a borrower. Therefore, the "restructuring agreement" referred to in Article 18 means an agreement between the lending bank and borrowing company (normally called an "Memorandum of Understanding") whereby the unsound borrower agrees to implement self-initiated actions, such as disposing of unnecessary assets or businesses or reducing labour costs, in order to make itself more accountable for the new borrowing.

In this regard, the provision of Article 18 does not apply to the cases where the publicly-funded banks participate in a workout or court-receivership proceeding as a member of the creditors' council or other interested parties' meeting. In the context of such a workout or court-receivership proceeding, the creditors are required to act pursuant to a resolution adopted collectively by all creditors and also in accordance with the rules set out in separate insolvency laws or a framework agreement (CRA). Therefore, there is no room for Article 18 to come into play in such insolvency proceeding.

Finally, in response to the Panel question, Korea confirms that the restriction set forth in Article 18 is imposed only when publicly-funded financial institutions intend to provide "new loans" to unsound companies. Such restriction does not apply when the financial institutions are engaged in

other activities, e.g., when a publicly-funded bank intends to collect existing loans, the requirement under Article 18 does not apply.

119. After the spin-of that led to the creation of DSME, what happened to the debt and assets left behind with DHI? Who were the creditors and owners of DHI after the spin-off and what percentage did each hold of the total debt and (negative) equity, respectively, of the post-spin-off DHI? What was the ultimate disposition of this debt and equity? What if any impact did this have on DSME and DMI?

Response

(1) The post-spin-off status of debt and assets left with DHI

After the spin-off in October 2000, DHI has been selling assets and collecting debts from debtors (mainly Daewoo affiliates). With the proceeds of such sales and debt collections, DHI has continuously repaid debts to its creditors. As of 31 May 2004, DHI has repaid KRW 260 billion to the creditors.

(2) Creditors and shareholders of DHI after the spin-off (as of December 2000)

(Unit: 1,000 shares, billion won)

Name of shareholders*	**Numbers of Shares (percentage)**	**Name of creditors**	**Amount (percentage)**
Daewoo Corporation	68,426(24.8%)	KAMCO	1,722.3(39.7%)
KDB	32,254 (11.7%)	KDB	138.8(3.2%)
Woo Chung Kim	22,814(8.3%)	Korea First Bank	116.8(2.7%)
Daewoo Electronics	17.091(6.2%)	Korea Exchange Bank	182.6(4.2%)
Daewoo Precision	4,065(1.5%)	Daehan ITC	120.5(2.8%)
General Public **	131,134(47.5%)	Other minority creditors***	2,051.6(47.4%)
Total	275,784(100%)	Total (borrowings)	4,332.6(100%)

* The shares of DHI were traded on the stock exchange after spin-off until 23 May 2001. As a result, the shareholders changed and the current shareholders comprise: KDB (1.45 per cent) and general public/minority shareholders (98.55 per cent).

** General public includes numerous minority shareholders each of which holds only fractional shares in no event more than 1 per cent of the total shares.

*** Minority creditors refer to small creditors each of which has outstanding loans of less than 1 per cent of the total borrowings.

(3) Plan for the ultimate disposition of DHI's debt and equity.

DHI will continue to carry on debt repayment activities until the end of 2004. Thereafter, DHI and its creditors would discuss the possibility of petitioning for bankruptcy proceeding in order to dispose of DHI's remaining debt and assets.

(4) Impact on DSME and DHIM (machinery company)

There is no particular impact that the ultimate disposition of DHI's debt and assets may have on DSME and DHIM.

120. Please comment on the EC's observation that the fact that 210 financial institutions signed the Corporate Restructuring Agreement in less than one week suggests that they were induced to do so by the Government of Korea.

Response

The workout framework was not created over such a short period of time as alluded by the EC. As early as in April 1998, the Korean banks began to study a coherent framework of the workout. At the same time, a task force carried out a more in-depth study of the basic concept of workout.

On 19 June 1998, the basic concept and structure of the Corporate Restructuring Agreement (CRA) as the framework agreement for workout was explained to 28 banks and financial institutions. Between 19 June and 24 June 1998, an intense process of commenting and negotiations took place among the financial institutions through their trade associations. On 24 June 1998, 33 financial institutions and associations representing all different financial sectors had the final negotiations and agreed to the final draft of the CRA. These representatives also set 25 June 1998 as the effective date of the CRA. Thereafter, the final draft of the CRA was sent through their respective sectoral associations to all individual financial institutions for review and signature. The financial institutions reviewed the draft CRA and signed it of their own volition. Due to the complexity of such review and signing procedure, the signed versions of the CRA were collected over a considerable period of time even after the effective date of 25 June 1998. At that time, nobody knew exactly how many financial institutions would sign the CRA, and it eventually turned out that 210 financial institutions signed it. The above negotiation procedures followed by the financial institutions were reasonable given the complexity and urgency of the matter. Moreover, the CRA was merely a "framework" agreement which did not in itself pose any substantive controversial issues (see Exhibit EC-42, Corporate Restructuring Agreement).

More importantly, at that time, there was a consensus among the financial institutions that, without a systematic framework for debt workout in place, the conditions of financially unsound companies would be aggravated and the creditor financial institutions' potential exposure to non-collectible debts will rapidly increase. Therefore, negotiating this workout framework agreement in a swift manner served the common interest of the financial institutions. In addition, as a general matter, the CRA was an implementation of the so-called London Approach. This provided a commonly accepted international basis that gave the institutions a general comfort level regarding the CRA and letting them focus on the details of its implementation.

121. Regarding the Daewoo workout, were any studies commissioned by creditors regarding the relationship between the going concern and liquidation values of Daewoo, other than the Arthur Andersen report? In particular, were any such studies commissioned by any creditors? Please provide copies of any such studies commissioned by any of the creditors.

Response

As far as the Government of Korea is aware, other than the Arthur Andersen report, there was no study commissioned by any creditor (whether domestic or foreign) of DHI.

122. Please comment on the EC's argument (paras. 257 of the EC's First Written Submission) that DSME assets 'should also have assumed 55 per cent of the negative net worth left behind' in DHI.

Response

The EC failed to clarify why it believes that DSME should have assumed 55 per cent of the negative net worth of the remaining DHI. The EC's argument seems to be based on its belief that the

spin-off structure whereby DHI was divided into 3 companies was wrong and that, instead, DHI should have been spun-off into only two operating companies in the proportions of **[BCI: Omitted from public version]**, respectively

The DHI workout plans had been devised as a single global package to seek maximum recovery of debt on an aggregate basis and, thus, the issue of benefit can not be analyzed on the basis of individual components of the workout plan as if each such component constituted a discrete act of financial contribution.

Moreover, the EC's assumption that the DHI spin-off should have followed only two-company approach has no reasonable basis. There are no multilaterally agreed rules on insolvency. Even within the EC there are many models. The only common element is determining what the best method for maximizing value recovery by the creditors is. In its 1999 report, Arthur Andersen established that a 3-company approach was a more advantageous alternative than the 2-company spin-off for the creditors (*See* **Exhibit Korea – 120**, section VIII. 2.2.2, pp. 89-90). The EC has failed to prove that the 2-company approach was more beneficial to the creditors.

Furthermore, in the case of DHI, the negative net worth of the remaining DHI was a result of trade receivables of Daewoo Motor and Daewoo Corporation that had been inserted into the DHI balance sheet and had no direct or indirect relationship with the production and sale of commercial vessels (*See* para. 256 of the EC's First Written Submission). Therefore, there was no rational basis for attributing the negative net worth of the remaining DHI to the shipbuilding operations of DSME.

123. Was Arthur Andersen / Anjin's determination that the going-concern value of DHl exceeded its liquidation value premised (at least in part) on the enactment of Article 45-2 of the Special Tax Treatment Control Law? In other words, was the KRW 236 billion tax measure taken into account by Arthur Andersen /Anjin in its analysis? Please explain.

Response

The Arthur Andersen's determination of the going concern value and the liquidation value was not premised on the enactment of Article 45-2 of the Special Tax Treatment Control Law ("STTCL"). There is no indication in the Arthur Andersen report that Arthur Andersen took into account any spin-off-related tax in its analysis.

E. SERIOUS PREJUDICE

124. On factors influencing ship prices, Korea argues that high freight rates are not particularly important at present, in view of the fact that currently the ship market 'is a buyers' market'. Korea's *Drewry Report* states that "workload shortage or overcapacity" are important determinants of price: "… yards that are short of work may prefer to take a lower price rather than have under-utilised capacity'. This representation by Korea's consultant would seem to be consistent with the EC's argument that excess capacity (in the Korean industry, supported by alleged subsidies) is a key factor behind the price suppression/depression it alleges, In other words, both sides seem to agree that excess capacity can drive down prices. Please comment on this specific point.

(The Panel recognizes that the parties disagree with respect to whether Korean capacity is 'excess' and whether the restructuring that kept the Korean shipyards in operation was subsidized, so it is not necessary to comment on that aspect.)

Response

Korea considers that shipbuilding prices are the result of a number of factors, none of which alone determine price levels for vessels. Rather, it is all the factors in interaction which determine such price levels. It has consistently argued that for the determination of whether alleged price depression or suppression is the effect of the subsidies which are claimed to exist, the existence and effect of all of these factors in combination must be taken into account, failing which a distorted or inaccurate picture is yielded of how the shipbuilding market evolves in terms of prices.

Korea has indicated that capacity is indeed one of the factors that influences prices, but maintains that this is only one of the factors and that it cannot be looked at in isolation from the other factors to assess why any price trend occurred. In Paragraphs 524 to 527 of its First Written Submission, Korea has confirmed that ship prices are deeply influenced by the interaction of supply and demand. It stated that demand means the demand/order including price requirements made by the shipowners who will take the trend in freight prices into account in formulating their requirements. On the supply side, Korea has indicated that whether there is any overcapacity and how production costs develop are the two main factors influencing price levels. In addition, however, Korea has indicated that other factors as well may greatly influence the price level of vessels. These relate to productivity improvement, insufficient workload or other factors specific to particular shipyards including expertise in designing and building certain types of vessels, payment terms, slot availability and delivery time.[7] Korea maintains its position that the assessment of the causal link is fact-driven and that all factors must be assessed in a comprehensive matter on a case-by-case basis.

This is no different from the position expressed by Drewry in Exhibit Korea – 70 in Section 3.6 when it states that "[p]rices in the shipbuilding market have always been volatile reflecting the influences of a variety of supply and demand side factors". Drewry considered the following factors, i.e.:

(i) Drewry concurred with the factors identified in the OECD report of March 2003 on "Recent Newbuilding Price Developments", i.e. shipbuilding orderbook, metals prices index, freight rates and exchange rates which are considered.

(ii) Drewry nevertheless considered that the OECD did not list all relevant factors and indicated that the following should also be considered:

- as regards supply side factors, workload shortage or overcapacity which may lead a yard to prefer to take lower prices rather than having under-utilized capacity; and

- as regards demand side factors, size, delivery date, payment terms, build times, speed – engine and hull form variations and manoeuvrability, hull strengthening e.g. for ice operation, equipment specification (brand name vs generic equipment), paint & coatings, innovative design, regulator (class and ship register), freight rates.

The EC itself during the First Substantive Meeting denied that it was looking at just capacity in its assessment on the existence of a vector whereby the alleged subsidies could have caused price suppression or depression. The EC, in the opinion of Korea correctly, indicated that the assessment on causation must include a multi-faceted approach.

[7] This approach is also reflected in Step 2 of Korea's proposed method to determine the degree of suppression or depression in response to the Panel's Question 91(d) (at pages 46 and 47 of Korea's responses to the Panel's questions) and in Korea's response to the Panel's Question 102 (at pages 55 and 56 of Korea's responses to the Panel's questions).

In line with the above, Korea considers that the EC has still not given a clear response on how alleged over-capacity would necessarily affect price levels. Having indicated itself that several factors in relation to supply and demand determine the prices of the commercial vessels in dispute, the EC has nevertheless failed to assess each of these factors and their effect on price levels and, as a result, has failed to demonstrate that the alleged subsidies themselves had price depression or suppression for their effect because of the existence of overcapacity as a vector. In fact, the EC has failed to demonstrate that the alleged restructuring subsidies caused overcapacity capable of influencing prices. The EC seems to presume that, in the absence of the alleged restructuring subsidies, the shipyards Daewoo, Halla and Daedong would have disappeared. But, as mentioned by Korea, nowhere in the world does insolvency *ipso facto* lead to termination and sale for scrap and, in the cases at issue all the less since the EC itself has pointed out that there were possible acquirers such as NHI for the yards in question. In addition, the EC itself has shown in its Attachments EC-2 and 6 to its responses to the Panel questions that these three yards in each like product type of vessels did not occupy a market position so as to be able to create significant price depression or suppression. In this regard, Korea refers to paragraphs 251 to 259 of Korea's Second Written Submission.

125. (a) The list of factors identified in the *Drewry Report* as determinants of ship price includes freight rates, delivery date/build time (which would seem to be related to capacity and thus supply and demand), and payment terms (which would seem to be related to financing). Drewry does not refer to any measure of the aggregate level of demand as such. Please explain.

Response

Drewry considers that the trend in demand for each like product separately is one of the factors that contribute to the relevant price level for the product considered. However, as mentioned in Section 1.2.2 of the Drewry report, considering only that price will vary directly in line with demand does not go far enough as there are many other demand and supply-related factors that contribute to determining the price level for any like product. In Section 1.2 of Exhibit Korea – 70, Drewry identifies a range of factors that are considered to have an impact on ship price, i.e.:

- External factors (para 1.2.1)
  - Freight rates
  - Exchange rates
  - Metals prices index
- Supply side (para 1.2.2)
  - Workload shortage or overcapacity
- Demand side (paras 1.2.3 and 1.2.1)
  - Size
  - Delivery date
  - Payment terms
  - Build time
  - Shipbuilding orderbook
- Demand side – technical factors (para 1.2.3)
  - Speed and manoeuvrability
  - Hull strengthening
  - Equipment specification
  - Paint & coatings
  - Innovative design
  - Regulatory: Class and Ship Register

While the aggregated supply-demand balance is, therefore, clearly a factor which affects price in the shipbuilding industry, Drewry considers that it is not the only or dominant factor. Applying the simple economic concept of supply-demand balance, however, encounters some problems in shipbuilding, primarily:

- the difficulty in quantifying shipbuilding capacity (as opposed to historical output levels)
- the fact that this capacity is not all dedicated to merchant shipbuilding and may also be in used for naval shipbuilding, ship repair and conversion and offshore structure construction in particular
- the lack of homogeneity in aggregate demand (primarily due to different ship types and sizes)
- the lack of homogeneity in aggregated supply due to the size capability of yards' facilities and the experience base regarding ship types that they have experience in building.

The result is that whilst demand may be able to be categorized according to size and type of vessels, supply cannot rigorously be divided on the same basis and so there is considerable non-homogeneity within the supply-demand balance.

(b) Also, in discussing Korean cost advantages on the supply side, Korea does not refer to cost of debt service/interest expenses. Please explain.

Response

Debt service costs tend to be specific to a particular yard's situation, both in terms of the structure of its financing of capital assets and also its working capital requirements. It is, therefore, not possible to take general economic indicators to estimate the relative cost advantages or otherwise of different yards in this respect. For example, in the EC there are many long established yards whose capital cost of facilities has long since been amortized and any interest on debt related to this will also have gone. Debt service costs related to facilities are, therefore, likely to be those associated with improvements and modernizations. In general terms, there has been a lower level of modernization at EC yards, but exceptions to this are to be found in the passenger shipbuilding yards and most particularly in the former East German yards like Aker MTW and Kvaerner Warnow Werft. In these yards the modernizations were state funded and then when the yards were privatized the new owners inherited the new facilities at a fraction of the investment costs – in this situation, the debt levels and hence debt service costs are driven by very specific circumstances which does not make for easy comparisons.

However, the area where Korea has significant cost advantages for such costs is in terms of the scale factor of its production. Firstly, debt service costs are supported by high workload volume throughputs and as such on a basis of output units the cost per unit will be lower than for smaller yards.

This is particularly relevant in the case of financing of facilities and capacity where the capital cost of providing 1,000 cgt of capacity will be far lower than in smaller capacity yards. The Figure 8.1 in Exhibit – Korea 70 gives an indication of the throughput scale differences between EC and Korean yards, particularly recognizing that most of the bigger EC entries are in fact groups comprising more than one yard.

A good example of the economies of scale is evident from the example of LNG-specific investment. As highlighted in the KPMG report submitted as Exhibit Korea – 108, FMI assessed that a European yard would need to cover the investment burden of LNG specific investment over a series of 3 LNG ships but subsequently changed its estimates for Daewoo to recovery over 10 ships, to reflect the higher throughput volumes of such vessels at the Korean yard. By the end of 2002, Daewoo had in fact received orders for 21 LNG vessels and so its capital expenditure and any debt

service cost associated with this is likely to be much lower than any European yard with only short series builds.

In respect of working capital requirements and the debt service costs of these, the Korean yards are considered to operate at an advantage to EC yards in this respect in view of the generally better cash flows achieved by their more front-end loaded contract payment instalments.

Therefore, Korea submits that the EC has not shown that debt service costs/interest expenses of the allegedly subsidized Korean yards have incurred such an increase over the years as to offset the decrease in costs that was shown in the Drewry report in Exhibit – Korea 70. And, in fact, as mentioned above, the debt service costs and interest expenses, as confirmed by the EC's expert, FMI, have shown a decreasing effect due to their spread over a greater throughput. Thus, Drewry's conclusion stands: the decrease in Korean costs of production is clearly greater than the decrease in prices of the vessels concerned.

126. Korea seems to imply that shipyards specialize in producing certain kinds of ships. If a given Korean shipyard has no history of producing, for example, ferryboats, could this be the basis for concluding that that shipyard cannot produce them? Please explain.

Response

The fact that a national industry or individual shipyard does not produce a particular type of ship, does not necessarily mean that it is physically or technically *incapable* of building that type of vessel. The reality is that there is a range of factors which places limitations (physical, economic and technical) on the shipyard such that it is either not economically viable for the yard to build them or that it does not have credibility as a competent builder in the customers' eyes.

The following are the main factors imposing limitations:

- ship size – the shipyard has to have building locations big enough to build the ship in question, this includes the height of lift for cranage and or headroom clearance in covered building berths for ships with very high superstructures;

- specialist facilities or skills – for certain types of vessels specialist facilities are required which must be provided in the shipyard or sometimes from a supplier or sub-contractor. Ship types that are generally recognised to have such requirements include:

    - Cruise ships: skills for the installation of glass atriums and interior decoration; high volume of modular cabins, highly complex interaction of specialist sub-contractors;

    - Ro-Ro ships: skills to install the watertight bow and stern doors and associated ramps;

    - Chemical tankers: some chemical tankers include tanks made of stainless steel which requires special welding equipment and welding skills;

    - LNG ships: ability to construct the special containment gas containment tanks or to lift in and install such tanks made by sub-contractors; high levels of insulation 'boxes' required to insulate the tanks; skills in the installation of steam turbine engines which are rarely used in other merchant ship types; and most recently gas turbines and dual fuel engine arrangements;

- FPSO and drill ships: skills in the installation of what is referred to as the 'topside' equipment for these vessels involved in seabed oil extraction and storage; specialist mooring and pipeline connections for loading and unloading cargo;

- Fast ferries: skills and facilities for construction of the aluminium hull and superstructure which requires specialised welding facilities and skills and sometimes hull jigs;

- Tankers: although less dramatic, tankers of most kinds have much higher levels of pipework and valves so a shipyard building tankers must have superior pipeshop capabilities and facilities in-house or by sub-contract than those building other ship types.

Shipyards tend to have a range of ship types and sizes which they produce and for which they gain a reputation in the marketplace with customers and hence they will focus their marketing efforts on these ship types and sizes. These are ship types and sizes in which they can be most cost competitive and where they have good customer credibility in terms of design, price, and delivery. Through a combination of self-selection and customer selection they focus on market sectors where they can maximise their competitive advantage.

This is not to say that they cannot move into other markets that are within their physical capability but to do this they will have to be able to hone their productivity; offer good designs and will need to build customer awareness in their competence and competitiveness in this market. They will recognize that yards already well established and active in these markets will have an advantage over them initially.

The fact that yards specialize in specific like product vessels can be shown for yards all over the world including for Japanese and Chinese yards but also for the EC yards as is demonstrated below. The data covers the same timescale of deliveries or orders from 1990 and records the involvement of 290 EC yards across all ship types over that time:

- **General Cargo and Multi-purpose ships:** 75 EC shipyards (or shipyard groups if not reported at yard level) have been involved in this sector so there has been plenty of participation with 771 vessels involved. But there has been no involvement by any the IZAR yards in Spain; any of the Fincantieri yards in Italy, Chantiers de l'Atlantique, Odense, Aker MTW, HDW, Lindenau, Kvaerner Masa Yards. The major yards involved have been Damen group, Peters Scheepswerf, Ferus Smit, Bodewes and Vollharding of Holland and JJ Sietas of Germany which have built 347 of the 771 ships.

- **Bulk Carriers:** 39 EC shipyards have been involved in this sector involving 154 ships but there has been no involvement from Chantiers de l'Atlantique, Odense, Aker MTW, Kvaerner Warnow Werft, Volkswerft, HDW, Lindenau, Kvaerner Masa Yards and only two built at IZAR group yards. Fincantieri yards however were involved with 16 of the 154 vessels. The market leader in this sector is Japan where 2,152 ships were involved followed by China with 454 ships. So any lack of involvement seems unlikely to be connected to Korean yards.

- **Container Ships:** 51 EC shipyards have been involved in this sector involving 693 ships but participation has varied dramatically by size of vessel. Whilst 39 yards were involved in building container ships of <1,000 teu, only 5 yards were involved in building container ships of 3,500 teu and above; 21 yards were involved with building mid range vessels of 1,000<3,500 teu. Kvaerner Masa Yards and Aker Finnyards of Finland and Chantiers de l'Atlantique of France did not participate in this market at all, whilst in Spain, IZAR groups yards built just 10 and Union Naval Valencia built another 2; and in Italy Fincantieri yards

were the only ones to participate with 9 vessels. The concentration of containership building within EC lies with the German yards, Dutch yards (for ships on less than 1,000 teu only) and with Odense of Denmark.

It is evident that the shipyard supply market within the EC is far from homogenous and some shipyards have a particularly strong focus on certain size or types of vessels, i.e.:

- **Damen Shipyards** group of Holland built 251 ships during the period of which 194 were either Tugs, General Cargo or Multi-purpose Cargo ships.

- **Lindenau Shipyard** in Germany where 21 of the 24 vessels with which it was involved during this period were Chemical Tankers.

- **Odense Shipyard** in Denmark, where 59 of the 76 vessels were container ships.

- **Chantiers de l'Atlantique** in France, where 32 of the 47 ships were Cruise Ships.

- **Kvaerner Masa Yards** where out of 54 ships, 25 were Cruise Ships, 9 were Ferries and 8 were Offshore.

- **Aker Finnyards** where out of 41 ships, 20 were either Cruise, Ferry or Passenger ships and another 4 were Reefers ships and 3 were RoRos.

- **Smaller Italian Yards:** Morini where 13 out of 20 ships were chemical tankers; Orlando where 10 out of 14 ships were chemical tankers; de Poli where 10 out of 20 were chemical tankers and another 7 were LPG ships; Rodriquez where 18 out of 29 were ferries and 6 were passenger ships; SEC where 16 out 24 were chemical tankers and 5 were Ro-Ros; Visentini where 14 out of 25 were Ro-Ro and 11 were ferries.

- **Smaller Spanish Yards:** Armon group where 47 out of 91 were fishing vessels and 43 were Tugs; Zamacona where out of 55 ships 36 were Tugs and 9 were fishing vessels; UN Valencia where out of 45 ships 23 were Tugs and 9 were chemical tankers; Freire where 21 out 27 ships were fishing vessels; Gijon Naval where out of 14 ships, 7 were fishing vessels and 7 were chemical tankers; Cies where 10 out of 11 were fishing vessels; Barreras where 11 out of 31 were fishing vessels, 9 were Vehicle Carriers and 6 were Ferries; Balenciaga where out of 16 ships 7 were fishing vessels and 6 were Tugs; de Huelva where 23 out of 35 were fishing vessels.

- **Small Dutch Yards:** Peters Scheepswerf where 57 out of 60 ships were General Cargo; Bodewes were 26 were General Cargo and 22 were Multi-purpose Cargo (MP Cargo); Vollharding where 25 were MP Cargo and 17 were General Cargo out of 63 ships; Tille where out of 22 ships 10 were Containers and 9 were MP Cargo; IHC Holland where 48 out of 51 ships were Dredgers; K Damen where 13 out of 20 were chemical carriers;

We believe that the above demonstrates that the supply side of the shipbuilding market is far from homogenous and that yards do tend to specialize in certain types and sizes of vessels. The reasons for this may relate to facility limitations, but may also be driven by the yards own appreciation of the sectors that it has the best competitive advantage in or by customers' views on technical competence and competitiveness for certain ship types.

127. In relation to the EC argument that the restructured yards pulled down prices of all other Korean yards, Korea asks the rhetorical question. Why stop there? Why not also blame Chinese or Japanese shipyards, if Korean subsidies triggered a price war? Is Korea's argument

that, if a global price war has been set off by a particular player in the market, that player should rot be deemed to be responsible because other players have followed its lead? Please explain.

Response

At the outset, Korea must note that the whole issue of price leadership is a difficult one in this case because the EC has dropped its claims of price undercutting. Normally cases can be expected to be built upon several possible elements of proof. The EC has chosen to avail itself of only price suppression or depression as is permitted under the treaty. However, simply because the treaty language permits of such a finding, that does not mean that it is a simple or even a normal thing to demonstrate adverse trade effects based on a single element of proof. In this dispute, the EC has explicitly rejected proving such other elements as price undercutting because, as the EC stated at the First Substantive Meeting, it could not meet the elements of proof of, for example Article 6.5. The EC has now tried to demonstrate price undercutting in a number of situations and attempted to claim that there is a difference between using price undercutting as a primary element of proof and using it to support price suppression or depression. This is false logic and a fatal legal flaw in the EC's argument. It has chosen to try to build a case without reference to the interrelated elements of proof; it is legally precluded from attempting to reintroduce them in another guise.

Keeping in mind the difficulty of identifying exactly what is meant by price leadership in light of the preclusion of arguments based on price undercutting, Korea considers as a general matter that it is possible for a single company to be a price leader. However, there are a number of qualifications to this statement. First, it must be shown that the price leadership is the effect of the alleged subsidy. To simply say that a company's products were price leaders is legally meaningless in the light of the treaty language of Article 6.3(c).

Second, regarding the assertions of the EC in paragraphs 80-82. Korea strongly objects to this line of argumentation. First of all, there is no legal basis or relevance for asserting that the "Korean shipyards" were price leaders. Unless the EC is alleging a separate geographic market for Korea there is no legal basis for lumping all of the Korean yards together in the manner done by the EC in those paragraphs. The EC reiterated that it was not making such an argument; therefore, its statements such as "Daedong/STX and Samho-HI/Hall-HI are two of four Korean shipyards that control 60 per cent of the market for product/chemical tankers" is legally meaningless. Unless the EC can demonstrate that STX and Halla individually were price leaders as an effect of the alleged subsidies, then the statements including the other yards are pointless. To take an example, if four companies (a subsidized Korean yard, a non-subsidized Korean yard, a Japanese yard and a European yard) were to compete for four sales and each obtained one sale, the EC claims that this means that the subsidized Korean yards won 50 per cent of the competitions. However, the non-subsidized Korean yard is in precisely the same position as the EC and Japanese yards. Each has a 25 per cent market share and each is equally influenced, or not, by the subsidized yard. Unless the EC is now implicitly trying to put forward some baseless allegations of collusion (of which we have seen no evidence nor heard any arguments), the mere fact of nationality does not sweep the other Korean yards into the subsidized yard's market share. The subsidized yard may or may not be a price leader in this hypothetical, but the proof of it will have to stand on the effects of that yard's subsidy, not through some bizarre nationality theory.

The Panel will recall that when challenged by Korea to defend these statements, the EC offered no proof whatever except to revert to some arguments about internal price competition that would arguably be relevant only in the context of an antidumping investigation or a subsidies dispute where there were separate geographic markets of which Korea was a distinct market. The EC offered no actual evidence because it has none. Quite simply, the EC has failed to provide any evidence that the allegedly subsidized yards were the price leaders and were so as an effect of the alleged subsidies.

Korea must also note again for the written record its objections to the way the EC has phrased its market share allegations. The EC several times referred to market shares of order books. Of course, those order books stretch over several years and can vary tremendously from yard to yard and from year to year. Therefore, it is impossible to know actually what the market share is or will be at any given time because the comparisons are not of the same time periods. At other points, the EC follows on such statements by making general allegations about market shares without identifying whether or not it is again referring to order books or some particular year. The EC does not identify any particular years. The EC is simply attempting to mislead the Panel by trying to disguise small shipyards within statistics that include larger shipyards over an unknown period of years.

Korea would also like to recall to the Panel the extensive information supplied by Korea demonstrating the significant cost advantages of all of the Korean shipyards. It is because of this indisputable fact that the EC has rejected its obligation to demonstrate that any alleged price leadership is an effect of the subsidization. As Korea pointed out in paragraph 282 of Korea's Oral Statement at the Second Substantive Meeting, the EC's continual reference to Hyundai-Mipo as a price leader when Hyundai-Mipo was not restructured and received a very limited number of APRGs and pre-shipment loans (even considering the *de minimis* levels of such credits even under the EC's calculations) demonstrates conclusively that any price leadership was not pursuant to the alleged subsidies.

II. TO THE EC

A. KEXIM LEGAL REGIME

128. Does a government necessarily provide a subsidy if it makes a financial contribution outside the normal field of commercial behaviour? Assume a government creates a new special finance mechanism that has never been offered by private banks. Assume that private banks subsequently begin providing the same finance mechanism on the same terms as the government initially offered, Assuming that the finance mechanism constitutes a financial contribution, would the initial offer of that finance mechanism by the government confer a benefit? Please explain.

Comments

Korea observes at the outset that this hypothetical question is based on an assumption that the "government" is providing a particular financial instrument. Particularly in the area of finance, many banks in the developing world (and in some EC member states as well) were set up to provide commercial lending in areas where there was simply a dearth of private sector experience and capability. As an initial matter, it must be determined whether these entities lending on a commercial basis are public bodies.

Korea assumes from the hypothetical that the Panel is positing for simplicity of argument that the finance mechanism is being extended by an organ of government (e.g., the Finance Ministry as per Question 106). In such a case, the *SCM Agreement* should not be interpreted as prohibiting the government from providing finance instruments that are new to the market. Such a presumption would be unduly constraining on all Members and particularly on developing country Members. A lack of an identical financial instrument in a certain period requires that the complainant must use data from a *comparable* period or comparable instruments with appropriate adjustments from the same period as a benchmark to determine whether there is a benefit.

129. The EC submits that KEXIM's website describes the PSL programme as designed "to encourage the export of capital goods such as … ships ... involving larger credits and longer

repayment terms than what suppliers or commercial banks would provide~" Isn't this what any development bank does? Do development banks necessarily provide subsidies? Please explain.

Comments

Korea would like to note again the oddity of the EC's argument regarding the status of KEXIM as based on credits of *longer* terms. This dispute is about extremely *short* term instruments. The EC also claims that KEXIM could offer larger amounts of credit, but the evidence is quite clear that the programmes in question were no larger in size than what commercial banks were willing to provide. Thus, the "evidence" that the EC offers cuts against its *per se* argument and also undermines any implication regarding governmental authority regarding the programmes in question (please refer to the answers to Questions 106 and 107, above).

B. APRG/PSL

130. Please comment on Exhibit Korea – 87, concerning country risk spreads.

131. Why, in its benefit calculations for KEXIM financing did the EC apply the S/M credit rating to DSME for the entire period for which calculations are presented including in particular the post-restructuring period? Is it the position of the EC that DSME remained uncreditworthy even after the restructuring? Please explain.

Comments

This is an example of the EC's false accusations against Korea permeating throughout this proceeding. While Korea will not reiterate its review of the fallacies of the EC's attempt to equate KEXIM credit ratings and other rating agencies' ratings (for the details with this respect, please refer to Exhibit Korea – 91), Korea would like to point out that KEXIM as well as other credit rating agencies adjusted DSME's credit rating upward right after its graduation from the workout (s*ee* Exhibit Korea – 92), having found that DSME's creditworthiness had improved through the workout exercise. Despite this, the EC baselessly treated DSME as being continuously in the worst financial situation. The EC's intent for doing so is quite evident. By falsely rating DSME's creditworthiness, the EC wished to prove the existence of a great benefit conferred on DSME.

132. Please comment on Korea's assertion that the collateral offered in respect of certain APRGs provided by foreign banks covered only a small portion of the guarantee" (para. 81 of Korea's oral statement at the Second Substantive Meeting).

133. At para. 105 of its Second Written Submission, the EC states that only domestic banks with "government association' provided APRGs to Samho. Regarding Figure 12 of the EC's First Written Submission, is Chubb a domestic bank? If so, does it have a "government association"? If there is such an association, what is its nature? Please explain,

134. In Exhibit EC-118, PWC asserts that "[t]he KSDA Bond Matrix is the accepted mark-to-market price for the domestic market". Does this mean that the EC disagrees with Korea's argument that the bond matrix represents hypothetical I projected rates, or does the EC accept Korea's argument but consider that the index nevertheless constitutes a reliable market benchmark? Please explain. What does market-to-market in this context mean? In particular, who was marking what to which market?

Comments

As detailed in Korea's Response to Panel Question 73, the KSDA bond rates are not the actual rates (or yields) of a specific corporate bond instrument, but simply a general index which

shows daily market trends or changes. As such, considerations as to industry sectors, issuers or terms and conditions for each instrument are not taken into account. Korea submits again that companies with the same credit ratings are perceived and treated differently in the market. As stated in paras 88 through 92 of the second Oral Statement by Korea, it would make no sense to maintain that general bond indices are somehow better than using financial instruments that the firms under examination actually used. Korea submitted Exhibits Korea – 18 through 22 as to financial instruments actually used.

135. Korea criticizes the EC for having used in its benefit calculations the 1-year bond price index instead of the 6-month index. Why was the 1-year index used? What is the effect on the EC's calculations of using the 6-month index?

136. At para. 95 of its oral statement, Korea presents a number of points criticizing the EC calculation methodology, and states that further details are contained in Exhibits Korea 90-102. Please respond to Korea's criticism in detail, including with reference to the content of these exhibits.

137. Korea submitted evidence (in response to Question 74 from the Panel) that KEXIM reduced the credit risk spread for HHI to **[BCI: Omitted from public version]**. Did the EC apply this **[BCI: Omitted from public version]** credit risk spread in the relevant part of its PSL analysis? Please refer to the relevant calculations where this adjustment was made.

138. The EC does not appear to have answered Questions 9 and 11 from the Panel. The EC's replies referred the Panel to the EC's reply to Question 8. That reply, however, focuses on KEXIM's "practice" of providing APRGs and PSLs, without identifying the APRG and PSL programmes "as such and without explaining how (if at all) they differ from the KEXIM legal regime "as such". Please provide full answers to Questions 9 and 11.

139. The Panel refers to Attachment 5 to the EC's replies to the Panel's questions after the First Substantive Meeting, which contains transaction-specific alleged benefit calculations for one PSL and one APRG. Please make the same calculation for each of the APRGs and PSLs at issue in these proceedings. In other words, for each shipyard, specify which AFRG *I* PSL relates to either LNG, product / chemical tankers, or container ships, and specify the amount of the alleged benefit as a % of the ship price. Please attach detailed worksheets.

140. Please comment on Korea's argument that KEXIM PSLs are made "at rates far higher than those the government has to pay for the funds so employed" (para. 277, Korea's First Written Submission).

Comments

Korea refers the Panel to para 112 of Korea's Second Written Submission which shows the KEXIM cost of funds for the relevant period.

C. ALLEGED ACTIONABLE SUBSIDIES

141. Para. 215 of the EC's First Written Submission states that "Daewoo" benefited from a 236 bn tax exemption alleged to be a subsidy. Para. 226 then refers to alleged benefit to Daewoo-SME". Para. 232, however, refers to benefit to "Daewoo-HI / Daewoo-SME". Please indicate precisely which legal entity received / benefited from the alleged tax concession.

Comments

See Korea's response to Panel Question 116.

142. In percentage terms, how much of the alleged benefit resulting form the "Daewoo" tax concession should be attributed to DSME's production of (i) LNGs, (ii) product / chemical tankers, and (iii) container ships? Please attached detailed worksheets.

143. Is it the EC's argument that the tax exemption was determinative in the decision to maintain Daewoo's shipbuilding operations as a going concern, rather than liquidating them? If so, where is this reflected in the Arthur Andersen/Anjin report or in other documentation before the Panel?

Comments

See Korea's response to Panel Question 123. There was no tax exemption of KRW 236 billion. Further, no tax exemption was reflected in the Arthur Andersen report.

144. Para. 162 of Korea's second oral statement refers to creditors rejecting the initial DHI workout proposal. Were such creditors included in the EC's claim of government entrustment or direction? If they were entrusted or directed by GOK, why / how did they reject the initial workout proposal?

145. The EC requests an adverse inference regarding Korea's alleged failure to provide a copy of the workout plan / report submitted by KDB on 24 November 1999. Please comment on the explanation set forth at pans 194 and 195 of Korea's second oral statement. If the EC still maintains its request, what is the legal basis for that request? Why does the EC consider that Korea should have made this report available to the EC / Panel earlier?

146. In response to Question 23 from the Panel, the EC asserts that "[t]he existence of a going concern analysis can be an indicia that a hypothetical private creditor would have acted in the same manner" Does the EC accept that the individual components of the Daewoo wrkou1 can be assessed on the basis of the Arthur Andersen report? If the Panel rejects the EC's argument that the Arthur Andersen report incorrectly determined that the going concern value of DHI exceeded its liquidation value, does this necessarily mean that the Panel should reject the EC's claims regarding the individual components of the workout? Please explain.

Comments

As stated in Korea's response to Panel Question 122, the DHI workout plans had been devised as a single global package to ensure maximum recovery of debt on an aggregate basis and, thus, a benefit cannot be analyzed on the basis of individual components. Therefore, if the Panel accepts that the creditors acted pursuant to market principles when they chose the workout rather than straightforward bankruptcy (liquidation), the Panel should reject the EC's claims regarding the individual components of the workout.

147. The EC asserted at the second meeting that creditors should have got more out of the Daewoo debt/equity swap. How could creditors have got more? Who / what benefited from the fact that they did not?

148. The EC proposes an outside investor standard when challenging the reorganization of Samho. This contrasts with the position taken by the EC in the GATT case concerning United States – Imposition of a definitive Countervailing Duty on Imports of Certain Steel Products Originating In France, Germany and the United Kingdom.[8] Why has the EC changed its position on this issue? Why does the EC now consider that the outside investor standard is preferable to the inside investor standard? Please explain.

[8] Report of the GATT Panel, SCM/185, issued 15 November 1994 (unadopted).

Comments

Korea refers to its response to Question 172.

149. If the Panel were to reject the EC's claim of government entrustment / direction of private creditors, would this mean that those private creditors provide a reliable market benchmark for determining whether or not the restructurings at issue conferred a benefit? Please explain. Did the EC address this issue in its previous written and oral submissions to the Panel. If yes, please indicate precisely where it did so.

Comments

The EC itself in paragraph 106 of its First Written Submission indicates that Article 1.1 of the *SCM Agreement* distinguishes between "government", "public body" and "private body" and that the concept of "private body" has been defined negatively as "any entity that is neither a government nor a public body" to ensure that there is no reason for circumvention in sub-paragraph (iv) of this Article. In other words, the EC has acknowledged that Article 1.1 has set up a closed framework of instances in which financial contributions may give rise to a subsidy that is either prohibited or actionable under the *SCM Agreement*. Thus, if a financial contribution is made neither by a government nor by a public body carrying out a government practice nor by a private body acting upon the entrustment or direction of the government, the financial contribution is **not** covered by Article 1.1 of the *SCM Agreement*. One must then logically conclude that nothing distinguishes the financial institutions which were found not to have acted under government direction or entrustment from any other private bodies and that they could as, in any other situation, provide a suitable benchmark for determining whether a benefit existed. In particular, there is nothing in Article 1.1 of the *SCM Agreement*, explicit or implicit, that creates a special category of private bodies which having been considered not to have undergone direction or entrustment of the government, would still be set aside as being an improper benchmark to determine whether a financial contribution afforded a benefit. All private bodies that are not under government direction or entrustment need to be treated alike.

In the EC's own rationale, those financial institutions that were not operating under entrustment or direction of the Government of Korea should be a proper benchmark to assess the existence of a benefit as the EC stated the following in paragraph 277 of the EC's First Written Submission:

> The relevant benchmark in the present case is the commercial behaviour of the private investors that at the same time were creditors of the distressed company. It is only the behaviour of financial institutions/creditors operating outside the scope of the Government of Korea's pressure that may be considered in assessing whether the restructuring plan for Daewoo-HI/Daewoo-SME was carried out on terms more favourable than those otherwise available in the market.

The EC also took the position that all financial institutions not acting under direction or entrustment are the benchmark for assessing the existence of a benefit in the response to Question 23 of the Panel at paragraph 99 of the EC's responses to the Panel's questions.[9]

In relying on the actions of creditors that it claims to be outside the control of the Government of Korea to determine a benchmark for the assessment on the existence of a benefit, the EC itself has made it clear that if domestic financial institutions do not act under government entrustment or

[9] The same position is expressed in the EC's response to the Panel's Question 24 at paragraph 100 of the EC's responses to the Panel's questions.

direction, these domestic financial institutions can be taken as a benchmark for the assessment on benefit.

150. Regarding the EC's Question 33 to Korea after the First Substantive Meeting, please explain why, if at all, the value of Samho's construction business is relevant to the present proceedings.

151. Korea asserts that the share of debt held by the foreign creditors who failed to participate in the Daewoo, workout was around **[BCI: Omitted from public version]**. Is it reasonable to expect a panel to condemn a restructuring on the basis of the behaviour of creditors holding only **[BCI: Omitted from public version]** of the debt?

152. Regarding the Daewoo workout, the EC makes various arguments regarding the purchase of debt and bonds by KAMCO. It is unclear whether these arguments support a separate claim regarding the KAMCO rates, or whether those arguments are made in support of the more general claim concerning the use of foreign creditors as the market benchmark. Please explain.

153. Please comment on Korea's argument (at para. 191 of Korea's Second Written Submission) that the BC, in its response to Question 22 of the Panel (which concerned the 'alleged specificity of the corporate restructuring" generally), allegedly concedes that the Court supervised corporate reorganizations undertaken by Halla and Daedong were not specific "because these companies seemed to have disappeared and the BC answers the question only in regards to DHI".

154. Regarding the STX reorganization, we note that the debt rescheduling exemption from interest is the sole element identified by the EC when calculating the amount of alleged benefit in Annex 3 of Attachment 1 to its replies to questions from the Panel after the First Substantive Meeting, We further note that the EC's rebuttal submission does not refer to the other elements of the restructuring identified in its First Written Submission, such as the issuance of bonds by Daedong. Does the EC still claim that the other elements of the restructuring including the bond issuance by Daedong, constituted a subsidy? If so, why were they not included in the abovementioned Attachment 3?

D. SERIOUS PREJUDICE

155. The EC has indicated that the Panel should determine the existence of price suppression/depression separately for LNGs, product/chemical tankers, and container ships.

(a) Does this mean that the EC is asking the Panel to issue three separate serious prejudice rulings, on LNGs, product/chemical tankers, and container ships, respectively?

(b) If not, please explain

156. In the information before the Panel, including the Annex V information are there additional examples (beyond those already referred to in the EC submissions) of bids by Korean shipyards, for which EC shipyards also are bidding, and where in the view of the EC the Korean yards have led prices downward.

157. (a) In the information before the Panel, including the Annex V information, are there examples/evidence of instances in which EC shipyards have considered, but declined to, bid due to low prevailing prices? For example, can the EC provide records of instances in which an EC yard was contacted by a ship broker concerning the possibility of bidding, but decided not to do so because of low prices.

(b) In any such instances, does the information before the Panel contain evidence of Korean pricing/bidding for the same sale?

Comments to questions 157 and 158

The EC itself has refrained from invoking Article 6.3(c) of the *SCM Agreement* on the basis of price undercutting or lost sales which are set forth in this Article as grounds for challenges separate from price depression or suppression. Therefore, Korea wishes to reiterate its concern that data on bids by EC and Korean yards showing price competition that might have constituted evidence on price undercutting or lost sales cannot now be reintroduced in the framework of this proceeding which is not based on price undercutting or lost sales. In addition, even if individual bids showing price competition were taken into account on the ground previously advocated by the EC during the First Substantive Meeting that there must be a certain amount of price undercutting in order for there to be price depression, based on Article 6.3(c) itself – as acknowledged by the EC – no price undercutting can be established unless there a strict test determining that the vessels in competing bids are "like products".

Notwithstanding these reservations, Korea notes that, out of the many hundreds of sales, the EC has only submitted data on a few bids in which EC and Korean yards participated that can, at best be qualified as shallow and repetitive since the same examples were used throughout the EC's submissions. Korea has identified the following:

- the sale by DHI of 2 LNGs to Solaia Shipping and to Repsol and 1 LNG to Bergesen (Responses to Annex V Questions, Attachment 4.4(21)-1, Exhibits EC-84, 85, 141, 142);[10]

- the sale of a container vessel to Hamburg Süd (Exhibit EC-88);[11]

- the offer for sale of a product and chemical tanker by EC yard Lindenau in competition with an unspecified Korean yard and as regards an unspecified shipowner (Exhibit EC-89) and the offer for sale of three product and chemical tankers by Aker covered in the same Exhibit;[12]

- the offer for sale of a product and chemical tanker by Lindenau for an unspecified Italian owner (Exhibit EC-90).[13]

Korea stresses that these were the only examples of actual competing bids referred to by the EC since the filing of its First Written Submission.

Even in the Annex V procedure, when the EC had not yet communicated its decision not to rely on price undercutting or lost sales, the evidence provided on the existence of price undercutting or lost sales was scarce and inconclusive.

[10] Korea rebutted the allegations made by the EC as regards these bids in paragraph 564 of its First Written Submission. A case study was also submitted by Drewry in its report attached as Exhibit Korea – 70, pages 7.25 to 7.27.

[11] Korea rebutted the allegations made by the EC as regards this bid in paragraph 584 of its First Written Submission.

[12] Korea rebutted the allegations made by the EC as regards this bid in paragraph 588 of its First Written Submission.

[13] Korea rebutted the allegations made by the EC as regards this bid in paragraph 589 of its First Written Submission.

Annex 6 submitted by the EC in the Annex V process contains four pages of price undercutting calculations for the following:

(i) containerships between 19,000 to 35,000 cgt for the period from 1 January to 31 December 1999 for 8 EC vessels vis-à-vis 6 Korean vessels;

(ii) containerships between 45,000 and 60,000 cgt for the period from 1 January to 31 December 1999 for 3 EC vessels vis-à-vis 7 Korean vessels;

(iii) container vessels from 19,000 to 35,000 cgt for the period from 1 January to 30 November 2000 for 18 EC vessels vis-à-vis only 3 Korean vessels;

(iv) LNGs for the period from May to July 2000 for 3 EC LNGs vis-à-vis 3 Korean LNGs;

(v) product and chemical carriers between 17,000 to 20,000 cgt for 3 EC vessels vis-à-vis 5 Korean vessels and only covering 2000.

This is not conclusive for the existence either of price undercutting or even of price undercutting that would allegedly give rise to price depression (in addition to the calculation errors which were according to Korea made in the calculations). The EC itself has provided in Annex 1b a list of 163 transactions involving EC vessels built from 1997 to June 2003 and, of course, Korea itself provided several hundreds of transactions for Korean vessels out of which only 24 were selected as having given rise to price undercutting. In addition, the instances selected by the EC are not representative of the time period covered in the present dispute from 1997 through 2003. It must be emphasized that, in spite of the data available, no single example of alleged price undercutting has been shown for 2001, 2002 or 2003. Also, while the EC does make the price comparison on the basis of differences in sizes (which, as mentioned, by Korea is the bare minimum to make a correct assessment of any sort of price trends in relation to commercial vessels), the ranges selected expressed in cgt are not representative of the full range in which container vessels and product and chemical tankers are sold. Finally, no accurate price comparison of the vessels can be made without considering differences in physical characteristics such as gearing, the type of engine and other features that were listed in Exhibit Korea – 109.[14]

Annex 7 submitted by the EC in the Annex V process contains 17 alleged examples of lost sales, by far not representative of the number of vessels contracted for during the relevant period from 1997 to 2003. In some instances, they are not attributed to any specific Korean yard. Moreover, in addition to being statistically and timewise not representative, the documents submitted contain several flaws of which some of the main ones are mentioned below:

- there is no direct documentary evidence and only hearsay is being offered by the EC yards (Annexes 7.4, 7,5, 7.6, 7.7, 7.8, 7.9, 7.10);

- cheaper vessels are recognized to exist in Eastern Europe or in Japan (Annexes 7.1, 7.3);

- the design offered by the EC yard is over-specified compared to the shipowners requirements or the vessel offered by a Korean yard or the design was not available (Annexes 7.1, 7.2, 7.3, 7.5, 7.12);

[14] Korea notes that it does not agree with the data or conclusions shown in this Annex 6 for various reasons including the fact that a price comparison made should have been made in US dollars, i.e. the currency universally used by yards to quote most of the sales prices of their vessels and not in EUROs which could not provide a true picture of price undercutting caused by subsidies.

- the EC offer is made without there being any order prospect and a broker just issued a general inquiry (Annexes 7.2, 7.3);

- the Korean yard alleged to have been competing is not shown in any register as having obtained an order from the shipowner concerned raising serious doubts as regards the accuracy of the lost sales allegations (Annex 7.4, 7.8);

- the contracts that exist with a Korean yard are for a substantially larger ship than that referred to in the alleged lost sale documents (Annex 7.9, 7.10);

- the tenders made by the Korean yards concerned are for a series of vessels, which has an effect on the price given economies of scale, without this being mentioned in the alleged lost sales documents and without it being indicated whether the EC yards concerned could build the full series within the time required by the shipowner (Annex 7.10);

- there was fierce competition among EC shipyards (Annexes 7.6/7.12);

- the EC yards were faced with dock restrictions requiring the adjustment of their designs (Annex 7.13);

- the EC yard was licensed to build Moss spherical type LNG containment systems, rather than GT membrane types and all the orders from the Repsol/Enagas tender were for Membrane GT type containment systems as a result of which the bid from the EC yard cannot be considered like (Annexes 7.14 and 7.16).

As a result, the documents provided by the EC cannot from the basis of any price depression allegations and, conspicuously, the EC made use of only a few of these documents in the actual panel process.

Moreover, in the alleged price undercutting cases referred to in Annex 6 in the Annex V process, there is no evidence of EC and Korean yards bidding for the same tender. All the EC has done is to compare prices for different bids for vessels that might fall in the same wide size range but may otherwise differ in important technical features.

In the alleged lost sales cases referred to in Annex 7 to the Annex V process, the Korean prices invoked are based on hearsay or allegations by the shipbrokers without any direct supporting evidence being supplied.

158. (a) Is it the view of the EC that excess shipbuilding capacity exists only in Korea, or is there also excess capacity in other countries?

(b) If your view that excess capacity exists only in Korea, please explain.

(c) If your view is that there is excess capacity also outside of Korea, where and how much is the excess?

(d) Is there any excess shipbuilding capacity in the EC? If not, what is the basis for this conclusion?

Comments

It is recognized within the industry that there is no easy way to rigorously measure shipbuilding capacity. However, significant attempts have been made over recent years, under the auspices of the OECD Working Party on Shipbuilding, to improve the estimation of shipbuilding capacity.

The latest estimates of capacity from OECD sources are an estimated figure for actual capacity in 2000 and a figure for anticipated capacity in 2005 which was also made and agreed in 2001[15] from estimates provided by the Japanese, EC, USA and Korean shipbuilding associations expressed in cgt. The following table shows an assessment of capacity utilization for the major shipbuilding regions based on these capacity assessments and shipbuilding output statistics from LR Shipbuilding returns.

	Versus 2000 capacity			**Versus projected 2005 capacity**		
	2001	**2002**	**2003**	**2001**	**2002**	**2003**
Japan	90%	93%	95%	84%	86%	88%
South Korea	94%	104%	111%	77%	84%	90%
EU countries	87%	84%	76%	78%	76%	68%
AWES non EC [1]	86%	83%	74%	78%	76%	68%
Other European	61%	80%	87%	54%	71%	77%
China, PR of	96%	110%	180%	63%	72%	118%
Asia & Pacific	43%	63%	48%	39%	58%	44%
NIS Countries [2]	29%	83%	64%	27%	77%	59%
North & South America	32%	44%	58%	29%	39%	52%
Africa & Middle East	8%	8%	8%	8%	8%	8%
Others	0%	0%	0%	0%	0%	0%
WORLD TOTAL	85%	91%	96%	74%	79%	83%

1 AWES non EC = Norway, Poland and Romania
2 NIS = Russia, Ukraine, Latvia, Lithuania, Geogia, Azerbaijan

While Korea is not endorsing this extremely general overview as an appropriate measure for the multiple industries examined in this WTO dispute, nonetheless, the table helps to indicate the situation regarding estimated excess capacity in the main shipbuilding regions in spite of the difficulty in defining shipbuilding capacity and the fact that the 2005 figure is a projection which is now some 3 years old.

Against both the 2000 capacity estimate and the 2005 capacity projection it can be seen that excess capacity exists all around the world. Regarding the major shipbuilding regions, it is noted that there is significant excess capacity within the EC yards and some overcapacity in Japan. The table below shows a country level breakdown for the EC's main shipbuilding countries.

[15] OECD Document C/WP6(2001)16 of 'Present Market Conditions and Future Outlook for the World Shipbuilding Industry' dated November 14, 2001 and prepared by the Secretariat of which an excerpt is attached in **Exhibit Korea – 123.**

	Versus 2000 capacity			Versus projected 2005 capacity		
	2001	**2002**	**2003**	**2001**	**2002**	**2003**
Denmark	68%	82%	72%	61%	73%	65%
Finland	116%	88%	69%	116%	88%	69%
France	165%	107%	139%	147%	95%	124%
Germany	102%	106%	79%	90%	93%	70%
Italy	80%	89%	88%	69%	77%	76%
Netherlands	77%	72%	43%	69%	64%	38%
Spain	59%	67%	88%	54%	62%	81%
United Kingdom	19%	21%	28%	19%	21%	28%
EU countries	**87%**	**84%**	**76%**	**78%**	**76%**	**68%**

Of particular note is the situation regarding China, where it is shown that output has exceeded the projected 2005 assessment. At the time of the 2001 projection, unlike the other major shipbuilding regions of Japan, Korea and the EC, China did not supply its own estimate nor has it done so subsequently. The OECD capacity estimates show that output has exceeded the estimated 2000 capacity figure in both 2002 and 2003 and exceeded the 2005 projected capacity in 2003.

However, there has been considerable growth in capacity in China since 2000 both through improved performance[16] and additional or enhanced facilities. Drewry Shipbuilding Consultants believes that there has been excess capacity within China during this period. Over the period 1999-2001 it is estimated that the top 20 shipbuilding yards in China (which represented approximately three quarters of the country capacity) were working at 55 per cent of their capacity. Drewry undertook a detailed estimate of capacity in China, based on the agreed OECD guidelines which reflects the type of ships built and performance over the period 1999-2001, which was published in its (non-commissioned) report on China's Shipyards issued in July 2003. This assessed Chinese capacity to be 3.187 million cgt at the end of 2002 which taken in conjunction with the reported output for China in 2002 and 2003 would indicate utilization levels of 49 per cent and 81 per cent respectively. Furthermore, Drewry calculated that a projected additional 0.353 million cgt was scheduled to come on line by 2005/6. This estimated 2005/6 capacity of 3.54 million cgt contrasts with the earlier OECD estimate for 2005 of 2.18 million cgt.

159. The Panel's written question 30 following the first meeting was as follows:

> **"In general, how much flexibility does a typical shipyard have to produce all or a broad range of ship types? What are the physical and other constraints on any given shipyard's potential product range? How important is prior experience to a shipyard's production cost and capability to build a particular type of ship? With reference to the above considerations, p1ease describe the capabilities and experience of each EC shipyard that produces or is capable of producing some or all of the kinds of commercial vessels cited in your serious prejudice claim."**

Please present a summary of any information already before the Panel, including the Annex V information, that is relevant to this point but was not referred to in the EC's original answer to this question.

[16] One of the great difficulties in this area is that potential capacity is profoundly influenced by efficiency of production, not just by nominal physical capacity. This explains in part why China with its great potential is such a "wild card" in the projections.

Comments

In light of the Panel's question, Korea cannot help but reiterate that the EC has not made available any information in this regard, whether by ship type or, *a fortiori*, by like product vessel in the framework of this proceeding. Korea has already expressed its surprise at the EC's statement in paragraph 131 of the EC's response to the Panel's Question 30. Indeed, the EC has circulated three questionnaires to the EC shipyards in the course of the EC's Trade Barrier Regulation proceedings during the period from 2000 to 2002 requesting information on vessels built and sold by the EC shipyards. It has obtained the co-operation of around 21 shipyards over this period providing responses to these questionnaires (*See* also Annex 1a of the documents submitted by the EC in the Annex V process). Based on the detailed information that it must have received and on data that should be available to its expert, FMI, it should have been possible to address at least for these 21 of the most important EC shipyards their capabilities and experience in producing some or all of the kinds of commercial vessels cited in the serious prejudice claims.

Korea also refers to Annex 1b of the documents supplied by the EC in the Annex V process which clearly indicates that many if not most of the EC yards during the period from 1997 to June 2003 produced only one - or at most two - types of commercial vessels concerned by the present dispute, for example:

- Aker MTW: product and chemical carriers, container ships;
- HDW: container ships;
- IZAR: product and chemical carriers, LNGs;
- Kvaerner Warnow: container ships
- Odense: container ships
- Thyssen: container ships
- Fincantieri: product and chemical carriers
- Kröger Werft: container ships
- Stralsund: container ships
- Peene Werft: container ships
- Flender Werft: container ships
- Lindenau: product and chemical carriers
- SSW: container ships
- Aker Ostsee: container ships.

Chantiers de l'Atlantique is not even on the list but should be listed only for LNGs anyways. This is confirmed for the above EC yards and for others in Annex 2b filed by the EC in the Annex V process with the list of orders per shipowner's nationality.

In fact, if the correct like product determination were taken into account, as argued by Korea, it would also be established that EC yards concentrate in specific size ranges within the product types of container ships and product and chemical carriers. Moreover, this is not the result of the bestowal of the alleged Korean subsidies but is the result of a more than decade-long evolution. This evolution started well before any of the alleged subsidies were granted and reflects a decision on the part of the EC yards to specialize in specific like product types of vessels, with the largest amongst the EC yards having decided to concentrate in particular on high value added vessels such as cruise ships, ferries or roll-on-roll-off vessels where they continue to occupy a very high market share. This may, however, be an effect of the myriad EC subsidies.

The EC yards have no intention to build every type of vessel or every type of size but have specialized more narrowly and made investments accordingly. By way of example, Korea refers to Annex 4b of the documents submitted by the EC in the Annex V process. In particular, the financial statements for 2002 of Aker MTW (refer to the Management Report for Fiscal Year 2002, Section 1 on Business Development at Exhibit 4/2) which, having stated that the yard was able to "beat Korean

competitors" for the order of 6 container ships of 2500 teu, to be built for the Iranian shipping line IRISL, and having a cruise ship on order.

> In 2002, the focus of investment was the replacement of equipment and systems, esp. to allow the parallel manufacture of container ships and cruise ships.

Reference is also made to the financial statements for Chantiers de l'Atlantique for the year closed on 31 March 2001 also included in Annex 4b of the data submitted by the EC in the Annex V process. In particular, the Message from the CEO Pierre Bilger at page 14 where it clearly identifies ferries, cruiseships and LNGs as well as naval building to be the continued priority. Of course, only LNGs are the subject of the present dispute, thereby confirming that Chantiers de l'Atlantique is not interested in containerships or product and chemical carriers (as is confirmed also by the fact that France has applied for the EC's temporary defense mechanism aid only in respect of LNGs).

Korea further refers the Panel to the financial statements of the important EC yard Fincantieri in Annex 4b. Korea notes that, while the yard in its annual reports refers in elaborate terms to its building of cruiseships and ferries, there is nothing on the building of other commercial vessels, save a cursory reference to the building of chemical tankers of which the EC itself says that these are outside the purview of the present dispute, notwithstanding that it maintains a supply substitutability for all vessels alike.

HDW in its financial statements for the year ended on 30 September 1997 also attached in Annex 4b states the following at page 12:

> Our product developments in merchant shipbuilding revolve round customer-driven solutions to sea transport problems of all kinds and also new concepts for passenger ships. HDW cruise ships are either modern ships built in the style of past eras or new types of luxury apartment ships never built before. With regard to freighters, we are concentrating on developing fast ferries and container ships, new insulating systems for gas tankers and designing ships for transporting reefer containers.

Having thus set its priorities, it is clear that HDW did not wish to pursue other vessel types such as LNGs or product and chemical tankers, or did not consider itself capable with respect to such other vessel types.

The Management Report for the 2001 Financial year of the financial statements of Kvaerner Warnow (Annex 4 thereto, Section 4) states the following:

> Container ships will continue to form KWW's core business. However the shipyards plans to expand its range of products in order to reduce its dependence on price trends in the container ship market. This objective will be attained in cooperation with partner shipyards within the Group. The expertise and reputation the yard has acquired in building the drilling platform will open up new opportunities for other offshore projects and will be built on and expanded in cooperation with partner yards within the Group.

Having already stated in Section 1.5 that R&D focused on the development of designs for standard container ships, it is clear that Kvaerner Warnow intentionally concentrated on the building of container ships and did not contemplate diversifying into other commercial vessels, but contemplated the additional building of drilling rigs.[17]

[17] Reference is also made to Kvaerner Warnow's management report for the 2000 financial year (Annex 4, page 5 of 6) also attached in Annex 4b where the yard stated that "KWW, which has specialised in the container ship market, will continue in the near future to depend on obtaining new contracts in this field."

The same is true for Volkswerft Stralsund which in Section 3. of its Annual Management Report attached to its financial statements for 1999 in Annex 4b indicated that "[t]he yard will continue to concentrate its marketing activities on medium-sized container ships and large special-purpose vessels for the offshore sector."[18]

160. Concerning the composite ship newbuilding price index furnished by the EC, the EC indicates that major shipbuilding consultants also maintain "more specific price information for particular ship types". In Attachment 2 to its answers to questions, the EC provides price information for two sizes of tankers and for eight sizes of container ships.

(a) Is this the "more specific' information to which the EC refers?

(b) Why does the EC show the particular breakouts that it does? Do other breakouts exist for these products? Please explain.

Comments

Korea refers to its response to Question 173 d) and e) regarding the detailed price series indices that are used in the industry.

161. The EC presents indices of estimated Korean production costs versus prices in support of its argument that there is price suppression/depression The EC indicates that its consultant, FMI, prepared the cost estimates, taking into account various known cost trends and cost advantages of the Korean yards. The EC in its answers to questions following the first meeting provided a description of the methodology used by FMI to prepare these estimates. The EC also indicated that, should the Panel so request, it would furnish the detailed underlying data. Is it the view of the EC that a graphical presentation of price indices, along with a description of methodology, constitutes prima facie evidence of evolution in Korean shipbuilding costs? Please explain.

Comments

Korea observes that the EC has not even provided production cost versus price indices for each of the vessel segments that the EC itself has identified. In the Second Substantive Meeting, upon a request of the Panel, the EC has confirmed that a serious prejudice assessment should be made for each of the three product segments identified by the EC separately. While the same question is now addressed in writing to the EC, having clearly separated the three product segments, in the EC's rationale, there is no reason why the EC should respond differently in writing. Thus, when the EC alleges that price suppression must exist because in the absence of price pressure due to Korean subsidies, the increase in demand, freight rates and cost of production would have led to price increases, the EC should have made a *prima facie* case in support of its allegations already in its First Written Submission for each of its own product segments separately.

The EC failed to do so and even further weakened the strength of its allegations in Attachments 2 and 6 of its responses to the Panel's questions as well as in its Second Written Submission. The following will clarify this:

Korea notes for the record that the same report mentions that "[t]he competitiveness and profitability of the shipyard would be improved if the production limits imposed by the EU were eased or lifted."

[18] Section 5. of the management report for the 2002 financial year also attached in Annex 4b) confirms that: "[o]ur acquisition activity will continue to focus on the tried and tested market segment of mid-sized container ships and supply ships."

	First Written Submission		**Attachment 2 of the EC's responses to the Panel's questions**	
	Price developments	Price and cost index	Price developments	Price and cost index
LNGs	Newbuilding price developments (Figure 30 at page 164)	Cost and price indices for Korean LNGs (Figure 38 at page 165) *No explanation on how these cost indices were obtained and which LNGs are reflected in these LNGs.*	Year-end prices of LNGs (Figure 1.3 at page 3)	Cost and price indices for Korean LNGs (Figure 1.5 at page 4 *Half of one page explanation on the "estimation" of cost indices (Section 4 at page 16) but still no clear explanation on how these costs were calculated or which LNGs are reflected in these indices.*
Container vessels	A graph with world market prices for 3,500 teu and for 1,100 teu container vessels taken from Clarkson Research Studies (Figure 41 in the EC's First Written Submission, at page 167)	Cost and price indices for Korean 3,500 teu container vessels (Figure 40 at page 166 of the EC's First Written Submission) *Price indices presumably calculated based on Figure 41.* *No explanation on how these cost indices were obtained and which container vessels are reflected.* *No explanation as to why conclusions for all container vessels are drawn on the basis of a specific size range only.*	A graph is shown with price developments for 8 different sizes of containers based on Clarkson research.	Cost and price indices are shown for a Korean panamax container ship (Figure 3.7 at page 15. *The comments with regard to the data in the First Written Submission remain. In addition, it is questioned whether the cost and price indices shown in Figure 3.7 can be reconciled with those in the First Written Submission. The latter reflected those of 3,500 teu container vessels while Attachment 6 to the EC's responses to the Panel questions indicates that Panamax container vessels which are reflected in Figure 3.7 cover vessels between about 4,000 and 5,000 teu (item 7. at page 1.)* *There seems to be an inconsistency in the EC's demonstration.*
Product and chemical tankers	No price developments shown at all.	Cost and price indices for Korean handysize product	Price developments for handymax and panamax products	No cost and price indices are shown and there is no indication

	First Written Submission		Attachment 2 of the EC's responses to the Panel's questions	
		and chemical tankers (Figure 43 at page 169 of the EC's First Written Submission) *No indication on how the price indices were determined.* *No explanation on how these cost indices were obtained and which container vessels are reflected.* *No explanation as to why conclusions for all product and chemical tankers are drawn on the basis of a specific size range only.*	tankers taken from Clarkson's (Figure 2.3 at page 8) *The data is shown for "product tankers" while the EC has constantly indicated that "product and chemical tankers" are concerned by the present dispute and has indicated in the Second Substantive Meeting that it is concerned with tankers that transport both oil and chemical products. It is, therefore, not clear whether these prices reflect sown in Figure 2.3 reflect those of the products concerned by this dispute.*	as to whether the EC maintains those shown in Figure 43 of its First Written Submission. *There is total uncertainty as to the allegations. If the EC meant to maintain Figure 43, the questions/observations in the third column of this table remain valid.*

As mentioned, it is not clear how the cost indices used were arrived at or whether the cost reports of FMI submitted in Annex 10a of the documents supplied by the EC in the Annex V process were taken into account. However, if they were, in addition to the criticism already mentioned by Korea in its Second Written Submission (at page 124) or in the Drewry Report (Exhibit Korea – 70 at page 8.22), Korea submits that the cost calculations are not sufficiently representative as to be conclusive. Indeed, cost calculations were made for the following vessels subject to the present dispute:

- Hanjin 4,900 teu container;
- Daewoo 5,100 teu container
- STX 51,000 dwt tanker (which may be a product tanker not concerned by this dispute)
- Hyundai Mipo handymax tanker[19]
- Daewoo LNG for Exmar
- Hyundai LNG for Golar
- Hyundai 2,500 teu
- Samsung 5,500 teu container
- Samsung LNG for British Gas

[19] For details on this vessel and the preceding three, refer to Section 6 of the FMI Mid-term report, Shipbuilding Marketing Report – Phase 4, March 2003, Annex 10a of the documents submitted by the EC in the Annex V process.

- STX panamax products tanker (which may not be concerned by this dispute that concerns combined product and chemicals tankers)
- STX product and chemicals tankers[20]
- Hyundai 7,200 teu container vessel,
- Daewoo LNG for Bergesen
- Samho Aframax tankers (which may not be concerned by this dispute that concerns combined product and chemicals tankers)
- Samsung 7,200 teu container ship
- Daedong 2,500 teu container ship
- Hyundai Mipo handysize products tanker (which, as mentioned above, may not be concerned)
- Shin-A handysize products tankers (which as mentioned above, may not be concerned)[21]
- Daedong 35,000 dwt tanker (if a product tanker, this product may not be concerned)
- Hanjin 5,608 teu container ship
- Hanjin 1,200 teu container ship
- Hanjin 6,250 teu container ship
- Halla 3,500 teu container ship
- Hyundai 6,800 teu container ship
- Hyundai 5,600 teu container ship
- Hyundai LNG for Bonny Gas Transport
- Hyundai 5,500 teu container ship
- Samsung 5,500 teu container ship
- Samsung 3,400 teu container ship[22]

Thus, it would seem that cost calculations have been made at best for around 25 vessels out of the hundreds of Korean vessels sold that are vessel types concerned by the dispute. Not even half of these cost calculations concern vessels built by restructured yards.

Korea, therefore, submits that if this were the basis for the cost indices set forth by the EC in relation to price indices, these cost indices are not representative compared with the total sales of the vessels concerned by the restructured yards in terms of the number of vessels sold or in terms of like product coverage. If these are not the basis for the cost indices, the indices relied upon by the EC constitute all the less *prima facie* evidence sufficient to demonstrate the existence of price suppression as they are assertions only without any substantiating evidence. In any event, Korea submits that the EC has not carried the burden of proof that rested on it.

162. What specific evidence/examples are contained in the information before the Panel in support of the EC argument that prices at one end of the product spectrum for a particular kind of ship influence prices along the entire spectrum? (For example, is there specific evidence in the information before the Panel that a downward movement in very large container ships brings about commensurate downward movement in all smaller sizes of container ships?)

[20] For details on this vessel and the preceding five, refer to Section 6 of the FMI Final report, Shipbuilding Market Monitoring – Phase 3, August 2002, Annex 10a of the documents submitted by the EC in the Annex V process.

[21] For details on this vessel and the preceding six, refer to Section 6 of the FMI Final report, Shipbuilding Market Monitoring, Phase 2, May 2001, Annex 10a of the documents submitted by the EC in the Annex V process.

[22] For details on this vessel and the preceding five, refer to Section 2.2.2 of the FMI Final summary report, Shipbuilding Market Monitoring, April 2000, Annex 10a of the documents submitted by the EC in the Annex V process.

163. (a) For each ship category, in practical terms how substitutable are different sizes/configurations (containment systems, in the ease of LNGs)? Are there specific evidence/examples in the information before the Panel? In addition, please furnish relevant portions of the industry publications discussed at the second meeting. (For example, one industry expert referred at the meeting to one of the industry publications that contains information relevant to cross-price elasticities).

Comments

For all ships, size is a major barrier to substitutability for several reasons:

1. bigger ships cannot physically operate on many of the routes or ports serviced by smaller vessels,

2. trade volumes would mean that bigger ships would have to operate part empty on many lower volume routes serviced by smaller vessels; and

3. ship operating economies of scale are such that it is considerably more expensive per unit of cargo carried in a small ship compared with a larger vessel (which is why larger ships are built). Information was provided in Exhibits Korea - 70 and 109 regarding the different operating costs of vessels and this information is published in Drewry's industry reports.

There are other reasons which tend to be more ship type specific, some of the main ones include:

Product/chemical tankers:

- IMO Class of the tanks on product chemical tankers limits the cargoes a vessel can carry by regulations, it would be particularly unlikely that expensive IMOI/II vessels would be used to carry oil products;

- Tank coatings limit the cargoes that can be carried in oil products and chemical/products tankers;

- Some cargoes trade in relatively small volumes from one destination to another whilst others are traded in high volume, small volumes of cargo require smaller tanks and higher levels of tank subdivision and it is economically not viable to carry small volumes in large tanks or *vice-versa*.

Container ships

- Smaller vessels tend to have lower speeds and can therefore not maintain the time schedules for liner services on routes that are operated by large vessels – this would result in a major failure of delivery service to customers;

- Large containerships are built without their own cargo handling gear because they trade between dedicated container ports which are equipped with high speed unloading facilities. They would therefore not be able to unload in less specialized ports that do not provide these since the ships are too large to be serviced by the cranes available in smaller ports. For this reason the ships using these smaller ports are equipped with their own cargo handling cranes;

- On certain trade routes – notably north–south routes – there are significantly higher volumes of refrigerated cargoes and these cannot effectively be traded by ships with lower levels of reefer capability which are intended to be traded on East-West routes.

LNG ships

- Ships destined to trade to ports that do not have land-side re-liquefaction facilities must incorporate these facilities on the ship or they cannot discharge their cargoes. The expansion of LNG trade is seeing an increase in such instances;

- Certain membrane systems experience 'sloshing' problems if they have partly empty tanks so they cannot discharge parts of their cargoes at different ports. This is mainly a consideration on certain Japanese LNG routes.

(b) Can the EC cite specific instances/situations in the information before the Panel where a shipowner has purchased and used a larger-than-usual ship for a particular run, due to a relatively low price for the larger ship?

164. What specific evidence is there in the information before the Panel that APRGs and PSLs around the time of the restructuring helped the shipyards in question to remain in operation, whether by improving their balance sheets/cash flow or otherwise?

165. For each category of ship, what has been the evolution in prices versus costs in other major shipbuilding countries since the mid-1990s, and how does this compare with the trends in Korean prices versus costs?

166. (a) For each of the three ship types, what specific evidence/examples are there in the information before the Panel (in addition to the domestic complaint by Samsung against Daewoo) that the restructured shipyards were the price leaders among the Korean producers?

(b) What evidence is there in the information before the Panel in support of the EC argument that the alleged restructuring subsidies enabled the restructured yards to drive down the prices charged by all other Korean shipyards?

(c) What has been the annual financial performance of the other (non-structured) Korean shipyards since the restructuring?

167. If, as the EC argues, shipyards have near-total flexibility to produce any kind of ship, and the Korean yards are heavily subsidized, why are Korean shipyards not more-or-less equally active in all kinds of ships (including cruise ships, ferries, etc.)?

Comments

Refer to the response to Question 126 which demonstrates that EC shipyards do not practice full supply-side substitutability across all ship types. The following examples demonstrate this is a common situation in other regions as well.

Japan has a large number of shipyards and builds ships across a wide range of ship types. Furthermore as it has a strong domestic customer base, it is unlikely that a yards absence from a market reflects any alleged anti-competitive actions by other countries' yards. Out of 130 yards in Japan that have delivered ships since 1990 or currently have ships on order:

- only 5 are active in the LNG sector
- only 11 are active in the passenger/cruiseship market for larger cruiseships
- 24 yards are active in the Reefer (refrigerated) ship market
- 26 yards are active in the Crude Oil tanker market
- 36 yards are active in the Containership market and only 9 are active in the market for teu ships of 3,500 teu or larger
- 47 yards are active in the LPG market

Some ship types are so specialist that there are only a few yards active across the whole world market. The obvious examples are for large Cruise ships where there are 7 yards worldwide who have built (or have on order) cruise ships of 60,000 gross tons or larger since 1990, and of the 86 ships involved 80 of them have been shared amongst 4 shipyard groups, namely: Chantiers de l'Atlantique, Fincantieri group, Kvaerner Masa Yards and Meyer Werft. The remaining 6 comprise 2 each at Bremer Vulkan, Lloyd Werft (both EC yards) and Mitsubishi HI of Japan. In the LNG sector, the number of active players is also of course limited, where 14 yards have built (or have on order) the 169 ships involved since 1990.

In fact, a full analysis of all ship types indicates that over 1100 yards (or shipbuilding groups) have participated in the market since 1990 and of these:

- 52 have built or have orders for Reefer ships
- 71 have built Crude Oil tankers
- 85 have built Dredgers
- 92 have built LPG
- 157 have built Ro-Ro ships
- 180 have built Container ships
- 211 have built Bulk Carriers
- 214 have built Offshore vessels
- 224 have built some IMO class of Chemical tanker
- 386 have built General Cargo or Multi-purpose cargo ships

Much reference has been made to the emergence of China as a major shipbuilding nation and a similar profile for China shows that of recorded deliveries/orders (some domestic and smaller vessels are unlikely to be fully reported) since 1990 there are 100 active shipbuilding yards, of which:

- none are involved with Cruise ships
- 1 is involved with LNG ships
- 3 are involved with Reefer ships
- 5 are involved with LPG ships
- 8 are involved with Ro-Ro ships
- 10 are involved with Crude Oil tankers
- 12 are involved with some IMO class of Chemical tanker
- 22 are involved with Offshore vessels
- 33 are involved with Bulk Carriers
- 37 are involved with Container ships
- 58 are involved with General Cargo or Multi-purpose cargo ships

We believe that this highlights the non-homogeneity of the shipbuilding market supply side, and the fact that in practice yards do not try to operate in all market sectors but concentrate on certain types where they have a competitive advantage.

III. TO BOTH PARTIES

A. ITEM(J) / ITEM (K), FIRST PARA.

168. The parties disagree as to whether APRGS constitute export credit guarantees and whether PSLs constitute export credits. Please provide any documentation (either from the shipbuilding industry, the OECD, or any other source) that you consider supports your position on these issues.

Response

The EC has challenged whether APRGs and PSLs are export credit guarantees based largely on who receives the facility. A couple of problems with the EC arguments are that the "beneficiary" as the EC identifies it, are different in the two instances. According to the EC's arguments, APRGs are on behalf of the foreign buyer and that is not an export guarantee. Of course, PSLs are on facilities provided directly to the shipbuilder which causes some problems in the EC's argumentation.

The EC tries to get around this problem by ignoring it and making a blanket statement that the second paragraph of item (k) refers to the OECD and therefore this must be the context for interpreting the first paragraph. Thus, according to the EC, the OECD interpretations would not encompass PSLs. As Korea has noted, there is no legal or logical basis for this line of argumentation. It is axiomatic that an exception is to be construed narrowly. Therefore, there is no basis at all for construing the rule and the exception to be of precisely the same breadth. The treaty language itself gives no such primacy to the OECD over the WTO. While the second paragraph of item (k) has been interpreted as providing a specific exception that applies to the OECD, this is a matter of interpretation for the OECD is not mentioned in the treaty text; While Korea, of course, is not rejecting the OECD as a useful gatherer of information, this sort of judicial interpretation certainly cannot be the basis for subordinating the WTO treaty to other provisions in the OECD documents.

The EC continues with its creation of new legal rules outside of the plain meaning of the language by arguing that export credit guarantees are meant only to include support for domestic producers to protect them from unknown foreign risks. Of course, the provisions of the items (j) and (k), first paragraph, do not limit themselves in this manner. This proposed limitation is a creation of the EC and one that the EC had to acknowledge during the course of the Second Substantive Meeting is anachronistic even if it were appropriate for the Panel to rely in its legal analysis on a somewhat dubious EC rendition of the "philosophy" of the OECD Arrangements. Moreover, as is demonstrated below, this EC characterization of covered and non-covered instruments is both highly artificial and simply inaccurate.

Korea has discussed before how it disagrees with the EC about the EC's extremely narrow construction (when it suits the EC's purposes) on the OECD language. Korea has already specifically provided evidence that the United States has made its views known in the OECD that it does not agree with such an overly narrow interpretation of what constitutes an export credit or guarantee. Indeed, Korea remains somewhat puzzled by this EC argument. The EC refers to the APRGs as guaranteeing the shipbuilders' *domestic* risk rather than the foreign risk. Of course, the parties would not be discussing the safe harbours if one was not assuming *arguendo* that the Panel had already found that these were export subsidies. As Korea noted during the Second Substantive Meeting, the nature of disputes such as this is that the respondent has to argue in the alternative on every contested issue after the first one. The respondent presents contingent arguments on the hypothetical assumption that it has lost the previous issues. On the other hand, the situation is totally different with respect to the complainant. The complainant must prevail on every one of the issues and, while it is not a rigid rule, normally would only address issues *arguendo* if it is making, for instance, a non-violation claim under Article 26 of the DSU. In this instance, it is impossible to see how the EC can argue that these are domestic instruments and not export instruments unless it wishes to concede the basic point of its

whole claim, i.e. export contingency. If it is a programme of credit guarantee and is contingent on exportation, it follows that it is an "export credit guarantee" within the meaning of item (j). In relation to this, the explanation by the UN Economic and Social Commission as to "export credit guarantee" is enlightening. The Commission defines the export credit guarantee as "instruments to safeguard export financing banks from losses that may occur from providing funds to exporters."[23] The Commission sees that export credit guarantee is likewise beneficial to exporters, as "[s]uch guarantee allows exporters to secure pre-shipment financing or post-shipment financing from a banking institution more easily."[24] When read in light of the following examples of other Member's practices, it is clear that the APRG squarely falls in the export credit guarantee, as it is an instrument to safeguard ship-buyers or the financing banks on their behalf from losses that may occur from providing funds to shipyards.

KEXIM is not alone in offering these sorts of instruments. For example, the Finnish ECA, Finnvera offers bond guarantees of various types. According to the Finnvera website, "the Bond Guarantee is a countersecurity for the bank issuing a bond on behalf of the exporter *in favour of the foreign buyer*. The bonds that the buyer may require include, for example, a bid bond, *an advance payment bond*, a performance bond or a maintenance period bond."[25] There are two important aspects to the explanation of the guarantee. First, Finnvera does not limit the guarantee to situations arising from foreign risk. Second, it also illustrates how a facility that nominally protects the foreign buyer really can operate to protect the shipbuilder from such foreign political risks – just the sort of risk the EC says are the focus of item (j): "For the exporter, the guarantee is an insurance against call of the bond. The guarantee provides cover against unfair call of the bond and against call owing to political risks. Political risks include war, insurrection or other such event in the buyer's country preventing an exporter from fulfilling the obligations under the contract, with the result that the buyer calls the bond."

Similarly, Hermes of Germany provides for the availability of the following kinds of bonds and guarantees: "Advance payment bonds, performance bonds and maintenance bonds."[26] ECGD in the United Kingdom provides a variety of export credit facilities to both buyers and suppliers; it does not seem to limit itself to one side of the transaction. Among the instruments it provides are various Bond Insurance Policies, or BIPs. ECGD identifies these BIPs as including:

> Advance Payment Guarantees. These are to protect the buyer against the loss of money paid in advance. They are particularly common where there is a significant design and manufacturing phase before the delivery of the equipment or goods to the buyer. The key risk for exporters with these bonds is that political events may frustrate a contract after the advance payment has been received, but before the goods have been delivered or the contract completed.[27]

The ECGD website goes on to explain that this foreign political risk is an import aspect, but not the only one. The BIPs guarantee against any unfair call of the bond, not just political risks which ECGD identifies separately. Another example comes from the EFIC (the Export Finance and Insurance Corporation) of Australia. The EFIC provides on behalf of eligible exporters "Advance Payment and Performance Bonds" as security for advance payments or in support of exporters' performance obligations under the contract.[28]

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[23] **Exhibit Korea – 137.** Excerpt from *Trade Facilitation Handbook* by UN Economic and Social Commission for Asia and the Pacific (p. 61) (ST/ESCAP/2224).

[24] Ibid.

[25] **Exhibit Korea – 124**. (emphasis added)

[26] **Exhibit Korea – 125**.

[27] **Exhibit Korea – 126**. Korea would specifically like to bring to the Panel's attention that the term "bond" is used interchangeably with the term "guarantee" by the ECGD and implicitly so by the other ECAs.

[28] **Exhibit Korea – 138**.

Export Development Canada ("EDC"), provides for pre-shipment financing "for exporters who need cash for manufacturing their goods before they export."[29] EDC goes on to explain:

> Pre-Shipment Financing helps Canadian exporters win more business by raising sufficient working capital to fund up-front costs associated with export contracts. EDC encourages Canadian financial institutions to advance pre-shipment loans to exporters.[30]

GIEK of Norway provides a "Pre-shipment guarantee. Protects the exporter against losses that may occur during the production, prior to delivery." It also provides "Bond Guarantees. Helps the exporters to furnish guarantees for tenders, advance payments or competition (bonds)".[31]

The ECGD and the Indian Exim Bank both provide for post shipment loans directly to the supplier, but that is not legally distinguishable from precisely the type of pre-shipment loans offered by various ECAs. Indeed, India Exim also offers the same sort of facility on a pre-shipment basis:

> Pre-Shipment Rupee Credit
>
> Pre-shipment Rupee Credit is extended to finance temporary funding requirement of export contracts. This facility enables provision of rupee mobilization expense for construction/turnkey projects. Exporters could also avail of credit in foreign currencies to finance cost of imported inputs for manufacture of export products to be supplied under the projects. Commercial banks also extend this facility for definite periods.[32]

India Exim also provides what it describes as Non-Fund based facilities that are "guarantees directly or in participation with other banks, for project export contract". These include:

> Advance Payment Guarantee.
>
> Exporters are expected to secure a mobilization advance of 10-20 per cent of the contract value which is normally released against bank guarantee and is generally recovered on a pro-rata basis from the progress payments during the project execution.[33]

It can be seen from these examples that both APRGs and pre-shipment loans are not limited to Korea. These facilities also do not fit so easily into the EC's simplistic construct of what is a domestic or foreign risk.[34] Clearly APRGs and PSLs are the instruments to which the safe harbours in items (j) and (k) first paragraph, respectively, may apply.

169. Item (j) refers to the provision of various "programmes". Assuming that an a contrario interpretation of item (j) is permissible, could it operate as a defence for individual APRG transactions, as opposed to the APRG programme per Se? Please explain. In particular, if the focus of item (j) is on the long-term operating costs of the programme, how could item (j)

[29] **Exhibit Korea – 127**.
[30] Ibid.
[31] **Exhibit Korea – 128**.
[32] **Exhibit Korea – 129**.
[33] Ibid.
[34] Indeed, if the EC's narrow and simplistic construct is correct, then a number of EC Member States are *prima facie* in violation of Part II of the *SCM Agreement* as their programmes would be outside of the parameters of the OECD Arrangement and not protected by any safe harbours.

determine whether or not individual transactions under the programme constitute export subsidies?

Response

As discussed during the Second Substantive Meeting, the language of item (j) would appear to require an assessment on a programmatic basis. That is, the Panel must look to see whether the premia charged in the programmes are covering the long-term operating costs of such programmes. Once that is established, then even if an individual transaction might be at a premium level that, if applied generally, would not cover the long term operating costs, then because the programme covers such costs, such an individual transaction would be within the safe harbour. The flip side of this point is that it necessarily follows that if the programme is not covering its long term operating costs, an individual transaction will not be within the safe harbour even if it is at a premium level that, if generalized, would cover the long term operating costs.

In Korea's view, the Panel must make a judgment call as to what is "long term" and then assess the evidence regarding whether or not the programme in question has covered its operating costs and losses during such period. While that may be a difficult inquiry in some other cases, Korea has supplied evidence in this dispute that demonstrates that the APRG and pre-shipment loan programmes have covered KEXIM's operating costs and losses over all periods including the difficult period of the Asian financial crisis.

B. APRG/PSL

170. Korea asserts that KEXIM PSL rates have been above certain DSME bond rates since 1999 (para. 231, Korea's First Written Submission). The EC asserts that certain DHI bonds were guaranteed (para. 124, EC's Second Written Submission). Are the parties referring to the same bonds, or were the DSME bonds referred to by Korea different from the DHl bonds referred to by the EC? Please explain.

Response

Korea would like to note that the statement by the EC in para 124 of its Second Written Submission is incorrect and misleading. Firstly, as clearly indicated in its Exhibit EC – 129 which was referred to in para 124 by the EC, all bonds listed therein are not guaranteed. While some of them are guaranteed, the rest are "non-guaranteed" (for example, *see* page 3 of Exhibit EC – 129). Secondly, as submitted earlier by Korea, when DSME and DHIM were spun-off from DHI, debts including corporate bonds were allocated to the two companies in accordance with the relevance to the spin-off companies. In other words, all DHI debts incurred thus far relating to shipbuilding business were assigned to DSME, and all debts incurred thus far relating to machinery manufacturing business were assigned to DHIM. However, Exhibit EC – 129 is not the one which took into account such debt allocation (as it was made prior to the spin-off), simply listed all the then outstanding DHI corporate bonds. The debts which were allocated to a distinct company cannot make a benchmark for DSME's loans. Korea hereby submits **Exhibit Korea – 139**. It lists such bonds that were ultimately assigned to DSME upon the spin-off out of the bonds listed in Exhibit EC – 129.

In contrast with this, the Exhibit Korea – 18 shows the balance of outstanding corporate bonds (which were ultimately assigned to DSME) as at the end of each quarter and the average interest rates of the outstanding bonds for the respective quarters. Thus, it can be said that the Exhibit Korea – 18 has reflected parts of Exhibit EC – 129, but not all of it. Korea considers that Exhibit Korea – 18 is more relevant than Exhibit EC – 129 when finding the benchmark.

171. Regarding Exhibit Korea – 16, are "KEB", "CHB" and Hanil Bank public bodies? If not, are they "entrusted or directed" private bodies? Please explain.

Response

KEB, CHB and Hanil Bank (currently Woori Bank) are commercial banks operating under the Banking Act which is generally applicable to all commercial banks. For the transition period during the Asian Financial Crisis and subsequent thereto, the Government of Korea and/or KDIC used to hold shareholdings in these banks as they had contributed capital in the framework of the financial sector restructuring.

As submitted by Korea in relation to the concept of "public body", a two-step analysis is required: i.e. (i) an entity will be a public body if it is empowered by the law of the State to exercise elements of the governmental authority and (ii) the acts in question will be considered acts of the State only if such entities were acting pursuant to such authority in the particular instance. Relating to the first step, there are no laws which empower the banks referred to above to exercise elements of the governmental authority. Further, when issuing the APRGs, these banks exercised no governmental authority. In light of this, these banks cannot be regarded as public bodies for the purpose of the *SCM Agreement*.

In order for the entrustment/direction to be established, the following three elements are to be satisfied: (i) an explicit and affirmative action be it delegation or command; (ii) addressed to a particular party and (iii) the object of which action is a particular task or duty. The EC has not established a *prima facie* case as to the entrustment/direction of the above banks to issue the APRGs concerned. Further, the EC has never specified any particular "function" that a private body was allegedly entrusted or directed by the Government of Korea to carry out. Korea reiterates that the requirements of Article (a)(1)(iv) are met only when it is established that the private body was entrusted or directed "to carry out one of more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments." Korea does not see any governmental practice involved in the issuance of APRGs. Importantly, beyond generalized assertions that at times border on crude stereotyping, the EC has offered no evidence of an explicit and affirmative delegation of command addressed to the specific banks ordering them to provide subsidies.

C. ALLEGED ACTIONABLE SUBSIDIES

172. Please comment on paras 504-509 of the report of the GATT panel in United States - Imposition of a Definitive Countervailing Duty on Imports of Certain Steel Products Originating In France, Germany, and the United Kingdom.

Response

Korea looks forward to seeing the EC's response to this question and Question 148. There are several ways of distinguishing the *Steel CVD* case. Unfortunately for the EC, all of them cut the wrong way and would support the EC's inside investor standard proposed in that case. Korea notes that the first point to take from the *Steel CVD* case is that it illustrates a couple of the differences between equity infusions and debt equity swaps in insolvency.

The whole issue of whether an inside investor or an outside investor would put further funds into a company in the form of equity infusions depends on an analysis of the possibility of achieving comparable rates of return on the marginal amounts of new investment. The EC was arguing that an inside investor has a somewhat different perspective because it will take into account the funds already invested when adding new marginal amounts. That is, if the new money can optimize returns on previously invested amounts, then the inside investor will be willing to possibly accept a lower nominal rate of return on the new investment. In effect, the inside investor looks at the new investment as a catalyst for a better return on the full investment. However, an outside investor,

according to the EC does not have that perspective of seeing new funds serving a catalytic function for a larger initial investment and therefore will require a higher rate of return on the new investment that it views in isolation. In essence both investors are acting on a rational market basis; it is simply a matter of different perspectives.

In the case of an insolvency, however, there is no new money being invested. The goal is to maximize the return on whatever was already lent, recognizing that it will in all cases be – at least in the short term – a negative return. The inside/outside investor discussion serves as an analogy for this decision making process. The foreign creditors who have a very small stake in the business are less willing to deal with the legal and workout processes in another country. There is an administrative carrying cost for getting involved in such processes that can be quite high. On the other hand, domestically-based creditors that have a larger exposure both to the company and to the market in general are in a position analogous to an inside investor who has a much larger stake to protect and for whom the carrying costs of dealing with a Korean insolvency are significantly less than the foreign lender. In addition , just as the incentives are different, the leverage is different. The party that has a desire to get out and has a relatively small exposure can block the process in a manner that would bring disproportionate pain to the inside lenders. Thus, by using this leverage, the foreign creditors can obtain a higher initial payment on their debts from other creditors. But the issue does not end there in the case of DSME for the outside lenders asked for a residual amount of out-of-the-money warrants. If one steps back and looks at the transaction as a whole, the inside lenders took less up front, but a larger long term potential benefit through the equity they received in exchange for their debt. The outside lenders took a larger initial amount and settled for a smaller long-term potential with the warrants thereby minimizing their risks and carrying costs for dealing with a Korean insolvency. Thus, both sides took similar amounts out of the transaction but in different forms. Both acted as perfectly rational creditors or "investors" reflecting their different perspectives as domestic/inside and foreign/outside players.[35]

Korea also notes that it does not have the benefit of seeing the academic report the US relied upon in the *Steel CVD* case, but the description of it sounds abstract in the extreme and, therefore, of limited use. It is a highly academic exercise to posit that two parties are in precisely the same position. No persons have exactly the same perspective and no persons have perfect information upon which to base their decisions. That is why there are negotiations. If this were not the case, the Doha Round would not just have begun at Doha, but would also have ended there for all of the perfectly informed rational Member representatives would have been able to instantly settle their differences. There would have been no different perspectives if the hypothetical were followed because everyone would be in identical positions. Of course, the real world does not operate that way and did not in the Korean workouts. The parties bargained to obtain the best results they could in difficult circumstances. They set their goals according to their specific needs and used what leverage they had to achieve them as best they could. Thus, the EC's argument regarding the different perspectives of inside investors in the case of equity infusions applies even more strongly in the case of different creditors in the case of insolvency workouts.

In light of the above discussion, Korea also would like to point out another issue illustrated by the comparison of these issues in the *Steel CVD* case with the current workouts. As Korea has noted in its submissions and the *Substantive Meetings*, there is no transfer of funds in the present case. The debt was valued by the lenders and the negotiations to carve up the remains of the company were undertaken based on their respective valuations. There were no new sources of funds to pay any of the creditors. Thus, for the EC to say that the domestic creditors took too little for their debt simply ignores the point that there was nothing more there for them to get. *It was merely a question of allocation between creditors.* The only possible source of extra funds would have been if the valuation exercise had resulted in a determination that the termination and selling for scrap of the

[35] Korea notes that the Lawes Report, Exhibit Korea – 105, supports this conclusion.

assets would have yielded more funds than doing the workout. No creditors -- either domestic or foreign, insiders or outsiders -- came to that conclusion.

Korea also notes that in some cases a litigant will abandon an earlier position if it loses that argument. In the referenced panel report, however, the EC did not "lose" the point. Rather, the Panel explicitly was deferring to the administering authority regarding the insider/outsider argument. In paragraphs 466 and 490, the Panel noted that it was not up to it to make its own judgments about the weight of the evidence. In paragraph 503, the Panel noted that it was the Panel's duty to see whether the EC had established that the administering authority had not acted on a rational basis. In paragraph 507 the Panel noted that there might be circumstances where inside and outside investors might have different perspectives. In paragraph 508, the Panel noted that the EC had presented a possible alternative approach, but that was not enough when the task of the Panel was examining whether there was a failure of the DOC to consider relevant facts (the DOC also claimed that it had in fact considered some of the factors put forward by the EC). Thus, the EC did not lose the point as to which was a better approach. Rather, the EC was merely unable to assert that the approach it put forward was the only rational approach. In contrast, this Panel is not reviewing an administrative decision and, therefore, must make its own judgment about which approach is best. If the EC now abandons its earlier position it is, to say the very least, opportunism practiced at the expense of logic and consistency.

D. SERIOUS PREJUDICE

173. (a) For each of the three ship types at issue in this dispute, how are ship data normally maintained by the industry, and by industry analysts?

Response

Industry data for ships and shipbuilding is maintained and held through detailed electronic ship databases, including:

- LR Fairplay Register of Ships,
- LR Fairplay World Shipping Encyclopedia/PC Register/ Newbuilding Register,
- Clarksons Ship Registers (available for Bulk Carriers, Chemical Tankers, Gas Carriers (only LPG), Containerships (including multi-purpose and Ro-Ro ships), Offshore Service vessels, Reefers, and Tankers).
- Marbase

These electronic databases comprise individual ship records for completed ships and each record comprises many detailed fields of technical, commercial, operational and construction information. The data in these fields is subject to availability and reflects the type of ship and technical characteristics. Ship type and sub-type categories are used in all and whilst there is much commonality of data, there is no standard format. Sub-type data provides much greater detail than primary or main ship type groupings and hence users of the data choose which level is most appropriate for their use. The following examples are provided:

Lloyds Register Fairplay	
World Shipping Encyclopedia/PC Register	**Register of Ships**
Vessel Types	**Ship Types**
Bulker Combination Container Dry Cargo Miscellaneous Offshore Passenger/Ferry Reefer Ro-Ro Tanker (including LNGs)	Bulk Carriers – 14 sub types Dry Cargo/Passenger – 24 sub types *(incl containers and reefers)* Tankers – 19 sub types (including LNGs) Offshore – 9 sub types Fishing – 9 sub types Miscellaneous – 30 sub types Non-merchant ships – 4 sub types Non-propelled – 2 sub types Non-seagoing merchant ships – 13 sub types Non-ship structures – 1 sub type
180 Sub Type codes approx	125 Sub Type codes approx

The tables attached in **Exhibit Korea – 130** show the groupings of ship types used in the LR Fairplay World Fleet Statistics which is also used in LR Fairplay Quarterly Shipbuilding Statistics. In this Exhibit, it can be seen that the chemical/oil product tanker category is included with chemical tankers in the basic grouping of the chemical rather than oil tankers reflecting the significant complexity that IMO chemical requirements bring. This contradicts the EC's attempts to include chemical/oil tankers with pure oil products tankers.

Common ship-type specific information held in databases includes:

- Containerships – teu capacity, reefer slot capacity, cargo handling gear details,
- Chemical Tankers – IMO Class, tank capacities in cu metres, numbers of tanks,
- LNG Ships - tank capacity in cu m,

There are a huge number of fields covering technical characteristics which are completed subject to data availability. Gross tonnage is a field common to all ship types, deadweight is a field common to all cargo ships and teu to all container ships. cgt values are sometimes held in some database, cgt coefficients in others but cgt values can be calculated from GT. Certain information such as price is generally from public sources and so may be only sporadically available and of variable accuracy. These databases also generally hold more limited data on ships on order (but not delivered) availability of technical and other details is far more spasmodic for these than for delivered vessels.

These electronic databases form the basis of many of the statistical reports produced at time intervals and the extensive number of fields available means that data can be summarized in many different ways. These databases are generally available on subscription and many industry players (shipowners, shipyards, and analysts) will have access to these and use them as a key information source.

The importance of these databases is that the availability of information is no longer restricted by the format of regular statistical reports and industry analysts can access and interrogate data in whatever form is necessary to ensure accuracy and consistency.

(b) In particular, are these three categories of ships recognized and used routinely for purposes of industry analysis?

Response

The basis of most analysis is the electronic databases referred to earlier together with market intelligence and detailed market knowledge and these are used to prepare certain regularly issued reports.

These reports routinely provide information based on ship types but do not necessarily coincide with the categorization of containerships, product and chemical tankers and LNGs proposed by the EC which explains why it is, in particular, so difficult to identify the EC's product category for product and chemical tankers.

The product chemical and LNG ship types covered by this dispute fall within the category of tankers (as shown in the ship type classification table in the response to Question 173 – a) above), which is a broad grouping which includes, crude oil tankers, product tankers, chemical tankers, gas carriers as well as specialist types (again, without any category for product and chemical tankers). In the LR Fairplay Register of Ships, for example, this includes the following tanker types: Beer, Bitumen, Chemical/Oil Products, Chemical, Crude Oil, Edible Oil, Fish Oil, Fruit Juice, Latex, LNG, LPG, Molasses, Oil Products, Oil Sludge, Vegetable Oil, Water, Wine.

General type classification are, however, sometimes inconsistent with detailed technical fields as a result of data input or reporting inconsistencies, and as such data must be looked at taking into account the context in which information is required to avoid misleading, inaccurate or incomplete data.[36]

In general terms, the following classifications of tankers are generally widely observed:

- Crude oil
- Oil Products
- Chemical[37]
- Gas Carriers – which consistently identify LPG and LNG as separate types

As far as containerships are concerned, these are usually referred to separately to other ship types.

Size bands are used for almost all in-sector analyses and also for some cross sector analyses. **Exhibit Korea – 131** shows the use of size bands within ship types on a regular basis in various industry publications. *See* the response to Question 173(c), (d) and (f) for examples of those commonly used for reporting and analysis purposes. Common statistics are the numbers of ships/orders, GT (gross tonnage) and dwt (deadweight tonnage for cargo carrying ships only) and in the case of containerships teu capacity - this information is used by shipyards and shipowners alike and covers both new orders, orderbook and deliveries. Orderbook information is generally shown both in aggregate terms and phased by year of delivery.

Cgt (compensated gross tonnage) is of no interest to shipowners or brokers, but is regularly used for certain shipbuilding purposes, namely shipbuilding capacity, aggregated shipbuilding

[36] For example, in the preparation of the Drewry reports in Exhibit Korea – 70, 109 and 110, Drewry established through inspection of the above sources that ships with IMO chemical classes were listed as oil product tankers and *vice-versa*. Thus, there was considerable inaccuracy and incompleteness in this respect. Drewry therefore made use of various sources to maximize the accuracy and completeness of the products/chemical tanker category.

[37] Note that in **Exhibit Korea – 130**, LR Fairplay include chemical/oil tankers under the category of chemicals and not oil products which contrasts with how the EC has used this data.

demand and shipbuilding output. The choice of which parameter to use is determined by the purpose for which the analysis is to be undertaken.

Other characteristics of the vessels such as whether they are equipped with gearing or have reefer capacity may also be taken into account in a number of industry reports.

(c) If so, how are they defined, and for what purposes are these categories used?

Response

The use of ship type categories is not rigorously defined and therefore reflects the categories used by those providing the original data as well as some data input discrepancies. The general categories used are listed in (b) above.

The categories as defined in (b) are used for an extensive number of purposes but most regularly in reports reflecting numbers of vessels, orders or output by shipyards and shipbuilding countries. The following types of industry analysis make use of these categories which, Korea repeats, are significantly more complex than the three broad categories that the EC tries to portray as being standard in industry reports:

- Statistical reports produced at regular time intervals – yearly, quarterly, monthly etc, including

    - LR Fairplay World Fleet Statistics – Annually
    - LR Fairplay Quarterly Shipbuilding Statistics
    - BRL Newbuilding Enquiry – Quarterly
    - Clarksons World Shipyard Monitor – Monthly
    - Drewry Monthly
    - Fairplay Solutions with Newbuildings – Monthly
    - Clarksons Shipping Intelligence - Weekly
    - Ship Price Series (*See* response to section (c) for details)

- Industry reports – providing commentary and deeper insights as well as data – examples include shipbuilding reports from analysts like Ocean Shipping Consultants and Drewry Shipping Consultants

- Brokers reports – with commentary and ad-hoc information on different shipping sectors from broking houses such as Fearnleys and BRS

Additionally, there are certain shipbuilding statistics available from international organizations such as the OECD although not all countries submit reports on a regular basis and the OECD will often refer to other industry sources for data analysis purposes. Certain information is also provided by government agencies or national industry associations/bodies.

Examples are provided in **Exhibit Korea – 131** of sample sections of the following publications to give an indication of the format and parameters used in such reports including the use of size bands with ship types:

- LR Fairplay Quarterly Shipbuilding Statistics
- Clarksons World Shipyard Monitor
- Drewry Monthly
- Drewry World Shipbuilding Reports, 1999.

(d) When analysts report on pricing tends, do they normally refer to prices for each category as a whole, or for subcategories thereof, broken out, for example, by size and/or other characteristics.

Response

A number of industry analysts report pricing trends using Ship Price Series[38], in addition to commentary and qualitative reports. The main ones of these are:

- Clarksons Ship Price Series and Newbuilding Price Index
- Drewry Ship Price Series
- Lloyds Shipping Economist

Such price information is kept by vessel type and size. The following tables show the vessels types and sizes for which price series information is available from Clarksons, Lloyds Shipping Economist and Drewry. Whilst other organisations do publish similar information sporadically, these are felt to be the main regular sources of publicly available information of this nature. Exhibit Korea – 131 includes price series data from Clarksons World Shipyard Monitor and Drewry Monthly publications. Other price series data is published in quarterly and annual publications.

It can be seen that in virtually all cases, ship types are broken down by size. Moreover, whilst the individual size categories may vary, there is a certain level of commonality. Key characteristics or qualifiers are also provided in some indices such as IMO Class for Chemical Tankers and whether a series is for a geared or gearless ship in the case of containers.

	Ship Type	**Clarksons World Shipyard Monitor**	**Lloyds Shipping Economist**	**Drewry Monthly / Quarterly or Annual Reports**
Oil Tanker /Tankers				
	VLCC	300,000 dwt	300,000 dwt	260-280,000 dwt
	Suezmax Tkr	150,000 dwt	160,000 dwt	140-145,000 dwt
	Aframax Tkr	110,000 dwt	110,000 dwt	95-105,000 dwt
	Panamax Tkr	70,000 dwt	72,000 dwt	68-70,000 dwt
	Handy Tanker	47,000 dwt		
	Handymax – clean		45,000 dwt	
	Products Tkr			40-45,000 dwt
Chemical Tkrs				
	42-45,000 dwt IMO III			42-45,000 dwt
	37,000 dwt IMO III			37,000 dwt
	14-16,000 dwt IMO II			14-16,000 dwt
	5-6,000 dwt IMO II			5-6,000 dwt
Bulk Carriers				
	Capesize BC	170,000 dwt	170,000 dwt	150-180,000 dwt
	Panamax BC	75,000 dwt	72,000 dwt	70-75,000 dwt
	Handymax BC	51,000 dwt	51,000 dwt	40-45,000 dwt
	Handysize BC	30,000dwt	45,000dwt	25-30,000dwt
Container				
	Container			400 teu - geared
	Container	725 teu		
	Container	1,000 teu	1,000 teu	1,000 teu - geared

[38] A ship price series is where the approximate current price of a particular size of ship is reported and recorded by industry analysts on a regular basis to monitor price trends for that type and size of ship.

	Ship Type	Clarksons World Shipyard Monitor	Lloyds Shipping Economist	Drewry Monthly / Quarterly or Annual Reports
	Container			1,500 teu – geared
	Container	1,700 teu		
	Container	2,000 teu		2,000 teu – gearless
	Container		2,500 teu	2,500 teu – gearless
	Container	2,750 teu		
	Container	3,500 teu		3,500 teu – gearless
	Container		4,000 teu	
	Container	4,600 teu		
	Container			5,500 teu – gearless
	Container	6,200 teu		
	Container			6,500 teu - gearless
	Container		7,000 teu	
Gas Carriers				
	LNG	138,000cu m	140,000cu m	125-138,000cu m
	LPG	78,000cu m	78,000cu m	75,000cu m
	LPG		52,000cu m	35,000cu m
	LPG		24,000cu m	15,000cu m
	LPG		8,000cu m	3,000cu m
General Cargo				
	General Cargo		20,000 dwt	
	General Cargo		10,000 dwt	
Other				
	Ro-Ro			
	Ro-Ro			
	Reefer		10,000 dwt	
Price Index		Yes		Not routinely published

The price information used to compile these data comes from price reports for individual ship types from order records and, in the absence of such order records, from brokers' reports regarding 'rumoured' negotiations.

(e) If they provide a range of pricing information at different levels of aggregation, how are these different data series used?

The main level of aggregation is from a range of price series into a single newbuilding index. This is usually done as a mathematical average (or price per dwt average) and not a weighted average reflecting the overall composition of the fleet. A single newbuilding index is a basic way of looking at what is happening overall to shipbuilding prices as opposed to sector or size band specific trends. So if a broad range of price series is used and prices are rising in some and dropping in others, the newbuilding index trend will be moderated by this. However, as the price indices do not cover all ship types and because it is not weighted by the composition of the demand across different types and sizes, it has to be used with extreme caution and interpreted in the light of industry knowledge.

Price series are not generally aggregated to provide a single trend for a particular broad ship category because it is recognized that the differing trends between different size bands is a significant factor. Whilst these trend differences may seem small in relation to overall market price movements, they are highly significant to industry players because they demonstrate different underpinning factors

for different ship sizes. For example, there may be a particular shortage of smaller vessels affecting freight rates and hence ordering trends for these vessels and not larger ones.

Price series are therefore only indicators of what is happening for sample ship types which will be chosen to reflect commonly used types or sizes of vessels. Where a range of sizes are given, they are useful to see that trends can be varying differently within the same ship type. When only a single price trend is given for a particular type this generally means that this is the most popular size of vessel in use or that there is not a consistent enough stream of data for another size to construct and maintain a price series.

Industry players are generally fully aware that price series data must always be used with caution and care.

(f) Please provide documentation (including in particular relevant excerpts from the published industry reports discussed at the second meeting) showing examples of the various breakouts to which you refer.

Response

Examples provided, in addition to those provided in the responses to earlier sections of this question:

- Drewry Annual Shipbuilding Review 2000[39]
- Drewry LNG Market Review 2003/04[40]
- Clarksons World Shipyard Monitor[41]
- Clarksons Shipping Intelligence Weekly.[42]

174. Korea argues that demand should be measured in numbers of vessels, and/or workload years (i.e. order backlog) rather than compensated gross tons of new orders. The EC responds that cgt is more accurate as a measure of supply and demand, and that even measured in workload years, demand trends are as represented by the EC.

(a) Could each party explain the technical differences between the two measures, and provide further detail as to why it believes its preferred measure represents a more accurate picture of demand than the other.

Response

Compensated Gross tonnage ("cgt") is a measure developed by the shipbuilding industry as a broad brush estimate of the workload content for the construction of ships. It is calculated by multiplying the Gross Tonnage value of a ship by a compensation coefficient from an agreed list of coefficients for different types and sizes of vessels. Gross Tonnage - despite it name is in fact a volume measure which reflects the physical volumetric size of the ship – and not a weight measure. A copy of the OECD agreed list of coefficients is provided in **Exhibit Korea – 136** and it can be seen that the coefficients are applied to broad size bands. Hence, the measure is a crude one and one which takes no account of specification or design differences between similar ships.

The measure was developed to allow cross sector assessments for the purposes of assessing and recording total shipbuilding activity levels and assessing capacity versus demand. Using this

[39] **Exhibit Korea – 132**.
[40] **Exhibit Korea – 133**.
[41] **Exhibit Korea – 134**.
[42] **Exhibit Korea – 135**.

measure it was possible for example to aggregate demand for passenger ships with that for bulk carriers or for containerships and tankers. It was never intended for ship-by-ship comparisons, for detailed market demand analysis or as a mechanism for looking at price influences by like product vessels.

Korea agrees that overall shipbuilding demand (i.e. cross ship type aggregate demand) is best considered in terms of cgt when looking at the level of shipbuilding activity overall. Similarly, overall shipbuilding capacity is best measured (however problematic a rigorous assessment is) in terms of cgt. In this fashion, an estimated aggregated supply-demand balance can be considered which inevitably needs to be a reflection across ship types. However, it is well recognized by the industry that the supply-demand balance is not the only or dominant factor in terms of price influence.

The difference of opinion between Korea and the EC relates to determining which sectors Korean and EC yards compete in, what the price influences or influencers are and the interpretation of supply-demand balance indicators. Korea believes it is necessary to concentrate on numbers of orders and timeframe of those orders when looking to determine the market strength of a yard and its ability or likelihood to influence prices.

Orderbook phasing and timing of new Orders

Firstly, in respect of the interpretation of supply-demand balance, the true supply-demand balance can only be determined by looking at the phasing of orders over the orderbook timeframe. The level of the orderbook in itself cannot indicate what level of supply-demand balance exists, neither can it indicate the market share of any particular market player over the orderbook period.

By way of example and ignoring the issue of work-in-progress: if world shipbuilding capacity is for simplicity, sake assumed to be 25 million cgt, and the orderbook is 75 million cgt, what does that mean? If this orderbook is phased over three years then in simple terms it would indicate full capacity, if however it is phased over 5 years it represents a significant shortfall of demand against capacity. Furthermore, without looking at the phasing of that orderbook it cannot tell us whether there is excess capacity in the early years or whether this is simply the feathering of demand as it fades out gradually at the ends of the orderbook following a period of full utilisation.[43]

The delivery timescale of an order has to be taken into consideration in order to determine the true supply-demand balance for a delivery at a given date. Two orders placed in the same month but for different delivery dates reflect different demand-supply balances. A highly competitive yard with a long orderbook may not in fact be able to quote for an owner who needs a ship quickly – in this case a less competitive yard with a shorter orderbook may quote possibly at a low price to win work (to avoid underutilization). Alternatively, an owner with an existing order for that delivery may decide to sell his delivery slot at a premium price. The price level in this situation is clearly not influenced by the yard with the long orderbook. Timing of the orderbook is therefore clearly important. **Exhibit Korea – 132** shows that demand projections are phased over time. **Exhibits Korea – 134 and 135** show that orderbook is reported in industry publications showing phasing over time.

Similarly, it is clear that if one country has 50 per cent of the orderbook at the present time this does not indicate that they will eventually have delivered 50 per cent of the output, it depends over what period of time their orderbook is spread in comparison to other countries. It is a recognized fact that the timescale of orderbooks and the lead time on orders can vary significantly from country to country. Korea believes therefore that in considering the current orderbook it is always necessary to consider the time horizon of this and how this can vary from yard to yard and country to country. This is why the EC's assessment of market position in Attachments E – 2 and 6 of the EC's responses

[43] In reality of course it is further complicated by what proportion of that orderbook is already under construction and over what period of time this will be delivered.

to the first Panel questions based on a snapshot situation in January 2004 gives no accurate picture of the actual comparative market strength of any shipbuilding country or individual shipyard.

The level of new orders or order intake is a clearer indication of who is actively contracting at a particular time and hence who is actually winning contracts at a particular price level. If a country or yard has a full orderbook for e.g. the next three years, it may decide not to take on further orders and therefore may cease winning orders in that year. In this situation, it is likely to have a high share of the orderbook, but as it is not actively signing up new orders it is difficult to see how it can be a major influencer of prices at that time. Korea therefore does not agree that an orderbook is a meaningful indicator of who can influence prices.

Use of cgt versus number of vessels

Consideration of the market in cgt without size bands means that it is not possible to differentiate between a single order for a large vessel and multiple orders for smaller vessels – Korea believes that these situations need to be considered differently. For this reason, Korea believes that it is the number of orders placed at a particular time for ships of a given type and size that needs to be considered. To provide an example: a workload of 60,000 cgt in the container sector could, without any further qualification, equally represent one order for a 7,500 teu ship or 12 orders for 500 teu ships or some other combination.

To understand why Korea believes it is the number of orders within a particular size range that should be considered to assess market share and influence, rather than the total workcontent across all size bands, we offer an example. Consider the situation when an owner wishes to place an order for say a 7,500 teu containership. This is a large vessel measuring around 320m in length and 43m in width and many shipyards will not have sufficiently large building facilities to construct a vessel of this size (although they may regularly build smaller container ships that *are* within their size capability). The owner will therefore be considering only those yards that have the physical capability to build such a large vessel, and of these there will be a list of yards which have experience in such vessels and which are considered to be most competitive for this type of vessel – these will be the preferred yards.

At the same time another owner is looking to place an order for a 500 teu containership, this is a much smaller ship at around 120m in length and 20m in width. There are a much larger number of yards with smaller facilities that will be capable of building of and have experience in building such vessels. Whilst the larger yards can also build this size of vessel it is not economic for them to do so as it results in poor utilization of the dock or building berth (to be partially occupied by such a small vessel) and other production facilities. Furthermore, the larger yard knows there will be much higher levels of competition for this ship. So it is highly unlikely that either the owner or the larger build yards will be seriously contemplating the placing/winning of this small ship order at a larger shipyard.

In terms of end use, the 7,500 teu containership will be used on the major long haul high volume container routes, typically running East – West, between large dedicated container ports with highly sophisticated in-port container handling cranes. The smaller ship will however be operating on coastal or feeder routes on low volume trade routes, typically between smaller ports that do not have dedicated specialized container handling facilities. It would not be physically possible for the larger ship to access the smaller ships' ports and clearly on a low volume route it would run nearly empty and have no on-deck cranes to unload its cargo. The smaller ship, could operate on the bigger ships routes. However, its operating costs would make it highly uneconomic, its speed would mean it could not maintain the schedule and of course it would need lots of these ships to handle the total cargo volume.

In this scenario, the smaller ship will be built in different yards to the bigger vessel and will operate on different routes. So with no supply or demand side commonality it is difficult to see how

the price of one could depress, suppress or inflate the price of the other. The consideration of cgt, rather than numbers of vessels, without reference to size bands would assume that not only would the order, and hence builder, of the larger ships have an impact in the separate market of the smaller ship, but its impact would be around 12 time greater (with a value of around 60,000 cgt) than that exerted by the builder of the smaller vessel (with a value of around 4,500 cgt). Why would an order for a very large vessel placed with a yard that would not build the smaller vessel influence the price asked by the smaller yard that could not build the larger vessel?

In contrast, the consideration of numbers of orders placed within broad size bands, recognizes the supply side and demand side commonality of such vessels, which will operate on similar routes and be built in yards with similar size and experience capability. It is therefore possible that similar factors will affect the prices of these vessels whether they be the supply side factors e.g. shipyard supply-demand balance or the demand side factors e.g. freight rates. In this situation however it is also important to consider the timing of both order and delivery.

One final note is that the EC's point that considering small and large vessels purely on numbers leads to a small fishing boat yard becoming the price leader, is clearly erroneous. Firstly, all analysis on the basis of numbers is being looked at within a given ship type and, secondly, it is being considered in terms of size bands, and so orders for small fishing boats will not come into consideration when considering price influences for containerships be they large or small.

Therefore in summary in simply looking at aggregated demand-supply balance then cgt is the appropriate measure, and to assess levels of utilisation, the orderbook must be phased over time to compare it with capacity.

In terms of determining who or what influences prices, it is necessary to consider the transactions that are taking place rather than the volume of work, the size bands that different yards are active in, and the level of ordering activity that is going on at the current time. It must be remembered however that those orders may be being placed on different timescales and hence against different supply-demand balances.

(b) Which measure is used by industry analysts and the industry when analyzing demand trends?

Response

(i) Shipbuilding demand is driven by two factors; Firstly replacement, i.e.: demand for ships going out of service and, secondly, expansion demand due to projected increase in cargo-miles (i.e. cargo volumes x shipping distances). Demand for cargo ships, therefore, has to be assessed in terms of cargo carrying capacity and the base measures are, therefore, cargo measures such as deadweight, teu, or cubic metres of gas, depending on which ship type is under consideration. This demand then has to be converted into the numbers and sizes of ships. **Exhibit Korea – 132** shows examples of ship type specific demand projection in cargo volumes and size bands.

To calculate aggregate demand this has then to be turned into GT demand by each ship type and size and then again into cgt by applying the relevant compensation factors to the GT volumes. Shipbuilding demand cannot be projected in cgt directly. **Exhibit Korea – 132** shows aggregated shipbuilding demand projection in cgt and numbers of vessels.

(ii) Monitoring of shipbuilding output, however, is generally done in terms numbers of vessels, GT and deadweight for most cargo ship types and also in terms of teu and CU metres for containerships and LNG and LPG gas carriers. **Exhibit Korea – 131**

shows examples of dwt, teu and cu metres as well as numbers of ship/orders. Shipbuilding output is also monitored in cgt and this is done by applying the appropriate compensation coefficient for the ship type and size to the GT value.

(iii) Shipbuilding capacity is assessed in cgt and the OECD agreed methodology for doing this is to assess yard capacity based on the ship types and sizes currently being produced and reflecting current productivity or delivery performance in terms of the time taken to construct such ships types. Hence a yard or country's capacity will alter if it alters the type of vessels that it generally builds or its performance in building those.

(iv) Industry analysts compare shipbuilding capacity and projected capacity in cgt with actual shipbuilding output and projected shipbuilding demand in cgt in order to consider the supply-demand balance and capacity utilization.

Whilst shipbuilding output and projected demand can be considered by ship types, shipbuilding capacity cannot be segmented on this basis because yards may build a limited range of different ship types. Ship type specific supply-demand balances cannot therefore be developed.

(v) Very little if any analysis is done into *who* influences prices and so there are no easy benchmarks to compare against. The analysis of price tends to be either a simple indication of what is happening to the price rather than why it is happening or simply offers qualitative commentary.

Korea reiterates that measurements used in the industry to reflect demand such as cgt cannot be transposed to determine market position and the capability of yards to influence prices. There are a range of supply and demand side factors or external factors that can influence prices. Prices can be influenced by any or all of these (and other) factors at any particular time. Supply-demand balance is not the only or necessarily dominant factor. Analysis of price trends may tend to look at the various different factors, and the basis of analysis will reflect that perspective. However, in this situation it is not looking at the impact of a particular yard or group of yards but simply the contributory effect of one factor on ship prices. Factors such as steel prices and exchange rates are not sector specific, whereas factors such as freight rates do have sector specific dimensions. Freight rates and ship prices do however show different trends within different size bands within a particular ship type.

In the previous section an explanation is provided to explain why Korea feels that it is more appropriate to consider the numbers of orders, ship type and size bands rather than simply the ship types and cgt volume. In the following question Korea explains why market shares should be considered in similar terms of considering price suppression or depression allegations.

(c) If both are routinely used, please explain the circumstances in which they are used, and provide examples from independently prepared sources (the published industry reports discussed at the meeting, OECD documents, etc.).

Response

Numbers of ships, deadweight, GT and cgt are only routinely used for shipbuilding demand projection and output monitoring and not for analysis of price influences. Various examples have been provided showing output monitoring reports and order volumes and orderbooks.

Exhibit Korea – 131 shows orderbook, completions and new orders by numbers of vessels and cargo measures (deadweight, teu and cu metres) according to ship type and size.

Exhibit Korea – 134 shows ship deliveries reported by number of vessels, deadweight and cgt in for different ship types and size bands, and with orderbook (future deliveries) phased over timescale.

Exhibit Korea – 135 shows orderbooks by ship type and size bands measured in numbers or ships and cargo volumes and with orderbook delivery phased over timescale.

175. In response to EC arguments concerning market share as a factor in price leadership, Korea variously states that market share does not demonstrate price leadership, but also that Korean yards' market shares are too small for them to be able to influence prices. Both sides thus seem to view market share as somehow relevant to the question of price leadership.

(a) How (on the basis of what sort of concrete data and analysis) can price leadership be determined/established?

Response

Korea considers and has consistently taken the position that the market share of the allegedly subsidized shipbuilders is one of the indicators to take into account in determining whether it is the alleged subsidies that have a price depressive or suppressive effect (refer to Korea's response to the Panel's Question 91(d) at pages 46 and 47) but is not solely sufficient to show a price depressive or suppressive effect due to the subsidies themselves. The allegedly subsidized Korean shipbuilders alone did not occupy such a market position that they could lead prices for each of the product segments concerned because the EC or other shipbuilders had comparatively equal or stronger market positions or because of fluctuations in market shares (refer to Korea's First Written Submission at pages 228 to 231 as well as its Second Written Submission at pages 105 to 110).

In order to determine whether *subsidies* have caused any price depression or suppression through the allegedly subsidized yards acting as price leaders, Korea submits that all the steps described in its response to Panel Question 91 should be followed. The concrete data and analysis indicated therein should be compiled and assessed so as to determine whether it was the alleged subsidies that caused price depression or suppression, i.e. including the compilation of the demand and supply factors, the effect of prices of other non-subsidized shipbuilders or the effect of the prices of the subsidized shipbuilders.

(b) What role in such an analysis would levels and trends in market shares play?

Response

In Korea's view, levels and trends in market share play a dual role as explained in its response to Question 91(d), i.e.:

- if, with respect to each like product, there are a number of non-subsidized shipbuilders which collectively have sufficient market shares to be able to lead or substantially influence the setting of the market prices, then the prices charged by these non-subsidized shipbuilders will constitute the ceiling of the prices that can be charged by the EC shipyards, regardless of the effect of the alleged subsidy in question.

- if with respect to each like product, the allegedly subsidized shipbuilders have sufficient market shares to be able to lead or substantially influence the setting of market prices, one should proceed to compare the prices of the vessels sold by the allegedly subsidized shipbuilders with those of the non-subsidized shipbuilders to determine whether the subsidies have had price depression or suppression for their

effect. If the market share of the allegedly subsidized shipbuilders is insufficient or if these shipbuilders have not maintained a substantial market share consistently, no such price comparison need to be made as it will be impossible to establish a causal link of sufficient strength between the existence of the alleged subsidies and any price depression or suppression. Moreover, this exercise requires a detailed cost analysis to compare any cost advantages to the size of the alleged subsidy and, in turn, a comparison to the other prices offered. The only alternative is a "but for" analysis to the effect that but for the subsidy the yard's capacity would have completely exited the market. In fact, that was what the EC was trying to rely on exclusively before it improperly attempted to reintroduce price undercutting again.

(c) How large a market share would a given market participant need to be able to exercise price leadership.

Response

No simple figure can be given as to the threshold which is sufficient for a market participant to be able to influence prices. This will depend on the product and the market concerned. In the present case of commercial vessels, the relative market share of all market participants and, separately, of the allegedly subsidized shipyards must be determined over a sufficient period of time and for each product separately. A relatively equal or stronger market share of non-subsidized participants will be a strong indicator that the allegedly subsidized shipyards cannot have exercised price depression or suppression. In addition, in a highly fragmented market characterized by many market participants, a very low market share may be sufficient whilst in other cases, when the number of market participants is relatively small as in the present case, a much higher market share will be required to exercise price depression or suppression.

The period of time over which market share is held should be sufficient in order to determine that there is an established market position; a short-term increase in market share as such will be insufficient to establish a price leadership in terms of price depression or suppression. In addition, in the case of an inquiry into subsidies, market shares must be investigated over a period of time preceding the bestowal of the alleged subsidies and thereafter in order to determine whether there is a timewise coincidence between the occupation or the maintenance of a market share of sufficient strength and the granting of the subsidies.

It is on this basis that Drewry has drawn its conclusions on the possibility for the three allegedly restructured yards to depress or suppress prices of the EC like product vessels in its report submitted as Exhibit Korea – 110.

In Exhibit Korea – 115, Korea summarized the findings of the EC's consultant FMI from their 'Background report – Detailed evaluation of key price movements' dated August 2003 (Annex 5a of the Annex V responses). Whilst Korea reserves its position in respect to a number of findings of this report, it is clear from this that the EC's own interpretation of price leadership was in no way consistent with the market share of the alleged price leaders. It is also noted that in six out of seven categories FMI identified that Korea was not the lowest price competitor.

IV. TO THIRD PARTIES

A. ITEM (J) I ITEM (K), FIRST PARA.

176. The parties disagree on whether or not APRGs and PSU constitute export credit guarantees and export credits respectively. The EC submits that they do not, whereas Korea asserts that they do.

Would your export credit agency treat APRGs as export credit guarantees, and PSLs as export credits? Please explain and provide relevant documentation.

KOREA'S COMMENTS WITH REGARD TO

ATTACHMENT EC – 8
ATTACHMENT EC – 9
EXHIBIT EC – 146
EXHIBIT EC – 147

1. Comments with regard to Attachment EC – 8

The EC's detailed points on the Drewry report submitted in Exhibit Korea – 70 run to some 20 pages of comments from which it is simply not possible to derive coherent lines of argument or comment. Many of the points concentrate on irrelevant issues, are repetitive or not intelligible. Beyond these issues on which Korea disagrees but which it considers are not of prime relevance, the following issues are important most of which are, in fact, reflected in the Panel's questions to which Korea responded in the present document or on which it commented when the question was addressed to the EC. These are the following:

(i) The fact that no accurate assessment on price depression or suppression can be prepared with regard to containerships, product and chemical tankers and LNGs without a strict like product identification taking into account the size and the use of the vessels. Korea has shown in its responses to Panel Questions 173 that shipbuilding industry publications do not always identify separately the three product categories referred to by the EC (in particular, the product and chemical tankers) and that industry publications do most often identify separately the different sizes of vessels as well as certain other characteristics (such as gearing or reefer capability) including when prices are reported.

Korea confirms that there are clear differences in end-uses between the like product vessels that were identified in the Drewry report in Exhibit Korea – 70 as elaborated on in Exhibit Korea – 108. In this regard, the EC's claim that the end use of a vessel can change during its lifetime is not grounded in fact: post panamax container vessels will not change to be used as small coaster feeders no more than oil products will be transported in chemical tankers.

(ii) The fact that the market strength of the allegedly subsidized Korean yards must be assessed based on the number of vessels ordered with them over a representative number of years preceding and following their corporate restructuring. Korea has elaborated on its response to Panel question 174 on the grounds that render CGT and the orderbook on 1 January 2004 inadequate to assess market strength such that the yards could influence prices. CGT is considered the proper standard of measurement for overall shipbuilding demand and capacity thus allowing an assessment on the aggregated supply-demand balance. However, as the measure is developed for an across sector assessment but not for ship-to-ship comparisons. Consideration of the market in CGT without size bands does not allow to properly assess market strength for price assessment purposes and is not used for this purpose in the industry.

(iii) The fact that the allegedly subsidized Korean yards and the EC yards compete as regards different like product vessels. A detailed Drewry report has been submitted in Exhibit Korea – 110 showing for each like product, the number of vessels sold by the EC and the allegedly restructured Korean yards. This clearly indicates that these Korean yards have primarily sold like product vessels that were not or hardly sold by the EC yards and this already during the period well preceding the bestowal of the alleged subsidies.

2. Comments with regard to Attachment EC – 9

The EC started its Attachment – 9 based on the Attachment 4 to Korea's Second Written Submission. However, as the recalculation provided in the EC Attachment – 9 is incorrect, it does not prove that a benefit was conferred. The fallacies are the following: (i) the EC erroneously equated a corporate bond rating "C" with a KEXIM credit rating "SM"; (ii) the EC misunderstood the structure of KEXIM interest rates; and (iii) the EC did not reflect the early repayments by DSME of its debt. Korea will discuss each issue briefly.

(i) Erroneous equation "C" with "SM"

As detailed in Exhibit Korea – 91, the corporate bond ratings by outside rating agencies and KEXIM credit ratings are incompatible. Not only are the underlying risks different, but the grading factors are as well. Korea would like to note that such incompatibility results in "mismatches" of KEXIM credit ratings and bond ratings shown in Exhibit Korea – 92. Indeed, while KEXIM graded a company with P4, P5 or SM, a credit rating agency rated the company's bond with rating "C". The similarity on rating definitions only cannot justify the inherent distinctiveness of the ratings.

(ii) Misunderstanding of KEXIM interest rate structure

As submitted in Korea Response to Panel Questions 47 and 73 and Exhibit Korea – 93, KEXIM interest rates were determined by adding up the base rate plus the then applicable spreads (target margin, credit risk spread, market adjustment rates, etc.). When *Yangdo Dambo* was provided, the "credit risk spread" was decreased by 50 per cent. Notwithstanding this, the EC appears to calculate the rates by adding up the base rate plus 50 per cent of credit risk spread only, which is incorrect. For all transactions referred to in EC Attachment – 9, KEXIM determined the interest rates based on "WNPRI 6month" the base rate plus spread of 1.96. The spread is composed of a credit risk spread of 0.15 (50 per cent of 0.3 which was the then applicable credit risk spread) and an adjustment spread of 0.46. (*See* page 2 of Exhibit Korea – 93)[44]

(iii) Early repayments

Also, DSME made early repayments of its PSLs for projects 000145P and 000146P. This resulted in small amounts of interests incurred (*See* Attachment – 4 to Korea's Second Written Submission). While the EC did not have this information regarding early repayments by DSME, it should nevertheless have been more cautions and raised the issue after reviewing Attachment Korea - 4.

3. Comments with regard to Exhibit EC – 146

3.1 Contrary to FMI's statement in Section 2.1 of the Exhibit EC – 146, Korea does not qualify the cost modeling done by the EC team as being lightweight. Certainly, a significant amount of efforts has gone into the calculations made but it remains as the EC claims itself that the cost modeling process is based on "assumptions" in which shipbuilding costs have been estimated or assumed to be at a certain level. No amount of effort and research will fundamentally alter the inherent accuracy limitations of the model. The inaccuracy of these assumptions has been demonstrated in Exhibit Korea – 108 in which KPMG has made a cost analysis of certain LNG carriers built by DSME. This report shows that the actual costs amounts and the FMI assumptions/estimations are strikingly different primarily as regards the following:

[44] Korea corrects that the commitment dates for all projects concerned were 21 December 2000, not 21 December 2001. The "adjustment spread" had been effective until it was replaced with the "market adjustment rate" in June 2001.

- material costs
- labour cost
- license fee
- overhead and SG&A
- debt service costs
- non-operating expenses.

Hence, these estimations, proven wrong with the actual figures, cannot be the basis for a conclusion that the costs of the allegedly subsidized Korean yards have increased to such an extent that prices should have increased and, hence, that price suppression or depression existed. Furthermore the inherent inaccuracy of the model has been demonstrated by the level of revisions/recalculations that the EC/FMI have already made in their detailed reports. As a matter of fact, nowhere do the EC or FMI indicate the link between the results of the cost model and the conclusion that the overall costs increased since the time when FMI started preparing the cost model.

When describing the approach to the treatment of overhead costs in the model, it is stated that these are spread evenly (the basis of allocation is not however discussed) across the full output of the shipyard and states specifically: "If this is not the case it would have to be shown that some proportion of the workload is capable of contributing more than its average share of overhead burden." This seems curious when elsewhere, EC and FMI have gone to considerable effort to then separate out that certain investments and overhead costs must be specially attributed to LNG, and has then struggled to come up with sensible ship series numbers over which to attribute this for Korean yards in comparison to EC yards. Furthermore elsewhere the EC has made strenuous efforts to suggest that shipyard supply has full substitutability and that any yard can build any ships type but it simultaneously advises the hearing that of the special skills and investment needed for LNG and that 'not any yard can build an LNG ship'. In fact, it is the EC and FMI's arguments that seem to change dramatically depending on what it wants to prove and this is all within the confines of this case.

The EC and FMI try to portray it as if Korea and Drewry had omitted to take depreciation and debt-servicing costs into account when concluding that Korean costs decreased instead of increased. However, in the first place, the EC and FMI did not show that depreciation and debt-servicing costs increased over the relevant period of time in order to substantiate their finding that prices should have increased and, in fact, as mentioned in Exhibit Korea – 108, DSME by paying its debts early, decreased its debt-servicing costs. If debt-service costs have not increased and have in some instances been significantly decreased by early repayment, the effect on overall costs will be at worst neutral and at best an improvement. Certainly there has been no fundamental reduction in throughput volumes that would in any way have increased the cost per unit output, if anything, the reverse would be the case.

Reference is also made to Korea's response to Panel Question 125(b) in the present document where it is explained that debt-service costs tend to be very specific to a particular yard's situation and, hence, not amenable to general trend indicators. This fact is evidenced by the situation at the former East German yards of Kvaerner Warnow Werft, Aker MTW and Volkwerft Stralsund where the state-funded investment was written-off and the new owners inherited the newly constructed facilities at a fraction of their cost and hence debt-service cost.. In any event, Korea considers that it has given full evidence of the fact that cost economies achieved by the three allegedly subsidized yards have been significantly greater than price decreases and that, as a result, there is no substance to the EC's allegation that increased costs should have led to increased prices.

3.2 With regard to FMI's assertions on the factors that have an influence on prices in the first paragraph of Section 3 of the FMI report in Exhibit EC – 146, Korea refers to its response to Panel Questions 124 and 125 in the present document in which it also addresses the allegations on capacity in the second paragraph of this Section of the FMI report. In particular, Korea reiterates that the

measurement of capacity in CGT and based on a snapshot for May 2004 yields an arbitrary result that does not reflect the true market position of the three allegedly subsidized yards. First, as the EC alleges that price depression or suppression was caused to container ships, product and chemical tankers and LNGs through the alleged subsidies, the market position of the allegedly subsidized yards must at the very least be specified in these three vessel categories and not include other vessel categories as well (refer to the two last sentences of paragraph 2 of Section 3 of the FMI report). Second, no assessment on price depression or suppression and the vector that can lead to price depression or suppression can be made without strict assessment of the like products involved and assessment for each of the like products separately. Korea has demonstrated in its earlier submissions and in the present document that there is no global like product for containerships, product and chemical tankers and LNGs and that significant differences exist within these broad categories including as regards the use of vessels. Hence, the market position of each of the allegedly restructured yards must be determined for each like product vessel separately. Finally, for the reasons set forth by Korea in its responses to Panel Questions 173 and 174 in the present document, the use of CGT and orderbook yields no accurate reflection of the true market position of any shipyard at any given point in time.

3.3 As regards the lumping together of various Korean shipyards whether allegedly subsidized or not, Korea has reiterated the reasons this is incorrect in its response to Panel Question 127 in this regard. Not only is such lumping of all or several of the Korean shipyards not supported in law but, in addition, it is pointless in practical terms as the Korean shipyards that are not alleged to be subsidized are in exactly the same competitive position as non-Korean shipyards.

3.4 FMI persists in expressing the view that price depression or suppression must be assessed for so-called coherent sections of the industry en bloc in the fourth paragraph of Section 3 and refers to the 1999 report of Drewry Shipping Consultants. In this regard, in the first instance the tenets of price depression and suppression for this case are driven by the specific legal aspects of the *SCM Agreement*, which is not something which is, or ever would be, addressed in a general industry publication. In fact, in some places EC and FMI appear to be suggesting that price effects tend to be universal on an industry-wide basis (i.e. all shipbuilding sectors), and in this they are straying into areas that are outside the scope of this case, in others they seem to say that they are consistent against 'coherent sections' (a concept which they do not explain). In any case this is simply not correct – in fact, in the Appendices to Drewry's 1999 report (that was selectively invoked by the EC) a table is included which shows the different price trends of different ships types, sizes and specifications. Inspection of this data clearly demonstrates that prices have not moved in the same manner across all sectors and size segments (this Appendix is included in Exhibit Korea – 131 of the responses to Panel questions). Furthermore in the basic shipbuilding demand assessments (Forecast newbuilding deliveries) also contained in the Appendices to these reports, the demand is clearly indicated on a ship type and size band basis, with no concept of a crude 'en bloc' approach.

3.4 Significant evidence that there is no general supply substitutability as claimed by FMI has been provided by Korea including in Exhibit Korea – 108 and in the responses to the Panel Questions 126 and in the comments to Question 159. Since many years including the period well preceding the bestowal of the alleged subsidies, the EC yards have specialized in specific vessel categories and sizes thereof. Their own statements in their financial statements and the specialized press indicate that this was a conscious and rather permanent move.

3.5 General price indices (which, in fact, reflect market anticipations and not actual price developments) for the shipbuilding industry as a whole or broad vessel categories are not suited to address the specific legal question of Article 6.3(c), i.e. whether the subsidies had price depression or suppression for their effect for the like product vessels. In particular, Figure 1 presented in Exhibit EC – 146 is not suitable for the assessment under Article 6.3(c) as it reflects a relatively short period and a distant fraction of the period after the bestowal of the alleged subsidies. In addition, Korea has noted that FMI itself admits that "there are clearly differences in elasticity depending on specific conditions

in the market sector concerned". Korea reiterates that it is precisely these differences that are important and must be grasped in order to determine whether it is the subsidies that had price depression or suppression for their effect. A general trend as such is not a standard for the assessment under Article 6.3(c).

4. Comments with regard to Exhibit EC – 147

The situation involved in the present dispute settlement procedure is subject to a strict legal framework that is totally outside the purview of any general industry publications as is the case of the 1999 Drewry report referred to in this Exhibit. However, much more importantly, the excerpt selected by the EC is extremely selective and does not provide an accurate portrayal of a report that is over 220 pages. In particular, the EC omits to make reference to the following issues that are also addressed in the report:

- No reference is made to the significant coverage (4 pages) of EC subsidies and other direct interventions in the shipbuilding market that is also present in the report;

- No reference is made to the statements made in the report regarding the Chinese and Japanese influences on capacity growth including "… the Japanese responded by removing production constraints which together with improvements in productivity boosted their capacity by as much as 20 per cent … the Chinese have also more than doubled their capacity during the 1990s";

- The use of CGT as a measure is clearly explained in relation to its relevance to volume of work content involved in newbuilding, not interpretation of price influences and influencers;

- The report clearly differentiates chemical from products tankers, and clearly analyses ship types within size bands which is consistent with Drewry's approach in Exhibit Korea – 70. The EC is, therefore, incorrect to state that it refers to three main sectors of tankers, container ships and bulk carriers, and that no subdivision of this is made;

- No mention is made of the fact that Drewry produces other regular specialist shipping publications that analyze chemical, LNG, dry bulk and products tankers with substantial detail of size, sub-categories, ownership, trading patterns, etc. Additionally, no reference is made to the later Shipbuilding Report published by Drewry in Nov 2000.

- The headline item on newbuilding prices states "currency devaluation, failing steel prices and advances in technology are the main reasons why newbuilding prices fell by as much as 20 per cent in 1998";

- The report does not offer any comments on the presence or otherwise of price depression, suppression, lost sales or serious prejudice, and it is not clear why selective references are being made to support the EC's case on this;

- Drewry does not routinely publish a general newbuilding price index recognizing the danger of using such figures in isolation or without caution;

- No reference is made to the clear statement that it was Japan that was clearly the leading shipbuilding nation – and it is, therefore, difficult to see how it is Korean yards that could be considered price dominant;

- If the report states that Korean shipyards globally are competitive, that is not an indication of any price depression or suppression by the allegedly restructured yards caused by the alleged subsidies.

The EC and FMI's reference to this excerpt has been used to imply that excess capacity has been solely caused by Korean yards, when very clearly the report makes reference to capacity growth (as a result of performance, new facilities and de-limitation) in many areas, specifically Japan and China as well as Korea.

ANNEX G-5

RESPONSES OF KOREA TO SUPPLEMENTAL QUESTIONS FROM THE PANEL AND COMMENTS ON THE SUPPLEMENTAL QUESTIONS TO THE EUROPEAN COMMUNITIES

(9 July 2004)

I. TO KOREA

A. APRG/PSL

177. Korea argues that country risk accounts for the difference in premia charged on APRGs by foreign banks as compared to Korean banks. What specific examples of foreign issued APRGs are there in which not only the existence but the amount of country risk premium can be shown, and what specific examples of Korean-issued APRGs are there in which the absence of country risk premium can be shown?

Response

As described in Exhibits Korea – 86a and 86b, when setting the APRG premia foreign APRG issuers separately consider the country risk of Korea on top of the general risks (financial and performance risks) of the shipyards. However, given that the foreign APRG issuers treat the amount of country risk premium as strict business confidential information, information on specific amount of country risk actually applied by foreign banks is not readily accessible to the Government of Korea. Nonetheless, Korea hereby submits **Exhibit Korea – 140** which indicates that **[BCI: Omitted from public version].**

As for the Korean-issued APRGs, Korea refers the Panel to Korea's response to Panel Question 58 wherein Korea provided three examples which are clearly showing the absence of country risk premium. Korea reiterates below these examples for the convenience of the Panel.

[BCI: Omitted from public version.]

178. Concerning the examples submitted by Korea in Exhibit KOR-83 of instances where the buyer imposed requirements concerning the issuer of the APRG in question, it appears that the buyers were seeking guarantors with strong credit ratings/financial soundness. What is the relevance of these examples to the question of whether or not KEXIM was charging market rates on its APRGs?

Response

Korea submitted that information to demonstrate the material distinctions between the positions of the foreign APRG issuers and Korean issuers of APRGs. The foreign issuers were used in the limited period of the Asian financial crisis (see Exhibits Korea 86a and 86b) due to the specific request by certain foreign (EC) buyers. Because the requirements of the customers were different and the situations of the issuers were different, these isolated and statistically irrelevant instances were not representative of the general conditions pertaining within the Korean market. Among other things, due to the strong credit rating of the foreign issuers, they were considered better guarantors and therefore

could charge higher premia. They also had to reflect the country risk premium which was relatively high during the financial crisis. Moreover, as Korea submitted in paras 207 through 216 of its First Written Submission, in order for certain rates to be eligible for any market benchmarks, not only such rates must have comparable terms and conditions including comparable collateral, but also such rates have to constitute a statistically representative number of transactions. Because APRGs extended by certain financial institutions are rare and exceptional due to empirical differences, the rates of such APRGs cannot constitute a comparable and objective benchmark. Please also refer to Korea Response 47 to Panel Questions for further details.

179. The "County Risk Management" Comptroller's handbook of the US Comptroller of the Currency, attached as Exhibit KOR-84 states at page 3 that "a domestic borrower's credit risk might increase because of significant export receivables from a foreign country...". Does this passage not suggest that a Korean bank issuing an APRG to a Korean shipyard would bear a certain country risk because the transaction was an export transaction, i.e. involved "export receivables from a foreign country"?

Response

Nowhere does the handbook imply that the country risk can be applied to "every" domestic counterparty that is involved in "an export transaction". Rather, the handbook itself establishes that the country risk may be exceptionally applied to transactions with domestic counter parties under very limited circumstances, e.g., where the business of a domestic borrower is heavily relying on the businesses associated with that particular foreign country with respect to which the country risk is assessed.

The handbook confirms that the application of country risk to domestic transactions is not a general practice. Along the line, it states that the country risk factor may be applied to domestic counterparties "where appropriate when assessing the creditworthiness of domestic counterparties", and states that "country risk would be pertinent to exposures to US-domiciled counterparties if the creditworthiness of the borrower or of a guarantor…is significantly affected by events in a foreign country." (*see* the third full paragraph on page 2 of the handbook et. seq.; emphasis added).

This explanation is understandable because, in the situations where the business of a borrower (or guarantor) is heavily relying on transactions associated with **a specific foreign country**, events in such a foreign country will directly and significantly affect the general credit risks of the borrower (or guarantor) which in turn will significantly and directly affect the creditworthiness of the borrower (or guarantor). Only in such specific circumstances, would it make sense to take into account the country risk of **such specific foreign country** when assessing the creditworthiness of such borrower (or guarantor).

By contrast, no Korean shipyards deal exclusively with **a specific foreign country** such that the events in such foreign country would significantly and directly affect the creditworthiness of the Korean shipyards. Further, it should be noted that among the buyers of Korean ships, the absolute majority of buyers are coming from the so-called "High Income OECD countries", e.g., the EU, Norway, US and Japan as defined by the World Bank. No foreign financial institution would apply country risk with respect to counterparties from such countries as they do not bear any country risks. For reference, under the Arrangement on Officially Supported Export Credit, the High Income OECD countries are classified as "category 0" countries, to which no country risk is assigned (*see* Article 24 b) and c) of the OECD Arrangement).

Moreover, even if a Korean shipyard were exposed to the country risk of a particular foreign country by retaining significant "export receivables" from the buyers in that foreign country, the country risk it bears is the country risk of that particular "foreign" country, and not the country risk of

"Korea". In other words, in such case, any Korean banks issuing APRGs to such Korean shipyard would apply the country risk of the said "foreign" country, not the "Korean" country risk.

In light of the above, a Korean bank issuing an APRG to a Korean shipyard would not bear a country risk merely on the ground that a transaction was an export transaction (i.e. involved "export receivables from a foreign country"). Korean yards do not bear a country risk because their export receivables are not from a foreign country that carries any noticeable country risk, but from High Income OECD countries. Even if they were exposed to the risk of a particular foreign country, the country risk that the Korean banks issuing APRGs to Korean shipyards must consider is that of a particular "foreign" country, not the country risk of "Korea" which is at issue in the present proceeding.

180. Further on country risk, was it not the case that during the period of the financial crisis in particular, the Korean domestic banks were facing similar "Korea risks" to those that would have been faced by foreign banks (for example, risk of expropriation of assets, risk of currency manipulations, etc.)? Please explain in detail.

Response

Country risk by definition is the risk that economic, social, and political conditions and events in a foreign country will adversely affect an institution's financial interests (*see* also the response to Panel Question 179). In other words, it is the risk that a country will not be able to honour its external financial commitments due to the occurrence of certain conditions or events. Therefore, in assessing a country risk, the likelihood of whether a country will service its external debts is to be measured and analyzed. As such, the country risk is the factor to be examined, reviewed and considered by a party *outside* the country concerned. As a result of a foreign party's (e.g., foreign APRG issuer) efforts to hedge such country risk, such foreign party tends to charge higher premium rates.

On the other hand, Korean domestic banks, by definition, cannot face the risk of their own country. Risks from events in their own country are no longer "country risk."

Korea does not agree that the Korean domestic banks were facing similar "Korean risks" to those that would have been faced by foreign banks. Korea would like to emphasize that, when "Korea risks" was mentioned in the context of country risk, it meant the risk to Korea's ability to honour its "external" financial commitments. In this regard, Korean domestic banks cannot face similar "Korea risks" to those faced by foreign banks. Moreover, in light of the definition of country risk, the country risk factors (risk of expropriation of assets, risk of currency manipulations, etc.) must be understood to mean those that are of such nature that rather directly affect external financial obligations of Korea. Therefore, these risks, by nature, could not be the same as those risks faced by Korean domestic banks.

In any event, it may be true that during the period of the financial crisis, the Korean banks were facing credit risks which were generally increased throughout the country, even though they are of different nature from the "country risk factors" as faced by foreign banks. Such an increased risk during the crisis was, however, taken into account by the Korean banks as the "general credit risk" of the Korean shipyards. Of course, foreign banks, too, considered the same "general credit risk" with respect to the Korean yards, separately and in addition to the country risk of Korea.

181. Would not similar considerations as to risk of expropriation, risk of currency manipulation, etc. be taken into account by any bank involved in financing foreign trade (wherever that bank happens to be domiciled)? Please explain in detail.

Response

Korea's response to Question 180 also applies here.

Having said that, Korea takes the term "financing foreign trade" in a broad sense to mean any financing related to foreign trade. As noted in Responses 179 through 180 above, every export transaction does not trigger a bank's consideration of country risks. As Korea noted in Response 179 in detail, it depends on the types of such financing transactions and in what context the country risk of a borrower is examined.

In addition, as far as country risk is concerned, whether the bank is located inside the country or outside the country is the determining factor. Please refer to Reponses 179 and 180 above for more details.

182. At paragraph 81 of its oral statement, Korea argues that it is not only the type but also the amount of coverage by collateral that is important in comparing different APRGs. In this connection, Korea argues that the collateral cited by the EC at paragraph 100 of its second submission covered only a small portion of the guarantee. Korea then cites Exhibit Korea – 88, a transaction which according to Korea involved no collateral. How does this demonstrate that the collateral referred to by the EC covered only a small portion of the guarantee?

Response

Korea submitted Exhibit Korea – 88 to confirm and clarify its response to Panel Question 71 (as well as Korea's response to EC Question 14) in which it explained that in the specific instance of the APRG transaction between Shinhan Bank and Hanjin no collaterals were involved. As the EC subsequently challenged such statements by Korea (*see* para. 106 of the EC's Second Written Submission), Korea submitted the Exhibit for confirmation and clarification purposes.

Korea refers the Panel to Korea's response to EC Question 14 in relation to the provision of no collateral or a small collateral coverage that directly affects the determination of APRG premium rates.

B. ALLEGED ACTIONABLE SUBSIDIES

183. Please comment on Exhibit EC - 145, containing PwC's reactions to the Arthur Andersen/Anjin submission in Exhibit KOR-79.

Response

Despite numerous points raised by PwC in Exhibit EC – 145, it failed to establish that it was better for the creditors to liquidate, rather than restructure, DHI. As explained in detail by Anjin in **Exhibit Korea – 141**, the creditors' recoverable amount under any going concern scenario was always higher than the recoverable amount in the liquidation scenario. This was so even when correction is made for the double-counting of tax shield effect.

For details, please refer to Anjin's response (**Exhibit Korea – 141**) to PwC's comments.

184. In particular, please comment on the statement at page 3 that "the Enterprise Value of the restructured company is lower than the Enterprise Value of the company computed without debt restructuring".

Response

It is true that, according to Anjin's calculations in the 1999 Report, the Enterprise Value of the restructured company was lower than the Enterprise Value of the same company without restructuring. This was a formalistic result from the technical model used by Anjin arising from a carry-over of a residual amount of shareholder value in the debt/equity swap. However, the creditors decided that the proposed workout plan of spinning off the two companies that had no synergistic value and undertaking debt/equity swaps and debt restructuring was preferable from the perspective of ultimate collectibility on the debt. Moreover, as Anjin points out and PwC does not contradict, in no event was the Enterprise Value of the restructured company lower than the liquidation value of the same company. Therefore, this fact does not affect the creditor financial institutions' decision to restructure DHI, rather than liquidate it.

For details, please refer to Anjin's response (**Exhibit Korea – 141**) to PwC's comments.

C. SERIOUS PREJUDICE

185. Concerning Exhibit KOR-115:

(a) No information is provided as to the source for the prices presented in this document. Please identify in detail the source(s).

(b) No dates are associated with any of the prices shown in the documents. Please provide this information.

(c) No information is provided as to what the prices shown in the document represent (i.e., contract prices, bids, etc.). For each price shown, please indicate precisely what it represents.

(d) No information is provided in respect of LNGs. Please provide the same sort of information on LNGs for the same period(s) and on the same basis as the information in the table.

Response

(a) The source of the information is the document entitled "Background report – Detailed evaluation of key price movements" prepared by the EC's consultant, FMI, in August 2003[1] that was submitted as Annex 5a-2) by the EC itself in the Annex V process and is submitted herewith for the convenience of the Panel in **Exhibit Korea - 142**.

(b) The prices shown are the average prices for the period from 1997 to 2003, i.e., the prices shown in the following tables in the FMI report supplied as Annex 5a-2) by the EC in the Annex V process and now attached as Exhibit Korea – 142:

[1] Refer to paragraph 293 of Korea's Oral Statement delivered at the Second Substantive Meeting which identifies the source of the data shown in the table in Exhibit Korea – 115.

-	for handysize tankers:	Table 2.1 at page 2 of the report;
-	for handymax product tankers:	Table 2.2 at page 4 of the report;
-	for panamax product tankers:	Table 2.3 at page 6 of the report;
-	for chemical tankers:	Table 2.4 at page 8 of the report;
-	for feeder container vessels:	Table 3.1 at page 12 of the report;
-	for panamax container vessels:	Table 3.2 at page 15 of the report;
-	for post panamax container vessels:	Table 3.3 at page 16 of the report.

(c) According to Section 1.1 of the FMI report in Exhibit Korea – 142, the prices are the average price per CGT calculated for the period from 1997 to 2003. FMI identifies the source of the data as being BRL Shipping Consultants. Korea assumes but the EC and its consultant would be better qualified to confirm that this data reflects the order prices shown in the FMI reports which the EC itself submitted as Annex 10 in the Annex V process. The important factor is that these are average prices set forth by the EC's consultant, FMI, and the EC themselves.

(d) Korea is unable to provide the same information for LNGs as the data source which is the FMI report submitted by the EC in the Annex V process does not contain this data for LNGs.

186. Concerning Exhibit KOR- 109, Korea presents certain breakouts of different sizes of container ships and tankers. For LNGs, while the text in Korea - 109 refers to various sizes of LNGs, no statistics are presented broken out by size. Please explain.

Response

As at February 2004 and since 1996 virtually all LNG vessels that have been ordered have been for vessels of 135,000 cu metres or larger, reflecting the recent growth in LNG ship sizes as LNG trade volumes have increased. In fact, of nearly 100 orders placed from 1996 only three have been for smaller vessels, one for a small coastal vessel of <10,000 cu metres capacity built in EC, another of 74,000 cu metres capacity built in EC and a third of 23,000 cu metres capacity built in Japan. The other vessels all fall within the 135 – 145,000 cu metres capacity range except for one single vessel of 153,000 cu metres on order in France. Orders for the next generation of larger LNG vessels in the 180 – 250,000 cu metres capacity range have yet to be confirmed.

Given this concentration of vessel size over the timescale covered by this complaint and the fact that Korea has only built vessels of 120,000 cu metres or larger, no breakdown of LNG orders by size was felt to be appropriate or necessary to reflect the current size band in which LNG vessels are primarily built.

II. TO THE EC

A. APRG/PSL

187. Please comment on Korea's recalculations of benefit in Exhibits Korea - 91-102.

B. ALLEGED ACTIONABLE SUBSIDIES

188. Concerning the question of whether the restructuring of Daewoo was subsidized, please provide a summary, based on all of the submissions of Arthur Andersen/Anjin and PwC, of the EC's analysis and conclusions in respect of whether DHl should have been liquidated instead of restructure. In this summary, all relevant figures should be shown in tabular from, with cites

and cross-references to the original Arthur Andersen report of November 1999 assessing the value of bill under various scenarios.

189. Concerning the Daewoo restructuring

(a) Concerning the most recent PwC submission (Exhibit EC - 145), please explain in detail the statement at page 3 that the Anjin analysis indicated "that the Enterprise Value of the restructured company is lower than the Enterprise Value of the company computed without debt restructuring".

(b) What is "enterprise value" and how does it differ from "going concern value"?

(c) What is the significance of the fact that the "enterprise value" was lower under one set of calculations than under another? How if at all does it affect the central issue raised by the EC, namely the decision to restructure instead of liquidate Daewoo?

(d) What is the significance of Anjin's reply in Exhibit KOR-7O that enterprise value *was* reduced under the analysis of the restructuring scenario from what it had been under the valuation of tile non-restructured company? What if anything is the significance that enterprise value calculations differed under two scenarios for the central issue posed by the BC, namely whether it was better to liquidate or to restructure Daewoo?

190. The data presented in Exhibit KOR-108 show interested depreciation expense in the in the cost/profitability analysis for Daewoo. Please comment. How can this be reconciled with the EC's assertion that these costs have not been adequately reflected in Daewoo's prices?

191. Exhibit KOR-107 sets forth the results of the court-ordered/supervised restructuring of Daedong. Presumably, such a restructuring had to proceed in accordance with Korean bankruptcy law. On what basis does the EC allege that nevertheless it involved a subsidy?

C. SERIOUS PREJUDICE

192. One conclusion that might be drawn from Exhibits KOR-91-102 is that Korea accepts that there is a benefit from the KEXIM financing at issue, but that the benefit in a number of cases is quite small (0.5 per cent or less). If one accepts that the benefit is of the magnitude reflected in these Korean exhibits, what would be the implications for the EC's serious prejudice analysis and conclusions?

Comment by Korea on this question addressed to the EC

Without prejudice to the fact that Korea does not accept in its Exhibits Korea – 91 to 102 that the KEXIM facilities conferred a benefit,[2] Korea considers that the KEXIM facilities cannot have had price depression or suppression for their effect in the first place because the EC itself admits that KEXIM's base rate for APRGs has increased while its credit risk spreads became more conservative. Hence, if anything the KEXIM facilities should have exercised less pressure on the prices for vessels. In addition, the EC itself shows fluctuating price trends (i.e., decreases and increases) in Attachment 2 to its responses to the Panel questions (especially in Figure 2.3). As it does not show a decrease in the benefits allegedly afforded by KEXIM in periods of increasing price trends, there is all the less evidence of a price depressive or suppressive effect of the KEXIM financing facilities. In the second place, the magnitude of the price depression/suppression alleged in Attachment 2 to the EC's

[2] *See*, for example, Korea's response to Panel Question 114.

responses to the initial Panel questions is blatantly out of proportion with the magnitude of the alleged benefit.

Notwithstanding the EC's allegations of qualitative effects of the KEXIM facilities (which Korea disputes), Article 6.3(c) of the *SCM Agreement* explicitly requires that the alleged subsidies must have "significant" price depression or suppression for their effect. Hence, the letter of this provision requires a quantification of the effects of the subsidies and a benefit of 0.5 per cent does not meet this threshold while the blatant difference in the proportion of the alleged benefit and the alleged price depression/suppression clearly demonstrates that there is no causal link between the alleged KEXIM benefits and the price depression/suppression asserted.

Once again, in response to this new EC "evidence" Korea must recall that, even if one were to accept the EC's approach, the EC still has not explained how such *de minimis* subsidies contribute to developing or improperly maintaining excess capacity leading to price suppression. As Korea has noted in the past, the EC seems to be trying to avoid this very direct and clear requirement of the treaty language to demonstrate that the significant price suppression is the effect of the subsidy by trying to attach any alleged subsidy it can to a product and then sweep that product as a whole into the price suppression analysis. Furthermore, the EC does not really attempt to do this in relation to the products. The EC even ignored evidence that many ships produced by unrestructured shipyards did not "benefit" from APRGs or pre-shipment loans, but nonetheless attempted to sweep every ship into its analysis.

The EC at the latter stages attempted to move a little away from this totally capacity dependant approach and reintroduce price undercutting as a supporting element of its price suppression/depression analysis. Aside from the legal block on this reintroduction of an abandoned argument, the EC leaves unexplained how such *de minimis* subsidies could have resulted in the alleged price suppression or depression when, by the EC's own admission, the Korean yards enjoyed a considerably larger cost advantage. There would simply be no competitive effect from such subsidy.

Finally, if these *de minimis* subsidies were to have such an effect, then the causal effect of the much higher level of EC subsidies (which the EC does not and cannot contest) on the marketplace would overwhelm and displace any effect of the alleged Korea subsidies. In such a case, it would be impermissible to attribute to the Korean subsidies effects that were actually caused by the much larger EC subsidies.

193. Exhibit KOR-112, concerning MOCIE's intervention at the request of Samsung, could be viewed as indicating that the government takes action if prices are too low. If this is the case, what are the implications for the EC's serious prejudice claim?

Comment by Korea on this question addressed to the EC

In its response of 2 July 2004 to the EC's Question 5 addressed to Korea, Korea explained in detail the background of MOCIE's intervention in the Hamburg Sud-DSME transaction. As demonstrated there, MOCIE was not concerned with the price level as such, but with the anti-competitive behaviour of the parties involved in that transaction. In any event, this MOCIE intervention does not support the EC's serious prejudice claim. Instead, it indicates that it was a European shipyard, Odense, that was offering the lowest prices and thus depressing prices (*see* Exhibit EC - 88).

194. If the Panel were to accept the product subdivisions set forth in Exhibit KOR-109, how would this affect the EC's analysis of price suppression/depression? Please respond in detail.

195. Please comment on Exhibit KOR-115.

COMMENTS BY KOREA ON THE NEW FACTUAL INFORMATION SUBMITTED BY THE EC AND THE US ON 2 JULY 2004

134. In Exhibit EC - 118, PwC asserts that "[t]he KSDA Bond Matrix is the accepted mark-to-market price for the domestic market". Does this mean that the EC disagrees with Korea's argument that the bond matrix represents hypothetical / projected rates, or does the EC accept Korea's argument but consider that the index nevertheless constitutes a reliable market benchmark? Please explain. What does "mark~to~market" in this context mean? In particular, who was marking what to which market?

Comment on the EC's new factual information; Exhibit EC – 148 regarding KSDA Bond Matrix

In Exhibit EC – 148, PwC argues that the KSDA Bond Matrix is the mark-to-market price for the domestic market and that "mark-to-market" means that "KSDA employees update every day the price and yields of the bond used in all the indices". While the explanation by PwC regarding the term "mark-to-market" is not clear enough to fully resolve its ambiguity (please recall that the Panel specifically asked *who was marking what to which market*), PwC nonetheless seems to focus on daily collection activity of data.

However, such daily collection activity does not automatically mean that the Matrix accurately reflects the "price" of a bond or even bonds issued in a particular sector of industry. In fact, PwC itself admits the limitation of the Matrix by stating that it is the "representation of the yield … at a specific moment in time". This statement is nothing but saying that the Matrix is only a general index, which Korea already explained in its response to Panel Question 73. Representation is a representation (whatever it may mean). It cannot be *the* price (i.e., yield in the instant context) of a specific bond.

For the better understanding of the Panel, Korea submits below some cases showing actual yields of specific bonds compared to the corresponding KSDA Bond Matrix (both of which are available at the KSDA website).

Case 1

Issuing Company: Hyundai Heavy Industry
Bond Classification: HHI 100 KSDA Standard Code: KR6009544M29
Issue Date: 21 February 2001 Expiry date: 21 February 2004
Credit Rating upon Issuance: A0

(Unit: %)

Date	**HHI 100 Weighted Average Yield**	**KSDA Bond Matrix Rated A0**	**KSDA Bond Matrix Rated A0**	**KSDA Bond Matrix Rated A0**
		3M	6M	9M
2003-11-26	4.38	4.8		
2003-11-24	4.38	4.8		
2003-09-02	4.32		4.89	
2003-05-26	5.9			5.08
2003-05-23	5.87			5.06

Case 2

Issuing Company: Hyundai Heavy Industry
Bond Classification: HHI 102 KSDA Standard Code: KR6009544M78
Issue Date: 23 July 2001 Expiry Date: 23 July 2004
Credit Rating: A0

(Unit: %)

Date	HHI 102 Weighted Average Yield	KSDA Bond Matrix Rated A0	KSDA Bond Matrix Rated A0	KSDA Bond Matrix Rated A0
		3M	6M	9M
2003-12-17	4.8			5.24
2003-11-24	4.99			5.11

Case 3

Issuing Company: Samsung Heavy Industry
Bond Classification: SHI 84 KSDA Standard Code: KR6010144M21
Issue Date: 24 February 2001 Expiry Date: 24 February 2004
Credit Rating: A0

(Unit: %)

Date	Weighted Average Yield Rate	KSDA Bond Matrix Rated A0	KSDA Bond Matrix Rated A0	KSDA Bond Matrix Rated A0
		3M	6M	9M
2003-12-11	4.52	4.93		
2003-11-11	4.32		4.88	
2003-07-25	4.72		5.13	
2003-05-28	5.15			5.05
2003-05-20	5.13			5.02

Note: The months (3M, 6M, 9M) represent the remaining months to the expiry date.

The above tables show that the KSDA Bond Matrix does not represent actual yields of the bonds issued. For example, when looking at yields rates of HHI 100 (the remaining period of which to the expiry is approximately 3 months) on 26 November 2003 and the KSDA Bond Matrix 3M on that date, several questions arise inevitably: (i) What is the market price of a bond with credit rating A? HHI 100 bond yield? or the KSDA Bond Matrix?; (ii) Is HHI 100 bond yield below market price if the KSDA Bond Matrix is the "market price"?; (iii) Does this mean that HHI 100 bond yield was above the market price back in May 2003? (iv) (Assuming so,) then why do investors make investment into HHI 100 bond on 26 November 2003?; (v) (Further assuming that an investor purchases bonds of a company in the same industry sector as HHI), which one should be the reference, HHI bond yield or the KDB Bond Matrix?; (vi) Why the prices of HHI 100 bond and HHI 102 bond are different as at the time both bonds are having the same months remaining period? (vii) Why the prices of HHI 100 bond and SHI 84 bond (both of which are having 3 months remaining period as of November 2003) are different?; and the questions may continue on and on..

Should the KSDA Bond Matrix be the market price, it provides no clear answers to the above questions. This means that the KSDA Bond Matrix is only an index which indicates the market situations on a specific date. It does not reflect specific situations of the industry sector, the issuers, and the preferences in the market. Thus, it can in no event be a "price" at which a specific bond can be purchased. At best, it may be a preliminary indicator that an investor may use as a first reference before studying the market further.

Further, Korea would like to clarify certain points made by the EC which are misleading and factually baseless. The EC submitted that "the corporate bonds actually issued by the yards were not appropriate benchmarks as regards corporate bonds (i) because they were guaranteed by a bank, (ii) were not issued in the same currency or (iii) not issued at the same time as KEXIM PSLs" (*see* para. 21 in the EC response to Panel Questions). These assertions are incorrect. In the first place, in no instance were bank guarantees provided in relation to the corporate bonds issued by the Korean yards. The EC has never provided any evidence to substantiate this assertion. Secondly, most bonds were issued in Korean Won. The instances where foreign currency bonds were issued were extremely limited (i.e., **[BCI: Omitted from public version]**). As indicated in **Exhibit Korea – 139** submitted already, even **[BCI: Omitted from public version]** issued its bonds in Korean Won in most of the cases and no other Korea yards have issued bonds in foreign currency. Lastly, the EC asserts that bonds were not issued at the same time with PSLs. While bonds may not have been issued on the exact same dates as PSLs, this fact cannot necessarily dismiss those corporate bonds actually issued by the shipyards from the eligible list of benchmarks. There is no requirement that, in order to be comparable, an instrument being compared must be issued on the same date as another instrument concerned. As stated in Korea's response to Panel Question 170, Korea considers that the average interest rates for financial instruments actually used by the shipyards, presented on a quarterly basis, would be proper benchmarks and these quarterly data can avoid possible anomalies when comparing the instruments on day-to-day basis.

136. At para. 95 of its oral statement, Korea presents a number of points criticizing the EC calculation methodology, and states that further details are contained in Exhibits Korea 90-102. Please respond to Korea's criticism in detail, including with reference to the content of these exhibits.

Comment on the EC's new factual information

Comments on Exhibit EC - 148 regarding incompatibility of credit ratings

On the issue of compatibility of KEXIM credit ratings for PSLs with the bond ratings by other rating agencies, PwC contests in Exhibit EC – 148 Korea's arguments that (i) the levels of underlying credit risks are different and (ii) factors for grading are not alike.

First of all, the content of PwC's report casts into question whether PwC really has the expertise to opine on the nature and mechanism of determining credit ratings. As discussed below and demonstrated by the report and materials submitted by Korea, PwC's analysis is full of fallacies and distortions which a banking expert would never make.

In particular, Korea is surprised by the bold statement of PwC that "…a private loan and a bond having the same ratings will present the same obligor repayment capacity and the same credit exposure risk…Both should therefore be remunerated with the same interest rate" (*see* the last paragraph at page 5 of Exhibit EC – 148. Emphasis added). When making this puzzling statement, PwC seems to be ignorant of the fact that banks and rating agencies apply different factors in determining the ratings for different types of financial products and, therefore, that different types of products (e.g., bank loan v. corporate bond, corporate bond v. commercial paper) carry different interest/yield rates even where the borrower or the issuer of these products is the same company. This is a fact well-known to every financial expert in the world. According to the PwC's logic, a company

(e.g., Hyundai), which has a stable and uniform rating, should borrow loans or issue bonds, CPs, CDs or whatever instruments always at the same interest rate at a given time, assuming that maturity and collateral (or non-collateral) are the same. This is non-sensical, at the very least.

PwC begins its fallacious analysis by challenging the statement in Exhibit Korea – 91. It disputes the statement that corporate bond rating (i.e., issue rating) in Korea could actually be considered same as the "issuer" rating whereas KEXIM ratings were the "facility rating" that takes into account all the characteristics of the credit facility. Then, PwC takes the DSME bonds as an example, and states that the ratings of these bonds as secured by collateral, cannot be considered the same as the rating of DSME and that *[t]he rating of the bonds reflects the collateral of the bond emission just as KEXIM ratings reflect the collateral of the loans granted*. PwC first ignores the fact that the corporate bonds issued and traded in Korea are mostly non-collateralized bonds and the bond rates quoted by KSDA are based on "unsecured long-term senior bonds". Second, after admitting that the rating of DSME bonds reflect collaterals just as KEXIM rating does, PwC then fails to explain why the DSME bonds cannot be used as benchmark for KEXIM's PSLs.

Thereafter, based on a study by the society of actuaries, PwC attempts to rebut Korea's argument that there is no correlation between KEXIM rating on its loans (which are equivalent to privately-placed bonds) and the ratings on the publicly traded corporate bonds because default rates for private debt placements are lower than that for public debt placements. However, this study does not contradict the conclusions of Carey (1998) relied upon by Korea. Indeed, PwC quoted the following statements which appear, in fact, to contradict the allegation by the EC:

- "Over the sample period studied, private placements with most recent internal ratings the equivalent of investment grade and BB have loss experience similar to publics in spite of worse incidence or default rates *because of better loss severities* on private placements",

- "Relative to publicly issued bonds, private placements with most recent internal ratings the equivalent of B and riskier offer *superior experience* *with respect to all of incidence, severity and economic loss"* (*see* the first paragraph on page 5 of Exhibit EC – 148. Emphasis added).

Korea cannot figure out what PwC is trying to establish with these statements. The plain reading of these statements still leads to the conclusion, as drawn by Korea, that the privately placed debt instrument (such as KEXIM's PSLs), by nature, generally involves lower default risks than public placements with a given credit rating. Hence, PwC's analysis fails to rebut Korea's argument (i) that credit risks for a bank credit rating are lower than those for the corresponding corporate bond rating and (ii) that for the same corporate entity, the corporate bond rating must be higher than the credit rating for bank facilities in order to have equivalent credit risk.

Interestingly, the statement by the society of US actuaries admits that the insurance companies fairly frequently disagree with NAIC and with each other on credit rating, although, on average, the disagreements are small. These disagreements arise even if the companies engaged in the same insurance business are assessing the credit risk involved in the same financial product, i.e., corporate bonds. This demonstrates how significant the disagreements would be in cases where KEXIM as a bank assesses the credit risk of its borrower in loan transactions while a credit rating agency, such as KIS, assigns ratings to corporate bonds which are totally different products from a bank loan. In this regard, the PwC's assertion that "the correlation between corporate bond ratings and KEXIM ratings [on loans] should exist at least for ratings better than or equal to BB [rating by a credit rating agency on corporate bonds]" is non-sensical.

In order to redress this flaw, PwC quotes the actuaries society's statement that "the more pessimistic one is usually the one with the highest predictive power"(*see* the second paragraph on

page 5 of Exhibit EC – 148). However, it is obvious that this "usual" order of predictive power applies only within the context of the same insurance companies who are assessing credit risks on the same financial instrument (i.e. corporate bond). In addition, the society of actuaries has never conducted a study, and therefore does not dare to express an opinion on whether such "usual" order of predictive power would apply to a totally heterogeneous situation where a bank assigns rating to a borrower in loan transactions while a credit rating agency assigns a rating to a corporate bond. In such a case, a comparison is not possible as the two agencies are using two different measurements, considering totally different factors.

PwC's egregious analysis does not stop here. It further attempts to convince the Panel of the correlation by trying to implement a mechanistic match between the credit rating agency's "A to C" ratings and KEXIM's "P to SM" rating system merely based on definitional similarities. At the outset, Korea would like to point out that such a mechanistic matching technique is meaningless as long as rating agencies do in practice assign different ratings to even the same borrower/issuer or to the same financial instrument under different circumstances. Using the same rating definition (expressed in language that permits diverse applications in actual cases) does not guarantee that all different raters would assign the same rating. As mentioned earlier, the statement by the actuaries society admits that disagreements in rating frequently take place even among companies engaged in the same insurance business.

Moreover, Korea cannot understand where PwC's conclusion that KEXIM's P5 rating is comparable to a "BBB" rating comes from. PwC appears to take P5 instead of P4 simply because P5 is a lower rating to P4 (*see* Table 1 on page 7 of Exhibit EC – 148). However, Figure 2 in the same page of the PwC report seems to either conflict with Table 1, or only shows that the credit spread for BBB is corresponding to the credit spread for P4, not P5. Furthermore, PwC has failed to provide any support for its conclusion that KEXIM's SM rating should be equivalent to "C". PwC has only provided Table 1 which only refers to the chronology of the changes implemented by KEXIM in its credit rating systems of KEXIM, but ends with "BB" as the worst rating in the last column of the first row (*see* Table 1 on page 7 of Exhibit EC – 148). The natural reaction to this would then be to inquire why it is only "C", not "single B"that corresponds to KEXIM rating SM?

In any event, as noted before, this whole matching exercise is highly mechanistic and cannot support the EC's allegation that rating X on corporate bonds always corresponds to rating Y in KEXIM rating system. This means that the EC's attempt to use corporate bonds as a benchmark for KEXIM PSLs is not acceptable. Assuming *arguendo* that there was a financial contribution, the right approach would be to compare the rates of KEXIM PSLs granted to a shipbuilder with the rates of other financial products used by the same shipbuilder.

In order to support Korea's claim that KEXIM credit ratings are not compatible with the corporate bond ratings and to rebut various other allegations of the PwC and the EC, Korea supplements Exhibit Korea – 91 with a report by KEXIM as a banking expert, which is submitted herewith as **Exhibit Korea – 143**. Korea summarizes below the key information provided by this report.

(1) First of all, the report points out that the elements for assessing credit risks are different from each other. More specifically, KEXIM credit rating systems look into "probability of defaults", "loss given default" and "expected loss". The report states:

> It is a uniform practice in banking industry to review, examine and analyze following three elements when assigning credit ratings: **probability of default (PD), loss given default (LGD), and expected loss (EL)**. (*See* the second paragraph of II.A.1. of **Exhibit Korea – 143**).

By contrast, the rating agencies are reviewing only the "probability of defaults", not "loss given default" or "expected loss." This must result in having materially different horizons as to the risks associated. The report further continues:

> According to Moody's study on *Bank Loan Loss Given* Default, it is evident that there exists a significant difference in expected loss between bank loan rating and corporate bond rating. In consequence, the risk premiums are different, which ultimately results in the difference in interest rates.

<Exhibit 6: "Bank Loan Loss Given Default", November 2000, Moody's Investors Service, p.9>

Exhibit 6

Descriptive Statistics for the Time to Default Resolution

Bank Loans	Count	Average	Median	Maximum	10th Percentile	Minimum	Standard Deviation
Sr. Secured	119	$69.5	$74.0	$98.0	$39.2	$15.0	$22.5
Sr. Unsecured	33	$52.1	$50.0	$88.0	$5.8	$5.0	$28.6
Long Term Public Debt (of these same Bank Loan Borrowers)							
Sr. Secured	6	$59.1	$49.0	$98.5	$30.0	$0.1	$32.6
Sr. Unsecured	51	$45.1	$44.0	$104.8	$16.0	$0.5	$25.7
Sr. Sub	55	$29.4	$24.0	$98.0	$4.0	$0.5	$23.6
Sub	32	$29.1	$29.3	$87.5	$4.5	$0.5	$20.6
Jr. Sub	5	$10.8	$12.5	$20.8	$3.7	$1.5	$7.2

> As shown in the chart above in Exhibit 6 to Bank Loan Loss Given Default by Moody's, "the mean bank loan value in default is 69.5 per cent for senior secured and 52.1 per cent for senior unsecured,"[3] whereas the mean value of long-term public debt is 59.1 per cent for senior secured and 45.1 per cent for senior unsecured. (*See* para. II.A.2.of **Exhibit Korea - 143.)**

(2) Secondly, as Korea submitted, banks adopt a so-called "point-in-time" approach whereas rating agencies use the "through-the-cycle" approach. This makes the two rating systems quite different from each other as the banks seek "most likely cases" while the agencies are anticipating "stress" scenario. This inevitably results in the different properties of both ratings so that, for example, in contrast with bank credit rating system, "agency ratings may not have the same sensitivity to change… of bank risk ratings" (*see* the last paragraph of II.B.1 of **Exhibit Korea – 143**).

In view of these distinctive properties including different elements for assessing credit risks and dissimilar approaches, bank credit rating systems cannot be compatible with agency rating systems. This is supported by Moody's, which clearly states that:

> In which Moody's has rated both a company's credit facilities and its bonds, the bank loan rating is one or more refined rating categories higher than the bond rating. (*See* the first paragraph of III of **Exhibit Korea – 143**).

Based on the reasons as detailed above, Korea reiterates that bank credit rating systems cannot be compatible with agency rating systems.

Comments on Attachment EC - 10 regarding recalculations of benefit by the EC

In Attachment EC - 10, the EC provided a chart showing that KEXIM PSLs conferred a benefit by way of recalculations showing certain adjustments. While Korea will show the fallacies in these recalculations below, Korea would like to emphasize some additional points.

[3] Bank Loan Loss Given Default, November 2000, Moody's Investors Service, p.1

- Korea cannot agree that the KSDA Bond Matrix provides a benchmark.

As Korea detailed in its comments on the EC's response to Panel Question 134 above, the KSDA Bond Matrix is mere a preliminary indicator that an investor may use as a first reference before studying the market further. It cannot be a market price or benchmark.

- Further, Korea cannot agree that KEXIM credit ratings and corporate bond ratings are comparable.

As explained in detail above and in Exhibit Korea – 143, KEXIM credit rating are not comparable to ratings by credit rating agencies. This is undoubtedly supported by the unequivocal statements by Moody's. Korea will not reiterate those herein again.

- In most cases, the EC found "negative or minimal" margins only.

As Korea cannot agree on the methodology suggested by the EC, Korea denies the existence of any benefits. However, even if Korea accepts the methodology for the discussion purposes only, most cases reflect negative or minimal benefit margins. This is so even when following the EC's methodology in its entirety, and it is even more so when following the methodology corrected by Korea. Korea herewith submits **Exhibits Korea – 145 through 149** to substantiate this claim.

In relation to this, the EC made another attempt to provide a misleading portrayal of hard facts. In para. 58 of its responses to the Panel Questions, the EC states that "the difference between the market benchmark and the KEXIM rate is more than 30 per cent when expressed as a proportion to the KEXIM actual spread rate" (emphasis added). It is evident why the EC did this. After establishing that even in the EC's own methodology, only minimal benefit margins are obtained, the EC now attempts to exaggerate the magnitude of alleged benefit margins by comparing those with KEXIM's credit risk spread. The credit risk spread, however, is only a fraction of the overall rate.

In addition, as Korea explained during the Second Substantive Meeting, the EC can show these "minimal" alleged benefit margins for only a small fraction of the PSLs extended by KEXIM. The tables below are summaries in relation to these instances. Given the small number of instances where the minimal margins would be found and the magnitude of such margins, Korea considers that the EC's claims are unfounded and unsupported and must be rejected by the Panel when taking a decision on all facts and evidence before it.

EC Recalculation

Shipyard	**PSL Cases where positive benefit was found**	**Alleged Benefit**							
		lower than -1%	**-1 ~ -0.5%**	**-0.5 ~ 0%**	**0 ~ 0.25%**	**0.25 ~ 0.5%**	**0.5 ~ 0.75%**	**0.75 ~ 1%**	**Over 1%**
DSME	37/136						5		32
HHI	22/197		4	29	5	6	6	2	3
Mipo	27/142		1	1	11	3	3	4	6
Samsung	1/8			1	1				
Hanjin	8/45		3	4	1	3	3		1
Samho	8/45							4	4
STX	6/6								6
Total	109/579		8	35	18	12	17	10	52

Corrigendum by Korea

Shipyard	PSL Cases where positive margin was found	Margin							
		lower than -1%	-1 - - 0.5%	-0.5 – 0%	0 - 0.25 %	0.25 – 0.5%	0.5 - 0.75 %	0.75 – 1%	Over 1%
DSME	0/136	1	12	24					
HHI	17/197		5	33	4	4	9		
Mipo	23/142		1	5	12	9	2		
Samsung	1/8			1	1				
Hanjin	6/45		3	6		2	3		1
Samho	0/45		2	6					
STX	6/6								6
Total	53/579	1	23	75	17	15	14	0	7

Note: The number "579" is the total PSL cases listed in Korea's Annex V Responses Attachment 1.2(30).

- The EC's approach is inconsistent as regards the selection of its alleged benchmarks.

As Korea established with the concurrence of the EC, the PSL is a short term loan facility, the duration of which is not exceeding 6 months. This has been an undisputed fact in this proceeding as is also shown by the EC itself when it used benchmarks of a 6 month duration in Exhibit EC – 125.

Notwithstanding this, the EC now abruptly starts to allege that a benchmark with a 1-year duration should be used in certain cases. In support, the EC alleges that the base rates for certain instances of PSLs are **[BCI: Omitted from public version]**. This is non-sensical. As has been established and thus far alleged by the EC itself, a proper benchmark must be a facility conferred with similar terms and conditions. The term must be assessed based on its duration, not the name of base rates. Korea would like to ask the EC how and why the EC used the 6 month KSDA Bond Matrix to PSLs conferred to STX where the base rates were "fixed" rates.

Korea provides one example to show that while the base rate is WNPRI1Y, the average duration of PSL instalments is not exceeding 6 months as below.

[BCI: Omitted from public version.]

- The EC still failed to adjust Samho's PSL for a 100 per cent physical collateral.

In this connection, the EC has kept proffering its traditional "best information available" rule by stating that it is not "KEXIM's policy to keep and maintain any worksheet or similar documents necessary for the consideration of collaterals" (*See* para. 49 of its response). This is egregious, and it is another example showing the bad faith of the EC.

Korea submitted KEXIM's list of pre-shipment loans to shipbuilders as Korea Annex V Attachment 1.2(30)-1 and Exhibit Korea – 60 which clearly show that as to **[BCI: Omitted from public version.]** Korea hereby submits the relevant pages of KEXIM list of pre-shipment loans to shipbuilders as **Exhibit Korea – 144** to substantiate this (the EC purposefully submitted as Exhibit EC – 24 only a part of the list). For more details, please refer to the corrigendum on the EC's recalculation with respect to Samho (**Exhibit Korea – 145**).

- The EC wrongly applied "Adjustment Duration (AD Duration)".

As the EC explained, the "AD duration" was employed for obtaining the 6-month KSDA Bond Matrix in Exhibit EC –125 with respect to certain PSL instances as to DSME. The AD duration was explained as the difference between the Treasury Bond yield 1 year and Treasury Bond yield 6 mont.sh. Given that a 6-months KSDA Bond Matrix exists, there is no need to consider the AD duration. Further, with respect to DSME, the EC did not apply the KSDA Bond Matrix. Instead, it followed the interest rate determination procedure under the KEXIM Guidelines Interest Rates and Fees. In these circumstances, it is not necessary to consider the AD Duration. Please refer to corrigendum with respect to DSME (**Exhibit Korea – 146**).

- Korea submits **Exhibits Korea – 145 through 149** for corrigendum on the EC's recalculation.

While Korea does not agree with the EC's methodology, Korea nonetheless submits **Exhibits Korea – 145 through 149** on the EC's benefit recalculation in order to correct manifest clerical errors by Korea in previous Exhibits and to identify the EC's misunderstandings or false allegations.

139. The Panel refers to Attachment 5 to the EC's replies to the Panel's questions after the first substantive meeting, which contains transaction-specific alleged benefit calculations for one PSL and one APRG. Please make the same calculation for each of the APRGs and PSLs at issue in these proceedings. In other words, for each shipyard, specify which APRG I PSL relates to either LNG, product / chemical tankers, or container ships, and specify the amount of the alleged benefit as a % of the ship price. Please attach detailed worksheets.

Comment on the EC's new factual information

Comments on Attachment EC – 11

In Attachment EC - 11, the EC attempted to provide the ad valorem benefits with respect to a fraction of PSL instances. Korea is compelled to point out below the serious fallacies contained in this document.

- Korea does not agree that benefits were conferred.

As explained above, the benefit calculation methodology by the EC including the selection of benchmarks is affected by grave and inherent fallacies. Hence, Korea rejects the existence of any benefit and the magnitude of the benefit alleged by the EC. Korea refers to its above explanations in this regard.

- The EC's PSL duration is false.

This is another example to show the bad faith by the EC. As clearly indicated in Attachment Korea - 4 to Korea's Second Written Submission and described in Korea response to EC Question 19, PSLs are disbursed in several instalments generally at the time of "steel-cutting", "keel laying", and "launching". The number of instalments and disbursement amounts vary depending on the projects. Hence, each instalment must have a different duration.

This notwithstanding, the EC applied the entire period from the commitment date to the expiry date as the duration of the PSL. This by itself is conflicting with it own benchmark which is a 6 month KSDA Bond Matrix. In addition, Attachment EC – 11 itself refers to Attachment EC – 9, which, in turn, is based on Korea's Attachment Korea - 4 above. Should the instalment disbursements be taken into account, the calculation would be complex. However, irrespective of whether the

calculations are complex, the EC is not exempted from its obligation to provide correct calculations (assuming all other factors are established). To disregard this is not justifiable.

- The ad valorem benefit would be decreased substantially.

Korea hereby submits **Exhibit Korea – 150** in order to show (i) again the duration of each instalment disbursement as for the all projects for which the EC provided "projected" ad valorem benefits and (ii) there are early repayments in some cases, which must be taken into account for calculation and to provide the PSL interest amounts that KEXIM charged.

If the EC should count all of these factors, the ad valorem benefit would be decreased substantially.

Comments on Attachment EC – 12

Also, as explained by Korea during the Second Substantive Meeting, the EC alleges that it established a benefit for a small fraction of APRGs only. The table below is the summary of those instances. Korea submits this for the better understanding as to the egregiousness of the EC's claim.

Shipyard	Alleged number of APRG instances out of total APRG transactions
DSME	21/261
Mipo	0/126
HHI	0/347
Sansung	4/141
Samho	4/82
Hanjin	2/32
STX	2/126
Total	33/1115

In addition, in Exhibit EC – 12, the EC attempted to provide the ad valorem benefits with respect to a fraction of APRG instances. As with the PSLs, the EC made the same egregious and bad faith attempts.

- Korea cannot, and shall not, agree on the existence of benefit.

As submitted earlier, Korea cannot agree on the benchmarks the EC proffered. As stated, in order to be eligible for constituting benchmarks, (i) the subject rates must be market representative in terms of instances and (ii) the terms and conditions must be comparable. However, the proffered benchmarks are gravely lacking those criteria. Thus, Korea neither agrees that a benefit was conferred nor a benefit of the magnitude alleged. Korea refers to its explanations in this regard hereinabove.

- The EC disregarded the fact that advance payments are to be made in instalments.

While the EC itself indicated in its Attachment EC – 12 that the advance payments are to be made in instalments, the EC disregarded this and took the entire period from the contract date to delivery date as the duration for entire advance payments.

While the EC finger-pointed Korea for not providing the relevant information, it should have made, at least, an attempt for a reasonable reconstruction. Without this, the EC should be condemned.

142. In percentage terms, how much of the alleged benefit resulting from the "Daewoo" tax concession should be attributed to DSME's production of (i) LNGs, (ii) product I chemical tankers, and (iii) container ships? Please attach detailed worksheets.

Comment on the EC's new factual information

In Attachment EC - 13, the EC has re-quantified the alleged subsidies received by Daewoo-SME by adding the alleged tax subsidy. The EC argues that the total benefit provided to Daewoo-SME under "scenario 1"[4] amounts to KRW 2,889,985 million which is summarized in the table below.

	In million KRW
Debt-for-equity swap	649,089
Tax concessions: 55% * 236,000	129,800
Debt rescheduling	173,153
Negative net worth of DHI to be assumed by Daewoo-SME = 55%*3,523,533	1,937,943
Total	2,889,985

However, Korea has demonstrated that the DHI restructuring had been made under market conditions and that there was no benefit conferred. Therefore, the EC's quantification of the alleged benefits is fictional.

Nonetheless, Korea would like to make a few comments below to show that, even under the EC's incorrect assumptions, no benefit has been conferred or continues.

(a) Debt-for-equity swap

For those reasons presented by Korea[5], KRW 3,500 which was the stock price on the first day of trading[6] cannot represent the true value of the stock of DSME.

Instead, the DSME creditors agreed to the debt-for-equity swap as a long term investment, and Exhibit Korea – 103[7] clearly demonstrates that the price of DSME shares as of August 2001 was in the range of US$ 10 (approximately KRW 12.000 – 13,000) per share.

(b) Tax concessions

As demonstrated by Korea[8], the EC has failed to establish that any financial contribution had been made to, or any benefit had been conferred upon, DSME in the form of tax concessions.

(c) Debt rescheduling

The EC has calculated the alleged benefit from the debt rescheduling based on the terms of debt rescheduling (e.g., reduction of interest rates and changes in the repayment schedule of principals) as provided in the Comprehensive Agreement on Corporate Workout (MOU) of 20 January 2000. However, the EC fails to recognize the fact that DSME graduated from the workout

[4] This means an alleged scenario that DHI restructuring was not made under normal conditions and, thus, the company should have been liquidated.
[5] Korea's Second Written Submission, paras 160 – 167.
[6] Attachment EC -13, Footnote 2.
[7] Non-binding Offer by Newcastle Heavy Industries dated 16 August 2001.
[8] *See*, e.g., Korea's response to the Panel Question 116.

on 23 August 2001 due to its remarkable business performance and that, as a result, the original terms of debt rescheduling under the above MOU have been cancelled.

The following table summarizes the original terms of debt rescheduling under the MOU and the revised terms of the principal and interest payments agreed upon between DSME and the creditor financial institutions at the time of termination of the DHI workout procedure:[9]

	Original terms under MOU	**Revised terms upon Workout termination**
Terms of repayment of principal	To be repaid each year from and after 2003 in the amount equivalent to 5% of the total principal amount	As for KAMCO and SGIC, to be repaid in equal instalments during 2002-2003 (actually so repaid); As for other financial institutions, to be repaid in equal instalments during 2002-2004 (actually so repaid).
Terms of interest payments	Interest on secured debt: Prime rate Interest on unsecured debt: Prime rate – 3%	As for financial institutions which have applicable interest rates for the outstanding debt: the applicable interest rates at CB credit rating BBB or above. As for those which do not have applicable interest rates: the interest rates determined by adding not more than 2.5% to yield rates on 3 year national treasury bonds.

The EC also fails to acknowledge that most of the DSME debts assumed from DHI through spin-off ("workout debts") have been repaid (or swapped into equity) during 2002 – 2004. Korea has provided complete details of the changes in the interest rates during the DHI workout and at the termination of the workout procedures, as well as the dates and amounts of repayments by DSME debt principals.[10]

As a result of such early repayment (or swap into equity as of 14 December 2000) by DSME, the workout debts of DSME have been drastically reduced from KRW 1,095 billion as of 31 December 2000 to KRW 34.9 billion as of 31 December 2003.

<Status of Workout Debt Repayments> (In billions of KRW)

12/31/2000	**12/31/2001**	**12/31/2002**	**12/31/2003**
1,095.3	187.7	74.8	34.9

The EC argues that DHI obtained "gains on exemption of debts" of KRW 1,321,830 million and that, of this amount, KRW 173,153 million is to be allocated to DSME. The EC argument is based on "DHI 1999 audited accounts."

However, these "debt exemption gains" indicated in the 1999 audited accounts were calculated based on the assumption that the original debt restructuring terms under the MOU of 20 January 2000 would continue to be implemented according to those terms. Because the MOU debt restructuring terms have not been implemented as originally agreed, the EC's benefit calculation is flawed even under the EC's own 'benefit' calculations. Furthermore, the "gains" as used in accounting theory cannot be considered as equivalent to the legal concept of "benefit" within the meaning of Article 1.1(b) of the *SCM Agreement*.

[9] *See* **Exhibit Korea – 151**, Korea Development Bank's Notices on termination of DSME workout.
[10] Exhibit Korea - 77, Repayment of Debt Principal by DSME (Annex V Attachment 3.1(21)).

Once again, it can be seen that the EC is making an argument that any debts restructured during proceedings subsequent to insolvency are *per se* subsidies. The EC's purported calculation of the subsidy amount consists of the full debt load without any restructuring. Of course, this is not in accord with the legal principles of any market economy, including those of each and every EC Member State. The EC has completely failed to present to this Panel any workable model based on either normative or empirical standards for the proper amount of debt to be restructured. Of course, as a matter of logic and as supported by the evidence, by the time there is an insolvency, the debt has been valued by the market. Restructuring it is merely reflecting on the books the reality of the market place. There was no new equity being inserted into these companies; it was merely a matter of allocating the value as between the various classes of financial instruments. The only question is whether these companies were kept in existence as going concerns rather than being terminated and sold off for scrap to obtain a higher value for the creditors. And the EC has presented no evidence that any creditors, either domestic or foreign or of any class of creditor favoured such a result.

(d) Re-allocation of negative net worth

Please refer to Korea's response to the Panel Question 122.

143. Is it the EC's argument that the tax exemption was determinative in the decision to maintain Daewoo's shipbuilding operations as a going concern, rather than liquidating them? If so, where is this reflected in the Arthur Andersen/Anjin report or in other documentation before the Panel?

Comment on the EC's new factual information

In Exhibit EC - 148, PwC argues that tax consequences of the DHI restructuring would result in lower values for the going concern scenario. Based on this view, the EC argues that the tax exemption was a determining factor in the decision to maintain DHI's shipbuilding operations as a going concern, rather than liquidating them.

However, as elaborated by Korea in its response to Panel Question 116, the EC's "core claim" based on Article 46 of the Corporate Tax Act does not make sense, as the proposed DHI spin-off was to be made at book value (i.e., without valuation at the time of spin-off). Arthur Andersen's analysis of the going concern value had also been based on the assumption that the spin-off would be made at book value and, thus, no tax liability would arise under Article 46 of the Corporate Tax Act in connection with the DHI spin-off. In that regard, contrary to the EC's allegation, there were no tax consequences that Arthur Andersen had to consider in its analysis of DHI's going concern value.

As indicated in Korea's response to Panel Question 116, even if the DHI restructuring had, in theory, entailed a special additional tax, it was the remaining DHI as the "transferor" of the assets, not DSME that was responsible for any such liability under the Corporate Tax Act (Articles 2 and 99).[11]

Therefore, the going concern value of DHI could not have been affected by such tax consequences (if any), because DHI's going concern value was to be calculated on the basis of estimated cash flows from the shipbuilding and machinery operations of DHI (i.e., DSME and DHIM).

[11] Exhibit Korea – 121, Articles 2 and 99(1). Moreover, the remaining DHI's obligation to pay the special additional tax was to be deferred (i.e., the remaining DHI did not have to pay the tax following the spin-off) by virtue of Article 99(11) of the Corporate Tax Act, as the terms of DHI spin-off as assumed by Arthur Andersen satisfied all the criteria set out in Article 46 of the Corporate Tax Act.

144. Para. 162 of Korea's second oral statement refers to creditors rejecting the initial DHI workout proposal. Were such creditors included in the EC's claim of government entrustment or direction? If they were entrusted or directed by GOK, why / how did they reject the initial workout proposal?

Comment on the EC's new factual information

Based on the Exhibits referred to in its response, the EC makes new arguments that distort the facts relating to the rejection by certain creditors of the proposed DHI workout plan.

As described in Korea's First Written Submission[12], the DHI workout plan itself (i.e., spin-off, debt rescheduling and debt-for-equity swap) was rejected at the 3rd CCFI meeting held on 24 November 1999. Attachment 10 to Korea's First Written Submission also shows that Agenda Nos. 1, 2 and 3, which constituted key features of DHI workout plan, were rejected at the CCFI meeting. Therefore, the EC's allegation that "the general plan to restructure Daewoo-HI had been agreed to at the 3rd CCFI meeting" (para. 83) is false.[13] The fact that the "DHI restructuring plan" itself was rejected at that meeting is also supported by the article from Seoul Economic Daily News (Exhibit Korea – 104) which clearly states that the "proposed workout plan" was rejected.

Moreover, contrary to the EC's allegation, the creditors who rejected the proposed workout plan included not only the investment trust companies, but also other financial institutions (mainly non-secured lenders). The investment trust companies accounted only for 31.99 per cent of the total voting rights at the CCFI meeting[14], while the actual voting results at the 3rd CCFI meeting[15] shows that the voting percentage of the dissenting creditors was substantially greater than 31.99 per cent. In this regard, the article from Seoul Economic Daily News again confirmed that the issue was "the debt recovery ratios between the secured and non-secured creditors,"[16] and therefore, was not confined to investment trust companies.

In its response to the Panel question, the EC failed to explain why these creditors had rejected the workout proposal if they were entrusted or directed by the Government of Korea. Instead, it tries to avoid this difficult question by focusing only on the 4 trillion Won Daewoo CPs because this was an issue for investment trust companies which purchased Daewoo CPs, but not necessarily so for the other financial institutions which also rejected the purposed DHI workout plan.

However, it is not clear what the EC is trying to establish by arguing that the investment trust companies objected to the treatment of the 4 trillion Won CPs with the view that the Government (through KAMCO) would recognize the "clear inequities"[17] and that, "consequently," the loan was purchased by KAMCO at **[BCI: Omitted from public version]** of its face value.[18] First of all, with this argument, the EC admits that the investment trust companies were not directed or entrusted to accept the proposed DHI workout plan. Instead, according to the EC, the investment trust companies rejected the proposed workout plan in order to draw the Government's attention to their problem.

Second, the EC conceals the fact that it was almost one year later that KAMCO purchased the Daewoo CPs from the investment trust companies (i.e., between September and December 2000).[19] It

[12] See paragraph 351.

[13] The EC relies on the ambiguous statement in Exhibit EC-55, but this must be read in the more specific context of the CCFI meeting described in Attachment 10 to Korea's First Written Submission.

[14] Attachment 9 to Korea's First Written Submission.

[15] *See* Attachment 10 to Korea's First Written Submission.

[16] Exhibit Korea – 104.

[17] The EC response, paragraphs 86 and 87.

[18] The EC response, paragraph 88.

[19] *See* the last paragraph in Korea's reply to Annex V Questions at page 60 (Exhibit EC-39).

is non-sensical to argue that the investment trust companies' rejection of the DHI workout plan that took place on 24 November 1999 was the reason for KAMCO's purchase of Daewoo CPs that took place 1 year later.

145. The EC requests an adverse inference regarding Korea's alleged failure to provide a copy of the workout plan / report submitted by KDB on 24 November 1999. Please comment on the explanation set forth at paras 194 and 195 of Korea's second oral statement. If the EC still maintains its request, what is the legal basis for that request? Why does the EC consider that Korea should have made this report available to the EC / Panel earlier?

Comment on the EC's new factual information

Korea still cannot understand the basis of the EC's request for adverse inferences and what the EC tries to establish through the alleged adverse inferences.

It appears that the EC assumes that "the workout plan" existed in the form of a separate report similar to the report prepared by Arthur Andersen. This is not true. The KDB proposed a workout plan, based on the Arthur Andersen report, only in the form of "agenda" submitted to the CCFI meetings. Attachment 10 to Korea's First Written Submission clearly shows what the workout plan was actually meant to be. In fact, the agenda No. 1 through No. 7 tabled before the 3rd CCFI meeting constituted the "workout plan" proposed by KDB. There was no separate report containing the DHI workout plan.

On the other hand, in its very First Written Submission, Korea made clear that KDB had proposed a "workout plan" (i.e., agenda submitted to the CCFI meetings) based on the Arthur Andersen report and that the initial workout plan had been continuously revised by KDB as the lead bank and proposed to the CCFI meetings in the form of agenda.[20] Korea stated that the basic features of the workout plan had been finalized through the third, fourth and sixth meetings of the CCFI.[21] In this way, Korea made the existence of workout plan known to the EC and never concealed it.

Therefore, the EC's allegation that Korea revealed the existence of the workout plan only after the EC had highlighted it, is inconsistent with the submissions of Korea, and therefore must be rejected.

158. (a) Is it the view of the EC that excess shipbuilding capacity exists only in Korea, or is there also excess capacity in other countries?

(b) If your view that excess capacity exists only in Korea, please explain.

(c) If your view is that there is excess capacity also outside of Korea, where and how much is the excess?

(d) Is there any excess shipbuilding capacity in the EC? If not, what is the basis for this conclusion?

Comment on the EC's new factual information

Korea notes that there is nothing in paragraph 55 of the OECD document in Exhibit EC – 151 that confirms that Korean shipyards have *massively expanded* as the EC claims. What the document states is that Korea has stepped up capacity "by improving productivity at its yards, especially its newer facilities that started a more full range of operations since the mid-1990s". If the increased

[20] Korea's First Written Submission, paragraphs 351 – 353.
[21] Korea's First Written Submission, paragraph 350.

capacity was achieved by improving productivity (for all Korean yards alike, restructured or not restructured), the excess capacity is not caused by the alleged subsidies. Why would Korea have stopped productivity increases yielding lower costs, as the EC asserts it should have, because of existing excess capacity in other shipbuilding countries? This makes no sense.

159. The Panel's written question 30 following the first meeting was as follows:

"In general, how much flexibility does a typical shipyard have to produce all or a broad range of ship types? What are the physical and other constraints on any given shipyard's potential product range? How important is prior experience to a shipyard's production cost and capability to build a particular type of ship? With reference to the above considerations, please describe the capabilities and experience of each EC shipyard that produces or is capable of producing some or all of the kinds of commercial vessels cited in your serious prejudice claim".

Please present a summary of any information already before the Panel, including the Annex V information, that is relevant to this point but was not referred to in the EC's original answer to this question.

Comment on the EC's new factual information

The Clarkson World Shipyard Monitor for May 2004 now submitted by the EC in Exhibit EC - 152 confirms rather than rebuts Korea's demonstration that yards do heavily specialize in specific ship types and size bands and that all yards do not build a full range or even a very wide range of vessels. **Exhibit Korea – 152** hereto reflects some examples by way of illustration of what is contained in Exhibit EC – 152 and confirms Korea's position. There is, therefore, not supply-side substitutability.

160. Concerning the composite ship newbuilding price index furnished by the EC, the EC indicates that major shipbuilding consultants also maintain "more specific price information for particular ship types". In Attachment 2 to its answers to questions, the EC provides price information for two sizes of tankers and for eight sizes of container ships.

(a) Is this the "more specific" information to which the EC refers?

(b) Why does the EC show the particular breakouts that it does? Do other breakouts exist for these products? Please explain.

Comment on the EC's new factual information

It is a matter of opinion only as to what is the most commonly used source of newbuilding prices. There are many sources other than the "Clarkson World Shipyard Monitor" referred to by the EC such as electronic databases, brokers, broker reports and other indices as indicated by Korea in its response to Panel Question 173.

In addition, Exhibit EC - 152 does not supply price series indices for *all* ship types covered by other analysts and at the very least cannot, therefore, reasonably be described as the most comprehensive source. The table provided by Korea in its response to Panel Question 173 d) shows that both Lloyds Shipping Economist and Drewry publish prices series in their routine publications which include ship types and sizes not covered by Clarksons, i.e. Chemical Tankers, Refrigerated ships (Reefers), General Cargo, LPG (more size options offered), Bulk Carriers (additional size options) and containers (more size options). For this reason alone, these other sources of ship prices must also be considered for the purpose of the present proceeding.

161. The EC presents indices of estimated Korean production costs versus prices in support of its argument that there is price suppression/depression. The EC indicates that its consultant,

FMI, prepared the cost estimates, taking into account various known cost trends and cost advantages of the Korean yards. The EC in its answers to questions following the first meeting provided a description of the methodology used by FMI to prepare these estimates. The EC also indicated that, should the Panel so request, it would furnish the detailed underlying data. Is it the view of the EC that a graphical presentation of price indices, along with a description of methodology, constitutes prima facie evidence of evolution in Korean shipbuilding costs? Please explain.

Comment on the EC's new factual information

In connection with Exhibit EC - 156 (FMI's "cost modelling details Angelicousis LNG Tanker at Daewoo"), the EC does not explain the basis and methodology of FMI's cost estimation. The spreadsheet shows various cost categories and relative percentages of cost allocation between cost categories, but it fails to explain why and how such relative percentages between cost categories represent those of DSME.

Korea has already shown that the EC's cost estimation is unrealistic. In Exhibit Korea – 108 (Cost Analysis Report), KPMG has verified the actual costs incurred by DSME for production of LNG carriers and confirmed that FMI's cost estimation was simply a fiction. FMI's cost analysis is nothing but an "estimation" from various sources including EC yards and cannot replace the actual costs. Moreover, it is based on FMI's experience with the shipbuilding activity of European shipyards. It is non-sensical to argue that such a fictitious analysis can provide any plausible estimate of Korean yards' costs.

Interestingly, Exhibit EC - 156 concerns the "Angelicousis" project for which DSME has not even begun any production work and, therefore, has not yet incurred any actual cost of production. Nonetheless, the EC claims that it already knows what the DSME cost would be.

In this situation, it is ridiculous for the EC to state that these cost analysis have led it to "conclude" that prices offered by Korean yards are not in line with costs of production, and that this gap is widening.

In this regard, Exhibit EC - 156 demonstrates that the EC's argument on suppression or depression is totally baseless and unrealistic, rather than supporting the EC's claim.

Korea has observed a number of times how the EC has attempted to use anti-dumping theories to support it subsidies case and how ill they fit the treaty language. Now, in addition to trying to base their subsidization theory on a constructed value approach, it may be observed from this new EC "evidence" that they have added the new oddity of apparently claiming that Korea is a non-market economy and trying to use the EC to develop a surrogate price.

162. What specific evidence/examples are contained in the information before the Panel in support of the EC argument that prices at one end of the product spectrum for a particular kind of ship influence prices along the entire spectrum? (For example, is there specific evidence in the information before the Panel that a downward movement in very large container ships brings about commensurate downward movement in all smaller sizes of container ships?)

Comments on the EC's new factual information

The quotation by the EC in its paragraph 144 does not respond to the Panel's question. Indeed, as the EC's citation clearly indicates, the document deals with the geographical market and indicates that the impact on one part of the geographical market is felt in the rest of the geographical market. That is totally different from stating that the price of a particular kind of ship influences the prices along the entire spectrum of the like product vessels. Moreover, in any event, the statement by

the OECD Secretariat as referred to by the EC has been the subject of a specific disagreement entered by Korea and China.[22]

In addition, the information presented by the EC itself in Exhibit EC – 152, page 8 of Clarksons World Shipyard Monitor for May 2004 issue, demonstrates that prices of different sizes of vessels, contrary to the EC's allegations, do not move together.

The scale on both the graph on this page and also Figure 1 in Exhibit EC – 146 also referred to, obscures the detail of price trends. The following table takes the ship prices from page 8 of Exhibit EC – 152 and shows the year-on-year percentage variations of prices for the different types and sizes of ships.

Ship	1997 v 1996	1998 v 1997	1999 v 1998	2000 v 1999	2001 v 2000	2002 v 2001	2003 v 2002	Apr 04 v 2003
VLCC – 300,000 dwt	1%	-13%	-5%	11%	-8%	-9%	21%	12%
Suezmax Tkr – 150,000 dwt	2%	-15%	-3%	24%	-11%	-6%	18%	14%
Aframax Tkr – 110,000 dwt	1%	-16%	-4%	26%	-13%	-3%	19%	16%
Panamax Tkr – 70,000 dwt		-16%	0%	16%	-11%	-2%	20%	9%
Handy Tkr – 47,000 dwt	0%	-17%	0%	13%	-11%	3%	17%	16%
Capesize BC – 170,000 dwt	4%	-19%	6%	16%	-11%	1%	32%	17%
Panamax BC – 75.000 dwt	2%	-26%	10%	2%	-9%	5%	26%	30%
Handymax BC – 51,000 dwt	-2%	-20%	11%	2%	-10%	3%	26%	21%
Handysize BC – 30,000 dwt	-5%	-21%	9%	-3%	-3%	3%	20%	14%
LNG	5%	-17%	-13%	5%	-4%	-9%	3%	9%
LPG	-9%	-6%	-3%	7%	0%	-3%	9%	11%
Container - 725 teu		-21%	4%	0%	-7%	0%	35%	9%
Container - 1,000 teu		-10%	-3%	3%	-14%	0%	19%	19%
Container - 1,700 teu		-16%	-6%	9%	-14%	-2%	21%	18%
Container - 2,000 teu		-12%	-3%	13%	-11%	-4%	13%	8%
Container - 2,750 teu		-18%	6%	14%	-17%	-5%	25%	14%

[22] Korea refers to Document C/WP6/SNG/M(2004)1/REV.1 of 4 June 2004 which contains a revised summary record of the OECD meeting of 29 – 30 March 2004 and provides at paragraph 14 that:

> Korea and China made it clear that they do not agree with one of the characteristics of the shipbuilding market described in paragraph 12(b), C/WP6/SNG(2004)2, which is not agreed among the SNG members.

Reference is also made to paragraph 17 of OECD Document C/WP6/SNG/M(2004)2 of 5 July 2004 containing the summary record of the OECD meeting held from 27 to 28 May 2004 which refers to the following statement by China:

> The Delegate of China indicated that the effect of an individual transaction on other transactions should not be overstated, because a single shipyard's influence is limited (due to the competitive nature of the market). Also, transactions are all different, and shipbuilding prices are not transparent in the market.

Ship	1997 v 1996	1998 v 1997	1999 v 1998	2000 v 1999	2001 v 2000	2002 v 2001	2003 v 2002	Apr 04 v 2003
Container - 3,500 teu		-16%	-10%	9%	-13%	-8%	29%	13%
Container - 4,600 teu						-13%	26%	15%
Container - 6,200 teu						-17%	18%	15%
RoRo 1,200 - 1,300 Lm			10%	-7%	-5%	-3%	19%	9%
RoRo 2,300 - 2,700 Lm			8%	2%	-6%	0%	6%	9%
Index	-2%	-15%	-4%	7%	-5%	-2%	12%	12%

Note: Tkr = tanker, BC = bulk carrier, LPG = Liquefied Petroleum Gas, Lm = Lane metres

The maximum and minimum percentage price changes are shown in bold and highlighted in yellow. It can be seen that there is a huge variety of differing trends between both ship types and different sizes of ship, which is consistent with the fact that there are a range of factors which influence price as stated by Korea previously.[23] For example:

- **At end 1999 compared to end 1998**: The largest (VLCC) tanker prices had dropped by 5 per cent whilst the two smallest (Panamax & Handy) showed no change; The largest bulk carrier had *risen* by 6 per cent whereas the Handymax had risen by nearly double that at 11 per cent; the 3,500 teu container ship price had *dropped* by 10 per cent whereas the 725 teu and 2,750 teu prices had *risen* by 4 and 6 per cent respectively.

- **At end 2002 compared to end 2001**: The largest (VLCC) tanker has dropped by 9 per cent whereas the smallest (Handy) has risen by 3 per cent; the Capesize Bulk carrier had risen by 1 per cent whereas the strongest rise was shown by the Panamax bulk carrier which had risen by 5 per cent; the two smallest (750 teu and 1,000 teu) container ships had shown no change whereas the price for the largest (6,200 teu) had dropped by 17 per cent; the price for the larger Ro-Ro remained stable whilst that of the smaller vessel dropped by 3 per cent.

Virtually every year shows examples of differences like these. There are also certain common overall trends often reflecting world-wide macro-economic factors, e.g., all prices showed decline between end 1997 and end 1998 and all prices showed an increase between end 2002 and end 2003 but even then the strength of movement varied from –6 per cent to –26 per cent from 1997 to 1998 and from 3 per cent to 35 per cent from 2002 to 2003. In other years the trend is mixed with some ship series showing prices rising and others showing prices dropping but still with significant differences in absolute percentage change.

To clarify that this variability has existed across the whole time period, the maximum variations from the 21 price series for each of the yearly comparisons are:

- 1997 v 1996: -9% to +4%
- 1998 v 1997: -6% to –26%
- 1999 v 1998: -13% to +11%
- 2000 v 1999: -7% to +26%
- 2001 v 2000: -17% to 0%
- 2002 v 2001: -17% to +5%
- 2003 v 2002: 3% to 35%

[23] Korea Exhibit 70, Korea response to Panel Question 124 and 125.

These are enormous variations that cannot be dismissed on the basis of gross, macro-level pricing charts. As Korea has pointed out in many instances regarding the EC's assertions, such a superficial level of analysis as the EC offers here would never be accepted from a domestic investigating authority and it follows that the Panel cannot base its own decision on such misleading generalities. The EC's generalized assertions conceal more than they reveal.

163. (a) For each ship category, in practical terms how substitutable are different sizes/configurations (containment systems, in the case of LNGs)? Are there specific evidence/examples in the information before the Panel? In addition, please furnish relevant portions of the industry publications discussed at the second meeting. (For example, one industry expert referred at the meeting to one of the industry publications that contains information relevant to cross-price elasticities).

(b) Can the EC cite specific instances/situations in the information before the Panel where a shipowner has purchased and used a larger-than-usual ship for a particular run, due to a relatively low price for the larger ship?

Comments on the EC's new factual information

Korea refers to its comments above as regards the factual information submitted by the EC in response to Questions 159 and 162.

The EC attempts to allege that the establishment of cross-elasticities must be assessed independently from demand factors because allegedly demand has been disconnected from price because of overcapacity. It then tries to assert that there is cross price elasticity by comparing the price development for one *single* type of tankers (Panamax tankers) by comparing the price development for this single ship type against the development of a price index for a non-specified scope of vessels but which seems to cover many different ship types including those that are not concerned by the present proceeding. In fact, however, Korea has argued all along that several factors contribute to the price level for vessels including demand.[24] At the same time, it is a gross exaggeration to assert as does the EC that for the purpose of determining price elasticities, the demand factor must be neutralized because of the existence of overcapacity. Thus, for the example of Panamax tankers chosen by the EC itself, pages 4 and 5 of Exhibit EC – 152 show an increase in orders from 2002 to 2003 and a corresponding increase in prices, alleged overcapacity notwithstanding.

The demonstration by the EC for one single vessel type is neither a complete response to the Panel's question nor representative of the vessels concerned by the present proceeding. This is true all the more because significant confusion has always existed in the EC's definition of the product and chemical tankers concerned by this proceeding and it is not clear to what extent the Panamax tankers referred to in Exhibit EC – 152 coincide with the combined product and chemical tankers that the EC claims to be the subject of the present proceeding. In addition, however, there are significant flaws in the EC's presentation, i.e.:

- The EC has used the example of a Panamax tanker which it cites as having 'little change in demand but significant movement in price' but this is not corroborated by the data on Pages 4 and 5 of the Exhibit EC – 152.

- Page 4 and 5 of Exhibit EC – 152 show that for Panamax tankers, the ordering trend for Apr 2004 (year to date orders) against last year is shown as '*down by 19 per cent*' and the order

[24] As last reiterated in Korea's response to Panel Questions 124 and 125.

volumes in both dwt and cgt[25] in 2003 are shown as, respectively, *'77 per cent and 82 per cent up'* on the levels of 2002. This does not indicate a condition of constant demand.

- Figure 2 shows a line which is by no means constant[26] and moreover month on month order levels changes are not usually treated as significant trends in themselves.

- The trend is shown over a short time period of one year, during a period where all prices were seen to be rising to varying degrees.

- In Figure 3, the EC plots the Panamax price against the FMI newbuilding price index, to try and demonstrate a correlation with overall shipbuilding price movements. The detailed basis of construction of the FMI index is not known, but Korea has indicated before that price indices need to be used with extreme care. To demonstrate this, attention is drawn to the Clarkson's price index on Page 8 of Exhibit EC – 152, where at the end of 1996 and the end of April 2004 the index is shown to be the same (at 133) but the prices for the various ship series are in fact significantly different – the most extreme being the Capesize bulk carrier at $39 million at the end of 1996 and $56 million at the end of April 2004. The correlation (or otherwise) of a particular ship series with a price index is not an indication that price movements or levels are constant within or across ship types and sizes.

166. (a) For each of the three ship types, what specific evidence/examples are there in the information before the Panel (in addition to the domestic complaint by Samsung against Daewoo) that the restructured shipyards were the price leaders among the Korean producers?

(b) What evidence is there in the information before the Panel in support of the EC argument that the alleged restructuring subsidies enabled the restructured yards to drive down the prices charged by all other Korean shipyards?

(c) What has been the annual financial performance of the other (non-structured) Korean shipyards since the restructuring?

Comments on the EC's new factual information

Acknowledging that there is no responsive information currently before the Panel, the EC attempts to rely on new information in Exhibit EC – 152 that was *not* already before the Panel. The EC thereby fails to appropriately and accurately respond to the Panel's question. In any event, Korea notes that the data shown at page 16 of Exhibit EC – 152 shows only the **total** output in 2003 or **total** orderbook as at April 2004 for each yard (recognizing again the near uselessness of the orderbook for calculating annual market shares). It therefore does not provide any information regarding the respective market shares in each of the different ship types as requested by the panel. Because the data is across ship type, the ranking is based on the cgt figure, which allows the workload of different types of ships to be aggregated. This gives no actual reflection or measurement, however, for the respective market position of the restructured yards for the ship types subject of the present dispute. Most importantly, it gives no support at all to any argument that the alleged *subsidies* resulted in price leadership. Indeed, it demonstrates that the EC has abandoned this critical causal link. Hence, as Exhibit EC – 82 as well gives no evidence on an alleged price leadership specifically of the restructured yards and, in particular, in a causal fashion that somehow affected the un-restructured

[25] Information on page 5 of the Exhibit.
[26] The source of this monthly data does not seem to be in this Exhibit EC – 152.

Korean yards in a special manner of some sort, the EC has failed to provide any evidence as requested by the Panel. [27]

Korea refers to its comments to the Panel Question 162 regarding the EC's claim in paragraph 162 that low prices have a contagious effect in shipbuilding. On a point of detail, the EC also makes an error in interpreting the extract from Exhibit EC – 82 when it asserts that three of the five big chaebols referred to are restructured shipyards. The reference to the 5 big chaebols is to Hyundai, Daewoo, Samsung, Hanjin and Halla, of which only 2 are (the antecedents of) restructured shipyards – Daewoo and Halla.

168. The parties disagree as to whether APRGs constitute export credit guarantees and whether PSLs constitute export credits. Please provide any documentation (either from the shipbuilding industry, the OECD, or any other source) that you consider supports your position on these issues.

Comment on the EC and US new factual information

The EC cites the so-called Knaepen Report to support its narrow reading items (j) and (k), first paragraph, of Annex I to the *SCM Agreement*. However, this illustrates the issue of the impropriety of making the WTO subservient to the OECD for interpretation of WTO treaty language. In its response, the EC acknowledges that the OECD was silent on the point of calculating premia at the time of conclusion of the Uruguay Round. But the EC offers *its interpretation* of a later OECD agreement to the effect that only reference to the buyer-country is used and therefore this later OECD agreement should be binding on the interpretation of items (j) and (k), first paragraph.

First, Korea does not agree with the interpretation put by the EC on the Knaepen Package which merely sets guidelines for determining premia in the case of an export country risk but does not state what other risks can occur in case of an export credit. There is nothing in the language that compels a limitation in terms of risk factor or recipient of the facility. The EC also ignores the fact that, as Korea demonstrated in its answer to Question 168, many WTO Members (including a number of EC Member States) issue just the sort of credits and guarantees as provided by KEXIM. These take into account a number of risk factors, but explicitly state that they take into account buyer political factors regardless who the direct recipient of the instrument is. As was also demonstrated by Korea in its answer, there is no limitation based on whom is the recipient of the credit or guarantee. Indeed, it would create a huge loophole to do otherwise. In light of the EC's stance and the evidence Korea has submitted, Korea must once again ask the question: is the EC admitting on the record that it considers its Member States to be offering prohibited export subsidies?

Second, even if one were to agree *arguendo* with the EC's interpretation of the Knaepen Package in the context of the OECD, such an OECD interpretation cannot bind the whole of the WTO Membership. It illustrates perfectly the fallacy of the EC's approach. According to panels and the Appellate Body, the narrow exception of item (k), second paragraph, applies to the OECD Arrangements even though the OECD is not mentioned. This has been both troublesome and controversial given the narrow base of OECD Membership. However, to try to claim that this narrow group can self-define on behalf of the whole WTO Membership the meaning of other **WTO** treaty terms such as those in items (j) and (k), first paragraph, is unacceptable. The WTO is not subservient to the OECD. Whatever might be the OECD's role under the narrow exception of item (k), second

[27] To avoid any possible confusion, Korea would like to clarify that the columns headed Capacity* at page 16 of Exhibit EC – 152 is not an assessment of capacity in accordance with OECD accepted guidelines. The footnote qualifies that the first three columns provide details of the number of building berths and docks and maximum length of these, the fourth column is the largest individual vessel built at the yard measured in gross tons since 1991, and the fifth column is the maximum annual output in CGT since 1991 which can still be considerably less than the capacity.

paragraph, that is the extent of its legal authority with respect to the WTO treaty.[28] The OECD's remit does not in any manner go to defining the WTO treaty terms in a manner binding on the DSB and the WTO Membership.

Furthermore, without some sort of dispute resolution mechanism within the OECD, there is simply no basis for stating that the OECD has assigned a certain meaning to a term. The EC and its Member States do not control the interpretation of OECD provisions. If another OECD Member such as Korea disputes the interpretation of OECD language being offered by another OECD Member such as the United States or the EC Member States, then this Panel cannot simply take the EC's word on it for what the OECD Arrangement provides. That is one of the many reasons why the Panel must interpret such terms as "export credits" or "export credit guarantees" on the basis of their ordinary meanings, not on a self-serving interpretation of the OECD Arrangement offered by the EC.

The United States submits some responses from the US Ex-Im Bank in response to the Panel's question. Korea notes that the US takes a much narrower approach to defining terms than it has in other contexts in the WTO.[29] But, perhaps not -- Korea notes that the response is quite strictly phrased as that of the US Ex-Im bank and not the US government as a whole. The submission concludes: "Because the Ex-Im guarantee covers the risk of the US exporter, rather than the foreign buyer, Ex-Im does not consider this program to be an export credit within the meaning of the OECD Arrangement." (Emphasis added) This answer may be all that Ex-Im is legally permitted to expound upon, but it is not responsive to the Panel's question. It also illustrates the difficulty with the EC's response as well. The question was whether it is an export credit *within the meaning of the WTO treaty, not the OECD Arrangement*. The US answer is illuminating, but more for what it does not say than what it does.

173 (a) For each of the three ship types at issue in this dispute, how are ship data normally maintained by the industry, and by industry analysts?

(b) In particular, are these three categories of ships recognized and used routinely for purposes of industry analysis?

(c) If so, how are they defined, and for what purposes are these categories used?

(d) When analysts report on pricing trends, do they normally refer to prices for each category as a whole, or for subcategories thereof, broken out, for example, by size and/or other characteristics.

(e) If they provide a range of pricing information at different levels of aggregation, how are these different data series used?

(f) Please provide documentation (including in particular relevant excerpts from the published industry reports discussed at the second meeting) showing examples of the various breakouts to which you refer.

[28] Korea also notes that extreme caution must be exercised on this issue of what the OECD Arrangements mean. Korea has had to illustrate to the Panel a number of instances when the EC has cited documents that do not reflect a consensus within the OECD. Even worse, the EC has attempted several times to cite OECD Secretariat language that the EC would (at least in instances when it is convenient) have the Panel refer to as controlling interpretations of WTO treaty language. Often it is not even clear if it is an official OECD Secretariat view or that of some individual staff members. Certainly OECD Secretariat views cannot be considered controlling; indeed, regarding the WTO treaty, they cannot be considered authoritative.

[29] See Korea First Submission, para. 275, footnote 177, citing: www.fas.gov.itp.wto.disciplines.htm.

Comments on the EC's new factual information

Lloyd's Register in Exhibit EC – 155 groups their ship type categories of:

- 'Chemical/oil products tanker' under the basic grouping of Chemical vessels. It is clear from this that it is the intention that this category would comprise vessels with chemical capability and hence an IMO Chemical Class.[30]

- 'Oil products tankers' under the basic grouping of Oil along with Crude oil tankers.

Additionally, it should be noted that Clarksons, in their publications and databases which are referred to by FMI (including Exhibit EC – 152), classifies its oil and chemical tanker data as follows:

- **Tanker** - refers to an uncoated vessel, i.e. cargo tanks are not coated
- **Product tanker** – refers to a coated vessel, i.e. cargo tanks are coated
- **Chemical and oil carriers** - refers to vessels with some form of IMO grade tanks (IMO I to III)

It is clear that these two reputable industry data sources, submitted as Exhibits by the EC, both consider vessels with any chemical capability to be a separate category to oil tankers and specifically to products tankers.

The EC and FMI have, however, chosen to ignore this and to try to group together some vessels with chemical classification with oil products tankers. Thus, they have artificially separated some chemical vessels from others and separated oil products tankers from other oil tankers such as crude tankers. Their categorization and analysis does not therefore reflect the main industry sources that they have, themselves, identified here. The classification used by FMI and the EC does not, therefore, broadly follow this taxonomy as claimed, and in the case of product/chemical tankers actually cuts right across it.

The above comments make it clear that the ship price series referred to by the EC in Exhibit EC – 152, do not include price trends for chemical vessels.

The EC also erroneously describes the price index published in Exhibit EC – 152 on page 8 'Shipbuilding Price Trends' as one relating to the average movement of tankers and bulk carriers when it is in fact constructed from price movements on a wider range of ship types including, as confirmed by Clarksons, tankers, bulk carriers, container ships and other dry cargo ships. Korea's previous comments on the caution required when using price index data are corroborated by this fairly basic error made by the EC and its advisors who seem, in fact, to place such store on this one data source to the exclusion of others.

174. Korea argues that demand should be measured in numbers of vessels, and/or workload years (i.e., order backlog) rather than compensated gross tons of new orders. The EC responds that CGT is more accurate as a measure of supply and demand, and that even measured in workload years, demand trends are as represented by the EC.

(a) Could each party explain the technical differences between the two measures, and provide further detail as to why it believes its preferred measure represents a more accurate picture of demand than the other.

[30] Korea has already noted that it is always necessary to be alert to the possibilities of anomalies caused by data input errors or misreporting.

(b) Which measure is used by industry analysts and the industry when analyzing demand trends?

(c) If both are routinely used, please explain the circumstances in which they are used, and provide examples from independently prepared sources (the published industry reports discussed at the meeting, OECD documents, etc.).

Comments on the EC's new factual information

The Exhibits referred to by the EC do not support the conclusion drawn by the EC. Whilst the EC in referring to Exhibits EC – 152 and 155 has highlighted that there are a range of units provided which are used according to the requirements of the analysis, (as stated also by Korea[31]), there is a significant difference between stating that *CGT is almost solely used in relation to shipbuilding* and inferring that it is also the *only* measure used in shipbuilding. The EC makes reference to the OECD use of the measure in capacity evaluation in Exhibit EC – 151, which is entirely appropriate, as it relates to capacity and cross sector capacity-demand balance. However, it makes no reference to the OECD's use of other measures such as, for example, in their own shipbuilding information statistics which show numbers of vessels, gross tons and CGT as is demonstrated in the OECD statistics on ship production, exports and orders in 2003 (Document C/WP6/SG(2004)5 of 2 May 2004 of which excerpts are submitted herewith in Exhibit Korea – 153).

The EC is wrong in paragraph 189 to infer from its reference to Exhibit EC – 151, that 'The number of ships is of limited statistical significance in statistical analysis of either the shipping or the shipbuilding industry….'. For example: it does not seem to recognize that one of the two main elements of shipbuilding demand – replacement demand – has to be based on an analysis of the numbers of ships likely to be taken out of service over a given time period.

Any analyst recognizes that there is a huge difference between a shipyard that has an orderbook or annual output of 150,000 cgt comprising:

- a single vessel e.g. 120,000 cgt cruise ship
- 3 large crude oil tankers e.g. 316,000 dwt VLCC
- 6 large oil product tankers e.g. 72,00 dwt product tankers
- 12 small bulk carriers e.g. 30,000 dwt bulk carriers
- a mix of more sophisticated ship types e,g. Ro-Ro, cable layer, ferries

All of the above options could equate to the same cgt value but a very different workload or order portfolio.

175. In response to EC arguments concerning market share as a factor in price leadership, Korea variously states that market share does not demonstrate price leadership, but also that Korean yards' market shares are too small for them to be able to influence prices. Both sides thus seem to view market share as somehow relevant to the question of price leadership.

(a) How (on the basis of what sort of concrete data and analysis) can price leadership be determined/established?

(b) What role in such an analysis would levels and trends in market shares play?

(c) How large a market share would a given market participant need to be able to exercise price leadership.

[31] Korea's response to Panel Question 173 b).

Page 16 of Exhibit EC – 152 refers to capacity but, as mentioned in Korea's comments to Panel Question 166, not in any terms that are used by the OECD. In addition, any reference to existing capacity does not mean that there is any excess capacity as such that would explain, as the EC tries to portray, a fierce price competition among Korean shipyards triggering price depression or suppression, let alone prove that the subsidies themselves caused the price depression or suppression. Finally, the so-called *capacity* shown in the relevant page is global capacity and not, as the EC tries to portray, capacity *in the market sectors concerned by the present proceeding*. Hence, this data cannot, in any event, support the view that excess capacity caused price depression or suppression for containerships, product and chemical tankers or LNGs.

As mentioned above, paragraph 10 of the OECD document supplied by the EC has been vigorously contradicted by Korea and China (*see* Korea's comments to Panel Question 162).

Finally, whether in Exhibit EC – 82 or in Exhibit EC – 157, reference is made to the Korean shipyards as a whole and not to each of the three restructured shipyards individually. Thus, the EC has not responded to the Panel's question in particular in subsection (c) thereof. But, in addition, there is nothing in these documents to support the view that the subsidies themselves caused price depression or suppression. Even if there were excess capacity on the part of the Korean yards that did not undergo restructuring that would have brought these yards to lower prices (which Korea disputes), this would still not demonstrate that the subsidies granted to the allegedly restructured yards caused price depression or suppression, all the more that there are other large shipyards on the market that participated vigorously in the bids for the vessels concerned by this dispute.

List of Exhibits

Exhibit Korea – 140	**Letter by ABN-AMRO re country risk premium**
Exhibit Korea – 141	**Anjin comments on the PwC analysis in Exhibit EC – 145**
Exhibit Korea – 142	"Background report – Detailed evaluation of key price movements" prepared by the EC's consultant, FMI, in August 2003
Exhibit Korea – 143	KEXIM report regarding the incompatibility between credit and corporate bond ratings
Exhibit Korea – 144	**KEXIM's list of PSLs (excerpts)**
Exhibit Korea – 145	**Corrigendum to the EC's recalculation on Samho**
Exhibit Korea – 146	**Corrigendum to the EC's recalculations on DSME**
Exhibits Korea – 147	**Corrigendum to the EC's recalculations on Hanjin**
Exhibit Korea – 148	**Corrigendum to the EC's recalculations on HHI**
Exhibit Korea – 149	**Corrigendum to the EC's recalculations on Mipo**
Exhibit Korea – 150	**PSL duration for each instalment disbursement**
Exhibit Korea – 151	Korea Development Bank's Notices on termination of DSME workout
Exhibit Korea – 152	Absence of supply-side substitutability as demonstrated in Exhibit EC – 152
Exhibit Korea – 153	OECD statistics on ship production, exports and orders in 2003, C/WP6/SG(2004)5 of 2 May 2004 (excerpts)

NOTE: Exhibits containing Business Confidential Information are shown in bold hereinabove.

ANNEX G-6

COMMENTS OF KOREA ON THE RESPONSES BY THE EUROPEAN COMMUNITIES TO SUPPLEMENTAL QUESTIONS

(23 July 2004)

II. TO THE EC

A. APRG/PSL

187. Please comment on Korea's recalculations of benefit in Exhibits Korea - 91-102.

Korea's comments

Please refer to Korea's comments on the Panel's Question 136 to the EC at pages 16 to 23 of Korea's submission of 9 July 2004.

B. ALLEGED ACTIONABLE SUBSIDIES

188. Concerning the question of whether the restructuring of Daewoo was subsidized, please provide a summary, based on all of the submissions of Arthur Andersen/Anjin and PwC, of the EC's analysis and conclusions in respect of whether DHl should have been liquidated instead of restructured. In this summary, all relevant figures should be shown in tabular from, with cites and cross-references to the original Arthur Andersen report of November 1999 assessing the value of DHI under various scenarios.

Korea's comments

Nothing in Exhibit EC-158 (PwC's Report) establishes that DHI should have been liquidated instead of restructured. Despite all of the analyses which PwC attempted to build in its various reports, PwC continuously concludes that the going concern value of DHI was greater than the liquidation value or that "it is not clear" that the going concern scenario, after taking into account the correction for the tax shield effect, would have remained the preferred solution.

In any event, PwC's assertions are based on a mis-presentation of facts and an application of finance theory that makes no sense. Exhibit Korea-141 (Anjin's 2nd Response) clearly demonstrates that the restructuring of DHI was the best solution for the creditors. In addition, Korea submits as **Exhibit Korea – 154** Anjin's 3rd Response, dated 23 July 2004, to the PwC's report (Exhibit EC-158).

189. Concerning the Daewoo restructuring:

(a) Concerning the most recent PwC submission (Exhibit EC - 145), please explain in detail the statement at page 3 that the Anjin analysis indicated "that the

Enterprise Value of the restructured company is lower than the Enterprise Value of the company computed without debt restructuring".

(b) What is "enterprise value" and how does it differ from "going concern value"?

(c) What is the significance of the fact that the "enterprise value" was lower under one set of calculations than under another? How if at all does it affect the central issue raised by the EC, namely the decision to restructure instead of liquidate Daewoo?

(d) What is the significance of Anjin's reply in Exhibit KOR-7O that enterprise value was reduced under the analysis of the restructuring scenario from what it had been under the valuation of tile non-restructured company? What if anything is the significance that enterprise value calculations differed under two scenarios for the central issue posed by the BC, namely whether it was better to liquidate or to restructure Daewoo?

Korea's comments

Please see Section III.2 of **Exhibit Korea – 154** (Anjin's 3rd Response) for detailed comments on the EC's reply.

As explained in the above section, the EC is trying to mislead the Panel by concealing the fact that the debt-to-equity swap contemplated in the DHI restructuring reduced the enterprise value of DHI as a restructured company by increasing the Weighted Average Cost of Capital (the discount rate). Contrary to the EC's allegation, Anjin (Arthur Andersen)'s calculation of the enterprise value was accurately made in accordance with the finance theory and there was no underestimation or overestimation.

Consequently, the EC's allegation that Arthur Andersen suddenly took into account the value of the remaining DHI's assets in order to come up with a post-restructuring enterprise value that is higher than the pre-restructuring value, is totally without merit. Moreover, Korea has demonstrated, as supported by Anjin's report (Exhibit Korea-141), that the size of any recoverable amounts from the remaining DHI does not make any difference in the comparison between the going concern value and the liquidation value, because the same estimated recoverable amount was incorporated into both the going concern value and the liquidation value. Please see also section III.2.2 of the **Exhibit Korea-154**, Anjin's 3rd Response.

The EC argues that the liquidation value of **[BCI: Omitted from public version]** was a "new fact". However, this figure was not a "new" fact. As explained in Section III.1.1 of **Exhibit Korea- 154** it was already presented in the 1999 Arthur Andersen Report (Appendix 11). This means that when the creditors considered all the valuations presented by Arthur Andersen in the 1999 Report, they also considered the amount of **[BCI: Omitted from public version]** which was mentioned in that Report.

In fact, the 1999 Report, as analysed and clarified by PwC and Anjin in their numerous reports submitted to the Panel as exhibits, clearly demonstrates that this 1999 Report was a thorough and comprehensive report based on in-depth analysis and gave the creditors reliable information in deciding on the restructuring of DHI. The 1999 Report shows that, when it made its assessment, Anjin considered carefully all the relevant data and circumstances relating to the Korean economy, shipbuilding industry and individual shipbuilders, as well as the business plans of DHI, in order to provide an objective and independent assessment of the real situation of DHI and of the various options available to the creditor financial institutions. Therefore, the creditor banks acted prudently

when they decided on the DHI restructuring taking into account the findings and recommendations contained in the 1999 Report.

190. The data presented in Exhibit KOR-108 show interest and depreciation expense in the cost/profitability analysis for Daewoo. Please comment. How can this be reconciled with the EC's assertion that these costs have not been adequately reflected in Daewoo's prices?

Korea's comments

(i) With regard to paragraph 9 of the EC's response:

Please see the document entitled "Response to Para. No. 9" in **Exhibit Korea – 155** (KPMG's Supplemental Response) for comments on this paragraph.

(ii) With regard to paragraphs 10 and 11 of the EC's response:

Please see "Response to Para. Nos. 10 and 11" of **Exhibit Korea – 155** for comments on paragraphs 10 and 11.

(iii) With regard to paragraph 12 of the EC's response:

As conceded by the EC itself, KPMG has compared the cost estimates or assumptions made by FMI with the real costs incurred by DSME. KPMG has found that FMI's cost estimates/assumptions were extremely higher than the real costs.

Of course, the real costs incurred by DSME were based on the debt situation of DSME after the debt restructuring was made, as the actual construction of the vessel was carried out after the debt restructuring in October 2000. Nevertheless, contrary to the EC's allegation, KPMG also confirms that, even if the pre-restructuring debt alleged by the EC had been taken into account, DSME could have offered the price of **[BCI: Omitted from public version]** that would still have yielded revenue and profit (see section 2.5.4 of Exhibit Korea-108 (KPMG's Cost Analysis Report)). KPMG has confirmed that the ordinary income from the three LNG carrier projects ranged from 18.8 per cent to 28 per cent of the sales revenue. Under these circumstances, even if the "pre-restructuring" debt servicing costs alleged by the EC were reflected in the DSME's cost base, the projects would still have generated a substantial ordinary profit.

This means not only that the FMI's "cost estimation or assumption" bears no relationship with reality and that it is useless for providing any sort of indication or guidance as regards DSME's actual costs, but also that there was no causal link between the alleged subsidy granted to DSME and the actual prices for the LNG carrier projects.

(iv) With regard to paragraph 13 of the EC's response:

Please see "Response to Para. No. 13" in **Exhibit Korea – 155**.

(v) With regard to paragraph 14 of the EC's response

Please see "Response to Para. Nos. 14 and 22" in **Exhibit Korea – 155** for comment on paragraph 14.

(vi) With regard to paragraphs 16 and 17 of the EC's response:

Please see "Response to Para. Nos. 16 and 17" in **Exhibit Korea –155**.

(vii) With regard to paragraphs 17 to 21 of the EC's response:

Please see "Response to Para. Nos. 17 - 21" in **Exhibit Korea– 155** for detailed comments on these paragraphs.

(viii) With regard to paragraph 22 of the EC's response:

Please see "Response to Para. Nos. 14 and 22" in **Exhibit Korea – 155** for comments on this paragraph.

(ix) With regard to paragraph 23 of the EC's response:

Efficiency is achieved not only by investment in facilities, but also by the increase in the productivity of the workforce, development of efficient management systems and other similar intangible improvements in the building process. Korean shipbuilders are known to be particularly efficient in terms of these latter factors. Shipyards which are efficient in this sense would have a low level of the "contract specific cost" which the EC includes in the category of "other direct costs."

Moreover, although it may be true that DSME made some capital expenditures towards building LNG carriers, DHI began to make such investments already in the early 1990's. Therefore, FMI's assumption that DSME made all of capital expenditures when it procured the LNG contracts in 2000 is not correct. Furthermore, KPMG has confirmed that the actual cost of investment incurred by DSME was far lower than what has been assumed by FMI based on its experience with the European yards.

In any event, as a matter of principle, it is incorrect to attribute to Korean shipyards the costs of the European shipyards as was done by FMI since the cost structure of Korean and EC shipyards is totally different.

(x) With regard to paragraph 24 of the EC's response:

Again, in this paragraph, the EC is trying to impose the European yards' cost model upon DSME. There is no point in this line of argument in a situation where an independent accounting firm has confirmed that the cost structure suggested by FMI based on the European model was totally different from the actual cost structure of DSME.

Contrary to the EC's allegation, KPMG did not say that these costs did not exist at all in DSME. In Exhibit Korea-108, KPMG indicated that the cost items mentioned by FMI (i.e., "cost of investment" and "contract specific costs") were included in the DSME's cost items under different account names (e.g., "repair expenses" and "depreciation" for "cost of investment", "overhead costs" and "SG&A expenses" for "contract specific costs"). Please see section 2.5.3(3) b. and c. of KPMG's Cost Analysis Report (Exhibit Korea-108). In addition, KPMG has confirmed that, in any event, the amounts allocated by FMI to these costs were significantly higher than the actual costs confirmed by KPMG from DSME's accounts.

(xi) With regard to paragraph 25 of the EC's response:

The EC presents no plausible basis to support its doubts regarding the accuracy of the ordinary income margin as confirmed by KPMG. However, the ordinary income of DSME is a "fact" that cannot be denied by a mere suspicion. From the viewpoint of inefficient European yards, it may look unrealistic that the Korean yards are making such high profits. But it should be noted that the outstanding performance by the Korean LNG yards has been made possible by such a profitability.

191. Exhibit KOR-107 sets forth the results of the court-ordered/supervised restructuring of Daedong. Presumably, such a restructuring had to proceed in accordance with Korean bankruptcy law. On what basis does the EC allege that nevertheless it involved a subsidy?

Korea's comments

The EC fails to acknowledge that the decisions to restructure a bankrupt company within the bankruptcy proceeding are made by the bankruptcy court, not by the creditors. Korea has demonstrated that, although a creditor bank may participate in the bankruptcy proceeding as members of the interested parties' meeting, it can neither take nor control the decision to restructure the company under the Korean law. In such a legal system, the EC fails to explain how the restructuring decision made by the bankruptcy court can constitute a subsidization by a creditor.

Moreover, the EC does not explain what "market" it refers to, when it says that a benefit may exist if the terms of the restructuring are more favourable than what would be obtained in the "market" even within a bankruptcy proceeding. In the court receivership proceeding, the restructuring has to proceed in accordance with the bankruptcy law. The bankruptcy court initiates the proceeding and approves the restructuring plan only when the going concern value of the company has been determined to be greater than the liquidation value. Other than this, the Korean bankruptcy law does not require the bankruptcy court to look into any "market" in approving the restructuring plan. Indeed, it does not make sense for the EC to suggest that a Korean bankruptcy court should try to find a benchmark for a restructuring procedure of a particular corporation where such argument is unheard of for any bankruptcy proceeding in any jurisdiction. In fact, there is no "market" that the court can refer to when it determines the restructuring plan, because the restructuring plan, in nature, has to be tailored to the specific situation of a particular bankrupt company.

In any event, the EC has failed to prove that the terms of the restructuring of Samho and Daedong were more favourable than what would be obtained on the "market" (whatever that may be) within the specific bankruptcy proceeding for these companies.

C. SERIOUS PREJUDICE

192. One conclusion that might be drawn from Exhibits KOR-91-102 is that Korea accepts that there is a benefit from the KEXIM financing at issue, but that the benefit in a number of cases is quite small (0.5 per cent or less). If one accepts that the benefit is of the magnitude reflected in these Korean exhibits, what would be the implications for the EC's serious prejudice analysis and conclusions?

Korea's comments

At the outset, Korea notes that it was offering the referenced analysis in the alternative. Korea does not in any manner accept the EC's premise that there was a benefit provided. In Korea's view, the EC has utilized incorrect benchmarks and analytical approaches. However, Korea has endeavoured to show that, even using such flawed data, the EC's calculations result in a *de minimis* level of subsidization. It is in the nature of cases such as this where there are a great many issues dependent on previous affirmative findings by the Panel that, in the absence of knowing ahead of time whether the Panel has made such affirmative findings on specific issues, Korea has felt compelled to respond to many EC allegations that Korea considers should be moot but cannot *assume* to be moot for purposes of presenting its case. It is also in the nature of such cases, that this arguing in the alternative is a burden that weighs particularly heavily on the respondent. Korea considers it very important that none of its arguments in the alternative be taken to mean that it accepts the EC's arguments on prior elements of the case.

Keeping the above-qualifications in mind, Korea notes that the EC continues to allege in its response that the KEXIM financing allows Korean shipyards "to offer a lower price than competing shipyards or to otherwise provide the most attractive contract terms for the buyer" and would thus "significantly strengthen the ability of KEXIM-subsidised shipyards to maintain their capacity (and the low prices in the market) when they would otherwise exit the market or reduce capacity".

Korea notes that there is not even an attempt on the part of the EC to adduce evidence in support of its response to the Panel's question. Neither does the EC respond to Korea's arguments in its comments to this Question as set forth in Korea's submission of 9 July. In short, for the Panel's convenience, these comments were the following:

- the conditions at which KEXIM financing was extended became more expensive as is recognized by the EC – these more expensive conditions (i.e., no longer a "benefit") cannot, therefore have led to price suppression or depression;[1]

- qualitative effects of an alleged subsidy only are insufficient when Article 6.3(c) of the *SCM Agreement* requires to demonstrate that the alleged subsidies have had a *significant* price depressive or suppressive effect, thus requiring a quantification;

- the very small benefit that the EC has been able to allege through the KEXIM financing is totally out of proportion with the range of the price depression and/or suppression margin that the EC alleges – there is no significant price depression and/or suppression caused by the alleged KEXIM benefits, all the more since the EC recognizes a very substantial cost advantage to the Korean shipyards vis-à-vis the EC shipyards;

- the EC fails to demonstrate that the alleged subsidies as such (rather than the products) have caused significant price depression and/or suppression though this is required under Article 6.3(c);

- even if one were to consider the effect of the products rather than that of the subsidies, the EC makes price depression and/or suppression allegations for the Korean commercial vessels at large in spite of the fact that the evidence demonstrates that KEXIM financing was *not* granted for many of the vessels sold thereby disproving that the financing kept in place capacity that would otherwise have exited the market;

- allegations in relation to price undercutting that the EC itself abandoned cannot be reintroduced under the guise of establishing price depression/suppression;

- EC subsidies of a substantially higher level are afforded to the EC shipyards overwhelming and displacing any effect of the alleged Korea subsidies - it would be impermissible to attribute to the Korean subsidies effects that were actually caused by the much larger EC subsidies.

193. Exhibit KOR-112, concerning MOCIE's intervention at the request of Samsung, could be viewed as indicating that the government takes action if prices are too low. If this is the case, what are the implications for the EC's serious prejudice claim?

Korea's comments

Korea stands by its earlier explanation of MOCIE's actions. Please refer to Korea's comments on this Panel Question, submitted on 9 July 2004.

[1] Korea would like to recall its overall arguments regarding evidence in the context of injury-type investigations, that it is necessarily the case that the most recent periods are the most relevant.

However, it is with interest that Korea notes the EC now is forced to deny the role for MOCIE that the EC itself alleges. If the EC's allegations regarding MOCIE were to be considered correct, then the MOCIE intervention indeed does undercut the EC's serious prejudice claim. The EC cannot have it both ways.

194. If the Panel were to accept the product subdivisions set forth in Exhibit KOR-109, how would this affect the EC's analysis of price suppression/depression? Please respond in detail.

Korea's comments

The EC's answer has begged the Panel's question. Instead of responding to the question, it attempts to make claims contradicting its former statements, hiding between a wall of generalization whilst making disparaging remarks without purpose or substance. Korea reads this lack of substantive response and mix of contradictory claims to demonstrate that the EC does not wish to answer the Panel's question because it will corroborate Korea's approach and claims.

(i) With regard to paragraph 30 of the EC's response

The EC now confirms that a larger ship costs more than a smaller ship and that economies of scale mean that parametric unit prices reduce as ships get bigger. This is precisely what Korea has been arguing: by amalgamating ships of different sizes, prices are taken into account that are not comparable because they reflect ships that are widely different in size. This cannot yield an accurate portrayal of price trends. Whether for price undercutting, price depression or suppression, prices for different sizes of ships are widely different and cannot be compared in order to derive an accurate price trend.

The EC further implies that work content is the only measure relating to shipbuilding whilst cargo-carrying parameters relate only to shipping. The shipbuilding market comprises suppliers and customers and the customers are shipowners who deal in cargo measures, hence cargo measures are part of the shipbuilding market, as well as the shipping market. Shipbuilding demand *has* to be calculated from a basis of cargo measures because that is the demand driver which underpins the requirement for ships (i.e, ships are required in order to carry cargo). Following the projection of demand in cargo measures, because of the differing cargo measures used for different ships, cargo measures are converted into CGT, using assumptions on vessel size mix distributions. This is done to allow the aggregation across different ship types that is necessary to calculate total demand. Shipbuilding capacity cannot be calculated separately by ship type[2] and hence it is not possible to undertake supply-demand balance analysis at ship type level. Thus, the EC's reliance on CGT is inconsistent with its own suggested three-way segmentation of the market.

The EC's view that price should be considered solely on a parametric basis of CGT would imply that price is considered only to be influenced by the aggregate supply-demand balance or by supply side work content criteria and that price will vary directly in relation to CGT for all sizes of vessels of a given ship type. Hence, the EC now seems effectively to be saying that material resources have no impact on the ship prices[3]. This in turn would imply that the demand side criteria, such as the earnings capacity of the ship, have no influence at all on the investment price that an owner will

[2] This inability to segment shipbuilding capacity by ship type is the non-homogeneity referred to by Korea in its response to Panel Question 125 which seems to have confused the EC in its 'Comments on New Factual Information', page 10 as submitted by the EC on 9 July 2004.

[3] It should be remembered of course that CGT in no way indicates the amount of material required to build the ship only the labour content. Hence, it takes no account of the different economies of scale present in terms of material resources compared to labour resources for building ships of different sizes.

accept. This, presumably, would imply, for example that the shipowner has no interest on the return on their investment. It is clear that this is simply *not* the case.

The weakness of the EC's reliance on CGT is further exposed when it is realised that ships are *never* segmented size wise on the basis of CGT. The only place that Korea has ever seen this is in the EC's own analysis and Annex V disclosures in respect of price undercutting, suppression and depression. At no time has the EC put forward third party examples of the use of CGT for size segmentation and this is because it is simply not used in the industry. If the EC accepts size segmentation, it must accept this on the basis of cargo measures, which would question its absolute dependence on CGT as the basis for all its analysis.

Korea has made it clear that it believes that prices in shipbuilding are influenced by a range of factors. Examples of such factors have been referred to by the EC as well as Korea. OECD documents have been submitted showing that OECD members consider that prices are influenced by a range of factors even though there are differences of opinion on the full range of the factors concerned and the extent of correlation between these factors under differing market conditions. The EC cannot now be arguing that only work content or macro-level supply-demand balance influence ship prices.

In its simplest form, cost is generally considered a supply-side factor whereas price is considered a demand side factor. It is hard, therefore, to understand the logic which underpins the claim that a price analysis should consider only one side of the market and that this should be dictated by a supply-side measure such as CGT (which only sellers understand and use), rather than demand side measures such as cargo measures (which both buyers and sellers use and understand) and that furthermore it is only the labour aspects of work content that should be considered. Moreover, if, as it has been alleged, the shipbuilding market is a buyer's market, it then follows that demand side criteria are more likely to dominate.

It is interesting to note that, Clarkson's Shipyard Monitor (and its sister publication Shipping Intelligence Weekly), which the EC believes to be the leading source of industry data, compiles its newbuilding index by averaging the US $/DWT across a broad basket of ship types calculated from its price series for different ship types. Clarkson's would therefore seem to feel that price per cargo unit (dwt being a cargo measure) is an important part of shipbuilding. This is confirmed in Clarkson's Sources and Methods statement (Page 4 last paragraph under section on Newbuilding Contracts and Prices) which is provided in **Exhibit Korea – 156**.

(ii) With regard to paragraph 31 of the EC's response

The EC makes disparaging remarks about Korea's understanding of the economics of shipbuilding prices, whereas it might be better served by reading what was actually written. All the while, the EC does not respond to the simple mathematical fact noted by Korea: an average price for period A during which primarily large-size, low unit-priced ships are built cannot be compared to an average price in the successive period B during which primarily small-size, high unit-priced vessels were built to determine whether price depression or suppression existed. This is inherent in the statement made by the EC itself: large-size ships are sold at much higher prices than small-size ships.

We note that the EC refers to weighting of prices according to product mix. Product mix is a term that refers to types of ships and sizes of vessels, however in this instance, the graph only represents weighting by size and not type of vessels, and so the EC is referring only to one of the two aspects of product mix. It is, however, worth noting, that the EC has in this fashion confirmed that both size and type are important parts of shipbuilding product mix, but it is therefore all the more difficult to understand their stance that ship size does not count. The illustration in the graph referred to by the EC using weighted average pricing was used to demonstrate the distortion that can be produced in simple average parametric prices (e.g., $/TEU) if no consideration is taken of the size mix of the demand over one period compared to the size mix of another period. This relates to the fact

that there are different factors that do not work in unison for all ship sizes. This in turn relates to the case put by Korea that ship size categories need to be taken into account as they represent different market factors because, for example:

- Not all shipyards can build all sizes of ships;[4]
- Ships of differing size are not used interchangeably;
- Economies of scale exist in relation to both ship construction costs and ship operating costs;
- Prices vary differently for different types and sizes of ships;
- Freight rates vary differently for different types and sizes of ships.

The EC in its price analysis, invokes this sort of distortion when it uses parametric pricing without the use of size bands – a weighted average price at any given point of time when primarily large ships are built simply cannot be compared to a weighted average price in the next period when primarily small ships are built.

(iii) With regard to paragraph 32 of the EC's response

Yet again the EC contradicts itself regarding its reference to complex passenger vessels when its states that 'cruise-ferries' are being built in Korea and China when trying to rebut Korea's arguments against universal supply-side substitutability. In paragraph 158 of the EC's response to Panel Question 165, the EC itself states *"or in the case of cruise ship operators who need vessels of such sophistication that Korean and Chinese yards are not considered experienced enough to deliver an acceptable ship.'* Now it seems when this argument does not suit them they refer to 'cruise-ferries' being built in South Korea and China. Which of these conflicting statements does the EC wish the Panel to believe? Further, Korea would like to point out that these 'cruise-ferries' are in fact ferries not cruise ships, as the EC is now trying to imply, and small ones at that. The maximum size of such vessels:

- in Korea being approximately 45,000 GT with a length of 210m
- in China being approximately 30,000 GT with a length of 200m

in contrast to the cruise ships of up to 148,000 GT with a length of up to 350m being built in the EC cruise shipbuilding yards. Cruise ships involve the height of luxury and only carry passengers for dedicated leisure purposes. Ferries can carry people and/or vehicles and may be used for both leisure and/or commercial purposes. They do not involve the height of luxury and can range from very basic cross-river craft to higher technology sea-going vessels, however in no way do they approach the complexity of cruise ships. Trying to compare these vessels to each other and group them in to the same complexity category is like trying to compare a crop-spraying aeroplane with an executive Lear jet aeroplane.

To further demonstrate the inconsistency of the EC, in paragraph 165 of the EC's response to Panel Question 167, the EC refers quite clearly to ferries being built in Korea and refers of Korea's intentions to 'pursue the cruise ship sector' recognising that it does not currently build such vessels. In no way are the terms 'cruise ship' and 'ferry' treated by the EC as being the same, but now suddenly, these ferries are being described as 'cruise-ferries'. The reality is that Korea builds some ferries but does not build cruise ships. China builds some ferries too but also does not build cruise ships. Japan

[4] Korea also submits that not all shipyards are credible builders of all types of ships.

delivered its first cruise ship in February this year (i.e. 2004). Cruise shipbuilding competence is centred in EC yards despite the EC attempts now to imply otherwise and to dismiss Korea's comments by misrepresentation.

The EC refers to Exhibit EC-152 regarding the alleged diversity of the Korean shipyard orderbooks but with its now familiar unspecified generalisations. Korea offers the following facts from the shipyard orderbook section of this Exhibit[5]:

- **Samho** has 70 ships on order totalling 8.3m DWT of which 39 are container ships of 4,130 TEU and above, 25 are tankers of 105,000 DWT and above (i.e. outside the size of the EC's ill-defined product/chemical category), 4 are bulk carriers of 170,00 DWT or above and 2 are LPG ships of 82,000 cbm. Only the container ships therefore overlap with the ship types under review and these are all above 4,000 TEU and 75 per cent of them are above 5,000 TEU.

- **Daewoo** has 104 ships on order totalling 11.4 million DWT of which 34 are tankers of 69,000 – 306,000 DWT. 19 are container ships of 4,000 TEU and above, 17 are LNG ships of 138,000 cbm and above (three of which have regasification capability), 13 are pure car carriers, 8 are bulk carriers of 75,000 – 174,000 DWT, 7 are LPG ships of 38 – 78,000 cbm, 6 are products tankers of 49,000 – 105,000 DWT. There are also two non-ship offshore structures on order.

- **STX** has 95 vessels on order totalling 4.8m DWT of which 67 are products tankers of 29,000 – 75,000 DWT, 18 are container ships of 2,500 – 3,500 TEU , 6 are bulk carriers of 75,500 DWT, 2 are chemical/oil carriers of 38,000 DWT and 2 are LPG ships of 23,000 cbm.

The EC claim seems therefore to have mixed types from various yards together to arrive at its list.

(iv) With regard to paragraph 33 of the EC's response

Both parties are now it seems in agreement that ships are made-to-order products and that there will inevitably be differences of specification between such ships. However, it should be remembered that elsewhere in its arguments, the EC has looked at price undercutting allegations on a US$/CGT price basis without any acknowledgement that specification differences may underpin price differences, as well as other factors. Once again its position seems to change according to its current line of argument.

The EC alleges that Korea has tried to avoid SCM disciplines by creating unlimited numbers of categories of products. However Korea has, in fact, not only based its price analysis on basic ship type and size band categories but has also demonstrated that there are other owner requirements which differentiate ships that may lie within the same size and type groupings. Such factors can significantly alter the cost of such vessels and the price that an owner will be prepared to pay. Far from tying to avoid SCM disciplines, Korea has recognised that practical consideration must be given to the basis of analysis[6] in accordance with the strict provisions of the *SCM Agreement* and has, therefore, undertaken its price analysis on clearly defined size and type groupings.

Korea considers that it is the EC that is trying to avoid the SCM disciplines by gross generalisation and its extraordinary claims that all ships of one basic type are interchangeable and are to be treated collectively irrespective of size. In its attempts at collectivisation, it has made some

[5] We have had to use Clarksons ship type categories for tankers, which include chemical/oil for ships with some IMO class and products.

[6] Exhibit Korea – 70 page 5.21 and others.

serious errors, for example, it firstly tried to claim that product and chemical tankers are a single entity, it subsequently confirms that it is excluding pure chemical carriers, it then uses sloppy and inaccurate data classifications that do not recognise regulatory differences between chemical tankers (as reflected by IMO chemical classes) and now seeks to group together some, still undefined, types of chemical tankers with pure products tankers, the latter of which are not allowed to carry chemicals at all.

Korea has taken considerable care to clearly explain the differences that do exist, to explain that there are inevitably grey areas[7] of overlap but that size and type categorisation result in a more pertinent analysis of the facts than the gross generalisations that the EC puts forward. The fact that much of the expert analysis undertaken by FMI for the EC has also chosen to adopt broadly similar size bands[8] clearly demonstrates that size segmentation is normal but that there are variations on the bands used by various parties or for various purposes. This is not evidence to support the EC's 'no size segmentation' arguments. One must ask the basic question of why the EC and its advisors FMI have ever made use of size bands if their assertion is that no size segregation is relevant rather than a difference of view in respect of the actual bands used for analysis? The EC is therefore consistent only in its inconsistency – overlooking its own use of size bands when it sees advantage in 'collectivisation'.

(v) With regard to paragraph 34 of the EC's response

Exhibit Korea - 109 was submitted to summarise and present the case for like product definition and not to restate the analysis rebutting alleged price suppression and depression which is reflected in the Drewry Report submitted as Exhibit Korea - 70. The legal concept of like product requires market categorisation which is driven by differences in technical characteristics as perceived by the user and reflected in end use. The disagreement between the EC and Korea on the use of CGT vs DWT/TEU or other cargo measures lies at the heart of this. The Panel recognises this, together with size segmentation, in its question with its reference to 'product subdivisions' but the EC has chosen to ignore this in its response.

The EC refers to its Attachment 2 to the Response to Panel Questions following the first substantive meeting in respect of its price analysis. It is interesting to note that in the first paragraph of this document the EC recognizes ship size in its statement ' *and figure 1.2 shows how this order intake was distributed by size'*. If size is not an issue in price suppression and depression, why is it the second factor highlighted in the FMI report?

Korea has already highlighted in its comments on the EC's response with regard to Panel Question 162 submitted on 9 July 2004 that the graph submitted by EC on page 5 of Exhibit EC-146 does not demonstrate *'sub-classes of ships moving broadly in unison'* and that the small scale with which the EC has presented this graph has masked significant variations, which are clearly evident in the numeric tabular format used by Korea to analyse the same Clarkson's price series data. Korea has in no way been selective in doing this as it has used the example quoted by the EC and has analysed every price series in that example and the result is evidence of significant price trend differences.

Korea's presentation of evidence in this fashion also demonstrates the inaccuracy of FMI's comments regarding 'strong correlation of price movements' in its Attachment 2 document. Once again, the EC has used small-scale graphical presentation to mask the significantly different price variations that are evident from numerical presentation of price trends. For example Korea's analysis highlights that between the end of 1998 and 1999, VLCC tanker (300,000 DWT) prices dropped by 5 per cent whereas Panamax (70,000 DWT) and Handy Tankers (47,000 DWT5) prices remained constant. But by the end of 2000 VLCCs had risen by another 11 per cent (cf end 1999) whereas

[7] Exhibit Korea – 109, page 1.
[8] As highlighted in Exhibit – Korea 109.

Aframax Tankers (110,000 DWT) had risen by 26 per cent, Panamax tankers by 16 per cent and Handy Tankers by 13 per cent. Prices do note even necessarily move in the same direction, for example at end 2002 VLCC prices were 9 per cent lower than at end 2001 but Handy Tanker prices were 3 per cent higher. This is not a pattern of *'moving broadly in unison'* or *'strong correlation'* as the EC and its advisors claim.

(vi) With regard to paragraph 35 of the EC's response

On the basis of the price change differentials demonstrated by Korea in its comments to the EC's new factual information, the EC has no grounds for claiming that a more detailed analysis on the basis of size segmentation would reveal the same mechanisms and would give the same results. The evidence provided by Korea is quite clear and the EC has provided no substantiated evidence to contradict it; its mere assertions to the contrary do not suffice.

(vii) With regard to paragraph 36 of the EC's response

Korea has already explained[9] that the use of orderbook as a measure of market presence is misleading because of the varying time horizons of orderbooks between regions and individual yards. It has also demonstrated that third party sources do not use orderbook in isolation but also present the phasing of the orderbook.[10]

Korea notes once again the lack of clarity and openness by the EC in not defining the size bands associated with its use of the terms 'handymax, panamax and post-panamax'. The EC quotes highly specific and emotive orderbook percentages but declines to clearly define the basis of these, so that its statements cannot be countered to demonstrate its misleading use of statistics. This is another example of the EC trying to blur the argument through statistical imprecision and to hide behind generalisation.

In addition, the EC continues to amalgamate restructured and non-restructured yards alike and makes assertions with reference to the Korean orderbook position despite the fact that unrestructured yards are significantly or even predominantly present in the orderbook position relied upon by the EC. Again, the EC relies on the alleged effect of the Korean vessels while the Treaty requires it to show the effect of the alleged Korean subsidies.

195. Please comment on Exhibit KOR-115.

Korea's comments

The EC in its response to the Panel's question alleges that the price levels indicated in Exhibit Korea - 115 "are the average of reported contract prices for the ship types in question for a seven-year period (1997-2003), adjusted by CGT. These averages are a very minor part of the FMI report and are meaningless without the time series graphs that accompany them". The EC further asserts that the "graphs showing the relative movement of different nationalities are of particular importance".

In fact, the graphs with the lines shown for different countries in the FMI report supplied as Exhibit Korea – 142 (*see* Figures 2.3, 2.8, 2.12, 2.18, 3.6 and 3.11) are simply inaccurate and misleading because of the following errors:

- These graphs are prepared from the 'spot graphs' offered for each country (*see* Figures 2.1, 2.2, 2.4, 2.5, 2.6, 2.7, 2.9, 2.10, 2.11, 2.13, 2.14, 2.15, 2.16, 2.17, 3.1, 3.2, 3.3, 3.4, 3.5, 3.7, 3.8, 3.9, 3.10). Nevertheless, these spot graphs reflect many half year points for which there

[9] Korea's response to Panel Question 174.
[10] Korea's response to Panel Question 174.

are no spots, presumably because there were no contracts or because there was no price data available.

- The error occurs when these spot graphs are translated into line graphs because they have simply joined the available dots, without any recognition of the fact that some times there was no data. This results in lines which may show as higher than Korea at a time when there is in fact no data.

- For example, in Figure 2.18 Korea, is shown as having lower prices (albeit marginally) than China over the period 1st half of 1998 to 2nd half of 1999. However, in fact, there were no data points for Korea on the spot graph in Figure 2.18 for the 1st and 2nd halves of 1998 and the 1st half of 1999 and there were different missing points for China in the spot graph in Figure 2.13. Absent any pricing data for Korea, the graph is wrong in implying that the prices for Korean vessels could have caused price depression or suppression. The time graphs shown in the FMI report are, therefore, inaccurate and misleading. In fact, the EC and FMI are over-simplifying the price setting for vessels and not Korea as the EC has stated.

The proper fashion to plot the spot graphs on a time series graph is to plot these as spot and partial line graphs. To demonstrate the profound difference that correct plotting makes, Korea presents one of these graphs, firstly as plotted by FMI in their document and secondly as replotted by Korea recognizing the absent data points. **Exhibit Korea – 157** shows all of the graphs replotted and highlights the erroneous commentary arising from the original graphs.

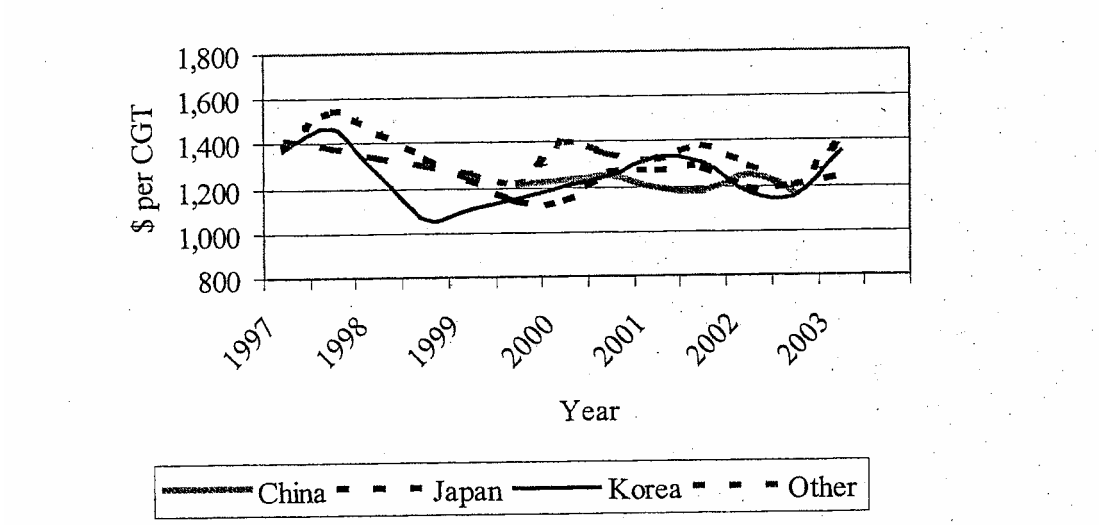
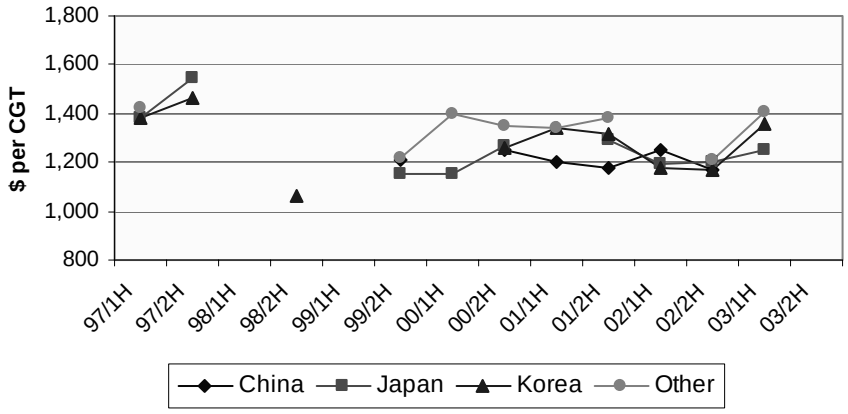


Figure 2.8 – Combined indication of the development of handymax tanker prices

Fig 2.8 Replotted by Korea
Handymax product tankers



- It remains that FMI itself has supplied in Tables 2.1, 2.2, 2.3, 2.4, 3.1, 3.2 and 3.3 average prices for different like product vessels for China, Korea, Japan, the EC and other shipbuilding countries for the period 1997 to 2003 and that the EC has submitted this data in the Annex V process. These prices must have a meaning or they would not have been included in an FMI report. They cannot be discarded as setting forth a minor part of the report. As the EC itself states, long-term price averages are meaningful for a trend analysis but the assessment on the existence of price depression or suppression is precisely an analysis of trends.

Korea further notes that the quotations cited to in the EC's response to the Panel's questions support rather than contradict what Korea has been stating all along, i.e., that the EC considers the alleged impact of Korean vessels, rather than the impact of the alleged Korean subsidies. In addition, even if the impact of Korean vessels is considered without considering whether these vessels benefited from the alleged subsidies (indeed, the EC considers sweeps all Korean vessels into its product depression and suppression allegations), the EC evidence itself fails to indicate that price depression or suppression were caused by the Korean vessels and *a fortiori* by the alleged subsides themselves. Reference is made by way of example to the following statements made by FMI:

- China appears to be the price leader for panamax tankers;

- Chemical tanker prices have been led by China since 2001;

- In the feeder container sector, prices appear to have been led in recent years by South Korea and China but with strong competition from Poland, Singapore and Taiwan;

- Handysize product tankers: China and South Korea, with South Korea dominating (*note*: but no sales or prices were plotted for the EC without any explanation),

- Panamax product tankers: China has remained the price leader in this sector over the period examined;

- Chemical tankers: Japan, South Korea and China have offered the lowest prices and in the past two years China appears to have been the price leader.

Korea notes that, contrary to the EC insinuations, it does not agree to the use of CGT for the purpose of measuring any capability to depress or suppress prices. Nevertheless, the EC itself relies

on this standard of measurement and its data confirms that Korean prices were not as a rule below those of EC vessels such as to cause price depression or suppression.

In respect of the EC's comment in paragraph 37, Korea notes that it has simply used the information that the EC has presented in its own case, and this does not in any way imply that Korea believes $/CGT to be the most appropriate measure for parametric pricing. Korea provides this as an argument in the alternative. Korea retains its view as expressed in Exhibit Korea – 70 that parametric pricing should be based on cargo measures such as dwt, teu and cbm. Korea has reiterated its previously stated reservations regarding the use of $/CGT in its comments pertaining to Question 194 in this document. Furthermore Korea reminds the Panel that CGT only reflects the labour work content of supply costs not the material content.

Korea stands by its own price analysis in Exhibit Korea – 70 which found no evidence of price depression or suppression in the market under review.

List of Exhibits

Exhibit Korea – 154	**Question 188 – Anjin's third response dated 23 July 2004**
Exhibit Korea – 155	**Question 190 - Supplemental response by KPMG**
Exhibit Korea – 156	**Question 194** - Clarkson's Sources and Methods statement (excerpt)
Exhibit Korea – 157	**Question 195** – Detailed comments on the FMI report in Exhibit Korea – 142

Note: The exhibits shown in bold contain Business Confidential Information.

ANNEX H

REQUEST FOR THE ESTABLISHMENT OF A PANEL

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ANNEX H

REQUEST FOR THE ESTABLISHMENT
OF A PANEL

WORLD TRADE ORGANIZATION

WT/DS273/2
13 June 2003

(03-3145)

Original: English

KOREA – MEASURES AFFECTING TRADE IN COMMERCIAL VESSELS

Request for the Establishment of a Panel by the European Communities

The following communication, dated 11 June 2003, from the Permanent Delegation of the European Commission to the Chairman of the Dispute Settlement Body, is circulated pursuant to Article 6.2 of the DSU.

On 21 October 2002, the European Communities requested consultations with the Government of the Republic of Korea (Korea) pursuant to Article 4 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (DSU), Article XXIII:1 of the *General Agreement on Tariffs and Trade 1994* (GATT 1994) and Articles 4, 7 and 30 of the *Agreement on Subsidies and Countervailing Measures* (*SCM Agreement*) with regard to measures affecting trade in commercial vessels. This request was circulated to the WTO Members on 24 October 2002 as document WT/DS273/1, "*Korea – Measures Affecting Trade in Commercial Vessels*".

Consultations were held on 22 November, 13 December 2002 and 7 May 2003. Unfortunately, these consultations failed to settle the dispute.

The European Communities therefore requests that a panel be established pursuant to Article 6 of the DSU, Article XXIII:2 of GATT 1994, Articles 4, 7 and 30 of the *SCM Agreement* (to the extent that Article 30 incorporates by reference Article XXIII of GATT 1994).

The measures that are the subject of this request are prohibited and actionable subsidies. In particular, the European Communities considers that the following measures are inconsistent with Korea's obligations under the *SCM Agreement*:

- The Act Establishing the Export-Import Bank of Korea ("KEXIM"), any implementing decrees and other regulations, that specifically allow and enable

KEXIM to provide Korean exporters of capital goods with financing at preferential rates.

- The pre-shipment loan and advance payment refund guarantee schemes established by KEXIM. Under the *pre-shipment loans programme*, KEXIM provides pre-delivery loans at preferential rates to finance production costs of export contracts, such as raw material cost, labour and overheads until delivery of the goods. Under the *advance payment refund guarantees programme*, KEXIM provides guarantees at preferential premium rates that a foreign buyer will be refunded any advance payments given to a Korean exporter, including any accrued interest on the advance payments, if the Korean exporter fails to perform his obligations under the relevant export contract.
  The individual granting of pre-shipment loans and advance payment refund guarantees by KEXIM to Korean shipyards, including Samho Heavy Industries, Daedong Shipbuilding Co., Daewoo Shipbuilding and Marine Engineering, Hyundai Heavy Industries, Hyundai Mipo, Samsung Heavy Industries and Hanjin Heavy Industries & Construction Co.

- The provision by the Korean Government, through government-owned and government-controlled banks, of corporate restructuring subsidies in the form of debt forgiveness, debt and interest relief and debt-to-equity swaps. These subsidies were granted to at least three shipyards (Daewoo Shipbuilding and Marine Engineering, Samho Heavy Industries, Daedong Shipbuilding Co)**.**

- The Special Tax Treatment Control Law, more specifically, the special taxation on in-kind contribution (Article 38) and the special taxation on spin-off (Article 45-2) scheme, establishes two tax programmes limited to companies under corporate restructuring and provides tax concessions to Daewoo, the combined benefit of which is estimated at won 78 billion.

The European Communities considers that the Korean measures are in breach of Korea's obligations under the provisions of the *SCM Agreement*, in particular, but not necessarily exclusively of:

– Articles 3.1(a) and 3.2 of the *SCM Agreement*, because, *inter alia*, the KEXIM Act, the advance payment refund guarantees and the pre-shipment loans provided by KEXIM and the corporate restructuring packages and tax concessions are specific subsidies within the meaning of Articles 1 and 2 of the *SCM Agreement* and are *de jure* or *de facto* export contingent.

– Article 5(a) of the *SCM Agreement*, because, *inter alia*, the above-mentioned KEXIM subsidies, the corporate restructuring packages and tax concessions are specific subsidies within the meaning of Articles 1 and 2 of the *SCM Agreement* and are causing injury to the Community industry.

– Article 5(c) of the *SCM Agreement*, because, *inter alia*, the above-mentioned KEXIM subsidies, the corporate restructuring packages and tax concessions are specific subsidies within the meaning of Articles 1 and 2 of the *SCM Agreement* and cause serious prejudice to the interests of the European Communities, in particular through significant price undercutting, price suppression, price depression or lost sales within the meaning of Articles 6.3 and 6.5 of the *SCM Agreement*.

The European Communities requests that a Panel be immediately established with standard terms of reference, in accordance with Articles 4.4 and 7.4 of the *SCM Agreement* and Article 7 of the DSU.

The European Communities asks that this request for the establishment of a Panel be placed on the agenda for the next meeting of the Dispute Settlement Body, which is scheduled to take place on 24 June 2003.

The European Communities further requests that the DSB at that meeting initiate the procedures provided for in Annex V of the *SCM Agreement* pursuant to paragraph 2 of that Annex. In particular, the European Communities requests that the DSB designate a representative to serve the function of facilitating the information-gathering process of Annex V. The European Communities is prepared to propose names to the DSB and is consulting with Korea on this matter. The European Communities also intends to put forward suggestions as to the information that should be sought under this procedure once the panel is established.