

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 banks³ remain intact.

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 methodology⁶, 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 the re is such an association, what is its nature? Please explain.

⁴ Korea's 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 1999⁹).

18. Chubb was only referred to with respect to the period *after* Samho's restructuring. The evidence submitted by Korea¹⁰ 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 rate, 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

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 before¹⁵, 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 Consultant¹⁶ 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-**

- 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 bonds²², 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 rating²⁴ 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**

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

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 Korea92**).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 PriceWaterhouseCoopers³⁴ 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 Panel³⁹ 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

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 report⁴⁰ 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 critic 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 Corrigendum⁴¹ 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

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 from 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-13⁵⁰, 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 PriceWaterhouseCoopers⁵¹, 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 1999⁵², 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

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, 3^d 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 confirmed⁶¹ 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 trusts⁶⁴, 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

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 evidence⁶⁸ 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.

⁷⁰Second 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 from 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 statement⁷¹ 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 procedure⁷² which showed that government owned or controlled secured creditors⁷³ had a ratio exceeding by far the required 75 per cent⁷⁴ 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 if 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 11(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.

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" 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 EC answers the question only in regards to DHI".

Response

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 Modelling 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 Monitor⁹²) 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.

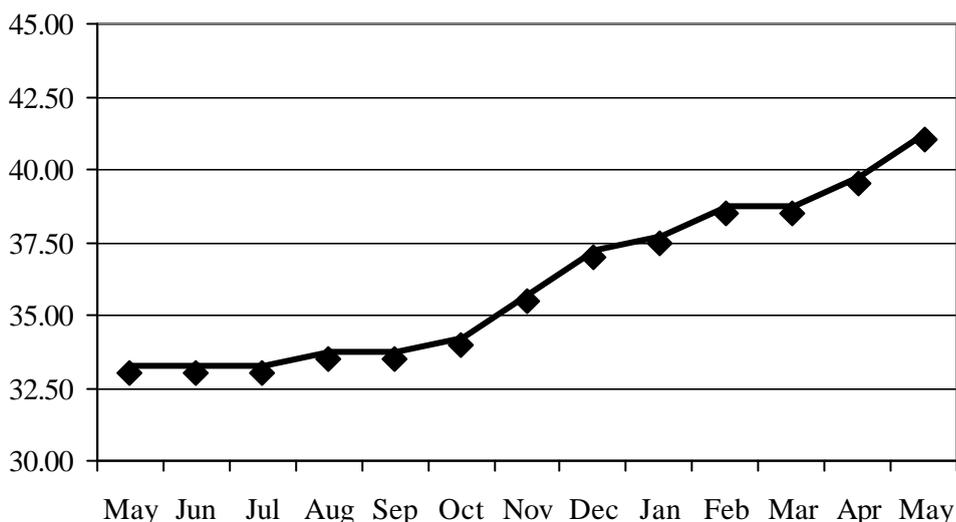


Figure 1 – Movement in Panamax tanker prices in 2003 / 2004 (\$ million)

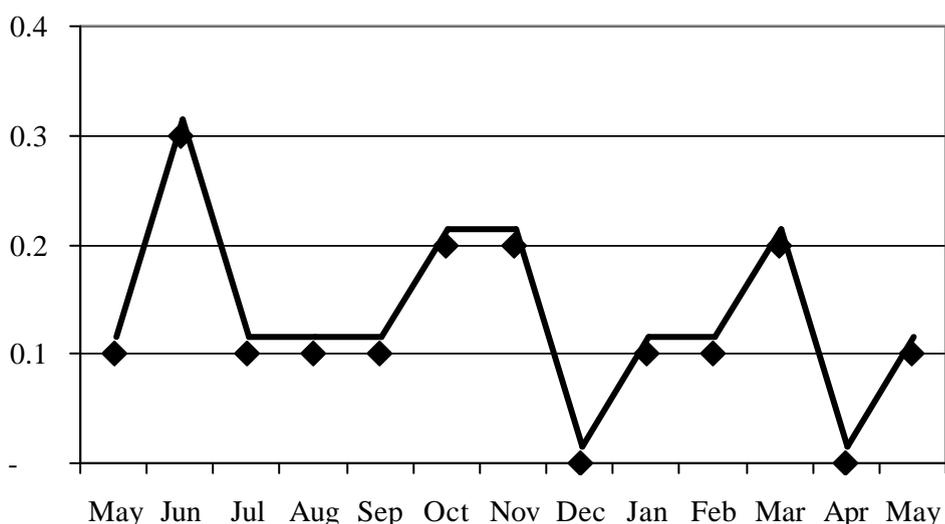


Figure 2 – Volume of Panamax tanker orders placed per month in 2003 / 2004 (million CGT)

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.

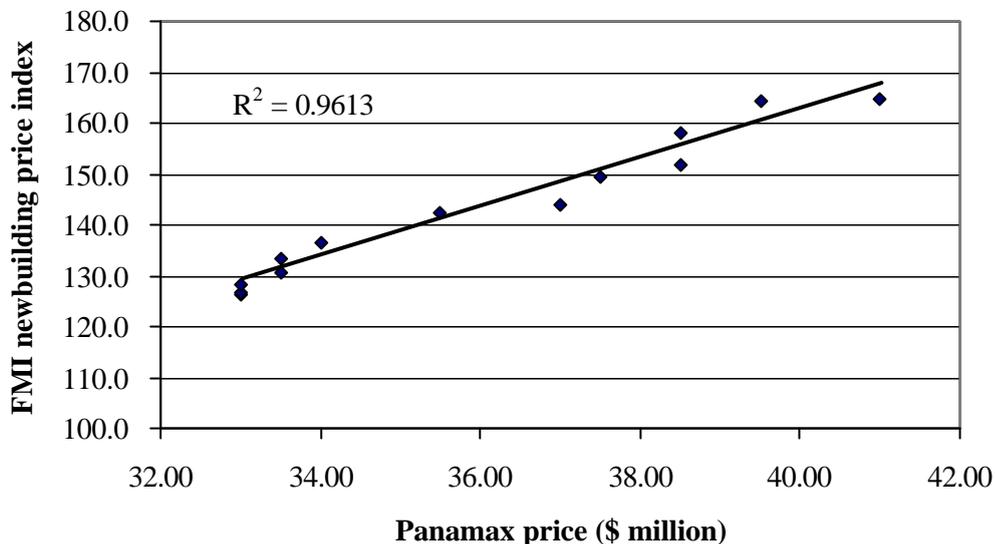


Figure 3 – The relationship between Panamax tanker prices and the newbuilding price index between May 2003 and May 2004

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.

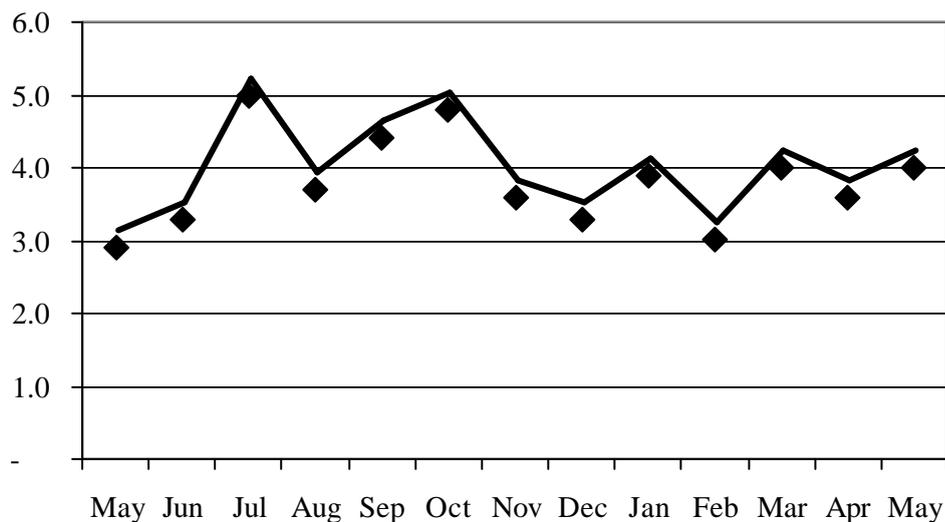


Figure 4 - Volume of all orders placed per month in 2003 / 2004 (million CGT)

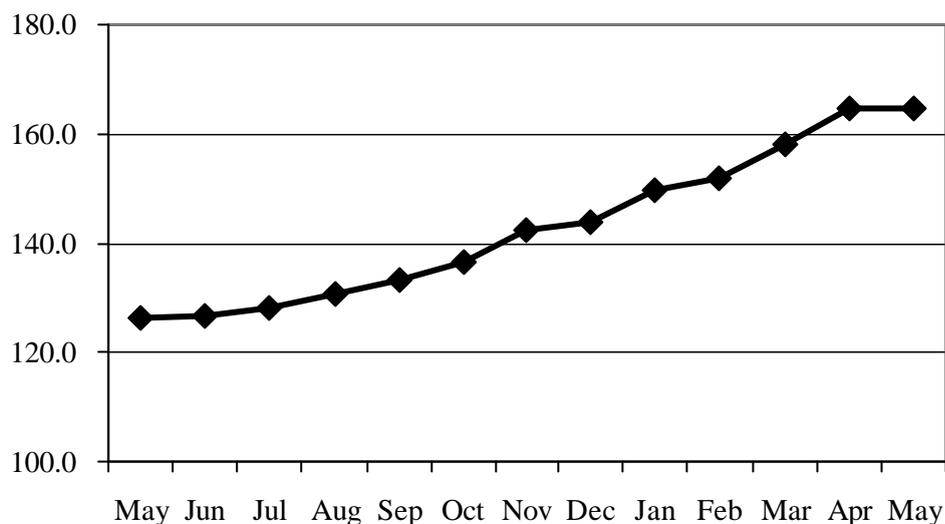


Figure 5 – FMI newbuilding price index in 2003 / 2004 (1987 = 100)

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 investor⁹⁹ 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 explained¹⁰⁰ 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

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 explained¹⁰³ 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 Won¹⁰⁴.

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 Monitor¹⁰⁶ 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 order¹¹¹ 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 Developments” 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 many 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 Korea’s 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 cranes 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:
 - o Cruise ships: skills for the installation of glass atriums and interior decoration; high volume of modular cabins, highly complex interaction of specialist sub-contractors;
 - o Ro-Ro ships: skills to install the watertight bow and stern doors and associated ramps;
 - o Chemical tankers: some chemical tankers include tanks made of stainless steel which requires special welding equipment and welding skills;
 - o 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;
 - o 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;
 - o Fast ferries: skills and facilities for construction of the aluminium hull and superstructure which requires specialised welding facilities and skills and sometimes hull jigs;
 - o 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; Rodriguez where 18 out of 29 were ferries and 6 were passenger ships; SEC where 16 out of 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 of 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 where 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 2001² 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 performance³ 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) <i>No explanation on how these cost indices were obtained and which LNGs are reflected in these LNGs.</i>	Year-end prices of LNGs (Figure 1.3 at page 3)	Cost and price indices for Korean LNGs (Figure 1.5 at page 4) <i>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.</i>
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)	<p><i>Price indices presumably calculated based on Figure 41.</i></p> <p><i>No explanation on how these cost indices were obtained and which container vessels are reflected.</i></p> <p><i>No explanation as to why conclusions for all container vessels are drawn on the basis of a specific size range only.</i></p>		<p><i>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.</i></p>
Product and chemical tankers	No price developments shown at all.	<p>Cost and price indices for Korean handysize product and chemical tankers (Figure 43 at page 169 of the EC's First Written Submission)</p> <p><i>No indication on how the price indices were determined.</i></p> <p><i>No explanation on how these cost indices were obtained and which container vessels are reflected.</i></p> <p><i>No explanation as to why conclusions for all product and chemical tankers</i></p>	<p>Price developments for handymax and panamax products tankers taken from Clarkson's (Figure 2.3 at page 8)</p> <p><i>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</i></p>	<p>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.</p> <p><i>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.</i></p>

	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
		<i>are drawn on the basis of a specific size range only.</i>	<i>products. It is, therefore, not clear whether these prices reflect sown in Figure 2.3 reflect those of the products concerned by this dispute.</i>	

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 tanker⁴
- 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 tankers⁵
- 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 ship⁷

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
- Chemical⁹
- 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°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 3per 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

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 unstructured 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 many 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 through 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 counterparties.

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 Korea's 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 (*see* 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 provisions 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 public 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-off 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 DHI 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 cranes 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 where 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 not 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 (*see* 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 market-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 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.

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 from 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 in 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?

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.

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 form 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 2001¹⁵ 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.

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 performance¹⁶ 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, 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.

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) <i>No explanation on how these cost indices were obtained and which LNGs are reflected in these LNGs.</i>	Year-end prices of LNGs (Figure 1.3 at page 3)	Cost and price indices for Korean LNGs (Figure 1.5 at page 4) <i>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.</i>
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) <i>Price indices presumably calculated based on Figure 41.</i> <i>No explanation on how these cost indices were obtained and which container vessels are reflected.</i> <i>No explanation as to why conclusions for all container vessels are drawn on the basis of a specific size range only.</i>	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). <i>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.)</i> <i>There seems to be an inconsistency in the EC's demonstration.</i>
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
	<p>and chemical tankers (Figure 43 at page 169 of the EC's First Written Submission)</p> <p><i>No indication on how the price indices were determined.</i></p> <p><i>No explanation on how these cost indices were obtained and which container vessels are reflected.</i></p> <p><i>No explanation as to why conclusions for all product and chemical tankers are drawn on the basis of a specific size range only.</i></p>	<p>tankers taken from Clarkson's (Figure 2.3 at page 8)</p> <p><i>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.</i></p> <p>as to whether the EC maintains those shown in Figure 43 of its First Written Submission.</p> <p><i>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.</i></p>

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 tanker¹⁹
- 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 tankers²⁰
- 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 ship²²

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 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).**

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 IMO/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

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 DHI 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	Bulk Carriers – 14 sub types
Combination	Dry Cargo/Passenger – 24 sub types (<i>incl containers and reefers</i>)
Container	Tankers – 19 sub types (including LNGs)
Dry Cargo	Offshore – 9 sub types
Miscellaneous	Fishing – 9 sub types
Offshore	Miscellaneous – 30 sub types
Passenger/Ferry	Non-merchant ships – 4 sub types
Reefer	Non-propelled – 2 sub types
Ro-Ro	Non-seagoing merchant ships – 13 sub types
Tanker (including LNGs)	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
- Chemical³⁷
- 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 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.**

Response

A number of industry analysts report pricing trends using Ship Price Series³⁸, 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 Tkr				
	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 2000³⁹
- Drewry LNG Market Review 2003/04⁴⁰
- Clarksons World Shipyard Monitor⁴¹
- 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 its 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 cautious 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 “Korea 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 Responses 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 2003¹ 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 DHI should have been liquidated instead of restructure. In this summary, all relevant figures should be shown in tabular form, 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-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 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 unstructured 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 public 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

Shipyards	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 6months 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 its 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
Samsung	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 Korea⁵, KRW 3,500 which was the stock price on the first day of trading⁶ 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 – 103⁷ 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 Korea⁸, 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 Submission¹², the DHI workout plan itself (i.e., spin-off, debt rescheduling and debt-for-equity swap) was rejected at the 3^d 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 3^d 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 meeting¹⁴, while the actual voting results at the 3^d CCFI meeting¹⁵ 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 proposed 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 price 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 its 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	1998 v	1999 v	2000 v	2001 v	2002 v	2003 v	Apr 04 v
	1996	1997	1998	1999	2000	2001	2002	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 cgt²⁵ 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 constant²⁶ 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 Korea³¹), 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

<u>Exhibit Korea – 140</u>	Letter by ABN-AMRO re country risk premium
<u>Exhibit Korea – 141</u>	Anjin comments on the PwC analysis in Exhibit EC – 145
<u>Exhibit Korea – 142</u>	“Background report – Detailed evaluation of key price movements” prepared by the EC’s consultant, FMI, in August 2003
<u>Exhibit Korea – 143</u>	KEXIM report regarding the incompatibility between credit and corporate bond ratings
<u>Exhibit Korea – 144</u>	KEXIM’s list of PSLs (excerpts)
<u>Exhibit Korea – 145</u>	Corrigendum to the EC’s recalculation on Samho
<u>Exhibit Korea – 146</u>	Corrigendum to the EC’s recalculations on DSME
<u>Exhibits Korea – 147</u>	Corrigendum to the EC’s recalculations on Hanjin
<u>Exhibit Korea – 148</u>	Corrigendum to the EC’s recalculations on HHI
<u>Exhibit Korea – 149</u>	Corrigendum to the EC’s recalculations on Mipo
<u>Exhibit Korea – 150</u>	PSL duration for each instalment disbursement
<u>Exhibit Korea – 151</u>	Korea Development Bank’s Notices on termination of DSME workout
<u>Exhibit Korea – 152</u>	Absence of supply-side substitutability as demonstrated in Exhibit EC – 152
<u>Exhibit Korea – 153</u>	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 DHI should have been liquidated instead of restructured. In this summary, all relevant figures should be shown in tabular form, 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-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 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 type² 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 prices³. 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 it 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 Exhibit⁵:

- **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 trying to avoid SCM disciplines, Korea has recognised that practical consideration must be given to the basis of analysis⁶ 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 areas⁷ 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 bands⁸ 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 not 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 explained⁹ 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 oversimplifying 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.

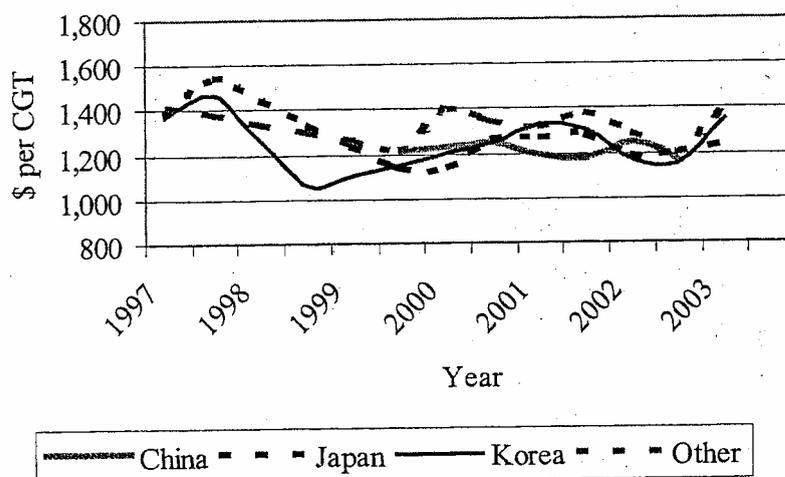
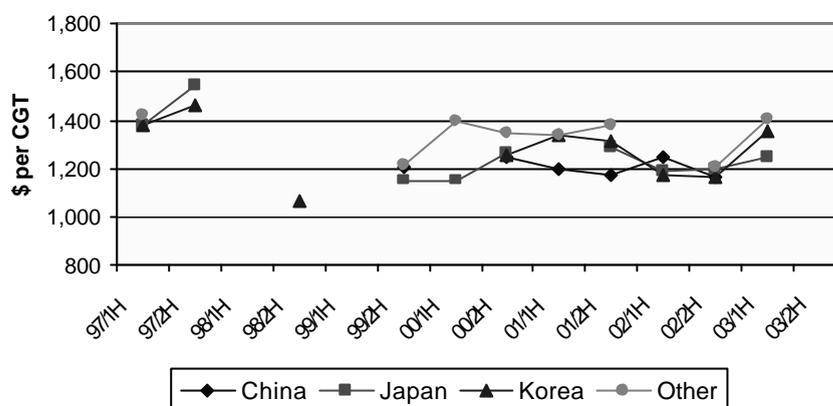


Figure 2.8 – Combined indication of the development of handymax tanker prices

**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 subsidies 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

<u>Exhibit Korea – 154</u>	Question 188 – Anjin’s third response dated 23 July 2004
<u>Exhibit Korea – 155</u>	Question 190 - Supplemental response by KPMG
<u>Exhibit Korea – 156</u>	Question 194 - Clarkson’s Sources and Methods statement (excerpt)
<u>Exhibit Korea – 157</u>	Question 195 – Detailed comments on the FMI report in Exhibit Korea – 142

Note: The exhibits shown in bold contain Business Confidential Information.