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The *Dispute Settlement Reports* of the World Trade Organization (the "WTO") include panel and Appellate Body reports, as well as arbitration awards, in disputes concerning the rights and obligations of WTO Members under the provisions of the *Marrakesh Agreement Establishing the World Trade Organization*. The *Dispute Settlement Reports* are available in English, French and Spanish. Starting with 1999, the first volume of each year contains a cumulative index of published disputes.

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KOREA - DEFINITIVE SAFEGUARD MEASURE ON IMPORTS OF CERTAIN DAIRY PRODUCTS

Report of the Appellate Body
WT/DS98/AB/R

Adopted by the Dispute Settlement Body
on 12 January 2000

Korea, *Appellant/Appellee*
European Communities, *Appellant/Appellee*
United States, *Third Participant*

Present:
El-Naggar, Presiding Member
Ehlermann, Member
Feliciano, Member

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I. INTRODUCTION

1. Korea and the European Communities appeal from certain issues of law and legal interpretations developed in the Panel Report, *Korea - Definitive Safeguard Measure on Imports of Certain Dairy Products* ("the Panel Report").[1] The Panel was established to consider a complaint by the European Communities relating to a definitive safeguard measure imposed by Korea on imports of certain dairy products.

2. On 17 May 1996, the Korean Trade Commission initiated an investigation of injury to the domestic industry by imports of skimmed milk powder preparations. The results of this investigation were published by the Korean Trade Commission in the *Investigation Report on Industrial Injury by the Office of Administration and Investigation* (the "OAI Report"). On 7 March 1997, Korea published in its Government Gazette its decision to apply a definitive safeguard measure in the form of a quantitative restriction on imports of the dairy products at issue. Korea notified the initiation and results of its investigation, as well as its decision to apply a safeguard measure, to the Committee on Safeguards. On 12 August 1997, following consultations in the Committee on Safeguards, the European Communities requested consultations with Korea under the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "DSU") regarding the consistency of Korea's safeguard measure with its WTO obligations. The European Communities subsequently requested the establishment of a panel to examine the consistency of Korea's safeguard measure with its obligations under Articles 2, 4, 5 and 12 of the *Agreement on Safeguards* and Article XIX of the GATT 1994. The United States participated as a third party in the proceedings before the Panel. The factual aspects of this dispute are set out in greater detail in the Panel Report.[2]

3. In its Report circulated to Members of the World Trade Organization ("the WTO") on 21 June 1999, the Panel concluded that Korea's definitive safeguard measure was imposed inconsistently with its WTO obligations in that:

[1] WT/DS98/R, 21 June 1999.
[2] Panel Report, paras. 1.1-2.8.

(a) Korea's serious injury determination is not consistent with the provisions of Article 4.2(a) of the Agreement on Safeguards;

(b) Korea's determination of the appropriate safeguard measure is not consistent with the provisions of Article 5 of the Agreement on Safeguards; and

(c) Korea's notifications to the Committee on Safeguards (G/SG/N/6/KOR/2, G/SG/N/8/KOR/1, G/SG/N/10/KOR/1, G/SG/N/10/KOR/1. Suppl) were not timely and therefore are not consistent with the provisions of Article 12.1 of the Agreement on Safeguards.[3]

The Panel rejected:

(a) the European Communities' claim that Korea violated the provisions of Article XIX:1 of GATT by failing to examine the "unforeseen developments";

(b) the European Communities' claim that Korea violated the provisions of Article 2.1 of the Agreement on Safeguards by failing to examine, as a separate and additional requirement, the "conditions" under which increased imports caused serious injury to the relevant domestic industry; and

(c) the European Communities' claims that the content of Korea's notifications to the Committee on Safeguards (G/SG/N/6/KOR/2, G/SG/N/8/KOR/1, G/SG/N/10/KOR/1, G/SG/N/10/KOR/1. Suppl) did not meet the requirements of Article 12.1, 12.2 and 12.3 of the *Agreement on Safeguards*.[4]

The Panel recommended that the Dispute Settlement Body (the "DSB") request Korea to bring the measures at issue into conformity with its obligations under the *Marrakesh Agreement Establishing the World Trade Organization* ("the *WTO Agreement*").[5]

4. On 15 September 1999, Korea notified the DSB of its decision to appeal certain issues of law covered in the Panel Report and certain legal interpretations developed by the Panel, pursuant to Article 16.4 of the DSU, and filed a Notice of Appeal with the Appellate Body pursuant to Rule 20 of the *Working Procedures for Appellate Review* (the "*Working Procedures*").[6] On 27 September 1999, Korea filed an appellant's submission.[7] The European Communities filed its own appellant's

[3] Panel Report, para. 8.1.
[4] *Ibid*., para. 8.2.
[5] *Ibid*., para. 8.4.
[6] WT/DS98/7, 16 September 1999.
[7] Pursuant to Rule 21 (1) of the *Working Procedures*.

submission on 30 September 1999.[8] Both Korea and the European Communities filed appellee's submissions on 11 October 1999.[9] On the same day, the United States filed a third participant's submission.[10]

5. The oral hearing in the appeal was held on 3 November 1999.[11] The participants and the third participant presented oral arguments and responded to questions put to them by Members of the Appellate Body Division hearing the appeal.

II. ARGUMENTS OF THE PARTICIPANTS AND THIRD PARTICIPANT

A. Claims of Error by Korea - Appellant

1. Article 6.2 of the DSU

6. Korea requests that the Appellate Body find that the Panel erred in its interpretation of Article 6.2 of the DSU and erred in finding that the European Communities' request for establishment of a panel satisfied the requirements of Article 6.2 of the DSU. According to Korea, the Panel erred as a matter of law in finding that, by merely listing four articles of the *Agreement on Safeguards* and Article XIX of the GATT 1994, the European Communities' request for establishment of a panel satisfied its obligations under Article 6.2 of the DSU. The mere listing of articles allegedly breached does not provide a brief summary of the legal basis of the complaint sufficient to present the problem clearly. By limiting the requirement under Article 6.2 of the DSU to a mere description of the claims, the Panel reduces the clause "sufficient to present the problem clearly" to inutility, contrary to the injunction given by the Appellate Body.[12]

7. In Korea's view, the failure of the European Communities to comply with its obligations under Article 6.2 of the DSU led to the adoption of imprecise terms of reference and failed to provide notice to Korea. This is contrary to the universally accepted principle in civil litigation, also applicable to the DSU, that the defendant must be able to understand, and be in a position to respond to, the claims brought by the applicant. The inadequacy of the request for the establishment of a panel also meant that third parties were prejudiced because they could not exercise fully their rights under the DSU.

8. Korea considers that it is self-evident that if the standard of "sufficient precision" can be satisfied in every case by the mere listing of the articles of the relevant agreements, a panel would never be required, as directed by the Appellate Body, to examine the request for the establishment of the panel "very carefully to

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8 Pursuant to Rule 23 (1) of the *Working Procedures*.
9 Pursuant to Rule 22 (1) and Rule 23(3) of the *Working Procedures*.
10 Pursuant to Rule 24 of the *Working Procedures*.
11 Pursuant to Rule 27 of the *Working Procedures*.
12 Appellate Body Report, *United States - Standards for Reformulated and Conventional Gasoline* ("*United States - Gasoline*"), WT/DS2/AB/R, adopted 20 May 1996, p. 23.

ensure its compliance with the letter and the spirit of Article 6.2 of the DSU".[13] The Panel made its finding in only two sentences, which cannot be considered a "very careful" examination of the European Communities' request. Further, the Panel Report lacks any discussion of the rationale for these findings, contrary to the requirements of Article 12.7 of the DSU.

9. Korea notes that the European Communities took a different approach in requesting the establishment of a panel challenging safeguard measures imposed by Argentina. On 10 June 1998, the European Communities submitted a request for establishment of a panel in the Argentina case, which included a more detailed description of the claims at issue.[14] Korea views this difference as evidence that the European Communities was fully aware of its obligations under Article 6.2 of the DSU, but, for its own reasons, failed to meet those obligations in the present case.

2. The OAI Report

10. Korea argues that the Panel erred in its characterization of the submission of the OAI Report. Korea submitted the OAI Report at the request of the Panel as background information, and did not rely on this Report in its defence. The submission of the OAI Report to the Panel should not have been viewed as a desire to place that report before the Panel either as the subject of dispute between the parties, or as evidence of Korea's compliance or noncompliance with the *Agreement on Safeguards*.

11. Korea notes that the Appellate Body has found that Members are under a duty and an obligation to respond promptly and fully to requests made by panels for information under Article 13.1 of the DSU, and that this duty is a specific manifestation of Members' engagement in dispute settlement proceedings in good faith as required by Article 3.10 of the DSU.[15] The Panel's reliance on the OAI Report can only discourage parties to future disputes from providing information to panels that might be useful in explaining the context of and background to disputes, and can only encourage parties to refuse to cooperate in the fact-finding process of panels.

12. Korea argues that the Panel erred in assessing Korea's actions solely on the basis of the OAI Report. Each of the claims of the European Communities was based on Korea's notifications to the Committee on Safeguards, and the Panel confirmed that the European Communities "initially relied on the notifications to the Committee on Safeguards to establish its claims".[16] The European Communities raised the issue of the OAI Report only in its rebuttal submissions. Following questioning from the Panel as to the precise nature of the European Communities' case, the European

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[13] Appellate Body Report, *European Communities - Regime for the Importation, Sale and Distribution of Bananas* ("*European Communities - Bananas*"), WT/DS27/AB/R, adopted 25 September 1997, para. 142.

[14] Request for the establishment of a panel by the European Communities, *Argentina - Safeguard Measures on Imports of Footwear*, WT/DS121/3, 11 June 1998.

[15] Appellate Body Report, *Canada - Measures Affecting the Export of Civilian Aircraft* ("*Canada -Aircraft*"), WT/DS70/AB/R, adopted 20 August 1999.

[16] Panel Report, para. 7.30.

Communities made claims alleging violations of Article 4 based on the OAI Report in its Rebuttal Submission and at the Second Meeting with the Panel. Since it had obtained an English translation of the OAI Report 17 months prior to the establishment of the Panel, the European Communities could have raised claims with respect to the OAI Report in its First Submission.

13. The Panel also erred by failing to consider Korea's argument that parties to a dispute settlement procedure cannot introduce new claims at, or subsequent to, the rebuttal stage. While arguments can be made at any stage of the proceedings, the fundamental claims of the complainant must be raised in the request for establishment of a panel or, at the latest, in the complaining Member's First Submission. To permit claims to be raised after that point denies both the respondent and third parties any effective right to address or rebut those claims. As the OAI Report was never raised by the European Communities until the rebuttal stage, any claim by the European Communities based on that Report was raised too late in the proceedings to allow Korea to fully defend itself, or to allow the United States as a third party to present any response to such claims.

14. In the view of Korea, the Panel also erred in establishing the claims, arguments and evidence that the European Communities itself should have established. The Panel's "inquisitorial" approach denied Korea and the United States their rights under the DSU, and established an inappropriate precedent on how complaining Members can manipulate panel proceedings to avoid full evaluation and response to their claims.

3. Burden of Proof

15. Korea submits that as a threshold matter, a panel must make a finding regarding whether the Member with the burden of proof has established a *prima facie* case of violation. As the Panel admitted, the requirement that the panel first make this threshold determination is supported by past Appellate Body practice.[17] The Panel, however, ignored this step and stated only that it would simply weigh the evidence at the end of the proceedings.

16. Korea argues that as a matter of law, the Panel erred in presuming that the European Communities satisfied its burden of proof, and in proceeding to find that Korea violated Article 4 of the *Agreement on Safeguards* based solely on the OAI Report. Had the Panel properly applied the requisite burden of proof, it could not, as a matter of law, have found that the European Communities made a *prima facie* case. The Panel based all of its findings regarding Article 4 of the *Agreement on Safeguards* exclusively on the OAI Report. However, as noted earlier, the European Communities conceded that this Report was not at issue between the parties. Therefore, the European Communities did not properly establish claims of violation

[17] Appellate Body Report, *Japan - Measures Affecting Agricultural Products* ("*Japan - Agricultural Products*"), WT/DS76/AB/R, adopted 19 March 1999, paras. 136-138; Appellate Body Report, *Korea - Taxes on Alcoholic Beverages*, WT/DS75/AB/R, WT/DS84/AB/R, adopted 17 February 1999, paras. 155-157.

of Article 4 of the *Agreement on Safeguards* based on the OAI Report, and, as a result, failed to establish a *prima facie* case.

17. The interpretation that the Panel cannot make claims for the parties finds support in the conclusions of the Appellate Body.[18] The Appellate Body has reaffirmed its view that a panel does not have the authority to take over the complainant's role in presenting its case.[19] The present case presents an even more compelling example of a panel improperly relieving a complaining Member of the task of presenting its case.

4. Article 5.1 of the Agreement on Safeguards

18. Korea argues that the Panel erred in interpreting Article 5.1 of the *Agreement on Safeguards* as imposing an obligation to apply a measure which in its totality is no more restrictive than is necessary to prevent or remedy serious injury and facilitate adjustment. Article 5.1 does not impose a clearly defined obligation on an importing Member applying a safeguard measure. The first sentence simply articulates a principle or objective, and imposes no binding obligation. If preventing or remedying serious injury and facilitating adjustment are merely goals or objectives, as the Panel concedes, then they are not requirements to be met by a Member applying a particular safeguard measure. A reasonable interpretation of the second sentence of Article 5.1 is that an importing Member may apply a safeguard measure consisting of a quantitative restriction at the level specified in that provision and need only provide clear justification if it deviates from such level. As to the third sentence of Article 5.1, the term "should" in that sentence is an exhortation to Members to meet the objectives in the first sentence.

19. Korea argues that the object and purpose of Article 5.1 of the *Agreement on Safeguards* similarly support Korea's interpretation that the first sentence of Article 5.1 simply articulates an objective. Article 5 is triggered after an importing Member has found that increased imports are causing serious injury or threat thereof to its domestic industry. If the requisite findings are properly made under Article 4 of the *Agreement of Safeguards*, Article 5 is not intended to unduly restrict the right of a Member to redress the emergency situation.

20. Korea submits that the Panel also erred in imposing on Korea an additional obligation to provide a detailed explanation of its decision relating to the application of a particular safeguard measure. There is no reference in Article 5 of the *Agreement on Safeguards* to any requirement for a detailed discussion of the decision to apply a safeguard measure, and no requirement to set forth analysis and reasoning regarding the factors considered. Article 4.2(c) states that the competent authority must publish, in accordance with the provisions of Article 3, a detailed analysis of the case under investigation, as well as a demonstration of the relevance of the factors examined. Article 5, however, contains no similar provision. The drafters must have intended to exclude the requirement to give a reasoned explanation, and such intention must be given effect.

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[18] Appellate Body Report, *Japan - Agricultural Products*, *supra*, footnote 17.
[19] Appellate Body Report, *Canada - Aircraft*, *supra*, footnote 15.

B. Arguments of the European Communities - Appellee

1. Article 6.2 of the DSU

21. The European Communities argues that the Appellate Body in *European Communities - Bananas* illustrated what can be sufficient to satisfy the requirements of Article 6.2 of the DSU.[20] The request for establishment of the Panel in the present dispute does not differ from that in *European Communities - Bananas* and should, *a fortiori*, meet the "sufficiency" standard.

22. Korea's contention that if the "sufficient precision" standard in Article 6.2 of the DSU can be satisfied in every case by listing the provisions relied upon, panels would never need to "examine the request for the establishment of the panel very carefully to ensure its compliance with both the letter and the spirit of Article 6.2 of the DSU" as required by the Appellate Body assumes an inherent conflict between the listing of articles and the careful examination of compliance with Article 6.2 of the DSU. The Appellate Body simply said that the listing of articles is one way to achieve the objectives of Article 6.2 with respect to the Panel's terms of reference and the opportunity for parties to effectively defend their interests. The standard set by the Appellate Body means that the listing of the provisions relied upon is sufficient, although it does not rule out that other means may be chosen to accomplish the objectives of Article 6.2 of the DSU. This standard is aimed at attaining the objectives of Article 6.2, which are the definition of the Panel's jurisdiction and the effective exercise of procedural rights by the parties. In the present case, the European Communities' request for the establishment of a Panel did not prevent Korea from effectively defending itself.

2. The OAI Report

23. The European Communities argues that Korea's appeal relating to the OAI Report should be rejected. The Panel did not consider the OAI Report as the sole relevant basis for its review of compliance with Article 4 of the *Agreement on Safeguards*. In addition, although it mostly relied on Korea's notifications to the Committee on Safeguards, the European Communities also addressed the OAI Report and showed that Korea's investigation was defective on any basis.

24. The European Communities argues that it did not rely only on Korea's notification to assert its claim under Article 4 of the *Agreement on Safeguards.* Even in its First Written Submission, the European Communities referred to the OAI Report. The European Communities initially referred to the best and latest evidence available, which was primarily that summarized in Korea's notification of 24 March 1997. The OAI Report was not the latest statement of what Korea actually did.

25. Korea confuses the notions of "claim" or "matter" within the meaning of Article 11 of the DSU, and that of "argument" and "evidence" in support of a claim. The Appellate Body has clarified the different meaning of all these terms and the

[20] Appellate Body Report, *European Communities - Bananas*, *supra*, footnote 13, paras. 142-143.

different stages of the dispute settlement procedure when they may be invoked.[21] As the European Communities' request for the establishment of a panel included a claim under Article 4 of the *Agreement on Safeguards*, it is irrelevant that the supporting evidence considered by the Panel in reviewing the European Communities' claim was mentioned only at the rebuttal stage of the proceedings.

26. The European Communities disagrees with Korea's argument that the OAI Report was not mentioned by the European Communities in its First Written Submission so that no claim concerning inconsistency with Article 4.2 based on the Report could have been raised at that stage. This argument is flawed because a claim can never be established or even inferred from evidence supplied in the course of proceedings. Further, Korea's position implies that the Panel could have considered the OAI Report in its assessment of Korea's defending arguments, but not in assessing the claim of the European Communities under Article 4.2 of the *Agreement on Safeguards*. This is contrary to the duty of a panel under Article 11 of the DSU to make an objective assessment of the matter before it.

3. Burden of Proof

27. The European Communities accepts that it had the burden of proof to establish its claims under Article 4 of the *Agreement on Safeguards*. Korea's argument that the European Communities should have used different sources for its evidence instead of Korea's notification to the Committee on Safeguards should be dismissed. There is, in the view of the European Communities, no burden of proof issue in this case.

28. The European Communities considers that there is no basis for Korea's argument that the European Communities did not make a *prima facie* case in its First Written Submission, even if this were necessary. Korea's argument assumes that the OAI Report constitutes the only correct basis for establishing claims under Article 4 of the *Agreement on Safeguards*.

29. According to the European Communities, the DSU requires a panel to make an objective assessment of the matter before it. A panel must weigh up all facts regardless of where they came from. The question of burden of proof only arises where there is insufficient evidence for a panel to conclude that a claim or affirmative defence is well-founded. In such a case, a panel needs to apply the rules concerning burden of proof in order to be able to decide on what basis it should proceed to consider any remaining questions before it. A panel does not have to make a finding that a complaining party has itself produced evidence sufficient to establish a *prima facie* case before considering evidence produced by the other party.

[21] Appellate Body Report, *Brazil - Measures Affecting Desiccated Coconut* ("*Brazil - Desiccated Coconut*"), WT/DS22/AB/R, adopted 20 March 1997; Appellate Body Report, *Guatemala - Anti-Dumping Investigation Regarding Portland Cement from Mexico* ("*Guatemala - Cement*"), WT/DS60/AB/R, adopted 25 November 1998; Appellate Body Report, *India - Patent Protection for Pharmaceutical and Agricultural Chemical Products* ("*India - Patents*"), WT/DS50/AB/R, adopted 16 January 1998, para. 88.

30. The European Communities argues that Korea misunderstands *Japan - Agricultural Products*. In that case, the complaining party had not even *claimed* that the alternative measure approved by the panel satisfied the relevant requirements under Article 5.6 of the *Agreement on the Application of Sanitary and Phytosanitary Measures*. This is a case of a panel "deciding *extra petitum*", and not a case of a party failing to satisfy the burden of proof.

4. Article 5.1 of the Agreement on Safeguards

31. The European Communities requests that the Appellate Body reject Korea's attempt to reverse the ordinary meaning of the terms used in Article 5.1 of the *Agreement on Safeguards* and designate clear obligations as "not mandatory". The words "a Member shall apply safeguard measures only to the extent necessary to prevent or remedy serious injury and to facilitate adjustment" clearly create a mandatory obligation.

32. The European Communities disagrees with Korea's view that a "reasonable interpretation" of the second sentence is that a Member need only provide a "clear justification" if it deviates from the average level of imports in the last three respresentative years; otherwise the importing Member is under no obligation to give a reasoned explanation. The plain and ordinary meaning of the words in the first sentence is that a Member applying a safeguard measure must in all cases provide an explanation that the measure at issue is not more restrictive than necessary.

33. With respect to Korea's argument that the use of the words "should" and "objectives" in the third sentence of Article 5.1 suggest that both the first and third sentences are setting out objectives and not "requirements", the European Communities notes that the word "should" has a number of ordinary meanings, including the expression of an obligation. The Appellate Body has itself come to this conclusion.[22]

34. The European Communities contends that, even assuming that an obligation which is not accompanied by criteria is not "mandatory", Article 5.1 does contain criteria for deciding what is necessary. The first sentence contains two express criteria which are: the extent necessary to prevent or remedy serious injury, and the extent necessary to facilitate adjustment. Further guidance on the application of Article 5.1 can be found in the context of that provision, in particular the other provisions of the *Agreement on Safeguards* and Article XIX of the GATT 1994, and in the object and purpose of safeguard measures.

35. The European Communities submits that, even if a Member is not required to explain why it concluded that the measure it takes is necessary to remedy the serious injury and facilitate the adjustment at the time the decision to apply a safeguard measure is taken, such Member must at the least be able to give an explanation when its measure is challenged in dispute settlement proceedings. As the Panel has demonstrated, Korea has not been able to, or even attempted to, justify its measure according to the criteria set out in the first sentence of Article 5.1 of the *Agreement on Safeguards*.

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[22] Appellate Body Report, *Canada - Aircraft*, *supra*, footnote 15.

C. Claims of Error by the European Communities - Appellant

1. Article XIX of the GATT 1994

36. The European Communities requests that the Appellate Body reverse the Panel's conclusion that the phrase "unforeseen developments" does not add conditions for any measure to be applied pursuant to Article XIX of the GATT 1994. The European Communities also requests that the Appellate Body complete the Panel's reasoning and find that, by applying a safeguard measure in a situation where increased imports were not the result of "unforeseen developments", Korea did not comply with the requirement contained in Article XIX:1(a) of the GATT 1994.

37. The European Communities considers that the Panel erred in law in interpreting Article XIX:1(a) contrary to the clear wording of that provision, and according to the Panel's own speculation about the intent of the Contracting Parties to the GATT 1947. The effect of the Panel's interpretation is to effectively write the "as a result of unforeseen developments" requirement out of Article XIX. As confirmed by Article 3.2 of the DSU, panels cannot diminish the rights of the European Communities by deleting one of the requirements which should be fulfilled before a safeguard action can be taken. As previously stated by the Appellate Body, "an interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility". [23]

38. The European Communities argues that the Panel interprets "unforeseen developments" contrary to the ordinary meaning of that term. The Panel ignores the fact that the word "if" in Article XIX:1(a) introduces a list of conditions under which safeguard measures may be imposed. The ordinary meaning of the term "as a result of unforeseen developments" is "as a consequence of a sudden change in a course of action or events or in conditions that has not been foreseen".

39. The European Communities considers that in addition to the ordinary meaning, the terms of a treaty should be read in their context. The context which sheds light on the interpretation of the "as a result of unforeseen developments" requirement is the rest of Article XIX:1(a) of the GATT 1994. The opening phrase of Article XIX:1(a) of the GATT 1994 is relevant context as it makes clear that, in fact, there are two pre-conditions which need to be present before a safeguard action can be taken. Imports should increase both as a result of unforeseen developments and the effect of tariff concessions or any other obligations under the GATT 1994.

40. The European Communities submits that the Appellate Body has confirmed that provisions of the GATT 1994 and the relevant Agreements in Annex 1A of the *WTO Agreement* represent a package of rights and obligations that must be considered in conjunction.[24] Article XIX:1(a) of the GATT 1994 explains what safeguard measures are and lays down basic principles, while the *Agreement on Safeguards* lays down rules for applying them. The requirement that increased imports must result from "unforeseen developments" and the other fundamental

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[23] Appellate Body Report, *United States - Gasoline*, *supra*, footnote 12, p. 23.

[24] Appellate Body Report, *Brazil - Desiccated Coconut*, *supra*, footnote 21; and Appellate Body Report, *Guatemala - Cement*, *supra*, footnote 21.

requirements of safeguard measures were not expressly repeated in the *Agreement on Safeguards* because they did not need to be clarified, added to or modified.

41. The European Communities requests that the Appellate Body find that the "as a result of unforeseen developments" requirement should be applied cumulatively with the requirements set out in the *Agreement on Safeguards*. The *Agreement on Safeguards* does not supersede or replace Article XIX:1(a) of the GATT 1994. Since there is no formal conflict between the provisions of Article 2.1 of the *Agreement on Safeguards* and Article XIX:1(a) of the GATT 1994, Members must comply with all obligations set out in Article XIX:1(a) of the GATT 1994 and the *Agreement on Safeguards*. The omission of "unforeseen developments" in the *Agreement on Safeguards* does not support the "logic" of the interpretation advanced by the Panel.

42. The European Communities considers that the term "unforeseen developments" should be interpreted in light of the object and purpose of both the *Agreement on Safeguards* and Article XIX of the GATT 1994. In the view of the European Communities, the object and purpose of the *Agreement on Safeguards* is inherently linked with Article XIX of the GATT 1994, which is entitled "*Emergency Action* on Imports of Particular Products". Safeguard measures are by definition a mechanism based on "emergencies". The aim of the safeguard mechanism lies in the unpredictability of an event and the possibility to take swift measures which safeguard the relevant domestic industry. The term "unforeseen developments" is meant to prevent the safeguard mechanism from being used to withdraw from liberalization obligations due to developments which were foreseeable and to avoid it being used to restrict trade in the case of developments that had no connection at all with trade liberalization.

43. The European Communities considers that the Panel incorrectly asserted that its interpretation of "unforeseen developments" is confirmed by the subsequent practice of the parties to the GATT. The *Hatters' Fur* case contradicts the Panel's thesis that the "unforeseen developments" condition is mere explanatory verbiage. [25] The European Communities submits that the members of the Working Party in the *Hatters' Fur* case found that the United States could not have reasonably been expected to foresee, at the time when it negotiated tariff reductions in 1947, that a style change of hats would take place on such a massive scale as to cause serious injury.

44. The argument that the "as a result of unforeseen developments" requirement is still valid as a requirement for the safeguard mechanism is supported by recent texts of national legislation which have been notified by a number of WTO Members under Article 12.6 of the *Agreement on Safeguards*. Korea, Costa Rica, Norway, Panama and Japan have all incorporated the phrase in their safeguards legislation.

[25] *Report of the Intersessional Working Party on the Complaint of Czechoslovakia Concerning the Withdrawal by the United States of a Tariff Concession under Article XIX of the GATT* ("*Hatters' Fur*"), GATT/CP/106, adopted 22 October 1951.

2. *Article 12.2 of the Agreement on Safeguards*

45. The European Communities submits that the Panel erred in its interpretation of the phrase "all pertinent information." In finding that Korea's notifications under Article 12.1(b)-(c) of the *Agreement on Safeguards* satisfied the requirement of "all pertinent information", the Panel set a new standard unsupported by the relevant provisions. The European Communities also requests that the Appellate Body complete the Panel's reasoning and find that Korea did not comply with the requirement to provide "all pertinent information" laid down in Article 12.2 of the *Agreement on Safeguards*.

46. The European Communities argues that the Panel developed and applied a new and less stringent standard of information, contrary to the wording, context and the object and purpose of Article 12.2. The requirement to provide "all pertinent information" in Article 12.2 cannot be replaced by a requirement to submit "the amount of information ... sufficient to be useful to Members with a substantial interest in the proposed measure". Had the Panel applied the correct test, it would have found that the evidence provided was not complete and, therefore, that Korea's notifications were inconsistent with that provision.

47. According to the European Communities, Article 12.2 sets a generally defined but broad standard of notification of "all pertinent information". That general and overall standard is immediately clarified by the express mention of a series of elements forming part of "all pertinent information". The expression "which *shall* include" makes it clear that, although the elements listed may not exhaust the notion of "all pertinent information", all of them must be provided in order to meet the "all pertinent information" standard.

48. In light of the context of Article 12.2, the "evidence of serious injury" to which that provision refers is the evidence concerning the matters mentioned in Article 4 of the *Agreement on Safeguards* which is the provision in that Agreement specifying the elements of "serious injury". As serious injury determination in a domestic safeguard procedure must rely on "evidence", it is clear that the information which must be notified pursuant to Article 12.2 includes evidence on the injury factors set out in Article 4.2(a). Furthermore, to enable review of whether the serious injury was caused by imports, evidence of a casual link, as required by Article 4.2(b), must also be included in the notification as part of the "pertinent information."

49. The European Communities argues that, while it is true that the Committee on Safeguards is vested with the power to request information, Article 12.2 expressly qualifies the information that the Committee on Safeguards may request as *additional* to that already required for the notifications under Article 12.1(b)-(c). This power cannot replace the unconditional, binding and enforceable obligation incumbent on the notifying Member.

50. The European Communities considers that it is clear from the provisions of Article 12.2 that the notification obligation pursues two main objectives. The first, which the Panel identified, is to allow the Members with trade interests to request consultations and defend their interests. The second is to ensure consistency and effective control of safeguards measures. In view of the "limitative and deprivational" character of safeguard measures, their inclusion in the WTO system is accompanied by limits to their use, so that the interests of all the parties are protected.

D. Arguments of Korea - Appellee

1. Article XIX of the GATT 1994

51. Korea argues that the Panel correctly considered that the reference to "unforeseen developments" in Article XIX:1(a) of the GATT 1994 does not impose an additional obligation for the imposition of safeguard measures. The drafters of the *Agreement on Safeguards* intended to strike a new balance and move beyond Article XIX of the GATT, which had proved to be difficult to apply in practice. Korea argues further that Article 2 of the *Agreement on Safeguards*, which lays out the "conditions" for taking safeguard measures and is titled accordingly, removes both the "unforeseen developments" language and the requirement to show that the difficulties were "the effect of the obligations incurred by the contracting party under this Agreement, including tariff concessions".

52. It is Korea's contention that, contrary to the European Communities' assertions, the removal of any pre-existing obligation regarding "unforeseen developments" was intended to *strengthen* the multilateral safeguard regime by ensuring the resort by Members to emergency action under the *Agreement on Safeguards*, rather than the use of trade-disruptive and non-transparent "grey area" measures.

53. While Korea concedes that nowhere in the *Agreement on Safeguards* is there an express derogation from Article XIX, Korea notes that the drafters did not need to expressly signal every derogation. Any doubt as to the precedence of those provisions of the *Agreement on Safeguards* over the provisions of Article XIX of the GATT is resolved by the General Interpretative Note to Annex 1A of the *WTO Agreement*. Further, to the extent that any condition regarding "unforeseen developments" applies, the traditional interpretative principles of *lex specialis* and *lex generalis* indicate that the more specific conditions under the *Agreement on Safeguards* apply over the more general conditions expressed in Article XIX.

54. With respect to the argument of the European Communities that "if" at the beginning of the provision introduces a list of conditions under which safeguard measures may be imposed, Korea contends that, while this may be true in the absence of the comma after "if", it is not true where the relevant phrase is set off by commas as a dependent clause. As the Panel found, the introductory phrase simply highlights the general situation where negotiated concessions may need to be set aside because of an emergency situation.

55. Korea argues that there is nothing in the context of the opening phrase to contradict the Panel's interpretation that a Member does not have to demonstrate the existence of "unforeseen developments" before it can impose safeguard measures. The arguments of the European Communities are irrelevant because they presume that the "unforeseen developments" clause established a condition in the first place. An analysis of the context of the relevant language in Article XIX supports the Panel's interpretation. As context, Articles 1, 2, and 11.1(a) of the *Agreement on Safeguards* demonstrate that the rules and conditions for applying safeguard measures are found in that Agreement.

56. Korea submits that the Panel's interpretation was also consistent with the object and purpose of the relevant provision in Article XIX. The European Communities attempts to bolster its interpretation by reference to the title of Article

XIX: "Emergency Action on Imports of a Particular Product", arguing that the safeguard measures are inherently linked to the existence of an emergency situation. A more appropriate interpretation is that the title and the provision relating to "unforeseen developments" simply set forth the general situation in which tariff concessions may be temporarily suspended, as the Panel correctly found. Korea considers that the object and purpose of the provision is fully consistent with the Panel's interpretation.

57. With respect to the argument of the European Communities regarding subsequent practice, Korea argues that the Panel properly viewed the *Hatters' Fur* case as reinforcing the proposition that the unforeseen developments "requirement" is not at all a condition as the Working Party considered that increased imports of fur felt hats were *ipso facto* an unforeseen development.

58. On national legislation, Korea submits that practice under Article XIX confirms that the contracting parties to the GATT did not consider that the condition of "unforeseen developments" was required. The legislation of Members cited by the European Communities as requiring "unforeseen developments" is also consistent with the Panel's interpretation, given that these Members simply copied, either verbatim or in a similar form, the language from Article XIX:1(a).

59. According to Korea, should the Appellate Body accept the European Communities' interpretation of Article XIX, it would be inappropriate for the Appellate Body to engage in a factual analysis as to whether unforeseen developments existed. Article 17.6 of the DSU expressly limits the Appellate Body's authority to the review of issues of law and legal interpretations. Although the Appellate Body has previously engaged in factual analysis in some cases, it has also refused to perform such analysis in other cases either because there were not enough uncontested facts in the record of the case, or because it was not necessary for the resolution of the dispute. As the parties in this case provided only very limited factual information regarding whether unforeseen developments in fact existed, the Appellate Body would need to engage in a renewed factual investigation in order to assess whether such developments existed at the time of the safeguards investigation.

60. Korea argues further, that if the Appellate Body accepts the European Communities' interpretation of Article XIX of GATT 1994 and decides to engage in a factual analysis, the Appellate Body should find that unforeseen developments existed at the time of the safeguards investigation and that, therefore, Korea acted in accordance with Article XIX. Korea liberalized imports of skimmed milk powder preparations and milk powder and applied a tariff rate of 40 percent and 220 percent on these products respectively. At that time and subsequent to the Uruguay Round, Korea had no reason to foresee that European Communities' milk powder exporters would change their product to skimmed milk powder preparations in order to circumvent the high tariff on milk powder. Korea could not have foreseen that the European Communities would circumvent Korea's good faith commitments.

2. Article 12.2 of the Agreement on Safeguards

61. Korea argues that the Appellate Body should reject the appeal of the European Communities relating to Article 12.2 of the *Agreement on Safeguards*. In the view of Korea, the Panel was correct in drawing a distinction between the

obligation in Article 12.2 to provide "all pertinent information", and that in Article 3 to address "all pertinent issues of fact and law". Accepting the interpretation of the European Communities would lead to the conclusion that a Member imposing a safeguard measure is required to provide the Committee on Safeguards with a broader or a more varied range of matters than such Member is required to include in its underlying investigation.

62. In the view of Korea, the Panel established a clear and comprehensible test as to what Members have to do, in that the amount of information notified must be sufficient to be useful to Members with a substantial interest in the proposed safeguard measure. The Panel reviewed the claims of the European Communities, and, after construing Article 12 in accordance with the object and purpose of that provision, concluded that the information provided by Korea was sufficient. The statement of the Panel relating to "what Korea considered to be evidence of injury" is a reference to the circumstances under which information was provided by Korea and should not to be taken as the standard applied by the Panel.

63. Korea submits that the European Communities' view that the purpose of Article 12 is to impose some additional and unspecified burden on a Member imposing a measure is contrary to the intention of the drafters for two reasons. First, had the drafters intended this, they would not have referred to the standard of "all pertinent information", but would have provided for a precise mechanism by which the analysis required under Articles 3 and 4 was made available to the Committee on Safeguards. Second, if an investigation fulfilled the requirements of Articles 2.1, 3.1 and 4 and had been notified *verbatim* to the Committee on Safeguards, the final sentence of Article 12.2 would be redundant. The obligation under Article 12 to provide "all pertinent information" is different from, and not as stringent as, the requirements under Articles 2, 3 and 4.

E. Arguments of the United States - Third Participant

1. Article XIX of the GATT 1994

64. In the view of the United States, the *Agreement on Safeguards* now completely occupies the field of regulation of safeguard measures in the WTO system. If it were possible for Members to pick and choose between the rights and obligations in the original package of Article XIX of the GATT 1994, and the rights and obligations in the revised package in the *Agreement on Safeguards*, and to bring claims under both agreements, the entire project represented by the *Agreement on Safeguards* would be revised *post hoc*. The text of Article XIX cannot be read outside the context of the *Agreement on Safeguards*. The omission of "unforeseen developments" from that Agreement was intentional, and this express omission must be given meaning.

65. The United States argues that the European Communities has provided no basis for suggesting that the phrase "unforeseeable developments" remains binding while other parts of Article XIX have ceased to be so. The suggestion that other provisions of Article XIX remain fully in effect is untenable. If the "unforeseen developments" condition in Article XIX:1(a) can still be independently read and enforced, divorced from its context in the *Agreement on Safeguards*, this might suggest that a Member could take compensatory measures whenever they would be

permissible under Article XIX:3, notwithstanding the limits on such measures in Article 8.3 of the *Agreement on Safeguards*.

66. The United States notes that legal scholars agree that under the *WTO Agreement*, "unforeseen developments" are no longer a prerequisite for a safeguard action.[26] State practice has also treated the question of "unforeseen developments" as marginal, legally non-binding or subsumed by other aspects of the safeguards process. The great majority of safeguards legislation, including that of the European Communities, notified to the WTO does not refer to "unforeseen developments," and thus does not require that the relevant domestic authorities investigate or make a determination in this respect. Thus, nearly all Members have demonstrated their belief that the existence of "unforeseen developments" is not required as a condition for taking safeguard measures.

III. ISSUES RAISED IN THIS APPEAL

67. This appeal raises the following issues:

(a) Whether the Panel erred in its conclusion that the clause in Article XIX:1(a) of the GATT 1994 - "if, as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions …" - does not add conditions for any safeguard measure to be applied pursuant to Article XIX of the GATT 1994;

(b) Whether the Panel erred in its interpretation and application of Article 5.1 of the *Agreement on Safeguards*;

(c) Whether the Panel erred in its interpretation and application of Article 12.2 of the *Agreement on Safeguards*;

(d) Whether the Panel erred in finding that the request for the establishment of a panel submitted by the European Communities met the requirements of Article 6.2 of the DSU;

(e) Whether the Panel improperly based its findings of inconsistency with Article 4.2 of *Agreement on Safeguards* on the OAI Report; and

(f) Whether the Panel erred in its application of the burden of proof in respect of its findings under Article 4 of the *Agreement on Safeguards*.

[26] *See* M. Bronckers, "Voluntary Export Restraints and the GATT 1994 Agreement on Safeguards", in J.H.J. Bourgeois, F. Berrod and E. Fournier (eds.), *The Uruguay Round Results: A European Lawyers' Perspective* (European University Press, 1995), p. 275; and M. Trebilcock and R. Howse, *The Regulation of International Trade*, 2nd ed. (Routledge, 1999), p. 228.

IV. CLAIMS UNDER ARTICLE XIX OF THE GATT 1994

68. The European Communities appeals the Panel's rejection of the claim by the European Communities that Korea violated the provisions of Article XIX:1 of the GATT 1994 by failing to examine whether the alleged increase in imports was "as a result of unforeseen developments".[27] The European Communities requests that the Appellate Body reverse the legal interpretations and findings made by the Panel in paragraphs 7.42 to 7.48 of the Panel Report, and, most notably, the "fundamental error"[28] made by the Panel in finding that:

> … the prior section of the sentence, "If, as a result of unforeseen developments and of the effect of obligations incurred by a contracting party under this Agreement, including tariff concessions…" *does not add conditions* for any measure to be applied pursuant to Article XIX … [29] (emphasis added)

The European Communities also asks that the Appellate Body complete the Panel's reasoning and find on the basis of uncontested facts on the record that Korea did not comply with the "requirement" contained in Article XIX:1(a) of the GATT 1994 to apply safeguard measures only where the alleged increase in imports is "as a result of unforeseen developments".[30]

69. In its examination of the claim of the European Communities under Article XIX:1 of the GATT 1994, the Panel stated that:

> We consider that the terms and prescriptions of Article XIX:1 of GATT are still generally applicable, as we are of the view that there is no conflict between the provisions of Article XIX:1 of GATT and those of Article 2.1 of the Agreement on Safeguards.[31]

70. Having decided that Article XIX:1 of the GATT 1994 is still applicable under the *WTO Agreement*, the Panel proceeded to examine the meaning of the clause in Article XIX:1(a) - "If, as a result of unforeseen developments and of the effect of the obligations incurred by a contracting party under this Agreement, including tariff concessions …". The Panel stated that, in its view, this clause:

> … *does not add conditions* for any measure to be applied pursuant to Article XIX but *rather serves as an explanation* of why an Article XIX measure may be needed, taking into account the fact that at the time (1947) the CONTRACTING PARTIES had just agreed (for the first time) on multilateral

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27 European Communities' appellant's submission, para. 14.
28 European Communities' appellant's submission, para. 15.
29 Panel Report, para. 7.42.
30 European Communities' appellant's submission, para. 17. *See* also para. 137.
31 Panel Report, para. 7.39.

> tariff bindings and on a general prohibition against quotas.[32] (emphasis added)

71. The Panel reasoned further:

> … the proposition "as a result of unforeseen developments and of the effect of the obligations incurred by a contracting party under this Agreement" *does not address the conditions for Article XIX measures to be applied but rather explains why a provision such as Article XIX may be needed*. For us, the object of this section of the first sentence of paragraph 1 of Article XIX cannot be anything else but a statement (of what we would now consider to be obvious) that because of the binding nature of the GATT obligations and concessions, tariffs and other obligations negotiated on the basis of trade expectations may need to be changed temporarily in light of actual unforeseen developments. *Thus, the phrase "unforeseen circumstances" does not specify anything additional as to the conditions under which measures pursuant to Article XIX may be applied*.[33] (emphasis added)

72. In the view of the Panel, the adoption of the *Agreement on Safeguards* without this "unforeseen developments" clause was "logical". Because Uruguay Round negotiators "understood that this reference to 'unforeseen developments' did not add to the rest of the paragraph (but rather describes its context), there was no need to insert it explicitly in the Agreement on Safeguards."[34]

73. On the basis of this reasoning, the Panel concluded:

> … we reject the specific claim of the European Communities that Korea was wrong in failing to examine whether the import trends of the products under investigation were the result of "unforeseen developments" contrary to Article XIX:1(a), as we consider that Article XIX of GATT does not contain such a requirement.[35]

74. We agree with the statement of the Panel that:

> It is now well established that the WTO Agreement is a "Single Undertaking" and therefore all WTO obligations are generally cumulative and Members must comply with all of them simultaneously … .[36]

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32 Panel Report, para. 7.42.
33 Panel Report, para. 7.45.
34 *Ibid*., para. 7.47.
35 *Ibid*., para. 7.48.
36 Panel Report, para. 7.38.

In this context, we note that Article II:2 of the *WTO Agreement* provides that:

> The agreements and associated legal instruments included in Annexes 1, 2 and 3 (hereinafter referred to as "Multilateral Trade Agreements") are *integral parts* of this Agreement, *binding on all Members*. (emphasis added)

75. We note, furthermore, that the GATT 1994 was incorporated into the *WTO Agreement* as one of the Multilateral Agreements on Trade in Goods contained in Annex 1A to the *WTO Agreement*. The GATT 1994 consists of: (a) the provisions of the GATT 1947, as rectified, amended or modified before the entry into force of the *WTO Agreement*; (b) provisions of certain other legal instruments which entered into force under the GATT 1947 and before the date of entry into force of the *WTO Agreement*; (c) a number of Uruguay Round Understandings on the interpretation of certain GATT articles; and (d) the Marrakesh Protocol to GATT 1994.[37] The *Agreement on Safeguards* is one of the thirteen Multilateral Agreements on Trade in Goods contained in Annex 1A of the *WTO Agreement*. It is important to understand that the *WTO Agreement* is *one* treaty. The GATT 1994 and the *Agreement on Safeguards* are both Multilateral Agreements on Trade in Goods contained in Annex 1A, which are integral parts of that treaty and are equally binding on all Members pursuant to Article II:2 of the *WTO Agreement*.

76. The specific relationship between Article XIX of the GATT 1994 and the *Agreement on Safeguards* within the *WTO Agreement* is set forth in Articles 1 and 11.1(a) of the *Agreement on Safeguards*:

> Article 1
>
> *General Provision*
>
> This Agreement establishes rules for the application of *safeguard measures* which shall be understood to mean *those measures provided for in* Article XIX of GATT 1994. (emphasis added)

> Article 11
>
> *Prohibition and Elimination of Certain Measures*
>
> 1. *(a)* A Member shall not take or seek any *emergency action* on imports of particular products *as set forth in Article XIX of GATT 1994 unless such action conforms with the provisions of that Article applied in accordance with this Agreement*. (emphasis added)

77. Article 1 states that the purpose of the *Agreement on Safeguards* is to establish "rules for the application of safeguard measures which shall be understood to mean *those measures provided for in* Article XIX of GATT 1994." (emphasis

[37] *See* paragraph 1 of the language incorporating the GATT 1994 into Annex 1A of the *WTO Agreement.*

added) The ordinary meaning of the language in Article 11.1(a) - "unless such action conforms with the provisions of that Article applied in accordance with this Agreement" - is that any safeguard action *must conform* with the provisions of Article XIX of the GATT 1994 *as well as* with the provisions of the *Agreement on Safeguards*. Thus, any safeguard measure[38] imposed after the entry into force of the *WTO Agreement* must comply with the provisions of *both* the *Agreement on Safeguards* and Article XIX of the GATT 1994.

78. Having found that the provisions of *both* Article XIX:1 of the GATT 1994 and Article 2.1 of the *Agreement on Safeguards* apply to any safeguard measure[39] taken under the *WTO Agreement*, we now turn to interpret the meaning of the clause - "as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions …" - in Article XIX:1(a). The provisions of Article XIX:1(a) of the GATT 1994 and Article 2.1 of the *Agreement on Safeguards* read as follows:

GATT 1994

Article XIX

Emergency Action on Imports of Particular Products

1. (a) If, *as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions*, any product is being imported into the territory of that Member in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers in that territory of like or directly competitive products, the Member shall be free, in respect of such product, and to the extent and for such time as may be necessary to prevent or remedy such injury, to suspend the obligation in whole or in part or to withdraw or modify the concession. (emphasis added)

Agreement on Safeguards

Article 2

Conditions

1. A Member may apply a safeguard measure to a product only if that Member has determined, pursuant to the provisions set out below, that such product is being imported into its territory in such increased quantities, absolute or relative to domestic production, and under such conditions as to cause or threaten to cause serious injury to the domestic industry that

[38] With the exception of special safeguard measures taken pursuant to Article 5 of the *Agreement on Agriculture* or Article 6 of the *Agreement on Textiles and Clothing*.
[39] *Supra,* footnote 38.

> produces like or directly competitive products. (footnote omitted)

79. The task before us in this appeal is *not* to interpret Article 2.1 of the *Agreement on Safeguards*, but *rather* to interpret Article XIX:1(a) of the GATT 1994. This appeal by the European Communities relates to the Panel's rejection of the claim by the European Communities that Korea violated the provisions of Article XIX:1(a) of the GATT 1994 by failing to examine whether the alleged increase in imports was "as a result of unforeseen developments". Therefore, our task in this appeal is to interpret the first clause in Article XIX:1(a) - "as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions …" - and to determine whether the Panel erred in rejecting the European Communities' claim under Article XIX:1 of the GATT 1994.

80. Before we commence our analysis of this clause in Article XIX:1(a), it is useful, first, to review certain principles relating to the interpretation of treaties. We note, first, that Article 3.2 of the DSU provides that the dispute settlement system of the WTO serves "to clarify the existing provisions of [the covered] agreements *in accordance with the customary rules of interpretation of public international law*." (emphasis added) The principles of interpretation of treaties set forth in Articles 31 and 32 of the *Vienna Convention on the Law of Treaties*[40] apply to the interpretation of provisions of the *WTO Agreement*.[41] We have also recognized, on several occasions, the principle of effectiveness in the interpretation of treaties (*ut res magis valeat quam pereat*) which requires that a treaty interpreter:

> … must give meaning and effect to all the terms of the treaty. An interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility.[42]

81. In light of the interpretive principle of effectiveness, it is the *duty* of any treaty interpreter to "read all applicable provisions of a treaty in a way that gives

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[40] *Vienna Convention on the Law of Treaties*, done at Vienna, 23 May 1969, 1155 U.N.T.S. 331; (1969) 8 International Legal Materials 679.

[41] As we have stipulated in, for example, Appellate Body Report, *United States - Gasoline*, *supra*, footnote 12, p. 17; Appellate Body Report, *Japan - Taxes on Alcoholic Beverages* ("*Japan - Alcoholic Beverages*"), WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, adopted 1 November 1996, p. 11; Appellate Body Report, *India - Patents*, *supra*, footnote 21, para. 46; Appellate Body Report, *European Communities - Customs Classification of Certain Computer Equipment* ("*European Communities - Computer Equipment*"), WT/DS62/AB/R, WT/DS67/AB/R, WT/DS68/AB/R, adopted 22 June 1998, para. 84; and Appellate Body Report, *United States - Import Prohibition of Certain Shrimp and Shrimp Products*, WT/DS58/AB/R, adopted 6 November 1998, para. 114.

[42] Appellate Body Report, *United States - Gasoline*, *supra*, footnote 12, p. 23. We also confirmed this principle in Appellate Body Report, *Japan - Alcoholic Beverages*, *supra*, footnote 41, p. 12; Appellate Body Report, *Canada - Measures Affecting the Importation of Milk and the Exportation of Dairy Products*, WT/DS103/AB/R, WT/DS113/AB/R, adopted 27 October 1999, para. 133; and Appellate Body Report, *Argentina - Safeguard Measures on Imports of Footwear*, WT/DS121/AB/R, circulated 14 December 1999, para. 88.

meaning to *all* of them, harmoniously."[43] An important corollary of this principle is that a treaty should be interpreted as a whole, and, in particular, its sections and parts should be read as a whole.[44] Article II:2 of the *WTO Agreement* expressly manifests the intention of the Uruguay Round negotiators that the provisions of the *WTO Agreement* and the Multilateral Trade Agreements included in its Annexes 1, 2 and 3 must be read as a whole.

82. Having said that *all of the provisions* of a treaty must be given meaning and legal effect, we believe that the clause in Article XIX:1(a) - "as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions …" - must have meaning. We do not agree with the Panel's conclusion that it "does not add conditions for any measure to be applied pursuant to Article XIX but rather serves as an explanation of why an Article XIX measure may be needed".[45] We also do not agree with the Panel that this clause "only describes generally the situations where the binding nature of the obligations contained in Articles II and XI of GATT may need to be set aside (for a certain period)."[46]

83. Having determined that this clause must have meaning, we now turn to examine what that meaning is. We refer again to the language of Article XIX:1(a), in its entirety:

> If, *as a result of unforeseen developments* and *of the effect of the obligations incurred* by a Member under this Agreement, including tariff concessions, *any product is being imported* into the territory of that Member in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers in that territory of like or directly competitive products, the Member shall be free, in respect of such product, and to the extent and for such time as

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[43] We have emphasized this in Appellate Body Report, *Argentina - Safeguard Measures on Imports of Footwear*, WT/DS121/AB/R, circulated 14 December 1999, para. 81. *See* also Appellate Body Report, *United States - Gasoline*, *supra*, footnote 12, p. 23; Appellate Body Report, *Japan - Alcoholic Beverages*, *supra*, footnote 41, p. 12; and Appellate Body Report, *India - Patents*, *supra*, footnote 21, para. 45.

[44] The duty to interpret a treaty as a whole has been clarified by the Permanent Court of International Justice in *Competence of the I.L.O. to Regulate Agricultural Labour* (1922), PCIJ, Series B, Nos. 2 and 3, p. 23. This approach has been followed by the International Court of Justice in *Ambatielos Case* (1953) *ICJ Reports*, p. 10; *Reservations to the Convention on the Prevention and Punishment of the Crime of Genocide* (1951) *ICJ Reports*, p. 15; and *Case Concerning Rights of United States Nationals in Morocco* (1952) *ICJ Reports*, pp. 196-199. *See* also I. Brownlie, *Principles of Public International Law*, 5th ed. (Clarendon Press, 1998), p. 634; G. Fitzmaurice, "The Law and Procedure of the International Court of Justice 1951-1954: Treaty Interpretation and Other Treaty Points", 33 *British Yearbook of International Law* (1957), p. 211 at p. 220; A. McNair, *The Law of Treaties* (Clarendon Press, 1961), pp. 381-382; I. Sinclair, *The Vienna Convention on the Law of Treaties* (Manchester University Press, 1984), pp. 127-129; M.O. Hudson, *La Cour Permanente de Justice Internationale* (Editions A Pedone, 1936), pp. 654-659; and L.A. Podesta Costa and J.M. Ruda, *Derecho Internacional Público*, Vol. 2 (Tipográfica, 1985), p. 105.

[45] Panel Report, para. 7.42.

[46] *Ibid*., para. 7.43.

> may be necessary to prevent or remedy such injury, to suspend the obligation in whole or in part or to withdraw or modify the concession. (emphasis added)

84. To determine the meaning of the clause - "as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions …" - in sub-paragraph (a) of Article XIX:1, we must examine these words in their ordinary meaning, in their context and in light of the object and purpose of Article XIX. We look first to the ordinary meaning of these words. As to the meaning of "unforeseen developments", we note that the dictionary definition of "unforeseen", particularly as it relates to the word "developments", is synonymous with "unexpected".[47] "Unforeseeable", on the other hand, is defined in the dictionaries as meaning "unpredictable" or "incapable of being foreseen, foretold or anticipated".[48] Thus, it seems to us that the ordinary meaning of the phrase "as a result of unforeseen developments" requires that the developments which led to a product being imported in such increased quantities and under such conditions as to cause or threaten to cause serious injury to domestic producers must have been "unexpected". With respect to the phrase "of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions", we believe that this phrase simply means that it must be demonstrated, as a matter of fact, that the importing Member has incurred obligations under the GATT 1994, including tariff concessions. Here, we note that the Schedules annexed to the GATT 1994 are made an integral part of Part I of that Agreement, pursuant to paragraph 7 of Article II of the GATT 1994. Therefore, any concession or commitment in a Member's Schedule is subject to the obligations contained in Article II of the GATT 1994.

85. When we examine this clause - "as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions …" - in its immediate context in Article XIX:1(a), we see that it relates directly to the second clause in that paragraph - "If, … , any product is being imported into the territory of that Member in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers in that territory of like or directly competitive products …". The latter, or second, clause in Article XIX:1(a) contains the three *conditions* for the application of safeguard measures. These *conditions*, which are reiterated in Article 2.1 of the *Agreement on Safeguards*[49], are that: (1) a product is being imported "in such quantities and under such conditions"; (2) "as to cause"; (3) serious injury or the threat of serious injury to domestic producers. The first clause in Article XIX:1(a) - "as a result of unforeseen developments and of the obligations incurred by a Member under the Agreement, including tariff concessions …" - is a dependent clause which, in our view, is linked grammatically to the verb phrase "is being imported" in the second clause of that paragraph. Although we do not view the first clause in Article XIX:1(a) as

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47 *See Webster's Third New International Dictionary* (Encyclopaedia Britannica Inc., 1966), Vol. 3, p. 2496; and *Black's Law Dictionary*, 6th ed. (West Publishing Company, 1990), p. 1530.

48 *Ibid*.

49 We note that the title of Article 2 of the *Agreement on Safeguards* is: "*Conditions*".

establishing independent *conditions* for the application of a safeguard measure, additional to the *conditions* set forth in the second clause of that paragraph, we do believe that the first clause describes certain *circumstances* which must be demonstrated as a matter of fact in order for a safeguard measure to be applied consistently with the provisions of Article XIX of the GATT 1994. In this sense, we believe that there is a logical connection between the circumstances described in the first clause - "as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions …" - and the conditions set forth in the second clause of Article XIX:1(a) for the imposition of a safeguard measure.

86. Our reading is supported by the context of these provisions. As part of the context of paragraph 1(a) of Article XIX, we note that the title of Article XIX is: "*Emergency Action on Imports of Particular Products*". The words "emergency action" also appear in Article 11.1(a) of the *Agreement on Safeguards*. We note once again, that Article XIX:1(a) requires that a product be imported "*in such increased quantities* and *under such conditions* as *to cause or threaten serious injury* to domestic producers … ". (emphasis added) In our view, the text of Article XIX:1(a) of the GATT 1994, read in its ordinary meaning and in its context, demonstrates that safeguard measures were intended by the drafters of the GATT to be matters out of the ordinary, to be matters of urgency, to be, in short, "emergency actions." And, such "emergency actions" are to be invoked only in situations when, as a result of obligations incurred under the GATT 1994, an importing Member finds itself confronted with developments it had not "foreseen" or "expected" when it incurred that obligation. The remedy that Article XIX:1(a) allows in this situation is temporarily to "suspend the obligation in whole or in part or to withdraw or modify the concession". Thus, Article XIX is clearly an extraordinary remedy.

87. This reading of these clauses is also confirmed by the object and purpose of Article XIX of the GATT 1994. The object and purpose of Article XIX is to allow a Member to re-adjust temporarily the balance in the level of concessions between that Member and other exporting Members when it is faced with "unexpected" and, thus, "unforeseen" circumstances which lead to a product "being imported" in "such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers … of like or directly competitive products". This allows an importing Member to give the domestic industry in question enough time to adjust to the new competitive conditions caused by the increased imports. We should not lose sight of the fact that taking safeguard action results in restrictions on imports arising from "fair" trade. The application of a safeguard measure does not depend upon "unfair" trade actions, as is the case with anti-dumping or countervailing measures.

88. Our reading of these prerequisites makes certain that *all* the relevant provisions of Article XIX of the GATT 1994 and the *Agreement on Safeguards* relating to safeguard measures are given their full meaning and their full legal effect. Our reading, too, is consistent with the desire expressed by the Uruguay Round negotiators in the Preamble to the *Agreement on Safeguards* "to clarify and *reinforce* the disciplines of GATT 1994, and *specifically those of its Article XIX* …, to

re-establish *multilateral control* over safeguards and eliminate measures that escape such control …".[50] In furthering this statement of the object and purpose of the *Agreement on Safeguards*, it must always be remembered that safeguard measures result in the temporary suspension of treaty concessions or the temporary withdrawal of treaty obligations, which are fundamental to the *WTO Agreement*, such as those in Article II and Article XI of the GATT 1994.

89. In addition, we note that our reading of the clause "as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions …" in Article XIX:1(a) is also consistent with the one GATT 1947 case that involved Article XIX, the so-called "*Hatters' Fur*" case.[51] Members of the Working Party in that case, in 1951, stated:

> … "unforeseen developments" should be interpreted to mean developments occurring after the negotiation of the relevant tariff concession which it would not be reasonable to expect that the negotiators of the country making the concession could and should have foreseen at the time when the concession was negotiated.[52]

90. On the basis of the above reasoning, we do not agree with the Panel that the clause - "as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions …" - "does not specify anything additional as to the conditions under which measures pursuant to Article XIX may be applied."[53] We, therefore, reverse the Panel's conclusion that "Article XIX of GATT does not contain such a requirement."[54]

91. The European Communities further requests that we complete the Panel's reasoning and find "on the basis of the found or uncontested facts" that by imposing a safeguard measure in circumstances where the alleged increase in imports was not "as a result of unforeseen developments" within the meaning of Article XIX:1(a) of the GATT 1994, Korea also violated its obligations under Article XIX of the GATT 1994.[55]

92. The Panel did not make any factual findings on whether the alleged increase in imports of skimmed milk powder preparations was "a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions …". The facts were also contested by the parties. While Korea argues that the increase in imports was "a result of unforeseen developments", the European Communities disagrees with this view of the facts. In the absence of any factual findings by the Panel or undisputed facts in the Panel

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[50] *Agreement on Safeguards*, Preamble.

[51] *Report of the Intersessional Working Party on the Complaint of Czechoslovakia Concerning the Withdrawal by the United States of a Tariff Concession under Article XIX of the GATT* ("*Hatters' Fur*"), GATT/CP/106, adopted 22 October 1951.

[52] *Ibid*., para. 9. This interpretation was proposed by the representative of Czechoslovakia, and was accepted by all the Members of the Working Party, with the exception of the United States.

[53] Panel Report, para. 7.45.

[54] *Ibid*., para. 7.48.

[55] European Communities' appellant's submission, para. 137. *See* also para. 17.

record relating to whether the alleged increase in imports was, indeed, "a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions …", we are not in a position, within the scope of our mandate set forth in Article 17 of the DSU, to complete the analysis and make a determination as to whether Korea acted inconsistently with its obligations under Article XIX:1(a). Accordingly, we are unable to come to a conclusion on whether or not Korea violated its obligations under Article XIX:1(a) of the GATT 1994.

V. ARTICLE 5.1 OF THE AGREEMENT ON SAFEGUARDS

93. Korea appeals from the Panel's interpretation and application of Article 5.1 of the *Agreement on Safeguards*. Article 5.1 provides:

> A Member shall apply safeguard measures only to the extent necessary to prevent or remedy serious injury and to facilitate adjustment. If a quantitative restriction is used, such a measure shall not reduce the quantity of imports below the level of a recent period which shall be the average of imports in the last three representative years for which statistics are available, unless clear justification is given that a different level is necessary to prevent or remedy serious injury. Members should choose measures most suitable for the achievement of these objectives.

94. In paragraph 7.101 of its Report, the Panel stated:

> In our view a measure is defined by the following elements: product coverage, form, duration and level. Thus, in order to comply with Article 5.1 a Member must apply *a measure which in its totality is no more restrictive than is necessary* to prevent or remedy the serious injury and facilitate adjustment. In addition, it must be possible for a Panel to evaluate, in accordance with the applicable standard of review, whether a Member has acted in compliance with Article 5.1. Therefore, the Member applying *the measure must provide a reasoned explanation* as to how the authorities reached the conclusion that the particular measure in question satisfies all the requirements of Article 5.1. We consider that the obligations of the first sentence of Article 5.1 apply to all safeguard measures in their entirety. (emphasis added)

95. Korea argues that the Panel erred in interpreting Article 5.1 as imposing on a Member applying a safeguard measure two "new" obligations which are not contained in that provision. In the view of Korea, the first sentence of Article 5.1 "does not impose a clearly-defined obligation on an importing Member … applying a safeguard measure".[56] Rather, it articulates a principle or an objective. Nor does

[56] Korea's appellant's submission, p. 38.

Article 5.1 contain an obligation to provide "a reasoned explanation as to how the authorities reached the conclusion that the particular measure in question satisfies all the requirements of Article 5.1."[57]

96. The first sentence of Article 5.1 provides:

> A Member shall apply safeguard measures only to the extent necessary to prevent or remedy serious injury and to facilitate adjustment.

We agree with the Panel that the wording of this provision leaves no room for doubt that it imposes an *obligation* on a Member applying a safeguard measure to ensure that the measure applied is commensurate with the goals of preventing or remedying serious injury and of facilitating adjustment.[58] We also agree that this obligation applies regardless of the particular form that a safeguard measure might take. Whether it takes the form of a quantitative restriction, a tariff or a tariff rate quota, the measure in question must be applied "only to the extent necessary" to achieve the goals set forth in the first sentence of Article 5.1.[59]

97. In paragraph 7.109 of its Report, the Panel stated:

> Members are required, *in their recommendations or determinations on the application* of a safeguard measure, *to explain* how they considered the facts before them and why they concluded, *at the time of the decision*, that the measure to be applied was necessary to remedy the serious injury and facilitate the adjustment of the industry. It is such reasoning and explanation concerning the measure adopted, essential to evaluate Korea's compliance with Article 5.1, which we cannot discern in Korea's determination to apply a safeguard measure in the present case. (emphasis added)

98. The second sentence of Article 5.1 provides:

> If a quantitative restriction is used, such a measure shall not reduce the quantity of imports below the level of a recent period which shall be the average of imports in the last three representative years for which statistics are available, unless clear justification is given that a different level is necessary to prevent or remedy serious injury.

This sentence requires a "clear justification" if a Member takes a safeguard measure in the form of a quantitative restriction which reduces the quantity of imports below the average of imports in the last three representative years for which statistics are available. We agree with the Panel that this "clear justification" has to be given by a Member applying a safeguard measure *at the time of the decision, in its recommendations or determinations on the application of the safeguard measure*.

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[57] *Ibid*., p. 41.
[58] Panel Report, paras. 7.100 and 7.101.
[59] *Ibid*., para. 7.101.

99. However, we do not see anything in Article 5.1 that establishes such an obligation for a safeguard measure *other* than a quantitative restriction which reduces the quantity of imports below the average of imports in the last three representative years. In particular, a Member is *not* obliged to justify in its recommendations or determinations a measure in the form of a quantitative restriction which is consistent with "the average of imports in the last three representative years for which statistics are available".

100. For these reasons, we do not agree with the Panel's broad finding in paragraph 7.109 that:

> Members are required, in their recommendations or determinations on the application of a safeguard measure, to explain how they considered the facts before them and why they concluded, at the time of the decision, that the measure to be applied was necessary to remedy serious injury and facilitate the adjustment of the industry.

101. On the basis of this interpretation, the Panel came to the conclusion that "Korea's determination of the measure did not meet the requirements of Article 5 of the Agreement on Safeguards".[60] Moreover, the Panel did not find it necessary to rule on whether the quantitative restriction applied by Korea reduced the quantity of imports below the average of imports in the last three representative years for which statistics are available. According to the Panel:

> Since we have already found that Korea's application of a measure was not consistent with the provisions of the first sentence of Article 5.1 which we consider to be generally applicable, also when a quantitative restriction based on the average import levels for the last three representative years is used, we do not address the question of whether the quota level was calculated consistently with the second sentence of Article 5.1.[61]

102. In deciding whether Korea has acted inconsistently with the second sentence of Article 5.1, we must determine whether the quantitative restriction imposed by Korea was below the average level of imports in the last three representative years for which statistics are available, and if so, whether Korea gave a reasoned explanation as required by the second sentence of Article 5.1. The Panel did not make any factual findings on the average level of imports of skimmed milk powder preparations in the last three representative years. The average level of imports in that period was also contested by the parties.[62] Accordingly, we are not in a position, within the scope of our mandate under Article 17 of the DSU, to complete the analysis in this case and make a determination as to the consistency of Korea's safeguard measure with the second sentence of Article 5.1.

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60 Panel Report, para. 7.110.
61 Panel Report, para. 7.111.
62 *Ibid*., paras. 4.613-4.626.

103. For these reasons, we uphold the Panel's finding, in paragraph 7.101 of its Report, that the first sentence of Article 5.1 imposes an *obligation* on a Member applying a safeguard measure to ensure that the measure applied is not more restrictive than necessary to prevent or remedy serious injury and to facilitate adjustment. However, we reverse the Panel's broad finding, in paragraph 7.109 of its Report, that Article 5.1 requires a Member to explain, at the time it makes its recommendations and determinations concerning the application of a safeguard measure, that its measure is necessary to remedy serious injury and to facilitate adjustment, even where the particular safeguard measure applied is *not* a quantitative restriction which reduces the quantity of imports below the average of imports in the last three representative years. As to the question whether Korea's safeguard measure is consistent with the second sentence of Article 5.1, we are unable to come to a conclusion in the absence of relevant factual findings in the Panel Report or undisputed facts in the Panel record.

VI. ARTICLE 12.2 OF THE AGREEMENT ON SAFEGUARDS

104. The European Communities appeals from the Panel's interpretation of the phrase "all pertinent information" in Article 12.2 of the *Agreement on Safeguards*. According to the European Communities, the Panel effectively replaced the appropriate standard of "all pertinent information" with a lower and subjective standard ("sufficient information to enable consultations") without any sound reasoning in support thereof.[63] The European Communities also requests the Appellate Body to complete the analysis and find on the basis of found and uncontested facts that Korea did not comply with the requirement to provide "all pertinent information" laid down in Article 12.2 of the *Agreement on Safeguards*.[64]

105. Article 12.2 of the *Agreement on Safeguards* provides:

> In making the notifications referred to in paragraphs 1(b) and 1(c), the Member proposing to apply or extend a safeguard measure shall provide the Committee on Safeguards with all pertinent information, which shall include evidence of serious injury or threat thereof caused by increased imports, precise description of the product involved and the proposed measure, proposed date of introduction, expected duration and timetable for progressive liberalization. In the case of an extension of a measure, evidence that the industry concerned is adjusting shall also be provided. The Council for Trade in Goods or the Committee on Safeguards may request such additional information as they may consider necessary from the Member proposing to apply or extend the measure.

106. In paragraph 7.127 of its Report, the Panel found:

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63 European Communities' appellant's submission, paras. 154-155.
64 *Ibid*., para. 142.

> … the ordinary meaning of the word "information" implies that the other Members must gain knowledge of the actions undertaken by the notifying Member. In this sense, the amount of information notified must be sufficient to be useful to Members with a substantial interest in the proposed safeguard measure.

107. In order to determine the appropriate meaning of "all pertinent information", we must examine this phrase in the light of the text and the context of Article 12 as well as the object and purpose of that Article. The text of Article 12.2 makes it clear that a Member proposing to apply a safeguard measure is required to provide the Committee on Safeguards with *all* pertinent, not just *any* pertinent, information. Moreover, it provides that such information *shall* include certain items listed immediately after the phrase "all pertinent information", namely, evidence of serious injury or threat thereof caused by increased imports, a precise description of the product involved and the proposed measure, the proposed date of introduction, the expected duration of the measure and a timetable for progressive liberalization. These items, which are listed as mandatory components of "all pertinent information", constitute a minimum notification requirement that must be met if a notification is to comply with the requirements of Article 12.

108. We do not agree with the Panel that "evidence of serious injury" in Article 12.2 is determined by what the notifying Member considers to be sufficient information.[65] What constitutes "evidence of serious injury" is spelled out in Article 4.2(a) of the *Agreement on Safeguards* which provides:

> … the competent authorities shall evaluate all relevant factors of an objective and quantifiable nature having a bearing on the situation of that industry, in particular, the rate and amount of the increase in imports of the product concerned in absolute and relative terms, the share of the domestic market taken by increased imports, changes in the level of sales, production, productivity, capacity utilization, profits and losses, and employment.

We believe that "evidence of serious injury" in the sense of Article 12.2 should refer, at a minimum, to the injury factors required to be evaluated under Article 4.2(a).[66] In other words, according to the text and the context of Article 12.2, a Member must, *at a minimum*, address in its notifications, pursuant to paragraphs 1(b) and 1(c) of Article 12, all the items specified in Article 12.2 as constituting "all pertinent information", as well as the factors listed in Article 4.2 that are required to be evaluated in a safeguards investigation. We believe that the standard set by Article 12 with respect to the content of "all pertinent information" to be notified to the Committee on Safeguards is an objective standard independent of the subjective assessment of the notifying Member.

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[65] Panel Report, para. 7.136.

[66] *See* Appellate Body Report, *Argentina - Safeguard Measures on Imports of Footwear*, WT/DS121/AB/R, circulated 14 December 1999, para. 136.

109. In concluding that there is a minimum objective standard, we do not mean to suggest that "evidence of serious injury" should include all the details of the recommendations and reasoning to be found in the report of the competent authorities. We agree with the Panel that, if such had been the intention of the drafters of the *Agreement on Safeguards*, they would have simply referred back to Articles 3 and 4 when requiring "evidence of serious injury" in Article 12.2.[67] There is, however, an intermediate position between notifying the full content of the report of the competent authorities and giving the notifying Member the discretion to determine what may be included in a notification. To comply with the requirements of Article 12.2, the notifications pursuant to paragraphs 1(b) and 1(c) of Article 12 must, *at a minimum*, address all the items specified in Article 12.2 as constituting "all pertinent information", as well as the factors listed in Article 4.2 that are required to be evaluated in a safeguards investigation.

110. We are aware that the last sentence of Article 12.2 provides that the Council for Trade in Goods or the Committee on Safeguards may request such additional information as they may consider necessary from the Member proposing to apply a safeguard measure. In our view, the request for additional information is meant to enable the Council for Trade in Goods or the Committee on Safeguards to seek information on elements of information not covered by Article 12.2 or Article 4.2, or to elicit further details on "evidence of serious injury". We note that the listing of elements is not exhaustive as they are cited following the words "including" or "in particular". Contrary to what Korea argued and the Panel reasoned, such a request is not meant to fill in gaps created by omitting elements required under "all relevant information" or "evidence of serious injury".

111. With respect to the object and purpose of Article 12, we agree with the Panel that:

> … the notification serves essentially a transparency and information purpose. In ensuring transparency, Article 12 allows Members through the Committee on Safeguards to review the measures. Another purpose of the notification of the finding of serious injury and of the proposed measure is to inform Members of the circumstances of the case and the conclusions of the investigation together with the importing country's particular intentions. This allows any interested Member to decide whether to request consultations with the importing country which may lead to modification of the proposed measure(s) and/or compensation.[68]

We believe that the purpose of notification is better served if it includes all the elements of information specified in Articles 12.2 and 4.2. In this way, exporting Members with a substantial interest in the product subject to a safeguard measure will be in a better position to engage in meaningful consultations, as envisaged by Article 12.3, than they would otherwise be if the notification did not include all such

[67] Panel Report, para. 7.127.
[68] Panel Report, para. 7.126.

elements. And, the Committee on Safeguards can more effectively carry out its surveillance function set out in Article 13 of the *Agreement on Safeguards*. At the same time, providing the requisite information to the Committee on Safeguards does not place an excessive burden on a Member proposing to apply a safeguard measure as such information is, or should be, readily available to it.

112. Whether Korea has acted consistently with the provisions of Article 12.2 depends on the content and extent of the information it has made available to the Committee on Safeguards in its notifications. According to the Panel:

> Korea's notification of the finding of serious injury caused by increased imports stated that imports had grown, that the domestic industry's share of domestic consumption had decreased and domestic stocks had increased. There is no explicit reference to any analysis of the level of sales, production, productivity, and employment as such, nor is there any reference to any causation element. … [69]

The Panel went on to state:

> We consider, however, that this notification contains sufficient information on what Korea considered to be evidence of injury caused by increased imports as well as on the other listed items in Article 12.2. … Consequently, we consider that the content of that Korean notification made pursuant to Article 12.1(b) meets the requirements of Article 12.2 of the Agreement on Safeguards.[70]

113. In light of the preceding analysis, we do not agree with the Panel that the content of Korea's notification in this case satisfies the requirement to provide "all pertinent information" to the Committee on Safeguards, since Korea failed to address all the factors that must be covered as "evidence of serious injury". Therefore, we reverse the Panel's finding in paragraph 7.136 of its Report, and conclude that Korea has acted inconsistently with its obligations under Article 12.2 of the *Agreement on Safeguards*.

[69] Panel Report, para. 7.135.
[70] *Ibid*., para. 7.136.

VII. ARTICLE 6.2 OF THE DSU

114. We turn now to certain procedural issues raised by Korea in the present appeal. The first of these procedural issues is whether the Panel erred in finding that the European Communities' request for the establishment of a panel met the requirements of Article 6.2 of the DSU.

115. Article 6.2 of the DSU reads as follows:

> The request for the establishment of a panel shall be made in writing. It shall indicate whether consultations were held, identify the specific measures at issue and provide a brief summary of the legal basis of the complaint sufficient to present the problem clearly. In case the applicant requests the establishment of a panel with other than standard terms of reference, the written request shall include the proposed text of special terms of reference.

116. In its examination of whether the European Communities' request for a panel met the requirements of Article 6.2 of the DSU, the Panel referred to a portion of a finding in our Report in *European Communities - Bananas*, in which we stated:

> "[we] accept the Panel's view that it was sufficient for the Complaining Parties to *list the provisions of the specific agreements alleged to have been violated* without setting out detailed arguments as to which specific aspects of the measures at issue relate to which specific provisions of those agreements".[71] (emphasis added by the Panel)

117. The Panel also quoted from the European Communities' request for a panel in the instant case in the following terms:

> The contested safeguard measure was imposed in the form of an import quota on imports of certain dairy products (Korean CN codes 0404.90.0000, 0404.10.2190, 0404.10.2900 and 1901.90.2000) effective as of 7 March 1997 and made public through notification in the revision of "Separated Notice of Export-Import" and in "Detailed Principle of Import Licence on Imitation Milk Powder. …
>
> Therefore, the EC requests that the panel consider and find that this measure is in breach of Korea's obligations under the provisions of the Agreement on Safeguards, in particular of Articles 2, 4, 5 and 12 of the said Agreement and in violation of Article XIX of GATT 1994.[72]

118. Without further discussion, the Panel arrived at two conclusions. The first is the general statement that "a request for establishment of a panel is sufficiently detailed if it contains a description of the measures at issue and the claims, i.e. the

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[71] Panel Report, para. 7.3. *See* Appellate Body Report, *supra*, footnote 13, para. 141.

[72] Panel Report, para. 7.6.

violations alleged."[73] The second conclusion of the Panel purports to be an application of this general statement to the case before it:

> We consider, therefore, that the EC request for establishment of a panel is sufficiently detailed as it contains a description of the measures at issue and the claims, i.e. the violations alleged.[74]

119. Korea appeals both from the Panel's general statement regarding sufficiency under Article 6.2 of the DSU, and from the application of that statement to the European Communities' request for a panel in the present case. Korea asks us to set aside the entirety of the panel proceedings because the Panel erred in law in interpreting and applying Article 6.2 of the DSU.

120. We start our analysis of the Panel's ruling by examining the text of Article 6.2 of the DSU. It is convenient to quote the pertinent part of Article 6.2, once more:

> The request for the establishment of a panel shall be made in writing. It shall indicate whether consultations were held, identify the specific measures at issue and provide a brief summary of the legal basis of the complaint sufficient to present the problem clearly. …

When parsed into its constituent parts, Article 6.2 may be seen to impose the following requirements. The request must: (i) be in writing; (ii) indicate whether consultations were held; (iii) identify the specific measures at issue; and (iv) provide a brief summary of the legal basis of the complaint sufficient to present the problem clearly. In its fourth requirement, Article 6.2 demands only a summary - and it may be a brief one - of the legal basis of the complaint; but the summary must, in any event, be one that is "sufficient to present the problem clearly". It is not enough, in other words, that "the legal basis of the complaint" is summarily identified; the identification must "present the problem clearly".

121. As the Panel noted[75], we said in *European Communities - Bananas*, that:

> [we] accept the Panel's view that it was sufficient for the Complaining Parties to list the provisions of the specific agreements alleged to have been violated without setting out detailed arguments as to which specific aspects of the measures at issue relate to which specific provisions of those agreements.[76]

It appears to us that the Panel read this portion of our findings in *European Communities - Bananas* as establishing a litmus test for determining the sufficiency of the statement of the legal basis of the complaint.

122. The Panel, however, failed to note that in *European Communities - Bananas*, we went on to say that:

> As a panel request is normally not subjected to detailed scrutiny by the DSB, it is incumbent upon a panel to examine

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73 Panel Report., para. 7.5.
74 *Ibid*., para. 7.7.
75 Panel Report, para. 7.3.
76 Appellate Body Report, *European Communities - Bananas*, *supra*, footnote 13, para. 141.

> the request for the establishment of the panel *very carefully to ensure its compliance with both the letter and the spirit of Article 6.2 of the DSU*. It is important that a panel request be sufficiently precise for two reasons: *first, it often forms the basis for the terms of reference of the panel pursuant to Article 7 of the DSU; and, second, it informs the defending party and the third parties of the legal basis of the complaint.* [77] (emphasis added)

123. Thus, we did not purport in *European Communities - Bananas* to establish the mere listing of the articles of an agreement alleged to have been breached as a standard of precision, observance of which would *always* constitute sufficient compliance with the requirements of Article 6.2, *in each and every case*, without regard to the particular circumstances of such cases. If we were in fact attempting to construct such a rule in that case, there would have been little point to our enjoining panels to examine a request for a panel "*very carefully to ensure its compliance with both the letter and the spirit of Article 6.2 of the DSU*". Close scrutiny of what we in fact said in *European Communities - Bananas* shows that we, firstly, restated the reasons why precision is necessary in a request for a panel; secondly, we stressed that claims, not detailed arguments, are what need to be set out with sufficient clarity; and thirdly, we agreed with the conclusion of the panel that, in that case, the listing of the articles of the agreements claimed to have been violated satisfied the *minimum* requirements of Article 6.2 of the DSU. In view of all the circumstances surrounding that case, we concurred with the panel that the European Communities had not been misled as to what claims were in fact being asserted against it as respondent.

124. Identification of the treaty provisions claimed to have been violated by the respondent is always necessary both for purposes of defining the terms of reference of a panel and for informing the respondent and the third parties of the claims made by the complainant; such identification is a minimum prerequisite if the legal basis of the complaint is to be presented at all.[78] But it may not always be enough. There may be situations where the simple listing of the articles of the agreement or agreements involved may, in the light of attendant circumstances, suffice to meet the standard of *clarity* in the statement of the legal basis of the complaint. However, there may also be situations in which the circumstances are such that the mere listing of treaty articles would not satisfy the standard of Article 6.2. This may be the case, for instance, where the articles listed establish not one single, distinct obligation, but rather multiple obligations. In such a situation, the listing of articles of an agreement, in and of itself, may fall short of the standard of Article 6.2.

125. In *European Communities - Bananas*, we stated:

> Article 6.2 of the DSU requires that the *claims*, and not the *arguments,* must all be specified sufficiently in the request for the establishment of a panel in order to allow the defending

[77] Appellate Body Report, *European Communities - Bananas*, *supra*, footnote 13, para. 142.

[78] *See* Appellate Body Report, *Brazil - Desiccated Coconut*, *supra*, footnote 21, p. 22; Appellate Body Report, *European Communities - Bananas*, *supra*, footnote 13, paras. 145 and 147; and Appellate Body Report, *India - Patents*, *supra*, footnote 21, paras. 89, 92 and 93.

> party and any third parties to know the legal basis of the complaint.[79]

126. In *European Communities - Computer Equipment*, we explored the due process objective of the request for the establishment of a panel with respect to the identification of the measure at issue, and concluded that:

> …We do not see how the alleged lack of precision of the terms, LAN equipment and PCs with multimedia capability, in the request for the establishment of a panel affected the rights of defence of the European Communities *in the course* of the panel proceedings. As the ability of the European Communities to defend itself was not prejudiced by a lack of knowing the measures at issue, we do not believe that the fundamental rule of due process was violated by the Panel.[80]

127. Along the same lines, we consider that whether the mere listing of the articles claimed to have been violated meets the standard of Article 6.2 must be examined on a case-by-case basis. In resolving that question, we take into account whether the ability of the respondent to defend itself was prejudiced, given the actual course of the panel proceedings, by the fact that the panel request simply listed the provisions claimed to have been violated.

128. For the foregoing reasons, we do not agree with the position, implicitly taken by the Panel, that the simple listing of articles of an agreement asserted to have been violated meets, always and in every case, the requirements of Article 6.2 of the DSU.

129. In the present case, we note that the European Communities' request for a panel, after identifying the Korean safeguard measure at issue, listed Articles 2, 4, 5 and 12 of the *Agreement on Safeguards* and Article XIX of the GATT 1994. Article XIX of the GATT 1994 has three sections and a total of five paragraphs, each of which has at least one distinct obligation. Articles 2, 4, 5 and 12 of the *Agreement on Safeguards* also have multiple paragraphs, most of which have at least one distinct obligation. The *Agreement on Safeguards* in fact addresses a complex multi-phased process from the initiation of an investigation, through evaluation of a number of factors, determination of serious injury and causation thereof, to the adoption of a definitive safeguard measure. Every phase must meet with certain legal requirements and comply with the legal standards set out in that Agreement.

130. In *European Communities - Bananas*, we called upon panels to examine the request for a panel "very carefully to ensure its compliance with both the letter and the spirit of Article 6.2 of the DSU". We note that the Panel in the present case treated this important issue in a perfunctory manner.[81] As discussed above, the Panel

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[79] Appellate Body Report, *European Communities - Bananas*, *supra,* footnote 13, para. 143.

[80] Appellate Body Report, *European Communities - Computer Equipment*, *supra*, footnote 41, para. 70.

[81] In our Report in *European Communities - Bananas*, we adverted to the possibility of dealing with Article 6.2 problems of the kind addressed there "without causing prejudice or unfairness to any party or third party" through standard, detailed working procedures for panels that provide for, *inter alia*, preliminary rulings (Appellate Body Report, *European Communities - Bananas*, *supra*, footnote 13, para. 144). We note that there appears to be no legal obstacle to the inclusion, in additional working procedures which panels adopt *ad hoc* after consultation with the parties, of

merely quoted a passage from our Report in *European Communities - Bananas* and the relevant part of the request for a panel. We consider that the Panel's treatment of this issue is not satisfactory.

131. In assessing whether the European Communities' request met the requirements of Article 6.2 of the DSU, we consider that, in view of the particular circumstances of this case and in line with the letter and spirit of Article 6.2, the European Communities' request should have been more detailed. However, Korea failed to demonstrate to us that the mere listing of the articles asserted to have been violated has prejudiced its ability to defend itself in the course of the Panel proceedings. Korea did assert that it had sustained prejudice, but offered no supporting particulars in its appellant's submission nor at the oral hearing. We, therefore, deny Korea's appeal relating to the consistency of the European Communities' request for the establishment of a panel with Article 6.2 of the DSU.

VIII. THE OAI REPORT

132. We come to the second procedural issue raised in this appeal, namely whether the Panel had improperly based its findings concerning the consistency of Korea's serious injury determination with Article 4.2 of the *Agreement on Safeguards* on the OAI Report.

133. In the course of reaching its conclusion that Korea's serious injury determination is not consistent with Article 4.2(a) of the *Agreement on Safeguards*[82], the Panel made the following statements:

> 7.30 … We note that the European Communities has initially relied on the notifications to the Committee on Safeguards to establish its claims. We are of the view that such notifications are not necessarily complete evidence of what the Korean national authorities actually *did*. Rather, the full reflection of the Korean investigation can only be found in the investigation report or the final determination by the Minister, and not (as argued by the European Communities at the first meeting of the Panel) in the notifications to the Committee on Safeguards. In its rebuttals and at the second meeting of the Panel with the parties, the European Communities, in support of its allegations, made reference to the OAI Report as well.
>
> …

provisions for preliminary rulings on, *inter alia*, questions concerning compliance with the requirements of Article 6.2.

[82] Panel Report, para. 8.1(a). This conclusion by the Panel is not appealed by Korea.

> 7.59 … Since our task is to make an objective assessment of the factual considerations and reasoning of the Korean authorities in arriving at a finding of serious injury at the time of the determination, our analysis of Korea's compliance with the provisions in Article 4.2 will be on the basis of the OAI Report. …

134. Korea appeals from the above statements of the Panel and ascribes three errors in law to the Panel. Korea claims that the Panel erred, firstly, in characterizing Korea's submission of the OAI Report to the Panel[83]; secondly, in assessing Korea's action solely on the basis of the OAI Report[84]; and thirdly, in failing to consider Korea's argument that parties to a dispute settlement procedure cannot introduce new claims at or subsequent to the rebuttal stage.[85]

135. In respect of Korea's first claim of error, we note that Korea submitted the OAI Report, in the Korean language, to the Panel as an attachment to its first written submission. The Panel said that if Korea wished to rely upon the OAI Report and to use it "in support of its allegations", Korea should submit that Report in one of the official languages of the WTO.[86] Korea did submit an English translation of the OAI Report after the first meeting of the Panel with the parties.[87] Korea now states that it did not place the OAI Report before the Panel "as a subject of dispute between the parties, or as evidence of compliance or non-compliance with the *Agreement on Safeguards*", but rather as "information that might be useful in explaining the context of and background to the dispute."[88] In addition to the OAI Report, Korea submitted other documentation that related to the actions taken by the Korean Government in the process leading to its safeguard measure.[89]

136. Whatever may have been Korea's specific purpose in submitting the OAI Report to the Panel, Korea must have believed that it was useful, in respect of its case as respondent, to do so. The Report clearly became part of the record of the Panel proceedings. We believe that the Panel was entitled to examine the Report and

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83 Korea's appellant's submission, p. 27.

84 *Ibid*., p. 23.

85 *Ibid*., pp. 25-26.

86 In para. 7.16 of its Report, the Panel stated:

> "… *should it wish to refer to the OAI Report in support of its allegations*, Korea should file a version of the report in one of the official languages of the WTO." (emphasis added)

In para. 7.18, of its Report, the Panel also stated:

> The Panel informed Korea that *if it intended to submit any piece of evidence, including the OAI Report*, it should do so by 20 November 1998, that is, the deadline given to the parties to answer the questions posed to them during the first substantive meeting of the Panel. In this way parties would be able to submit full and useful rebuttals before the second meeting of the Panel. (emphasis added)

87 On 20 November 1998, Korea submitted, together with its answers to the questions submitted to it, an English version of the OAI Report, as Exhibit Korea-6. *See* Panel Report, para. 7.18.

88 Korea's appellant's submission, p. 27. We note that in its appellee's submission, para. 51, the European Communities stated that Korea cited the OAI Report in para. 94 of its first written submission to refute the European Communities' claims.

89 Panel Report, para. 7.30, footnote 417.

to consider its import for the whole case since Korea had presented it with its first written submission, even though Korea might not have submitted the OAI Report as evidence in its own defence.

137. In its second claim of error, Korea appears to suggest that the Panel, in evaluating Korea's actions leading up to the adoption of its safeguard measure, should have looked solely to the evidence submitted by the European Communities as complaining party. We do not agree with Korea in this respect. It is, of course, true that the European Communities has the *onus* of establishing its claim that Korea's safeguard measure is inconsistent with the requirements of Article 4.2 of the *Agreement on Safeguards*. However, under Article 11 of the DSU, a panel is charged with the mandate to determine the facts of the case and to arrive at factual findings. In carrying out this mandate, a panel has the duty to examine and consider all the evidence before it, not just the evidence submitted by one or the other party, and to evaluate the relevance and probative force of each piece thereof. In *European Communities - Hormones*, we had occasion to stress that:

> The duty to make an objective assessment of the facts is, among other things, an obligation to consider the evidence presented to a panel and to make factual findings on the basis of that evidence. The deliberate disregard of, or refusal to consider, the evidence submitted to a panel is incompatible with a panel's duty to make an objective assessment of the facts. [90]

The determination of the significance and weight properly pertaining to the evidence presented by one party is a function of a panel's appreciation of the probative value of all the evidence submitted by both parties considered together.

138. We note that in examining the OAI Report, the Panel did not do anything out of the ordinary. The European Communities' claim was that Korea had disregarded certain requirements of Article 4.2 of the *Agreement on Safeguards* in its actions preceding and accompanying the adoption of its safeguard measure. The OAI Report was issued by the Korean authorities which, *inter alia*, investigated and evaluated the assertions of serious injury to the domestic industry involved. Thus, that Report was clearly relevant to the task of the Panel to determine the facts, and the Panel was within its discretionary authority in deciding whether or not, or to what extent, it should rely upon the Report in ascertaining the facts relating to Korea's injury determination.

139. Turning to Korea's third claim of error, we agree with Korea that a party to a dispute settlement proceeding may not introduce a new claim during or after the rebuttal stage. Indeed, any claim that is not asserted in the request for the establishment of a panel may not be submitted at any time after submission and acceptance of that request.[91] By "*claim*" we mean a claim that the respondent party has violated, or nullified or impaired the benefits arising from, an identified

[90] Appellate Body Report, *EC Measures Concerning Meat and Meat Products (Hormones)* ("*European Communities - Hormones*"), WT/DS26/AB/R, WT/DS48/AB/R, adopted 13 February 1998, para. 133.

[91] Appellate Body Report, *European Communities - Bananas*, *supra*, footnote 13, para. 143.

provision of a particular agreement. Such a *claim of violation* must, as we have already noted, be distinguished from the *arguments* adduced by a complaining party to demonstrate that the responding party's measure does indeed infringe upon the identified treaty provision.[92] Arguments supporting a claim are set out and progressively clarified in the first written submissions, the rebuttal submissions and the first and second panel meetings with the parties.[93] In *European Communities - Hormones*, we emphasized the substantial latitude enjoyed by panels in treating the *arguments* presented by either of the parties and said:

> … Panels are inhibited from addressing legal claims falling outside their terms of reference. However, nothing in the DSU limits the faculty of a panel freely to use arguments submitted by any of the parties - or to develop its own legal reasoning - to support its own findings and conclusions on the matter under its consideration.[94]

Both "claims" and "arguments" are distinct from the "evidence" which the complainant or respondent presents to support its assertions of fact and arguments.

140. Having carefully examined the Panel Report, we find no indication that the European Communities asserted a *new claim of violation* against Korea at or subsequent to the rebuttal stage of the proceedings. True enough, the European Communities in its first written submission relied mainly on Korea's notifications to the Committee on Safeguards to prove its claim that Korea had acted inconsistently with the requirements of Article 4.2 of the *Agreement on Safeguards*.[95] Subsequently, in its rebuttal submission and at the second meeting of the Panel with the parties, the European Communities explicitly referred to the OAI Report. The European Communities' reference to the OAI Report did not, however, constitute a new claim of violation. To the contrary, the European Communities referred to the OAI Report as *evidence or supplemental evidence* to substantiate the allegation of a violation of Article 4 already made in the request for the establishment of a panel.

141. We, therefore, conclude that the Panel did not err in law in basing its findings of inconsistency with Article 4.2 of the *Agreement on Safeguards* on the OAI Report.

IX. BURDEN OF PROOF

142. The third and last procedural issue raised in this appeal is whether the Panel erred in its application of the burden of proof in respect of its findings under Article 4 of the Agreement on Safeguards.

143. The Panel said in respect of the burden of proof:

> In the context of the present dispute, which is concerned with the assessment of the WTO compatibility of a safeguard

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92 *Ibid*., para. 141. *See* also Appellate Body Report, *India - Patents*, *supra*, footnote 21, para. 88; and Appellate Body Report, *European Communities - Hormones*, *supra*, footnote 90, para. 156.

93 Appellate Body Report, *India - Patents*, *supra*, footnote 21, para. 88.

94 Appellate Body Report, *European Communities - Hormones*, *supra*, footnote 90, para. 156.

95 The European Communities stated in para. 33 of its appellee's submission that the OAI Report is the same as the "KTC Report" and that in its first written submission it had already referred to the "KTC Report".

> measure imposed by a national authority, we consider that it is for the European Communities to submit a *prima facie* case of violation of the Agreement on Safeguards, namely, to demonstrate that the Korean safeguard measures are not justified by reference to Articles 2, 4, 5 and 12 of the Agreement on Safeguards. … In the present case, it is for Korea to effectively refute the European Communities' evidence and arguments, by submitting its own evidence and arguments in support of its assertions that, at the time of its determination, Korea did respect the requirements of the Agreement on Safeguards. As a matter of law the burden of proof rests with the European Communities, as complainant, and does not shift during the panel process. As a matter of process before the Panel, the European Communities will submit its arguments and evidence and Korea will respond to rebut the EC claims. At the end of this process, it is for the Panel to weigh and assess the evidence and arguments submitted by both parties in order to reach conclusions as to whether the EC claims are well-founded.[96]

144. In its appeal, Korea contends that "as a threshold matter", "a panel must evaluate and make a finding on whether the complaining Member (i.e., the Member with the burden of proof) has established a *prima facie* case of a violation", before requiring the respondent to submit evidence of its own case or defence. The Panel, in Korea's view, "ignored this step in describing how it would apply the burden of proof and stated that it would simply weigh the evidence at the end of the proceedings."[97] Thus, the Panel "did not consider and *a fortiori* did not find that the European Communities made a *prima facie* case that justified its proceeding to examine the evidence and arguments" of Korea.[98]

145. We find no provision in the DSU or in the *Agreement on Safeguards* that requires a panel to make an explicit ruling on whether the complainant has established a *prima facie* case of violation before a panel may proceed to examine the respondent's defence and evidence. In our Report in *India - Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products*, we stated:

> [W]e do not find it objectionable that the Panel took into account, in assessing whether the United States had made a *prima facie* case, the responses of India to the arguments of the United States. This way of proceeding does not imply, in our view, that the Panel shifted the burden of proof to India. We, therefore, are not of the opinion that the Panel erred in law in proceeding as it did.[99]

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96 Panel Report, para. 7.24.

97 Korea's appellant's submission, p. 30.

98 *Ibid*., p. 31.

99 Appellate Body Report, *India - Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products*, WT/DS90/AB/R, adopted 22 September 1999, para. 143. *See* also Appellate Body Report, *Canada - Aircraft*, *supra*, footnote 15, para. 192.

146. Korea next argues that the Panel erred "in presuming that the European Communities satisfied its burden of proof and in proceeding to find that Korea violated Article 4 of the *Agreement on Safeguards* based solely on the OAI Report." According to Korea, "the Panel does not have the authority to make a party's claims for it or otherwise relieve a party of its task of presenting a *prima facie* case."[100] Korea submits that it is the *complainant*, not the Panel, that must establish a *prima facie* case. Since the conclusions of the Panel in respect of Article 4 of the *Agreement on Safeguards* were not based on any claims raised before the Panel by the complainant, Korea contends that the Panel could not have properly concluded "that the European Communities had discharged its burden of proof in respect of Article 4."[101] The Panel, hence, according to Korea, should have dismissed the European Communities' case without proceeding to consideration of Korea's own arguments and evidence.

147. As we understand it, the thrust of Korea's appeal in this respect is that the Panel had in effect made the European Communities' case for the European Communities. In *Japan - Agricultural Products*, we said:

> We consider that it was for the United States to establish a *prima facie* case that there is an alternative measure that meets all three elements under Article 5.6 in order to establish a *prima facie* case of inconsistency with Article 5.6. Since the United States *did not even claim* before the Panel that the "determination of sorption levels" is an alternative measure which meets the three elements under Article 5.6, we are of the opinion that the United States did not establish a *prima facie* case that the "determination of sorption levels" is an alternative measure within the meaning of Article 5.6.[102] (emphasis added)

We went on to state:

> Article 13 of the DSU and Article 11.2 of the *SPS Agreement* suggest that panels have a significant investigative authority. However, this authority cannot be used by a panel to rule in favour of a complaining party which has not established a *prima facie* case of inconsistency *based on specific legal claims asserted by it*. A panel is entitled to seek information and advice from experts and from any other relevant source it chooses, pursuant to Article 13 of the DSU and, in an SPS case, Article 11.2 of the *SPS Agreement*, to help it to understand and evaluate the evidence submitted and the

[100] Korea's appellant's submission, p. 32.
[101] Korea's appellant's submission, p. 33.
[102] Appellate Body Report, *Japan - Agricultural Products*, *supra*, footnote 17, para. 126.

> arguments made by the parties, but *not to make the case for a complaining party*.[103] (emphasis added)

148. In the present case, as we have already noted, the Panel stated that initially, i.e., in its first written submission, the European Communities had relied mostly upon Korea's notifications to the Committee on Safeguards to support its claims.[104] The Panel record shows that at the first meeting of the Panel with the parties, the Panel posed the following questions to the European Communities:

> Does the EC believe that the obligation in Articles 3 and 4 of [the *Agreement on Safeguards*] are evidenced in the WTO Notifications? Why does the EC concentrate its argumentation only [on] what was reflected [in] these WTO notifications?

The European Communities responded that all information relating to Korea's safeguards investigation "should be found, or at least referred to, in the notification"[105] However, in its rebuttal submission and at the second meeting of the Panel with the parties, the European Communities made references to the OAI Report and relied on this Report as evidence or supplemental evidence to support its claim of violation of Article 4 of the *Agreement on Safeguards*.

149. On the basis of the questions posed by the Panel and the reactions of the European Communities, we see no ground to conclude that the Panel relieved the European Communities of its task of showing the inconsistency of Korea's safeguards investigation with Article 4.2 of the *Agreement on Safeguards*. The Panel did not overstep the bounds of legitimate management or guidance of the proceedings before it in the interest of efficiency and dispatch.

150. We, therefore, conclude that the Panel did not err in law in its application of the burden of proof in respect of its findings under Article 4 of the *Agreement on Safeguards*.

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[103] Appellate Body Report, *Japan - Agricultural Products*, *supra*, footnote 17, para. 129. We acknowledged this ruling in Appellate Body Report, *Canada - Aircraft*, *supra*, footnote 15, para. 194.

[104] Panel Report, para. 7.24.

[105] *See* the European Communities' answers to the Panel's questions presented at the first meeting with the Panel (10-11 November 1998). We also note that as part of its response to the Panel's question: "Where should the information used and analysis performed by the national authority of Korea in its determination of its safeguard measures be found?", Korea stated:

> Although it may be possible to conclude that the OAI Report forms the fundamental basis of the Government of Korea's determination, it should be clear that the [Korean Trade Commission] and the Minister together comprise the "competent authorities" and that … *any information used at any time subsequent to the issuance of the OAI Report and prior to the Minister's final decisions to implement relief measures is also relevant* and needs to be considered as part of that decision. (*See* Korea's answer to the Panel's questions presented at the first meeting with the Panel (10-11 November 1998); emphasis added)

In para. 33 of its appellee's submission, the European Communities stated that the notification by Korea of the adoption of its safeguard measure contained information more recent than that in the OAI Report and that the European Communities wanted to give Korea the "benefit of the doubt".

X. FINDINGS AND CONCLUSIONS

151. For the reasons set out in this Report, the Appellate Body:

(a) does not agree with the Panel that the clause - "as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions …" - "does not specify anything additional as to the conditions under which measures pursuant to Article XIX may be applied", and, therefore, reverses the Panel's conclusion in paragraph 7.48 of its Report that "Article XIX of GATT does not contain such a requirement";

(b) is unable to come to a conclusion on whether or not Korea violated its obligations under Article XIX:1(a) of the GATT 1994 in the absence of relevant factual findings in the Panel Report or undisputed facts in the Panel record;

(c) upholds the Panel's finding in paragraph 7.101 of its Report that the first sentence of Article 5.1 of the *Agreement on Safeguards* imposes an *obligation* on a Member applying a safeguard measure to ensure that the measure applied is not more restrictive than necessary to prevent or remedy serious injury and to facilitate adjustment;

(d) reverses the Panel's broad finding in paragraph 7.109 of its Report that Article 5.1 requires a Member to explain, at the time it makes its recommendations and determinations concerning the application of a safeguard measure, that its measure is necessary to remedy serious injury and to facilitate adjustment, even where the particular safeguard measure applied is *not* a quantitative restriction which reduces the quantity of imports below the average of imports in the last three representative years;

(e) is unable to come to a conclusion on whether or not Korea's safeguard measure is consistent with the second sentence of Article 5.1 of the *Agreement on Safeguards* in the absence of relevant factual findings in the Panel Report or undisputed facts in the Panel record;

(f) reverses the Panel's finding in paragraph 7.136 of its Report and concludes that Korea has acted inconsistently with its obligation to notify "all pertinent information" under Article 12.2 of the *Agreement on Safeguards*;

(g) denies Korea's appeal relating to the consistency of the European Communities' request for the establishment of a panel with Article 6.2 of the DSU;

(h) concludes that the Panel did not err in law in basing its findings of inconsistency with Article 4.2 of the *Agreement on Safeguards* on the OAI Report; and

(i) concludes that the Panel did not err in law in its application of the burden of proof in respect of its findings under Article 4 of the *Agreement on Safeguards*.

152. The Appellate Body *recommends* that the DSB request that Korea bring its safeguard measure found in this Report, and in the Panel Report as modified by this Report, to be inconsistent with the *Agreement on Safeguards* into conformity with its obligations under that Agreement.

KOREA - DEFINITIVE SAFEGUARD MEASURE ON IMPORTS OF CERTAIN DAIRY PRODUCTS

Report of the Panel
WT/DS98/R*

Adopted by the Dispute Settlement Body
on 12 January 2000
as modified by the Appellate Body Report

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* WT/DS98/R/Corr.1

I. INTRODUCTION

A. Background

1.1 On 12 August 1997, the European Communities requested consultations with Korea regarding a definitive safeguard measure on imports of certain dairy products (WT/DS98/1). The European Communities made their request pursuant to Article 4 of the Understanding on Rules and Procedures Governing the Settlement of Disputes ("DSU"), Article XXIII:1 of the General Agreement.

1.2 On 25 August 1997 Australia, requested to be joined in the consultations (WT/DS98/2). The request was accepted by Korea on 28 August 1997 (WT/DS98/3).

1.3 Pursuant to this request, the European Communities consulted with Korea in Geneva on 10 September 1997 and 16 October 1997. Australia participated in these consultations as a third party. No mutually satisfactory solution was reached.

1.4 On 9 January 1998, the European Communities requested the establishment of a panel with the standard terms of reference provided by Article 7 of the DSU (WT/DS98/4). The European Communities made this request pursuant to Article XXIII:2 of the General Agreement on Tariffs and Trade ("GATT"), Articles 4 and 6.1 of the DSU, and Article 14 of the Agreement on Safeguards. At the Dispute Settlement Body ("DSB") meeting of 22 January 1998, the European Communities informed the DSB that they were for the time being not pursuing its Panel request.

1.5 On 10 June 1998, the European Communities reiterated its request for the establishment of a Panel.

B. Establishment and Composition of the Panel

1.6 At its meeting on 22 July 1998, the Dispute Settlement Body ("DSB") established a panel pursuant to the EC's request (WT/DS98/5). The Panel's terms of reference are:

> To examine, in the light of the relevant provisions of the covered agreements cited by European Community in document WT/DS98/4 the matter referred to the DSB by the European Community in that document and to make such findings as will assist the DSB in making the recommendations or in giving the rulings provided for in those agreements.

1.7 The United States reserved its rights as to participate in the Panel proceedings as third party.

1.8 On 20 August 1998, the Panel was constituted with the following composition:

Chairman:	Mr. Ole Lundby
Members:	Ms. Leora Blumberg
	Ms. Luz Elena Reyes

C. Panel Proceedings

1.9 The Panel met with the Parties on 10/11 November 1998 and on 16/17 December 1998.

1.10 The Panel submitted its interim report to the parties on 3 March 1999. On 17 March 1999, both parties submitted written requests for the Panel to review precise

aspects of the interim report. At the request of the European Communities, the Panel held a further meeting with the parties on 29 March 1999 on the issues identified in the written comments. The Panel submitted its final report to the parties on 8 April 1999.

II. FACTUAL ASPECTS

2.1 This dispute concerns definitive safeguard measures imposed by Korea on imports of skimmed milk powder preparations ("SMPP") classified under tariff headings HS 0404.90.0000 and 1901.90.2000. On 17 May 1998, based on a request by the National Livestock Cooperatives Federation ("NLCF") filed on 2 May 1996, the Korean Trade Commission ("KTC") decided on the initiation of the requested investigation.

2.2 On 11 June 1996, Korea notified the WTO Committee on Safeguards under Article 12.1(a) of the Agreement on Safeguards regarding the KTC's initiation of a safeguards investigation and the reasons supporting initiation.[1]

2.3 On 23 October 1996, the KTC completed its Investigation Report on Industrial Injury Caused by the Increase of Certain Dairy Product Imports. A Notice of this fact was published in Korea's Official Gazette dated 11 November 1996. Non-confidential copies of the Investigation Report on Industrial Injury by the Office of Administration and Investigation ("OAI Report") were available on request prior to that date.

2.4 On 2 December 1996, Korea notified the Committee on Safeguards under Article 12.1(b) of the Agreement on Safeguards that the KTC had made a finding of serious injury to the domestic industry caused by the increased imports of dairy products.[2]

2.5 On 21 January 1997, Korea submitted a notification under Article 12(c) of the Agreement on Safeguards.[3] The notification informed the Committee that Korea proposed to apply a safeguard measure on imports of certain dairy products.

2.6 On 31 January 1997, Korea filed a notification pursuant to Article 9, footnote 2 of the Agreement on Safeguards regarding the non-application of safeguard measures to developing countries.[4]

2.7 The final decision by Korea to apply the safeguard measure was made, and went into effect, on 7 March 1997. Notice of the application of the measure was published in Korea's Official Gazette.

2.8 On 24 March 1997, Korea submitted a supplemental notification to the Committee on Safeguards under Article 12(c) of the Agreement on Safeguards.[5] In its notification, Korea informed the Committee that it had taken a final decision on the application of a safeguard measure on certain dairy products.

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1 G/SG/N/6/KOR/2 (1 July 1996).
2 G/SG/N/8/KOR/1 (6 December 1996).
3 G/SG/N/10/KOR/1 (27 January 1997).
4 G/SG/N/11/KOR/1 (21 February 1997).
5 G/SG/N/10/KOR/1/Suppl.1 (1 April 1997)

III. FINDINGS AND RECOMMENDATIONS REQUESTED BY THE PARTIES

A. European Community

3.1 The **European Communities** requested the Panel to find that Korea has violated Article XIX:1(a) of GATT and Articles 2.1, 4.2(a), 4.2(b), 5.1 and 12(1) to (3) of the Agreement on Safeguards.

B. Korea

3.2 **Korea** requested the Panel to find that the European Communities has not discharged its burden of proving that Korea failed to examine relevant facts or failed to explain adequately the basis for its determination and, therefore, conclude that the safeguard measure on SMPP was imposed by Korea in a manner fully consistent with its obligations under the Agreement on Safeguards.

IV. MAIN ARGUMENTS OF THE PARTIES[6]

A. Procedural Objections

1. Lack of Commercial Interest and Good Faith by the European Communities

(a) Objection of Korea

4.1 **Korea** raised a procedural objection alleging a lack of commercial interest by the European Communities as well as a failure to act in good faith on their part. The following are Korea's arguments in support of its objection:

4.2 Korea argues that the EC submission admits that it has little or no commercial interest in bringing this matter before the Panel.[7] This admission coupled with the abortive settlement procedure suggests that the current procedure lacks any issue in dispute between the parties and is merely an attempt to use the DSU to establish a precedent on safeguards. Korea is also concerned that the European Communities interest in receiving an advisory opinion is especially onerous upon Korea given the substantive weakness of the EC case.

4.3 During the course of these proceedings, Korea urged the Panel to consider that the EC objective is not to preserve its rights with respect to its exports of SMPP, but to secure an advisory opinion from the Panel. Under these circumstances, the European Communities recourse to formal dispute settlement represents an abuse of the WTO dispute settlement system.

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[6] The Panel notes that, unless otherwise specified, the footnotes in this section are those of the parties as they appear in their different submissions.

[7] *See*, in particular, EC's First Submission where the European Communities states: "The EC would stress that its complaints in this case, and notably those concerning the injury determination and procedural violations, are complaints of principle and that it considers all should be addressed by the Panel in its report."

4.4 Korea requests that the Panel consider the EC motives underlying recourse to formal WTO dispute settlement proceedings. Korea considers that the EC actions during consultations and its expression of limited interest in its first submission are inconsistent with the object and purpose of the WTO dispute settlement proceedings.

4.5 The DSU expressly provides that formal dispute settlement should be reserved for disputes where Members consider, in good faith, that their interests are being impaired.[8] Moreover, Article 3.7 of the DSU specifically instructs Members to exercise restraint in bringing dispute settlement cases and articulates a preference for mutually agreed solutions over resort to formal dispute settlement.[9]

4.6 It is important to note that a key strand of the EC case is that in some way Korea failed to provide the requisite information to the European Communities to enable them to enter into meaningful consultations that might lead to a settlement (which is, after all, the key objective of the DSU). While Article 12 of the Agreement on Safeguards has a specific series of requirements, Korea considers that the information provided to the Committee on Safeguards more than complied with the *pro forma* standards laid down by that Committee[10], and that this enabled the European Communities to enter into meaningful but ultimately unsuccessful negotiations. Korea notes that if it had indeed abused its obligations to provide information and to permit meaningful consultations, then it is difficult to explain how the Director-General of DGI of the Commission of the European Communities could have provided the Korean delegation with a letter accepting a settlement.[11] The fact that the Director-General had to later withdraw his acceptance of the settlement proposed by Korea is evidence of lack of good faith on the part of European Communities, rather than on the part of Korea.

(b) Response of the European Communities

4.7 At the first meeting of the Panel with the parties the **European Communities** responded to Korea's procedural objection as follows:

4.8 As to the alleged *lack of commercial interest* of the European Communities in bringing this complaint, the European Communities would recall that in the *EC - Bananas* case the Appellate Body, in reply to an analogous objection by the European Communities, held that*:*

> "a Member has broad discretion in deciding whether to bring a case against another Member under the DSU. The language of Article XXIII:1 of the GATT and of Article 3.7 of the DSU suggests,

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[8] Article 3.3 of the DSU provides that WTO dispute settlement is reserved for cases where a Member's benefits "are being impaired by measures taken by another Member." Article 3.10 states that "all Members will engage in these procedures in good faith in an effort to resolve the dispute."

[9] Article 3.7 provides that*:*

> "[b]efore bringing a case, a Member shall exercise its judgement as to whether actions under these procedures would be fruitful. The aim of the dispute settlement mechanism is to secure a positive solution to a dispute. A solution mutually acceptable to the parties to a dispute and consistent with the covered agreements is clearly to be preferred."

[10] WT/TC/NOTIF/SG/1 (15 October 1996).

[11] *See*, Exhibit Korea-11

> furthermore, that a Member is expected to be largely self-regulating in deciding whether any such action would be 'fruitful' ".[12]

4.9 As to the alleged *acceptance of a settlement* offered by Korea, the European Communities assume that Korea is not seriously arguing that documents like the ones attached to its First Submission as Exhibit Korea-11 could be considered as a proposal and acceptance of a settlement for purposes of WTO provisions, nor, presumably, in any other legal system. In reality, it is apparent from that Exhibit that Korea cannot even demonstrate that it ever sent the European Communities a formal proposal in due form, let alone that the European Communities received and accepted it.

2. Inadequacy of the EC Request for Establishment of a Panel

(a) Objection of Korea

4.10 **Korea** raises a procedural objection regarding the inadequacy of the EC request for establishment of a panel and requests the Panel to entirely reject the EC complaint on this basis. The following are Korea's arguments in support of this objection:

4.11 The EC request for the establishment of the Panel does not specify the nature of its dispute with sufficient clarity to permit Korea to conduct an effective defence. A detailed statement of the matter in dispute and the legal bases of the arguments is also necessary to permit third parties (who may not be intimately familiar with the details of the dispute) to assess whether or not to intervene.

4.12 In a request for establishment of a Panel under Article 6.2 of the DSU, a Complaining Party must "provide a brief summary of the legal basis of the complaint sufficient to present the problem clearly." In its request for the establishment of a Panel, the European Communities merely listed four articles of the Agreement on Safeguards. This listing of articles cannot satisfy the specific criteria of Article 6.2, especially in a request relating to the determination of a domestic authority under the Agreement on Safeguards.[13]

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[12] *See,* the Report of the Appellate Body in *European Communities - Regime for the Importation, Sale and Distribution of Bananas ("EC- Bananas")*, WT/DS27/AB/R, 9 September 1997, DSR 1997:II, 59, para. 135.

[13] In *Argentina - Safeguard Measures on Imports of Footwear ("Argentina - Footwear")*, for example, the EC's request, although still inadequate, included more specificity, stating that the European Communities:

> "request[s] that the Panel consider and find that these measures are in breach of Argentina's obligations under the provisions of the Agreement on Safeguards, in particular, but not necessarily exclusively, of Article 2 (especially the requirement of determining in an investigation that certain conditions are present and the non-discrimination obligation), Article 4 (in particular that all relevant factors must be investigated and to demonstrate the existence of a causal link), Article 5 (especially the condition that measures must only be applied to prevent or remedy serious injury), Article 6 (in particular the requirement of evidence of "critical circumstances") and Article 12 (especially the notification obligations) of the said Agreement and in violation of Article XIX of GATT (in particular the lack of "unforeseen developments"). WT/DS121/3 (11 June 1998).

4.13 Korea acknowledges that the Panel in *EC - Bananas* found that simply listing the articles and the relevant agreements in that case satisfied the "minimum requirements" of Article 6.2 of the DSU. Korea suggests that the Panel should refrain from following this interpretation, because such an approach encourages the establishment of imprecise and potentially speculative terms of reference, and, taking into account the general purpose of the DSU, undermines the object and purpose of Article 6.2. In any event, the instant case is distinguishable from the *EC - Bananas* case because, *inter alia,*:

(a) each Article under the Agreement on Safeguards does not identify "a distinct obligation," but encompasses a multitude of distinct obligations regarding a domestic authority's investigation;[14]

(b) the Panel's interpretation of Article 6.2 in *EC - Bananas* may have been influenced by its desire to prevent further delays in a dispute that had already been subject to two GATT Panel reviews and years of consultations;

(c) the Panel in *EC - Bananas* did not explicitly consider Article 4.4 of the DSU in evaluating the appropriate context;[15]

(d) the EC approach ignores the object and purpose of Article 6.2 because it does not identify the claims with sufficient precision to establish properly a Panel's jurisdiction or to give the parties and third parties sufficient notice of the claims at issue;[16] and

(e) previous GATT practice in antidumping and countervailing duty cases provides that the mere listing of articles is insufficient in cases involving a Panel review of a domestic authority's investigation.[17]

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[14] WT/DS27/R/USA, (22 May 1997), DSR 1997:II, 943, para. 7.3.

[15] Article 31 of the Vienna Convention on the Law of Treaties provides that a treaty must be interpreted in accordance with the ordinary meaning to be given to its terms in their context. The Panel in *EC - Bananas* considered that the appropriate context for interpreting Article 6.2 was Articles 3.2 and 3.3 of the DSU, and that such context does not support any interpretation not resulting in a prompt settlement of the dispute. *Ibid.* at paragraphs 7.6 to 7.8. Korea considers that Article 4.4 of the DSU is the more relevant context, given that it is the parallel provision to Article 6.2 addressing requests for consultations. Article 4.4 of the DSU requires that a request for consultations include "an indication of the legal basis for the complaint." Assuming the mere listing of articles satisfies Article 4.4, the drafters of the DSU must have intended that the language of Article 6.2 should be interpreted to require more specificity in a request for establishment of a Panel.

[16] In *Brazil - Measures Affecting Desiccated Coconut ("Brazil - Dessicated Coconut")*, the Appellate Body stated:

> "A Panel's terms of reference are important for two reasons. First, terms of reference fulfil an important due process objective-they give the parties and third parties sufficient information concerning the claims at issue in the dispute in order to allow them the opportunity to respond to the complainant's case. Second, they establish the jurisdiction of the Panel by defining the precise claims at issue in the dispute." (WT\DS22\AB\R (21 February 1997), DSR 1997:I, 167, at 186, Section VI, Terms of Reference).

[17] *United States - Anti-Dumping Duties on Imports of Fresh and Chilled Atlantic Salmon from Norway*, ADP/87, paras. 333-335 (adopted 26 April 1994); *United States - Countervailing Duties on Imports of Fresh and Chilled Atlantic Salmon from Norway*, SCM/153, paras. 208-214 (adopted 27 April 1994); *European Communities - Imposition of Anti-Dumping Duties on Imports of Cotton*

4.14 Further, Korea submits that the EC failure to comply with Article 6.2 of the DSU demonstrates the European Communities lack of any fundamental economic interest in this case, its negligent consideration of Korea's (and third-party Members') rights under the DSU, and its failure to give due consideration to the object and purpose of the WTO dispute settlement system. To preserve the integrity of the WTO dispute settlement system and the specific principles established therein, the Panel should find that the European Communities violated Article 6.2 of the DSU and should reject the European Communities complaint in its entirety.[18]

(b) Response of the European Communities

4.15 At the first meeting of the Panel with the parties the **European Communities** responded to Korea's position as follows:

4.16 The European Communities recall that, in the *EC - Bananas* case, the Appellate Body

> "accept[ed] the Panel's view that it was sufficient for the Complaining Parties to list the provisions of the specific agreements alleged to have been violated without setting out detailed arguments as to which specific aspects of the measures at issue relate to which specific provisions of those agreements".[19]

3. The Nature of the EC Case and its Request for Rulings by the Panel

(a) Submission of Korea

4.17 **Korea** asserts that the European Communities cannot challenge, and has implicitly accepted, the report of the investigating authority because it has not made any claims under Article 3 and 4.2(c) of the Agreement on Safeguards. In support of its position, Korea makes the following arguments:

Yarn from Brazil, ADP/137, paras. 438-466 (adopted 4 July 1995); *EC - Anti-Dumping Duties on Audiotapes in Cassettes Originating in Japan*, ADP/136, para. 295 (28 April 1995 (not adopted)). The Appellate Body in *Brazil - Dessicated Coconut* cited the cases under the Tokyo Round Anti-Dumping Code favourably in stating that a Complaining Party must precisely identify the claims in its request for establishment of a Panel. (*supra*, footnote 16)

[18] The Panel should not now try to assess whether the rights of Korea and third-party Members have been prejudiced by the EC's failure to comply with its obligations under Article 6.2. As a previous GATT Panel stated,

> "[we] could not understand the basis on which a Panel could after the fact consider whether certain claims might have been resolved in previous stages of the dispute settlement process had those claims been raised during those stages of the process. Nor would a Panel after the fact have a basis on which to consider whether the rights of third parties to protect their interests through participation in the Panel process were jeopardized by the failure of a complainant to raise a claim at the time it requested the establishment of a Panel." ADP/136, para. 301 (28 April 1995 (unadopted)).

[19] *See, EC - Bananas*, *supra*, footnote 12, paragraph 141.

(i) Article 3 of the Agreement on Safeguards

4.18 The EC claims must be viewed in the context of the terms of reference it sought when requesting the establishment of the Panel. The terms of reference serve as the basis upon which panels decide cases and panels can only rule on those issues that have been raised by the complaining party in the terms of reference.

4.19 Korea draws the Panel's attention to the terms of reference cited by the European Communities. These only refer to Articles 2, 4, 5 and 12 of the Agreement on Safeguards.[20] Further, the European Communities in their First Submission and Oral Statement request that the Panel limits its request for a ruling to whether "Korea has violated Article XIX:1(a) of the GATT and Articles 2.1, 4.2(a) and (b), 5.1, and 12(1) to (3) of the Agreement on Safeguards."

4.20 It is therefore clear that the European Communities have not invoked Article 3 of the Agreement on Safeguards in its request for a ruling from the Panel. Failure to invoke Article 3 has significant implications for the EC case because Article 3.1 deals with the adequacy of the competent authorities' report. The final sentence of Article 3.1 of the Agreement on Safeguards states that:

> "The competent authorities shall publish a report setting forth their findings and reasoned conclusions reached on all pertinent issues of fact and law."

4.21 The EC failure to invoke Article 3, whether intentionally or erroneously, leads one to conclude that the European Communities are not challenging the OAI Report. The European Communities confinement of their request for a ruling to the adequacy of notification under Article 12 becomes all the more clear in reviewing its answer to one of the Panel's questions. In Korea's view, this question sought to clarify the nature of the EC case. [21]Korea considered that the European Communities failed to answer this question, referring back to its answer in a previous question in which they state:[22]

> "A safeguard proceeding must be conducted in accordance with open and transparent procedures respecting the rights of defence of parties, which are the interested economic operators. It is for this purpose that Article 3 of the Agreement on Safeguards requires publication of a report 'setting forth their findings and reasoned conclusions reached on all pertinent issues of fact and law.'
>
> The proper forum for discussion between WTO Members concerning the compatibility of safeguard actions with the Agreement on Safeguards is however not the national investigating authority or courts, but rather consultations and dispute settlement. Accordingly, the European Communities consider that all the information should be found, or at least referred to, in the notifications. It notes in this

[20] WT/DS98/4 (12 January 1998).

[21] Korea recalled that the question read: "Does the EC believe that the obligation in Article 3 and 4 of the SA are evidence in the WTO notification? Why does the EC concentrate its argumentation only on what was reflected in these notifications?"

[22] Korea recalled that the previous question read: "Where should the information used and analysis performed by the national authority of Korea for its determination of a safeguard measure be found?"

> respect that Article 12.2 requires a Member to include in its notification 'all pertinent information.' This can be presented in summary form, but must cover all issues and must make clear reference to the source of the more detailed information. It is only in this way that the objectives of Article 12 can be achieved."

4.22 The EC answer refers to Article 3 which had never been at issue between the parties. In the light of the Appellate Body's ruling in *India - Patent Protection for Pharmaceutical and Agricultural Chemical Products*[23] and *Argentina - Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items*[24] that a claim "must be included in the request for establishment of a panel in order to come within a panel's terms of reference in a given case", the European Communities cannot augment the original terms of reference by invoking Article 3 at this stage of the proceedings.

4.23 The EC failure to invoke Article 3 leads to the conclusion that the European Communities references to serious injury in Article 4.2(a) and to causal link in Article 4.2(b) are used as standards of review in relation to the notification and consultation requirements of Article 12, which Korea maintains it has fully discharged.

(ii) Absence of Claims under Article 4.2(c) of the Agreement on Safeguards

4.24 The European Communities have not made any specific claims or put forward any arguments in relation to Article 4.2(c), and neither its First Submission nor its Oral Statement makes any reference to Article 4.2(c). Further, on both occasions where the European Communities have requested the Panel to make rulings or findings, it has omitted any reference to Article 4.2(c).

4.25 It is virtually impossible to understand what is being argued by asserting that the "relevant factors" and "causal link" have not been fully or correctly considered, yet accepting that the competent authorities promptly published "a detailed analysis on the case as well as the relevance of the factors examined." It is important for the Panel to note that the provisions of Article 4.2(c) detail a stage subsequent to the investigation of increased imports, serious injury and a causal link between the two. The conclusion that the European Communities accept the OAI Report is only strengthened by the EC failure to make any claims in relation to Article 3 which requires a competent authority to publish "a report setting forth their findings and reasoned conclusions reached on all pertinent issues of fact and law."

4.26 Korea points out that Article 4.2(c) of the Agreement on Safeguards cannot be raised at, or subsequent to, the rebuttal stage as an issue between the parties. The decisions by the Appellate Body in *India - Patent Protection for Pharmaceutical and Agricultural Chemical Products*[25] and *Argentina - Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items*[26] clearly show that the admission of

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23 WT/DS50/AB/R (19 December 1997) AB-1997-5, DSR 1998:I, 9.
24 WT/DS56/AB/R (27 March 1997) AB-1998-1, DSR 1998:III, 1003.
25 WT/DS50/AB/R (19 December 1997), AB-1995-5, DSR 1998:I, 9.
26 WT/DS56/AB/R, *supra*, footnote 24.

new arguments at the rebuttal stage would be a substantial violation of due process, and a significant violation of the respondent's ability to defend itself.

4.27 Strict adherence to that procedural requirement is important because the ability to understand and defend oneself against precise and comprehensible claims is vital to any system of law based on due process.[27] The Appellate Body in *Argentina - Textiles* summarized the two-stage process under the DSU[28] as follows:[29]

> "Under the Working Procedures in Appendix 3, the complaining party should set out its case in chief, including a full presentation of the facts on the basis of submission of supporting evidence, during the first stage. The second stage is generally designed to permit "rebuttals" by each party of the arguments and evidence submitted by the other parties."

4.28 Therefore, as requested by the European Communities in their First Submission and Oral Statement, Korea requests the Panel to limit its analysis of the EC claims to examining whether "Korea has violated Article XIX:1(a) of the GATT and Articles 2.1, 4.2(a) and (b), 5.1, and 12(1) to (3) of the Agreement on Safeguards."

4.29 Korea is of the view that the EC failure to invoke Article 3 and raise any claims under Article 4.2(c) in either its First Submission or Oral Statement can only be construed as meaning that Articles 4.2(a) and (b) are used as standards of review in relation to the notifications and consultations requirements of Article 12 of the Agreement on Safeguards. Thus, the Panel should only examine whether Korea's notification and consultations under Article 12 of the Agreement on Safeguards were timely and adequate and whether Korea imposed its safeguard measure in accordance with the requirements of Article 5.

4.30 At the second meeting of the panel with the parties, **Korea** further advanced its arguments regarding the nature of the EC case as follows:

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[27] Both Panels and the Appellate Body have ruled that the DSU is such a system (*See*, for example, *Argentina - Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items ("Argentina -Textiles")*, *supra*, footnote 24, para. 94).

[28] More specifically, as noted by the Appellate Body in *Argentina - Textiles*, the Working Procedures of the DSU divide the Panel process into two clear sections. The first stage, in which the parties make their case and set out their arguments is set out in paragraphs 4 and 5. These state:

> "Before the first substantive meeting of the panel with the parties, the parties to the dispute shall transmit to the panel written submissions in which they present the facts of the case and their arguments.
>
> At its first substantive meeting with the parties, the panel shall ask the party which has brought the complaint to present its case. Subsequently, and still at the same meeting, the party against which the complaint has been brought shall be asked to present its point of view."

The second stage, in which the parties rebut the claims and arguments put forward by the other parties in the first stage, is contained in paragraph 7, which states:

> "Formal rebuttals shall be made at a second substantive meeting of the panel. The party complained against shall have the right to take the floor first to be followed by the complaining party. The parties shall submit, prior to that meeting, written rebuttals to the panel."

[29] *See, Argentina -Textiles, supra,* footnote 24, para. 79.

4.31 In Korea's view, the unclear nature of the EC arguments stems from its apparently deliberate strategy of claiming that only the Notifications provided by Korea under Article 12 of the Agreement on Safeguards should be considered to determine whether the Korean safeguard measure is consistent with Article XIX of GATT 1994 and the Agreement on Safeguards. This lack of clarity in the EC arguments is further aggravated by confining its requests to Articles 2.1, 4.2(a), 4.2(b), 5.1 and 12(1) to (3). It does not cite Article 3, and has not made any claims in relation to Article 4.2(c).

4.32 Further, the European Communities expressly disregard the OAI Report, one of the central documents by which to evaluate the compliance of Korea's safeguard measure with the Agreement on Safeguards. Korea refers the Panel to the EC statement in its Rebuttal Submission:

> "The European Communities have already explained that the KTC report is not an appropriate source of information to evaluate Korea's compliance with its obligations arising under Article XIX of the GATT 1994 and the Agreement on Safeguards."

4.33 Accordingly, the Panel must consider the implications for the EC case of its failure to invoke Article 3, and its failure to make claims in relation to Article 4.2(c).

4.34 Korea is of the view that failure to invoke Article 3 implies that the European Communities have accepted that:

> "The competent authorities publish[ed] a report setting forth their findings and reasoned conclusions reached on all pertinent issues of fact and law."

4.35 Furthermore, failure to make claims under Article 4.2(c) implies that the European Communities have accepted that:

> "The competent authorities publish[ed] promptly, in accordance with the provisions of Article 3, a detailed analysis of the case under investigation as well as a demonstration of the relevance of the factors examined."

4.36 Combining the EC decision not to raise Articles 3 and 4.2(c) with its statement in its Rebuttal Submission noted above, Korea then concludes that the European Communities want the Panel to limit its review of the Korean investigation to its notifications under Article 12, and its obligations under Article 5. The EC failure to invoke Article 3 leads one to the conclusion that the European Communities references to serious injury in Article 4.2(a) and to causal link in Article 4.2(b) are used as standards of review in relation to the notification and consultation requirements of Article 12.

4.37 Korea cannot accept and the Panel should not accept that notifications under Article 12 have to include all documentation and analysis undertaken by the Korean competent authorities, including documents and analysis proving compliance with Articles 2, and 4.2(a) and (b). Clearly, Articles 2 and 4 have to be fulfilled by the competent authorities undertaking the investigations of increase in imports, serious injury and a causal link between the two. However, compliance with these requirements has to be judged against how the competent authorities conducted that analysis, and not against how their investigation was notified to Members.

4.38 However, the European Communities does not want to challenge the OAI Report as a relevant document, preferring to concentrate its argumentation to

challenging the quality and nature of Korea's notifications under Article 12. The European Communities appear to want to disregard the facts established and analysis undertaken in the 85-page OAI Report, and instead judge Korea's compliance with the Agreement on Safeguards in relation to notifications that were only intended to summarize Korea's investigation.

4.39 In Korea's view, the purpose of Article 12 is to provide WTO Members with a summary of what happened during the investigation, including a summary of relevant facts established and analysis undertaken. The level of information provided should be at least sufficient to permit those Members to enter into meaningful consultations, but Article 12 is not the basis upon which the investigation undertaken by the national authority must be judged. Korea submits that, as with other proceedings, such as antidumping and CVD or safeguard measures in textiles, it is always the governmental measure, and not a communication to the WTO that is under review as to a Member's conformity with the substantive provisions of the agreement in question.

4.40 By way of conclusion, Korea requests the Panel to conclude that the European Communities are only questioning Korea's compliance with Articles 5 and 12 of the Agreement.

(b) Response by the European Communities

4.41 At the second meeting of the panel with the parties, the **European Communities** replied as follows:

4.42 The European Communities agree with Korea that they are not bringing a complaint under Article 3 of the Agreement on Safeguards, nor is relying upon Article 4.2(c) thereof. Accordingly, it will not address the arguments developed by Korea in the first part of its Second Written Submission. It will only say that the absence of a complaint under Article 3 does not mean that the European Communities have accepted the content of the Investigation Report to be correct. The European Communities are complaining that Korea's measure does not satisfy the substantive conditions for such measures set out in Article XIX GATT 1994 and Articles 2.1, and 4.2 of the Agreement on Safeguards. This should be indication enough that it does not agree with the investigation report.

B. Subsidiary Issues

1. Burden of Proof and Standard of Review

(a) Submission by Korea

4.43 Regarding the issues of burden of proof and standard of review **Korea** submits the following arguments:

4.44 As a preliminary matter, the Panel should properly assign the burden of proof to the parties. The burden of proof is the fundamental obligation "of each of the parties to a dispute before an international tribunal to prove its claims to the

satisfaction of, and in accordance with the rules acceptable to, the tribunal".[30] This fundamental obligation does not shift between the parties during the dispute.[31] To discharge its burden of proof, the party assigned such burden must present conclusive evidence substantiating its claims, *i.e.,* the party that is required to satisfy the burden of proof must present more convincing evidence than the opposing party, and if the evidence is in equipoise, the party required to satisfy the burden of proof must lose.[32]

4.45 The party claiming that a Member State exercised its rights inconsistently with the Agreement on Safeguards has the obligation to prove such inconsistency. Therefore, as the Complaining Party asserting claims that Korea acted inconsistently with the Agreement on Safeguards, the European Communities have the burden of proof throughout the course of this proceeding to present conclusive evidence that their claims are true.

(i) Standard of Review

4.46 In light of the way the European Communities have presented their arguments in their First Submission, it appears to be necessary for the Panel to confirm the standard of review applicable in this case. Korea suggests that the Panel's role is to examine the Korean safeguard measure to determine whether it was imposed in accordance with Korea's international obligations under the Agreement on Safeguards. In conducting this examination, Korea suggests that the Panel should not engage in a *de novo* review in which it assumes the role of the investigating authority and seeks to replace its analysis of the facts and law for those of Korea. Nor should the Panel engage in assessing speculative or conclusionary arguments submitted by the European Communities as to whether the measure is appropriate or not. Instead, Korea suggests that the Panel should restrict its analysis to making an objective assessment as to whether Korea reasonably considered all relevant facts and adequately explained how such facts support the determination made.

4.47 In *United States - Restrictions on Imports of Cotton and Man-Made Fibre Underwear ("Underwear")*[33], Korea recalls the argument of the United States that a

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[30] Mojtaba Kazazi, *Burden of Proof and Related Issues*, *A Study on Evidence Before International Tribunals 30* (Kluwer Law International 1996).

[31] *Ibid.,* at 36; Joost Pauwelyn, *Evidence, Proof and Persuasion in WTO Dispute Settlement*, *Who Bears the Burden*?, J.Int'l Econ.L. 1, 232 (1998).

[32] *Ibid.,* at 255 and 258. WTO Panels and the Appellate Body have struggled with the proper articulation of burden of proof and have often confused the burden of proof with the procedural evidentiary concepts of burden of evidence or duty of passing the judge. These latter concepts are not recognized by international tribunals. Moreover, the shifting of a burden of evidence and the creation of "presumptions" by presenting, for example, *prima facie* evidence only inject more complexity into WTO decision making by raising the questions*:* What level of evidence constitutes *prima facie* evidence? What level of evidence is sufficient to rebut the presumption? One commentator suggests that the presumption technique creates the risk that WTO Panels and/or the Appellate Body in exercising their discretion may use this technique, in practice, to support results-oriented findings, *i.e.*, shift the burden to the party that it deems should lose. *Ibid.,* at 258. The articles referenced above by Pauwelyn and Kazazi provide an detailed discussion of the proper role of the burden of proof in international dispute settlement proceedings.

[33] *United States - Restrictions on Imports of Cotton and Man-made Fibre Underwear ("US - Underwear")*, WT/DS24/R, adopted 25 Frebrary 1997, DSR 1997:I, 31.

panel reviewing a safeguard measure under the special safeguard provisions of the Agreement on Textiles and Clothing ("ATC") should accord considerable deference to the determination by the US authorities. After citing the "*Transformers*" case where a panel refused to accord total deference to the domestic authority, the Panel stated the following:

> "7.12 We see great force in this argument. We do not, however, see our review as a substitute for the proceedings conducted by national investigating authorities or by the TMB. Rather, in our view, the Panel's function should be to assess objectively the review conducted by the national investigating authority, in this case the CITA. We draw particular attention to the fact that a series of panel reports in the anti-dumping and subsidies/countervailing duties context have made it clear that it is not the role of panels to engage in a *de novo* review. In our view, the same is true for panels operating in the context of the ATC, since they would be called upon, as in the context of cases dealing with anti-dumping and/or subsidies/countervailing duties, to review the consistency of a determination by a national investigating authority imposing a restriction under the relevant provisions of the relevant WTO legal instruments, in this case the ATC. In our view, the task of the Panel is to examine the consistency of the US action with the international obligations of the United States, and not the consistency of the US action with the US domestic statute implementing the international obligations of the United States. Consequently, the ATC constitutes, in our view, the relevant legal framework in this matter.
>
> 7.13 We have therefore decided, in accordance with Article 11 of the DSU, to make an objective assessment of the Statement issued by the US authorities on 23 March 1995 (the "March Statement") which, as the parties to the dispute agreed, constitutes the scope of the matter properly before the Panel without, however, engaging in a *de novo* review. [footnote omitted] In our view, an objective assessment would entail an examination of whether the CITA had examined all relevant facts before it (including facts which might detract from an affirmative determination in accordance with the second sentence of Article 6.2 of the ATC), whether adequate explanation had been provided of how the facts as a whole supported the determination made, and, consequently, whether the determination made was consistent with the international obligations of the United States. [footnote omitted] We note in this respect, that in response to a question by the Panel, the United States argued that the Panel had to examine whether the domestic authorities *had* based their determination on an examination of factors required by the ATC and whether the basis for the determination was adequately explained. In

> the US view, such an approach was compatible with the standard of review adopted in the "Fur Felt Hat" case. [footnote omitted][34]

4.48 The Panel in *US - Underwear*, therefore, expressly rejected that it should engage in a *de novo* review in examining the US safeguard measure under the ATC. The Panel then articulated a standard of review intended to account for the deference that should be accorded to national authorities in their conduct of a domestic investigation. In applying the standard of review in *US - Underwear*, however, the Panel interpreted the special safeguard provisions of the ATC as an "exception" to Article 2.4 of the ATC. As such, the Panel imposed on the United States the burden of proof to demonstrate it acted consistently with the ATC. Unlike Article 2.4 of the ATC, the Agreement on Safeguards and the terms contained therein should not be considered as an exception.

4.49 Therefore, consistent with the approach of the Panel in *US - Underwear*, in examining Korea's obligations in respect of the safeguard measure, Korea suggests that the Panel should restrict its analysis to making an objective assessment of the facts and law as provided under Article 11 of the DSU by examining whether Korea:

(a) examined all relevant facts before it at the time of the investigation; and

(b) provided an adequate explanation of how the facts before it as a whole supported the determination made.

4.50 In the view of Korea, use of the above approach would accord the proper amount of deference to Korea given that the Panel is reviewing a complex administrative investigation conducted by a Member's administering authority.

4.51 The Agreement on Safeguards requires a Member's competent authority to determine whether increased imports caused serious injury to the domestic industry. In assessing serious injury under Article 4.2(a), the competent authority is not required to give any specific weight or significance to any particular criterion. Under Article 4.2(a) of the Agreement, no criterion gives conclusive guidance as to whether serious injury occurred. The Agreement also does not require that each criterion be considered in isolation. Moreover, the Agreement on Safeguards contemplates that the competent authority may use other factors that are more relevant to a particular domestic industry in assessing serious injury.

4.52 The arguments raised by the European Communities in both the consultations under Article 12 of the Agreement on Safeguards and its submissions to the Panel imply that the European Communities are applying a very high (possibly an impossibly high) standard as to how the competent authorities of the Members should be permitted to conduct injury investigations. Korea submits that Members can set their own standards which may exceed those set out in Article 4.2.[35] Each

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[34] WT/DS24/R, *supra*, footnote 33 (Emphasis in original).

[35] For example, Article 10 of Regulation 3285/94, the EC's own implementation of the Agreement on Safeguards states:

> 1. Examination of the trend of imports, of the conditions in which they take place and of serious injury or threat of serious injury to Community producers resulting from such imports shall cover in particular the following factors:

Member State of the Agreement on Safeguards is, however, only obliged to comply with the standard of that Agreement, and not the standards used by other WTO Members.

4.53 Throughout the Uruguay Round, most major trading nations, the European Communities included, recognized and accepted that the agricultural sector presented a number of unique issues requiring specific and detailed consideration, and, where appropriate, the adoption of specific rules. One of the ways in which the unique features of agriculture was recognized and dealt with was the Agreement on Agriculture, and Article 5 of the Agreement which contains a specific, detailed safeguard procedure.[36]

4.54 Korea could not invoke the special safeguard provisions of Article 5 of the Agreement on Agriculture in this case. Therefore, to the extent that its domestic industry was being seriously injured by increased imports, Korea had to impose a safeguard measure consistent with the Agreement on Safeguards.

4.55 As the general system of rules for imposing safeguard measures, the Agreement on Safeguards will be applied to a number of different product sectors and, thus, has a degree of flexibility built into its structure and individual terms.[37]

(a) the volume of imports, in particular where there has been a significant increase, either in absolute terms or relative to production or consumption in the Community;

(b) the price of imports, in particular where there has been a significant price undercutting as compared with the price of a like product in the Community;

(c) the consequent impact on Community producers as indicated by trends in certain economic factors such as:

- production,
- capacity utilization,
- stocks,
- sales,
- market share,
- prices (*i.e.,* depression of prices or prevention of price increases which would normally have occurred),
- profits,
- return on capital employed,
- cash flow,
- employment;

factors other than trends in imports which are causing or may have caused injury to the Community producers concerned.

The increase in the proof of injury required by the EC as compared to the Agreement on Safeguards is indeed noted by the European Commission in the Explanatory Memorandum to the proposal for a new Regulation implementing the Agreement (COM(94)414 at page 306) where the Commission notes:

> "It should be pointed out, however, that Community legislation already contains precise rules that often go beyond the more general provisions of the Agreement on Safeguards. This is the case, for example, with the strict investigation deadlines and the more detailed list of factors to be considered in determining serious injury and the causal link between such injury and imports."

[36] The International Dairy Arrangement also made it clear that agricultural products had specific issues that needed to be addressed.

[37] *See,* for example, the following:

Certain injury criteria relevant to industrial or manufactured products may be irrelevant when applied to agricultural products, because those criteria are not objective and quantifiable or because they do not have a bearing on the situation of the particular agricultural industry, *i.e.,* they do not reflect the unique nature of the agricultural sector.[38] If particular criteria are not applicable to a specific agricultural sector, Members should be accorded the flexibility to examine other criteria that take into account the unique or specific nature of the products and industry under examination. Members should also be allowed to take into account criteria which are also relevant to the industry under examination.[39] Provided that relevant criteria have been considered and an adequate explanation as to whether or not they indicate serious injury has been given, the Panel should defer to the Member's determination as to whether the relevant criteria, when considered as a whole, may lead to an affirmative determination of serious injury.

4.56 In the view of Korea, the European Communities do not and cannot discharge their burden of proof simply by disputing the outcome of Korea's examination of the relevant facts or by contending that Korea has to provide an explanation of its analysis and conclusions that goes beyond the requirement to provide an adequate explanation. The European Communities must present conclusive evidence that Korea failed to examine relevant facts or failed to give an adequate explanation as to how the facts as a whole supported its determination. Korea submits that the Panel should conclude that the European Communities have failed to present evidence of this nature and that the European Communities have, therefore, failed to discharge their burden of proof regarding their claims that Korea acted inconsistently with the Agreement on Safeguards.

> "The General Agreement, and in particular, Articles II and XI on the one hand, and Article XIX on the other, is a balance between the need to provide the stability necessary for decisions relating to investment and international trade and the flexibility necessary for governments to accept international obligations."

Negotiating Group on Safeguards, Drafting History of Article XIX and Its Place in GATT, MTN.GNG/NG9/W/7 (16 September 1987) at 3.

> "Some [delegations] pointed out that it was unrealistic to set quantitative standards or automatic criteria for the determination of injury because not all factors were quantifiable and mathematical formulae could not be applied to all sectors of industry."

Negotiating Group on Safeguards, Meeting of 7 and 10 March 1988, MTN.GNG/NG9/5 (22 April 1988) at 5.

> "This safeguard authority, or escape clause, serves as a buffer between the more open trading environment required by the trade-liberalizing obligations of the GATT, and the dislocations of domestic workers and firms which sometimes result from increased competition with a wider variety of sources."

Janet A. Nuzum, "*The Agreement on Safeguards: U.S. Law Leads Revitalization of the Escape Clause*", in *The World Trade Organization, The Multilateral Trade Framework For the 21st Century and U.S. Implementing Legislation* 407, 408 (Terence P. Stewart ed., 1996).

[38] Article 4(2)(a) requires an evaluation of "all relevant factors of an objective and quantifiable nature having a bearing on the situation of ***that*** industry" (emphasis added). This appears to permit an investigation which takes into account the specific nature of the industry.

[39] In light of the fact that Article 4(2)(b) of the Agreement on Safeguards uses the term "in particular", factors other than those set forth in Article 4(2)(b) may be used to determine injury to a particular sector, such as agriculture.

4.57 At the first meeting of the panel with the parties **Korea** further advanced its arguments on the issue of standard of review as follows:

4.58 Article 11 of the DSU obliges the Panel to make an objective assessment of the facts of the case and the applicability of and conformity with the relevant covered agreements. In the absence of particular provisions on the standard of review in the Agreement on Safeguards and the GATT, these criteria need to be construed and considered in the light of the purpose and functions of the Agreement on Safeguards, past practices and precedents, and the allocation of the burden of proof.

4.59 By its very nature, the Agreement on Safeguards, as much as Article XIX GATT and other safeguard clauses, assists Governments in entering into trade liberalizing commitments, as they may call upon safeguards should subsequent economic difficulties arise in due course. By its very nature, this Agreement applies to complex and difficult constellations in difficult times. In applying the Agreement, Governments are, of course, bound by its rules and criteria. But they all share a common interest that these rules allow for adequate flexibility in responding to the difficult constellations and difficult times. In other words, the very function of safeguard clauses implies a considerable degree of discretionary powers to Governments in assessing the situation and in determining injury.

4.60 In reviewing safeguard measures imposed by Governments, panels therefore need to focus on whether the Government has exceeded its scope of discretionary powers. Within the bounds of discretionary powers, the matter therefore has to be assessed with considerable deference.

4.61 Such discretion and deference has been accorded to the operation of safeguard clauses in the past. The 150 measures notified under Article XIX GATT 1947[40] and the fact that they have not been challenged in dispute settlement but for two cases[41] proves the point in state practice.

4.62 This tradition is equally reflected in the new Agreement on Safeguards. While there was a need to strengthen disciplines and to prevent an abuse of the instrument, it still provides for adequate flexibility. Thus, Article 4.2 does not set forth a closed list of relevant factors, but allows Governments, in assessing injury, to take into account additional criteria of particular relevance for the sector concerned. In the present case, it therefore was possible to look into factors of particular relevance for agriculture, consider specific problems and factors relating to the dairy industry. All of this implies certain choices and therefore discretionary powers in construing and applying the injury test.

4.63 In assessing a safeguard measure, the Panel therefore must merely engage in reviewing the measure and its justification within the discretionary bounds of the Agreement. It clearly must not engage in assessing the situation anew. It must not make an independent ex post determination based upon arguments set forth by the complaining party. Its task is a more limited one.

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[40] GATT, Analytical Index*:* Guide to GATT Law and Practice at 539-559 (6th ed 1995).

[41] Working Party on *Withdrawal by the United States of a Tariff Concession under Article XIX of the General Agreement* ("*Fur Felt Hat*"), GATT/CP.6/SR 19 (adopted 22.10.51); Norway - Restrictions on Imports of Certain Textile Products, BISD 27S/119 (adopted 18 June 1980).

4.64 This is confirmed by recent panel practice relating to the application of safeguard clauses. In *US - Underwear*[42], the Panel was equally faced with the issue of assessing its scope and standard of review. It was a matter of finding, based upon Article 11 DSU, an appropriate way between Scylla and Charybdis: between total deference and close scrutiny. The Panel found that total deference to national injury determination could not live up to the standard of Article 11 DSU, while equally rejecting the idea of full review set forth in the *Transformers* case.[43] Instead, it set forth the task to "assess objectively the review conducted by the national investigating authority", to mean "to review the consistency of a determination by a national investigating authority imposing under the relevant provisions of the relevant WTO legal instruments" (para. 7.12).

4.65 Korea submits that the same standard of examining consistency should also apply to the Agreement on Safeguards. As the role and functions of safeguards are alike in different agreements, the standard of review defined and set forth by this panel should be of guidance in this first case on the Safeguard Agreement alike. It is therefore a matter to examine whether Korea remained within its bounds of discretion and had consistently examined all relevant facts before it at the time of the investigation, and provided an adequate explanation of how the facts before it as a whole supported the determination made.

4.66 Finally, the task of the Panel is further shaped and limited by the burden of proof in this case. While, in *US - Underwear*, it was for the United States to demonstrate compliance with the safeguard clauses of the Textile Agreement due to the fact that it had been invoked as an exception, the situation is different under the Agreement on Safeguards. Here, it is up to the complaining Party, the European Communities, to demonstrate that the review conducted by the national investigating authority does not live up to the legal requirements set forth by the Agreement and exceeds the bounds of discretion. It is up to it to demonstrate that Korea has acted inconsistently with and therefore in violation of the Safeguard Agreement.

4.67 The objective assessment by the Panel therefore needs to rely upon the facts and arguments put forth by Korea and those submitted by the European Communities. It is only to the extent the Panel concludes that facts, figures and arguments submitted by the European Communities demonstrate that Korea had failed to provide an adequate justification of the measure imposed, *i.e.*, an adequate explanation as to how the facts invoked supported the determination, that a violation could be established. In other words, it will not be appropriate for the Panel to replace with its own figures and arguments the determination made by Korea.

4.68 The arguments put forward by Korea in this case are shaped in accordance with this standard of review and allocation of the burden of proof. It is not a matter of justifying anew the measure imposed. Instead, Korea's arguments demonstrate that the EUROPEAN COMMUNITIES fails to provide evidence and arguments which would allow the Panel to conclude that Korea has acted beyond its discretionary

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[42] WT/DS24/R, supra, footnote 33.

[43] *New Zealand - Imports of Electrical Transformers from Finland ("Transformers")*, BISD 32S/55 (adopted 28 July 1985).

powers under the Agreement on Safeguards, and thus inconsistently with its obligations under international law.

4.69 Korea also notes that most jurisdictions provide a significant degree of latitude to investigating authorities to make injury determinations after considering complicated economic facts. For example, the European Communities' courts give a very wide degree of discretion to the European Commission in arriving at similar general economic and trade policy judgements. These courts will only review the Commission's assessment of complex factual issues where:

> "the Commission has exceeded the scope of its discretion by a distortion or manifest error of assessment of the facts or by misuse of powers or an abuse of process".[44]

4.70 However, if the EC arguments are limited to the quality, depth and breadth of Korea's notification and consultations and are not requiring the Panel to conduct a *de novo* review of the Korean competent authorities investigation, then Korea is of the view that it has far exceeded the requirements of the Agreement on Safeguards.

(b) Response of the European Communities

4.71 The **European Communities** respond to Korea's submission as follows:

4.72 Both the European Communities and Korea agree that the appropriate standard is that in Article 11 of the DSU, *i.e.,*

> "an objective assessment of the matter before it, including an objective assessment of the facts of the case and the applicability of and conformity with the relevant covered agreements"

4.73 However opposite conclusions are drawn as to what this means in the present case.

4.74 In its First Written Submission, Korea concluded that this requires examining whether Korea:

(a) examined all relevant facts before it at the time of the investigation; and

(b) provided an adequate explanation of how the facts before it as a whole supported the determination made.

4.75 Korea takes this formulation to mean that it need not seek out all the facts but may content itself with the "facts before it" and that even as regards the facts that it does have before it, it need only provide an "adequate" explanation of how these facts "as a whole" (that is viewed globally, rather than in detail) support its determination. The United States apparently does not draw the same conclusions as Korea from the same test because it comes to the conclusion that it was normally necessary to examine the whole of the defined domestic industry and that if Korea failed to evaluate relevant evidence, its determination would violate Article 4.2(a) of the Agreement on Safeguards.

4.76 The above formulation must be rejected since it results from Article 4.2(a) of the Agreement on Safeguards and the precedents set by the panel reports in *US - Shirts and Blouses* and *US - Underwear*[45] that

[44] *See,* for example Case C-225/91 *Matra v. Commission* [1993] ECR I-3203.

- the investigating authority has to seek out and consider "all relevant facts" (and not rely on what is "before it"); and
- it is necessary, at a minimum, for a serious injury determination under the Agreement on Safeguards to demonstrate that the relevance or otherwise of each of the injury factors listed in Article 4.2(a) of the Agreement on Safeguards was properly analyzed unless it is explained for what reason the injury factor may be disregarded. It is true that no injury factor "in isolation" can establish serious injury but that does not excuse a failure to examine them all.

4.77 Korea then argued that "the very function of safeguard clauses implies a considerable degree of discretionary powers to governments in assessing the situation and in determining injury" and that "the matter … has to be addressed with considerable deference".

4.78 It also claimed that most domestic jurisdictions "provide a significant degree of latitude to investigating authorities to make injury determinations after considering complicated facts" and even quoted a State aid case of the European Court of Justice in support.

4.79 On the first argument brought forward by Korea, the European Communities responded that the discretionary nature of safeguard measures which may have been accepted under GATT 1947 and is evidenced in the low number of disputes, is no longer compatible with the WTO. The Agreement on Safeguards has introduced an obligation to conduct a thorough investigation as a pre-condition for imposing measures and has removed the possibility of compensation during the first three years where the measure is held to be in conformity with the Agreement on Safeguards. In addition the WTO system, characterized by binding dispute settlement, is more based on the principle of legality and less on the principle of diplomacy than the former GATT.

4.80 The European Communities do not agree with the view that the intention of the Agreement on Safeguards was to increase the discretion allowed to Members. The preamble to the Agreement on Safeguards clearly contradicts this view since it recalls the intention of Members to reinforce the disciplines of Article XIX of GATT and to re-establish multilateral control over safeguards.

4.81 The European Communities also reject the attempt to import domestic standards of review of certain jurisdictions into the WTO dispute settlement.

4.82 First, the WTO dispute settlement system serves very different purposes to national administrative law systems. It is not designed to establish whether an investigating authority conducted itself in accordance with its duties but rather to adjudicate on the rights and obligations of Members of the WTO under the WTO Agreements.

4.83 Second, even if any of the principles applied by Member jurisdictions were relevant, the standards of all jurisdictions would have to be treated as equally valid and these standards are far too diverse to allow useful rules to be deduced. Terms such as "*de novo*" and "manifest error" have specific and often differing meanings in

[45] *See,* Panel Report in *United States - Measure Affecting Imports of Woven Wool Shirts and Blouses from India ("US - Shirts and Blouses")*, adopted 23 May 1997, DSR 1997:I, 343, WT/DS33/R; *US - Underwear*, *supra*, footnote 33.

different legal systems and so are probably best avoided as they are susceptible of creating conflicting interpretations between Members.

4.84 Thirdly, the guiding text is Article 11 of the DSU, which requires a standard of objective assessment of the facts. This is the standard and the terminology to be applied by Panels.

4.85 In the present case, the European Communities are not contesting the basic economic data produced by Korea but only its completeness and the conclusions drawn from it. The European Communities submit that the "objective assessment of the facts" referred to in Article 11. DSU cannot be satisfied by verifying *what conclusions* the investigating authority came to but must include *how* it came to those conclusions, that is to say *its reasoning.*

4.86 The European Communities recall that Panel Report *Brazil - Milk Powder,* also established that it is not sufficient for an authority to refer to the evidence it considered and state its conclusion. In the words of that panel: "It was incumbent upon the investigating authorities to provide a reasoned opinion explaining how such facts and arguments had led to their finding." [46]

(c) Rebuttal Response of Korea:

4.87 **Korea** makes the following rebuttal arguments:

4.88 First, as the complainant challenging a safeguard measure under the Agreement on Safeguards, it is for the European Communities to show that the claims it makes against Korea are proven.

4.89 Second, Korea reiterated its previously articulated standard of review in this case, as set in Paragraph 4.74 above and noted that the United States "agrees with Korea's assertions concerning the standard of review in safeguards cases."

4.90 At the second meeting of the panel with the parties **Korea** further advanced its arguments on the issue of standard of review as follows:

4.91 Based on the EC arguments on the standard of review in its Second Submission Korea believes that the European Communities is either:

(a) seeking to challenge the quality of the investigation undertaken by the Korean competent authorities; or

(b) whether intentionally or inadvertently, confusing the standard of review to be applied by the Panel in reviewing the Korea's investigation, with the standard of investigation applicable to the Korean investigating authority.

4.92 Korea requests the Panel to conclude that the European Communities cannot challenge the quality of the Korean competent authorities' investigation after the closing of the first round of Oral Statements. This results from Korea's belief that the lack of claims under Articles 3 and 4.2(c) of the Agreement on Safeguards implies that the European Communities have not at any time during these proceedings

[46] *See,* Panel Report on *Brazil - Imposition of Provisional and Definitive Countervailing Duties on Milk Powder and Certain Types of Milk from the European Economic Community ("Brazilian Milk Powder")*, adopted by the Committee on Subsidies and Countervailing Measures on 28 April 1994, SCM/179, and Corr. 1, at para 286.

challenged the quality of the investigation performed by Korea's competent authorities.

4.93 Korea submits that the European Communities are confusing the standard of review to be applied to the Panel's deliberations with the standard to be applied to the investigating authority. Korea notes that these are different concepts and require different analysis.

4.94 The EC arguments seek to obscure Korea's simple formulation of Standard of Review.

4.95 First, the European Communities argue that:

> "Korea takes this formulation to mean that it need not seek out all the facts but may content itself with the "facts before it" and that even as regards the facts that it does have before it, it need only provide an "adequate" explanation of how these facts "as a whole" (that is viewed globally, rather than in detail) support its determination."

4.96 This attempt to misconstrue Korea's argument must be corrected for the record. Clearly the standard of review articulated by Korea does not excuse the Korean investigating authority from conducting a thorough investigation of the facts. Korea's formulation of the standard of review requires the investigating authority to examine all relevant facts which have been uncovered by the investigation based on the requirements of the Agreement on Safeguards. The OAI Report is an 85 page document setting out numerous factual findings made by the OAI, and its analysis as to whether serious injury had been caused to the domestic industry, and whether this serious injury was caused by increased imports. It should be clear from this document alone that the Korean competent authorities undertook a thorough investigation of the case.

4.97 Second, the European Communities suggest that Korea has implied that the imposition of a safeguard measure is "discretionary". This is a complete misinterpretation of Korea's view of the nature of safeguards. Safeguard measures can only be imposed on the basis of the Agreement on Safeguards and not at the discretion of any national authority. The fundamental point is that the underlying purpose of safeguards imposed on the basis of the Agreement on Safeguards is to provide Members with recourse to emergency short-term measures. This specific purpose necessitates a reviewing body to accord a significant degree of deference to the investigating authority in relation to the factual, legal and economic analysis undertaken.

4.98 Third, the European Communities refer to the panel proceedings in *Brazilian Milk Powder*, both to challenge Korea's statement on standard of review, and its compliance with Article 4.2(a). Korea agrees with the earlier Panel's statements in relation to the nature and quality of examination that needs to be undertaken by an investigating authority, and is of the view that the Korean competent authorities met that standard in this case.

4.99 In fact, the *Brazilian Milk Powder* case demonstrates that the Panel should determine Korea's compliance with the Agreement on Safeguards based on the documents of the competent authorities. For the sake of completeness, the European Communities might also have referred the Panel to its own arguments on standard of review in paragraph 32 of that Panel report where it approved of:

> "paragraph 335 of the report of the panel on "*United States - Softwood Lumber*" [which] had stated that "[t]he Panel considered that in

> reviewing the action of the United States authorities in respect of determining the existence of sufficient evidence to initiate, the Panel was not to conduct a *de novo* review of the evidence relied upon by the United States authorities or otherwise to substitute its judgement as to the sufficiency of the particular evidence considered by the United States authorities. Rather ... [it] required consideration of whether a reasonable, unprejudiced person could have found, based upon the evidence relied upon by the United States at the time of initiation, that sufficient evidence existed of subsidy, injury and causal link to justify initiation of the investigation".[47]

4.100 However, the European Communities clear implication by referring to that Panel is that the quality and nature of the Korean authorities' analysis was similar to that of the Brazilian authorities. The European Communities comparison between three paragraphs of analysis in a two page document[48] does a disservice to the 85 pages of findings and closely reasoned analysis found in the OAI Report and the 17 page April 1 Notification.

4.101 Moreover, the European Communities reference to the *Brazilian Milk Powder* panel report is misleading. For brevity, Korea noted only two material differences between the Brazilian case and the case under investigation, as these clearly show that there can be no meaningful comparison between the two:

(a) the Panel found that Brazil had not undertaken any investigation whatsoever prior to the imposition of a provisional countervailing duty, therefore it could not have established that the relevant elements necessary for imposition of a duty were present;

(b) the Panel found that although Brazil was required to examine certain injury criteria in establishing material injury, it only referred to one such factor in its published documents.

4.102 Fourth, the European Communities examine Korea's arguments concerning the level of deference shown in national review procedures. However, it misses or overlooks Korea's fundamental point. Korea was not asking the Panel to apply any specific definitions or legal terms when it suggested that a number of judicial systems, including those in the EU and United States, afford national authorities carrying out detailed economic analysis a great deal of discretion. Korea's point is not the precise level of deference provided, but the fact that it is provided at all by courts when reviewing complicated, factual, legal and economic analysis.[49]

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[47] *See, Brazil Imposition of provisional and definitive countervailing duties on milk powder and certain types of milk from the EEC,* 28 April 1994 (SCM/179).

[48] *See,* Korea Exhibit 17.

[49] Again, Korea notes the extremely wide discretion provided to the Commission and Council of Ministers by the European Courts of Justice, and refers the Panel to, for example, the *SAM Schiffahrt* judgment ([1997] ECR I-4475), where the ECJ notes:

> "23. As the case-law has firmly established, in giving the Council the task of adopting this policy a common transport policy, the Treaty has conferred wide legislative powers upon it as regards the adoption of appropriate common rules (judgment in Case 97/78 Schumalla [1978] ECR 2311, paragraph 4).

(d) Rebuttal Response of the European Communities

4.103 At the second meeting of the Panel with the parties the **European Communities** made the following arguments:

4.104 The European Communities are not asking the Panel to redo the investigation, merely to examine the completeness and correctness of what was investigated and to verify the soundness and compatibility with the Agreement on Safeguards of the reasoning of Korea in imposing the measure. In applying this standard of review, the European Communities argue that Korea failed to investigate all the injury factors specifically mentioned in Article 4.2 and has drawn wrong conclusions from the facts which it did establish. In particular Korea failed to investigate profitability and employment of the major part of the domestic industry, the dairy farms and its causality analysis is fatally flawed by the fact that Korea ignored the protection offered the dairy farms and deliberately closed its eyes to the impact of the "milk quality scandal" on white milk consumption, by applying circular reasoning.

4.105 Korea's defence has generally been that it could not investigate certain injury factors because it did not have the data. The European Communities would make two comments: first, it should have obtained the data. The Safeguards Agreement requires an investigation (at a minimum) of all the injury factors listed in Article 4.2 of the Agreement on Safeguards; second, Korea cannot invoke its own failure to investigate in its defence.

4.106 A second line of defence used by Korea is to say that it could not collect the data since there was too much of it or it was too difficult. For example, it states that there are 20 000 dairy farms and it would have been impossible to investigate transaction prices for all of them. The European Communities would reply that the fact that it is difficult to obtain precise information does not mean that no attempt should be made to make an estimate. For example it is difficult to know how much damage is suffered by a person following a personal injury but this does not lead to judges dismissing claims for damage

24. In reviewing the exercise of such powers, the Court cannot substitute its own assessment for that of the Community legislature, but must confine itself to examining whether that latter assessment contains a manifest error or constitutes a misuse of powers, or whether the authority in question did not clearly exceed the bounds of its discretion (judgments in Case C-122/94 Commission v Council [1996] ECR I-881, paragraph 18; C-84/94 United Kingdom v Council [1996] ECR I-5755, paragraph 58; Case C-169/95 Spain v Commission [1997] ECR I-0000, paragraph 34).

25. The Court's case-law also shows that where, as in this case, implementation by the Council of a common policy requires it to assess a complex economic situation, its discretion is exercisable not only in relation to the nature and scope of the provisions which are to be adopted but also, to a certain extent, to the findings as to the basic facts, especially in the sense that it is free to base its assessment, if necessary, on findings of a general nature (judgments in Case 166/78 Italy v Council [1979] ECR 2575, paragraph 14; Case 138/79 Roquette Frères v Council [1980] ECR 3333, paragraph 25)."

2. *What Are the Appropriate Documents to be Considered by the Panel in Evaluating the Analysis Performed during the Investigation?*

4.107 The European Communities in their first submission based their arguments concerning the lack of compliance by Korea with its obligations under Articles 2 and 4[50] of the Agreement on Safeguards on the notifications Korea had made to the Committee on Safeguards. This situation led to an inquiry by the Panel to the parties as to what document or documents should be considered by the Panel as evidence of the information used and the analysis performed by Korea's competent authorities in determining the imposition of a safeguard measure.[51]

(a) Response of the European Communities

4.108 In response to the panel's question the **European Communities** argued:

4.109 A safeguard proceeding must be conducted in accordance with open and transparent procedures respecting the rights of defence of the parties, which are the interested economic operators. It is for this purpose that Article 3 of the Agreement on Safeguards requires publication of a report "setting forth their findings and reasoned conclusions reached on all pertinent issues of fact and law".

4.110 The proper forum for discussions between WTO Members concerning the compatibility of safeguard action with the Agreement on Safeguards is however not the national investigating authority or courts, but rather consultations and dispute settlement under the WTO. Accordingly, the European Communities consider that all the information should be found, or at least referred to, in the notifications. It notes in this respect that Article 12.2 requires a Member to include in its notification "all pertinent information." This can be presented in summary form but must cover all issues and must make clear reference to the source of the more detailed information. It is only in this way that the objectives of Article 12 can be achieved.

(b) Response of Korea

4.111 In the response to the Panel's question, **Korea** argued:

4.112 The Korean administrative process by which a safeguard measure is imposed has a number of stages.[52]

4.113 First, an interested party or parties files a petition with the KTC. The KTC reviews the petition to establish whether the petitioner has proper standing under Articles 32, 33 and 40 of the Foreign Trade Act and Articles 64, 65, 66 and 76 of the Enforcement Decree implementing the Act.

4.114 Second, the KTC deliberates the *prima facie* case to decide whether to initiate an investigation on industrial injury. With the Determination to Initiate an

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[50] The Panel notes that these two articles refer respectively to the conditions for the imposition of a safeguard measure and to the determination of serious injury or threat thereof necessary to impose such a measure.

[51] The Panel recalls that the question was*:* "Where should the information used and analysis performed by the national authority of Korea in its determination of its safeguard measure be found?"

[52] *See,* Exhibit Korea-12

Investigation, the KTC publishes a Public Notice of Investigation in the Korean Official Gazette, *Kwanbo*, which provides a summary of the determination to proceed. The Notice also contains details of the investigation to be undertaken; the timetable for the various stages, and contact details for the KTC. The initiation also triggers a notification to the WTO Committee on Safeguards, in the form of a notice conforming to G/SG/N/6.

4.115 In this case, the KTC made the Determination to Initiate an Investigation on 17 May 1996 (see Exhibit Korea-3).[53] The Public Notice of Initiation, which actually is a summary of the Determination (Exhibit Korea-3), was published in *Kwanbo* on 28 May 1996 (see Exhibit Korea-4), and this was the basis for the notification to the WTO Committee on Safeguards, G/SG/N/6/KOR/2 of 1 July 1996.

4.116 Third, the KTC forms an investigation team, normally led by an official from the Office of Administration and Investigation ("OAI"). This team undertakes the investigation and is responsible for the formulation of questionnaires, on-the-spot investigations, and the drafting of the interim report.

4.117 Fourth, prior to the finalization of the investigation report, the OAI holds a public hearing at which the findings in the investigation report are discussed with all relevant parties present at the hearing. Copies of the OAI's interim report are available to the interested parties prior to the hearing so that the OAI can take into account observations and comments made by interested parties at the public hearing before finalizing the investigation report. The date of the oral hearing is announced in *Kwanbo* to maximize transparency of this procedure.

4.118 In this case, the Notice of Public Hearing was published in *Kwanbo* on 25 July 1996 (see Exhibit Korea-13). The interim report was available from the KTC upon request as from 12 August 1996. The Public Hearing was held on 20 August 1996.

4.119 Fifth, taking into account the above interim stage, the OAI completes its report for final approval by the KTC commissioners. The report includes a detailed analysis of:

(a) the product under investigation;
(b) the domestic industry;
(c) like or directly competing products;
(d) increases in the level of imports;
(e) threat of or actual serious injury to the domestic industry; and
(f) the causal relationship between increased imports and serious injury.

4.120 The KTC deliberates the case for a determination on injury (including causal link) on the basis of the investigation report presented to it from the OAI. The KTC's determination of injury, whether affirmative or negative, is published in *Kwanbo* with a summary of the investigation result, the decision of injury, further schedules and other administrative information. The KTC's determination on injury also triggers a notification to the WTO Committee on Safeguards, in the form of notice conforming to G/SG/N/8. It is important to note that if the KTC makes a negative

[53] Korea noted that "Public Notice of" should be deleted from the headline of Exhibit Korea-3. The Determination itself was not published in Korea's Official Gazette.

determination on injury on the basis of the consideration on increased imports, serious injury, or causation, the case is rejected and no further action is possible.

4.121 In this case, the OAI Report was completed on 23 October 1996, and a Notice published in *Kwanbo* on 11 November 1996 (see Exhibit Korea-7).[54] The OAI Report was the basis for the notification to the WTO Committee on Safeguards of 2 December 1996, published by the WTO on 6 December 1996 (G/SG/N/8/KOR/1).[55] This Notification stated:

> "The Korean Trade Commission has not made a decision to apply a safeguard measure yet. Therefore, there is no information on such a measure at this time. The KTC will recommend to the relevant Minister an appropriate remedial measure within 45 days of the injury determination."

4.122 Sixth, in accordance with Article 34(1) of the Foreign Trade Act and Articles 71, 72 and 76 of the Enforcement Decree of the Foreign Trade Act, the KTC Commissioners then consider the OAI Report and decide on appropriate relief measures for recommendation to the relevant Minister.[56]

4.123 In this case, the KTC Commissioners decided on the relief measure, namely the quota, on 2 December 1996, and recommended it on 6 December 1996 to the Minister for Agriculture and Forestry for his deliberation.

4.124 Seventh, taking into account the outcome of "prior consultations" under Article 12.3 of the Agreement on Safeguards, the relevant Minister takes a decision concerning the relevant relief measure. If the Minister uses any additional reasoning not found in the OAI Report, this is provided in the relevant Notice. However, if no additional reasoning is used, then the Minister's determination adopts all relevant elements of the OAI Report.

4.125 In this case, Korea issued another notification to the Committee on Safeguards on 21 January 1997, by G/SG/N/10/KOR/1, published on 27 January 1997. The notification stated:

> Pursuant to Article 12.3 of the Agreement on Safeguards, the Republic of Korea will consult with Members having substantial interest in the products covered by the safeguard measure, for the purpose of providing further information. A delegation from Korea will stay in Geneva during the week beginning 3 February 1997 to meet with those Members, before it makes a final decision on the measure by the week beginning 24 February 1997."

4.126 In addition, the letter enclosing the Notification reserved the right of Korea to make further submissions to the Committee concerning the imposition of any relief measures.

4.127 Further, on 31 January 1997, Korea filed a notification with the Committee on Safeguards concerning the application of the proposed safeguard measure to

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[54] It generally takes 2-3 weeks to prepare a notice in cooperation with the Ministry of Administration, which is in charge of the operation of *Kwanbo*.

[55] It took nearly one month for the Notification to arrive at the WTO through diplomatic channels from the KTC.

[56] The KTC's recommendation on relief measures is not made public because it is only a recommendation that has no legal effect and that is subject to change by the relevant Minister.

developing countries. This was done in accordance with footnote 2 of Article 9 of the Agreement on Safeguards (see G/SG/N/11/KOR/1 of 21 February 1997, and Exhibit EC-8).

4.128 The Minister of Agriculture and Forestry took his decision on 1 March 1997, and a Notice of the decision was published in *Kwanbo* on 7 March 1997 (see Exhibit Korea-9).

4.129 On 24 March 1997, Korea notified the Committee on Safeguards of an addendum to G/SG/N/10/KOR/1 (G/SG/N/10/KOR/1/Suppl.1), which was circulated on 1 April 1997.

4.130 Therefore, Korea concludes that the information used and analysis performed is found in the seven stages set out above, including, where relevant, any additional information contained in any of the Notifications made to the Committee on Safeguards. Although it may be possible to conclude that the OAI Report forms the fundamental basis of Korea's determination, it should be clear that the KTC and the relevant Minister together comprise the "competent authorities" and that any decision to impose a safeguard measure must take into account prior consultations. Accordingly, in response to the Panel's question as to where to find "the information used and analysis performed by the national authority of Korea in its determination of its safeguard measure," Korea considers that any "information used or analysis undertaken" at any time subsequent to the issuance of the OAI Report and prior to the Minister's final decision to implement relief measures is also relevant and needs to be considered as part of that decision.

(c) Submission of the European Communities

4.131 In its second submission the **European Communities** further argued as follows:

4.132 The European Communities have based its attempts to show that Korea's measure was inconsistent with Article XIX of GATT and several provisions of the Agreement on Safeguards. In order to arrive at this conclusion the European Communities based themselves on Korea's 1 April 1997 Notification to the Committee on Safeguards, because it wanted to take into account all the facts and arguments on which the final position of its authorities was based. The European Communities assumed that all those facts and arguments would be reflected in the 1 April Notification in view of Korea's multilateral obligations, at least in summary and with appropriate reference to the relevant parts of other determinations of its competent authorities. Although the European Communities were prepared to accept the 1 April 1997 Notification as the ultimate source of the basis for Korea's determination, even that latest document could not sustain a close scrutiny.

4.133 The European Communities submit that, in any event, no other result is reached by looking at the documents which Korea refers to as its "final determination" or at the KTC's determination of injury. Indeed, in the course of its consultations with Korea the European Communities already challenged the WTO-legality of its intended measures before the 1 April Notification was published.

4.134 This was done on the basis of information available at that stage, which did not include the 1 April Notification but rather the information provided in Korea's documents and the explanations provided by Korea.

4.135 The European Communities further consider that its position as to the appropriate source of the information used and analysis performed by Korea's authorities is confirmed by Korea's replies to the questions of the Panel.
4.136 In its reply to the pertinent question of the Panel, Korea has described the various procedural steps leading to the imposition of the safeguard measure at issue in this dispute. In doing so, it has referred to, *inter alia*, several documents which were prepared by its competent authorities. It has also pointed out that according to its procedure these documents can be commented upon and revised accordingly, up to and including the draft final determination.
4.137 Furthermore, Korea itself admits that the final document in its procedure was the "Notice" of 7 March 1997 (produced as Exhibit Korea-9).
4.138 That document certainly fails to be "detailed" as required by Article 4.2(c) of the Agreement on Safeguards, be it directly, that is by the information included therein, or by reference, *i.e.,* by the documents which it may refer to.
4.139 In particular, the 7 March Notice, issued after the bilateral consultations with the European Communities had taken place, does not refer to any of the information and aspects raised in those consultations. Thus, if the 7 March Notice and possibly prior documents are the relevant sources, Korea disregarded, *inter alia*, the information provided in the consultations and without any reason being provided. By contrast, the 1 April Notification does take account of some of the objections made by the European Communities at the consultations.
4.140 Accordingly, the European Communities consider that its reliance on the 1 April Notification was more favourable to Korea.
4.141 Korea is itself admitting that its 1 April Notification was made to inform WTO Members of the details of the relief measures and it intended to be a summary of the "OAI Report" and of the "*additional findings*" based on prior consultations. Thus, the April Notification is the one (and only) document accounting for those "additional findings".

C. Claim under Article XIX:1(A) of GATT

(a) Claim by the European Communities

4.142 The **European Communities** claim that Korea violated Article XIX:1(a) of GATT by failing to examine whether the import trends of the products under investigation were the result of unforeseen developments . The European Communities made the following arguments in support of its claim:
4.143 Article XIX:1(a) of GATT stipulates*:*

> "If, as a result of *unforeseen developments and* of the effect of the *obligations incurred by a contracting party under this Agreement, including tariff concessions*, any product is being imported into the territory of that contracting party in such increased quantities *and under such conditions* as to cause or threaten to cause serious injury to domestic producers in that territory of like or directly competitive products, the contracting party shall be free, in respect of such product, and to the extent and for such time as may be necessary to prevent or remedy such injury, to suspend the obligation in whole or in part or to withdraw or modify the concession." (emphasis added)

4.144 It clearly results from the wording of Article XIX:1(a) that in order to allow the imposition of a safeguard measure not any increase in imports is relevant, but only those which result from both "unforeseen developments" and compliance with GATT obligations, including tariff liberalization according to a party's schedules of concessions.

4.145 Tariff concessions and other obligations are listed in Article XIX of GATT as an *additional* element to "unforeseen developments", so it necessarily follows that liberalization cannot constitute by itself such unforeseen developments. [57] If it were otherwise, a WTO Member would be allowed to withdraw the very benefits which it had undertaken to afford *e.g.,* by entering into tariff commitments as soon as those benefits materialize. This would neither be consistent with good faith interpretation of that provision nor with the liberalization aims pursued by GATT and the WTO Agreement overall. In any event, increased imports of the magnitude at issue in this case as a result of the tariff concessions agreed for SMPP cannot be considered "unforeseen" within the meaning of Article XIX:1(a).

4.146 The European Communities submit that, by failing to address how the increase in imports of milk powder blends and foodstuff preparations was the result of "unforeseen developments", Korea violated the obligations which it assumed under Article XIX:1(a) of GATT.

(b) Response by Korea

4.147 **Korea** responds to the EC arguments as follows:

4.148 Following unsuccessful negotiations during the Tokyo Round and after years of negotiations during the Uruguay Round, WTO Members finally concluded the Agreement on Safeguards. It was intended to establish a final, complete and balanced system of rules for the imposition of safeguards, which achieved a delicate balance among the different interests of the various groups concerned. Article 1 of the Agreement on Safeguards expressly states that the Agreement on Safeguards "establishes the rules for the application of safeguard measures." Article 1 does not provide that any different or additional rules provided under Article XIX of GATT must also apply to the application of safeguard measures.[58] Thus, in the view of Korea, the text of the Agreements supports the interpretation that the rules established in the Agreement on Safeguards are now the sole articulation of the rules that must be followed in the application of a safeguard measure[59]. Without prejudice to Korea's position that it complied with all of its international obligations in applying the safeguard measure at issue, Korea respectfully requests that the Panel examine this case in accordance with the interpretation of Korea.

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[57] This also reflects a generally accepted tenet of economic theory, *i.e.,* that tariff protection can be measured in advance according to specific formulas*: See* B. Hoekman, M. Kostecki, *The Political Economy of the World Trading System*, Oxford, 1995, pp. 88, 93.

[58] Contrary to Article 1 of the Agreement on Safeguards, Article 10 of the Agreement on Subsidies and Countervailing Measures states that "Members shall take all necessary steps to ensure that the imposition of a countervailing duty ... is in accordance with the provisions of Article VI of GATT and the terms of this Agreement."

[59] In terms of the General Interpretative Note to Annex 1A of the WTO Agreement, the rules on the Agreement on Safeguards must prevail over the conflicting rules in Article XIX of the GATT.

(c) Additional Arguments by the European Communities Made at the First Meeting of the Panel with the Parties

4.149 The **European Communities** responded to Korea's Argument by asserting that:

4.150 Korea relied on a very selective - and interpolated - quotation of Article 1. Thus, the original Article 1, reading "This Agreement establishes rules for the application of safeguard measures which shall be understood to mean those measures provided for in Article XIX of GATT" becomes "This Agreement establishes *the* rules for the application of safeguard measures", with the rest of the provision eloquently omitted. (emphasis added)

4.151 By doing so Korea simply refuses to face the fact that GATT was incorporated in the WTO system in its entirety. From the very inception of the new WTO system panels have recognized that the fragmentation of the multilateral trading system resulting from the independent co-existence of GATT 1947 and the so-called "side-agreements" is definitively over.[60] Most recently, in *Guatemala - Anti-Dumping Investigation Regarding Portland Cement from Mexico*,[61] the Appellate Body made clear in respect of dispute settlement provisions that

> "[a] special or additional provision should only be found to prevail over a provision of the DSU in a situation where adherence to the one provision will lead to a violation of the other provision, that is, in the case of a *conflict* between them". "[i]t is only where the provisions of the DSU and the special or additional rules and procedures of the covered agreement *cannot* be read as *complementing* each other that the special or additional provisions are to *prevail*" (emphasis in original)

4.152 It is precisely in those very same terms that the interpretative note to Annex IA to the WTO Agreement provides that: "In the event of a *conflict* between a provision of the General Agreement on Tariffs and Trade 1994 and a provision of another agreement in Annex IA … , the provision of the other Agreement *shall prevail* to the extent of the *conflict*." (emphasis added).

4.153 The European Communities failed to see how Article XIX:1(a), to the extent that it requires that the increase in imports must result from "unforeseen developments", could be said to be in conflict with the provisions of the Agreement on Safeguards. Clearly, the drafters of Article XIX had difficulties too, since they cumulated these requirements.

4.154 Furthermore, derogating from Article XIX is certainly not one of the aims of the Agreement on Safeguards. That agreement rather aims to "*clarify and reinforce* the disciplines of GATT and specifically those of *Article XIX* … to re-establish control over safeguards and eliminate measures that escape such control" and recognizes that "for these purposes a comprehensive agreement, applicable to all Members and based on the basic principles of GATT, is called for". (emphasis in original)

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[60] *See,* the Panel Report in *Brazil - Dessicated Coconut*, WT/DS22/R, adopted 20 March 1997, DSR 1997:I, *e.g.,* paras 227, 242.

[61] WT/DS60/AB/R, adopted 25 November 1998, DSR 1998:IX, 3763.

4.155 In response to a question by the Panel[62], the **European Communities** further clarified their arguments:
4.156 The European Communities consider that the requirement in Article XIX that safeguard measures only be taken in the event of "unforeseen developments" remains applicable even if not repeated in the Agreement on Safeguards.
4.157 Article 1 of that Agreement provides that "This Agreement establishes rules for the application of safeguard measures which shall be understood to mean those measures provided for in Article XIX of GATT".
4.158 It is clear from the omission of the definite Article before the word "rules" in this provision that the Agreement on Safeguards is *not* intended to be the exclusive source of safeguard rules.
4.159 It is true that Article 2 of the Agreement on Safeguards does not repeat the requirement of unforeseen developments but this can be explained by the intention of the Agreement on Safeguards to provide procedures for investigations. Unlike increased imports, other conditions, injury and causation, the existence of unforeseen circumstances is something within the knowledge of governments and does not require investigation involving economic operators. It is of interest to note that the requirement that the increased imports result from trade liberalization is also not mentioned in the Agreement on Safeguards (liberalization is also of course a matter within the knowledge of governments). Both these factors either exist or do not and do not need an investigation to be established. As is clearly stated in the preamble, the purpose of the Agreement on Safeguards was to clarify and reinforce the disciplines of Article XIX of GATT. The requirements of unforeseen developments and indeed the consequences of trade liberalization were not requirements which the contracting parties considered needed to be clarified and reinforced.
4.160 Article 11.1(a) of the Agreement on Safeguards expressly requires that safeguard action conform *both* to Article XIX GATT *and* to the Agreement on Safeguards. This is especially so in view of the fact that GATT and the Agreement on Safeguards are both contained in Annex 1A of the WTO Agreement and the General Interpretative Note to the WTO Agreement provides that the provisions of an agreement such as the Agreement on Safeguards should prevail over the GATT in the event of *conflict* and to the extent of the conflict. The European Communities see no conflict between Article XIX GATT and the Agreement on Safeguards.
4.161 In response to a request from the Panel that it clarify its interpretation of the *Brazil - Dessicated Coconut* case refered to in paragraph 4.151 above, the **European Communities** responded as follows:
4.162 The European Communities have referred to the *Brazil - Dessicated Coconut* case in reply to the position taken by Korea on the issue of the "applicable law". Korea has argued that "the rules established in the Agreement on Safeguards are now the sole articulation of the rules that must be followed in the application of a safeguard measure", to the exclusion of Article XIX of GATT, because Article 1 of

[62] The Panel recalls that the question was: "Please comment and discuss the legal relationship between the provisions of the Agreement on Safeguards and those of Article XIX of GATT, in particular with reference to 'unforeseen developments'."

the Agreement on Safeguards does not provide that any different or additional rule under Article XIX of GATT must also apply.

4.163 The European Communities disagree with Korea and consider that the *Brazil - Dessicated Coconut* Panel Report, upheld by the Appellate Body, supports its view that such an express provision is not required, but rather that GATT and the Agreement on Safeguards:

> "represent an *inseparable package* of rights and disciplines that must be considered *in conjunction*".[63]

4.164 The *Brazil - Dessicated Coconut* Panel also stated:

> "Article VI of GATT and the SCM Agreement represent a new and different package of rights and obligations, as among WTO Members, regarding the use of countervailing duties. … The SCM Agreements do not merely impose *additional* substantive and procedural *obligations* on a potential user of countervailing measures. Rather, the SCM Agreements and Article VI together define, clarify and in some cases modify the whole package of *rights* and obligations of a potential user of countervailing measures." [64]

4.165 The European Communities concur with the conclusion, drawn by the United States from this passage, that the "new package" made up by the Agreement on Safeguards and Article XIX of GATT is different from Article XIX of GATT 1947.

4.166 The European Communities however disagree with the additional conclusion drawn by the United States as a third party in this dispute that after the entry into force of the Agreement on Safeguards "those provisions of Article XIX *that remain in force* are incorporated into the Agreement on Safeguards" and that the requirement that "unforeseen developments" must have caused an increase in imports is no longer applicable. With this statement the United States seem to be attempting to reduce the "package" to the provisions of only one part, the Agreement on Safeguards. This is the opposite of what the Appellate Body meant when it agreed that the GATT provision and the specific agreement needed to be treated as an "inseparable package".

4.167 The European Communities added that, on the status of GATT in the WTO system, the *Brazil - Dessicated Coconut* Panel considered:

> "It is evident that both Article VI of GATT and the SCM Agreement have force, effect and purpose within the WTO Agreement. That GATT has not been superseded by other Multilateral Agreements on Trade in Goods ("MTN Agreements") is demonstrated by a general interpretative note to Annex 1A of the WTO Agreement. (footnote omitted) The fact that certain important provisions of Article VI of

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[63] Panel Report, para 227, recalled in Appellate Body Report, *supra*, footnote 16, at 179 (emphasis added). The Panel concluded for the non-separability of Article VI of GATT and the SCM Agreement in para 257 of its Report.

[64] Panel Report, para 246; Appellate Body Report, *supra*, footnote 16, at 180 (emphasis in original).

GATT are neither replicated nor elaborated in the SCM Agreement further demonstrates this point.[65]"

4.168 On the other hand, the European Communities recall that in that case the Panel did not have to decide on the precise content of the "new package", that is, on whether and to what extent the GATT provision at issue (Article VI) had been modified as a result of the relevant Agreement in Annex 1 A (the Agreement on Subsidies and Countervailing Measures). In fact, the Panel concluded for the inapplicability of the whole relevant "package" to the case before it.[66]

(d) Additional Arguments by Korea Made at the First Meeting of the Panel with the Parties

4.169 In response to a question by the Panel[67], **Korea** further clarified its arguments as follows:

4.170 Article XIX:1(a) of GATT 1947 provided that Contracting Parties could apply safeguard measures in response to "unforeseen developments" resulting in increased imports that threatened or caused serious injury to domestic producers of like or directly competitive products. GATT includes the text of GATT 1947, including Article XIX. The Agreement on Safeguards, however, does not include the condition of "unforeseen developments."

4.171 WTO dispute settlement panels and the Appellate Body have established that the language of GATT and the WTO Agreements should be interpreted in accordance with the rules of interpretation set forth in the Vienna Convention on the Law of Treaties[68] ("Vienna Convention"). These rules require an examination of the ordinary meaning of the words of a treaty, read in their context and in the light of the object and purpose of the treaty involved.[69]

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65 "For example, the SCM Agreement does not replicate or elaborate on Article VI:5 of GATT, which proscribes the imposition of both an anti-dumping and a countervailing duty to compensate for the same situation of dumping and export subsidization, nor does it address the issue of countervailing action on behalf of a third country as provided for in Article VI:6(b) and (c) of GATT. If the SCM Agreement were considered to supersede Article VI of GATT altogether with respect to countervailing measures, these provisions would lose all force and effect. Such a result could not have been intended." (Panel Report, para 227).

66 Panel Report, paras 231, 257.

67 The Panel recalls that the question was: "Please comment and discuss the legal relationship between the provisions of the Agreement on Safeguards and those of Article XIX of GATT, in particular with reference to 'unforeseen developments'."

68 Done at Vienna, 23 May 1969, 1155 U.N.T.S. 33; 8 International Legal Materials 679.

69 *See,* the Appellate Body Report in the *United States - Import Prohibition of Certain Shrimp and Shrimp Products* ("*United States - Shrimp*"), WT/DS58/AB/R, adopted 6 November 1998, DSR 1998:VII, 2755, footnote 82 and accompanying text, citing *United States - Standard for Conventional and Reformulated Gasoline*, ("*United States - Gasoline*") adopted 20 May 1996, WT/DS2/AB/R, DSR 1996:I, 3, at 15; *Japan - Taxes on Alcoholic Beverages*, ("*Japan - Alcoholic Beverages*") adopted 1 November 1996, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, DSR 1996:I, 97, at 104-106.*; India - Patent Protection for Pharmaceutical and Agricultural Chemical Products*, adopted 16 January 1998, WT/DS50/AB/R, DSR 1998:I, 9, paras. 45-46; *Argentina - Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items*, *supra*, footnote 24, para. 47; and *European Communities - Customs Classification of Certain Computer Equipment*,

4.172 Accordingly, in its interpretation of the Agreement on Safeguards and Article XIX, Korea first addresses the respective texts. After having established the meaning of the texts in their context, Korea discusses the object and purpose of the provisions at issue. In light of the disagreement between the parties to this dispute, Korea also analyses supplemental sources of interpretation in accordance with the Vienna Convention in order to clarify the meaning of the texts and the object and purpose of the provisions at issue.[70]

4.173 Korea submits that the legal relationship between the Agreement on Safeguards and Article XIX is based on the text of Articles 1 and 11.1(a) of the Agreement on Safeguards. Article 1 states that:

> *"[t]his Agreement establishes rules for the application of safeguard measures* which shall be understood to mean those measures provided for in Article XIX of GATT." (Emphasis added).

4.174 Article 11.1(a) of the Agreement on Safeguards states that

> "[a] Member shall not take or seek any emergency action on imports of particular products set forth in Article XIX of GATT unless such action conforms with the provisions of that Article *applied in accordance with this Agreement*." (Emphasis added).

4.175 Thus, Articles 1 and 11.1(a) of the Agreement on Safeguards clearly and conclusively establish that safeguard measures originally provided for in Article XIX may only be applied in accordance with the rules established under the Agreement on Safeguards.

4.176 Pursuant to the express terms of Article 11.1(a), the Agreement on Safeguards and Article XIX must be read together, and applied in accordance with the provisions of the Agreement on Safeguards.[71] The Appellate Body has established that, taken together, provisions of the GATT and the *WTO Agreements* create a new "package of rights."[72] Accordingly, Korea submits that the provisions of Article XIX have been defined, clarified, and modified according to the new "package of rights" applicable under the Agreement on Safeguards.

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adopted 22 June 1998, WT/DS62/AB/R, WT/DS67/AB/R, WT/DS68/AB/R, DSR 1998:V, 1851, para. 85.

[70] *See, United States - Shrimp*, Appellate Body Report, Section VI.A, stating that "[w]here the meaning imparted by the text itself is equivocal or inconclusive, or where confirmation of the correctness of the reading of the text itself is desired, light from the object and purpose of the treaty as a whole may usefully be sought." I. Sinclair, *The Vienna Convention on the Law of Treaties, 2nd ed.* (Manchester University Press, 1984), pp. 130-131.

[71] Although it may consider that the application of Article 11.1(a) may be inconvenient for its purposes, the EC cannot simply ignore its legal effect. As the Appellate Body has noted on two occasions "one of the corollaries of the 'general rule of interpretation' in the Vienna Convention is that interpretation must give meaning and effect to all terms of the treaty. An interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility." Appellate Body Report, *Japan - Alcoholic Beverages*, *supra*, footnote 69, at 104-106, citing Appellate Body Report, *United States - Gasoline*, *supra*, footnote 69, at 21

[72] *See, Brazil - Measures Affecting Desiccated Coconut*, *supra*, footnote 16, at 181, where the Appellate Body stated that "[t]he SCM Agreements do not merely impose additional substantive and procedural obligations on a potential user of countervailing measures. Rather, the SCM Agreements and Article VI together define, clarify and in some cases modify the whole package of rights and obligations of a potential user of countervailing measures." (Emphasis added.)

4.177 Korea submits that conflicts between the provisions of Article XIX and the Agreement on Safeguards must be resolved according to the *General Interpretative note to Annex 1A* to the *WTO Agreements* (the "Interpretative Note"), which provides:

> "In the event of conflict between a provision of the General Agreement on Tariffs and Trade 1994 and a provision of another agreement in Annex 1A to the Agreement Establishing the World Trade Organization…, the provision of the other agreement shall prevail to the extent of the conflict."

4.178 The provisions of the Agreement on Safeguards, therefore, prevail to the extent of conflict with Article XIX.

4.179 Pursuant to Article 11.1(a), safeguard measures must be applied in accordance with the Agreement on Safeguards. The "unforeseen developments" condition cannot be applied in accordance with the Agreement on Safeguards, because such condition is not specified in the Agreement. Article XIX, on the other hand, does require "unforeseen developments." This conflict[73] must be resolved according to the Interpretative Note, which requires that the Agreement on Safeguards must prevail to the extent of conflict with Article XIX.

4.180 Because the "unforeseen developments" condition of Article XIX does not conform with the provisions of the Agreement on Safeguards, Members are not required to consider such condition when taking or seeking the emergency actions on imports of particular products set forth in Article XIX of GATT.

4.181 In addition to the rule set forth in Article 11.1(a), Article 2 of the Agreement on Safeguards provides that "[a] Member may apply a safeguard measure to a product only if that Member has determined, *pursuant to the provisions set forth below*..." that the applicable criteria have been established (emphasis added). The "provisions below" of the Agreement on Safeguards do *not* include the "unforeseen developments" condition. Moreover, Article 2 continues to reiterate *every* provision of Article XIX:1(a) *except* those regarding "unforeseen developments" and "obligations incurred by a contracting party under [GATT], including tariff concessions." Thus, the language of Article 2 of the Agreement on Safeguards mandates the interpretation that the condition of "unforeseen developments" is not included in the new "package of rights" in effect under WTO law.

4.182 Korea considers that its interpretation of the WTO safeguards regime reflects the object and purpose of the Agreement on Safeguards together with Article XIX. The preamble to the Agreement on Safeguards includes the following as its object and purpose:

- to improve and strengthen the international trading system based on GATT; and

[73] In Korea's view the EC attempts to avoid "conflict" between the provisions of the agreements by comparing Article XIX:1(a) to Article 2 of the Agreement on Safeguards, which can, on their face, be read complementary to each other. The conflict that brings the Interpretative Note into application, however, is between Article XIX:1(a) and Article 11:1(a) of the Agreement on Safeguards, which requires that safeguard measures be applied according to the Agreement on Safeguards (that does not include the "unforeseen developments" condition).

- to clarify and reinforce the disciplines of GATT, and specifically those of its Article XIX..., to re-establish multilateral control over safeguards and eliminate measures that escape such control.

4.183 Korea considers that its interpretation of the Agreement on Safeguards and Article XIX is also consistent with the object and purpose of the *WTO Agreements* as a whole. The Appellate Body has noted that "[t]he authors of the new WTO regime intended to put an end to the fragmentation that had characterized the previous system." This intent is evident in the preamble to the *WTO Agreement*, which states, in pertinent part:

> "Resolved, therefore, to develop an integrated, more viable and durable multilateral trading system encompassing the General Agreement on Tariffs and Trade, the results of past trade liberalization efforts, and all of the results of the Uruguay Round of Multilateral Trade Negotiations."

4.184 Thus, the object and purpose of the provisions at issue, and of the *WTO Agreements* generally, is to introduce *changes* to the GATT regime that improve and strengthen the multilateral trading system.

4.185 The object and purpose of the provisions at issue is further illustrated by practice of the parties under Article XIX and the Agreement on Safeguards.[74] Practice under Article XIX confirms that the GATT Contracting Parties did not consider that the condition of "unforeseen developments" was required. For example, as early as 1951, the United States did not apply the "unforeseen developments" condition in determining whether to impose safeguard measures.[75]

4.186 Significantly, the *lack* of subsequent practice under Article XIX reflects the view held by many Contracting Parties that Article XIX's provisions were unrealistic and unusable. The proliferation of "grey area" measures since the inception of GATT 1947 is widely attributed to Contracting Parties' perception that the political and economic reality attendant to safeguard measures could not be accommodated under Article XIX.

4.187 Even if it is considered that "unforeseen developments" were required under GATT 1947, but were simply not complied with, practice by the parties confirms that "unforeseen developments" are not required under the Agreement on Safeguards. Safeguards practice subsequent to the WTO Agreements' entry into force is generally limited to Members' implementation of laws and regulations consistent with the Agreement on Safeguards, especially since the instant case is the first dispute to be brought under the Agreement on Safeguards. According to the notifications of legislation submitted to the Committee on Safeguards pursuant to Article 12.6 of the Agreement on Safeguards, the laws and regulations of the parties and third party to this dispute do not include the condition of "unforeseen developments[76]"

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[74] Article 31, Paragraph 3 of the Vienna Convention provides that in interpreting a treaty, "[t]here shall be taken into account, together with the context:... (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation[.]"

[75] In 1951, the US Congress passed the Trade Agreements Extension Act, which eliminated the "unforeseen conditions" requirement from US safeguards law.

[76] The European Communities - G/SG/N/1/EEC/1; the Republic of Korea - G/SG/N/1/KOR/1; the United States of America - G/SG/N/1/USA/1. Since the entry into force of the Agreement on

4.188 Under the presumption that these WTO Members have implemented the measures required under the Agreement on Safeguards in good faith, Korea submits that the absence of the "unforeseen developments" condition indicates that such condition in their domestic legislation is not considered to exist under the Agreement on Safeguards.

4.189 The object and purpose of the Agreement on Safeguards, as illustrated by the parties' practice, is to improve and strengthen the multilateral trading system by introducing effective means for applying safeguard measures. This object and purpose would be completely undermined by the inclusion of the "unforeseen developments" condition.

4.190 Korea considers that the relevant texts clearly do not require the condition of "unforeseen developments." To the extent that the texts are deemed ambiguous or unreasonable, however, Korea notes that preparatory work to the Agreement on Safeguards reinforces the negotiators' intent that the condition of "unforeseen developments" does not apply under the Agreement on Safeguards.[77]

4.191 The preparatory work to the Agreement on Safeguards provides additional guidance on the meaning of the texts and the object and purpose of the relevant agreements. In addition, Korea considers that the EC imposition of the "unforeseen developments" condition on Korea, but not on itself, would lead to a manifestly absurd and unreasonable result.[78] which is not tolerated under the Vienna Convention rules, and should be rejected by the Panel.

4.192 In reviewing the preparatory work to the Agreement on Safeguards, Korea first looks to the language of the disputed provision. As indicated above, the Agreement on Safeguards reiterates *every* provision of Article XIX:1(a) *except* those regarding "unforeseen developments" and "obligations incurred by a contracting party under [GATT], including tariff concessions." The Agreement on Safeguards'

Safeguards, the United States has conducted the following safeguards investigations, in which "unforeseen developments" were not considered*: Broom Corn Brooms*, Inv. Nos. TA-201-65 and NAFTA 302-1, USITC Pub. 2984 (Aug. 1996); *Fresh Tomatoes and Bell Peppers*, Inv. No. TA-201-66, USITC Pub. 2985 (Aug. 1996); and *Wheat Gluten*, Inv. No. TA-201-67, USITC Pub. 3088 (March 1998).

[77] For an example of the Appellate Body's recourse to treaty preparatory materials, *see United States - Shrimp* Appellate Body Report, *supra*, footnote 69, footnote 152, and accompanying text.

[78] Similarly, the Oral Statement of the United States notes that requiring the "unforeseen developments" condition would lead to yet another unreasonable result. In particular, the United States opines that

> "[i]t is simply not credible to suggest that a trade Minister would negotiate a particular concession if it could be foreseen that such a concession would result in increased imports that, in turn, would seriously injure an industry in the country granting the concession. A Minister who engaged in such conduct would, quite properly, be relieved of his or her post."

In this regard, Korea takes note of the United States' comment that the modification of Article XIX to delete the condition of "unforeseen developments" was "necessary in order to reflect actual practice." Oral Statement of the United States, p. 6, n8. (*See,* also discussion of safeguards practice under GATT at note [7], supra.)

negotiating drafts also reflect that the negotiators considered, and rejected, the "unforeseen developments" requirement.[79]

4.193 Several authors provide insight on the relationship of the Agreement on Safeguards and Article XIX under the new WTO safeguards regime. Professor Thiébaut Flory has opined that Article XIX "functioned for many years in a defective manner - moreover the Community has only triggered the safeguard clause under Article XIX twenty times since the beginning of the 1980's. This very low number of inquiries displays the defective nature of the functioning of the safeguard clause under Article XIX of the General Agreement of 1947...."[80] In the context of safeguard negotiations during the Uruguay Round, Pierre Didier has observed with respect to the "unexpected, sudden, and large" conditions contemplated by the negotiating group on safeguards, that "both the US and EU rejected this terminology as being too difficult to apply."[81]

4.194 Regarding the outcome of the Uruguay Round negotiations, Marco Bronckers notes that "exporting interests have also lost on a couple of points in the agreement, for example: - the triggering condition of injury no longer needs to be attributable to 'unforeseen developments' or to 'GATT obligations...."[82] In addition, Janet A. Nuzum, former Commissioner of the US International Trade Commission, has noted the change from Article XIX's requirements that the Agreement on Safeguards does not require "unforeseeable developments and of the effect of obligations incurred by a contracting party under [GATT] including tariff concessions...."[83] Finally, Edmond McGovern has expressed the view that "[t]he requirements in Article XIX:1 that the injury should occur "as a result of unforeseen developments and of the effect of obligations incurred... under this Agreement" were not repeated in the 1994 Agreement because they were no longer of practical significance."[84] Thus, learned commentary on the matter in dispute also leads to the conclusion that the "unforeseen developments" condition required under the "defective" Article XIX does not apply under the Agreement on Safeguards.

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[79] *See,* MTN.GNG/NG9/W/25, 27 June 1989; MTN.GNG/NG9/W/25/Rev.1, 15 January 1990; MTN.GNG/NG9/W/25/Rev.2, 13 July 1990; MTN.GNG/NG9/W/25/Rev.3, 31 October 1990; MTN.GNG/NG9/19, paragraph A.3.

[80] *The Agreement on Safeguards in The Uruguay Round Results, A European Lawyers' Perspective* (European Interuniversity Press 1996), pp. 265-66. In support of his opinion, Prof. Flory cites to an extensive list of GATT/WTO publicists, including*:* T. Flory, *Le GATT, driot international et commerce mondial* (LGDJ, 1968); J. Jackson, *World Trade and the Law of GATT* (The Bobbs-Merrill Company, 1969); J. Jackson, *The World Trading System* (MIT, 1989); M.C.E.J. Bronckers, *Selective Safeguard Measures in Multilateral Trade Relations* (Kluwer Law and Taxation, 1985); Edmond McGovern, *International Trade Regulation* (Globefield Press, 1985), pp. 291-310.

[81] Pierre Didier, *Les principaux accords de l'OMC et leur transposition dans la Communauté Européanne* (Bruyland, 1997) pp.271-272.

[82] Marco C.E.J. Bronckers, *Voluntary Export Restraints and the GATT Agreement on Safeguards, in The Uruguay Round Results, A European Lawyers' Perspective* (European Interuniversity Press 1996).

[83] *The Agreement on Safeguards, U.S. Law Leads Revitalization of the Escape Clause, in World Trade Organization, the Multilateral Framework for the 21st Century and U.S. Implementing Legislation* (American Bar Association, 1996) p. 413.

[84] *International Trade Regulation* (Globefield Press, 1998 update) p. 10.21-2.

4.195 Korea submits that the new "package of rights" in effect under the Agreement on Safeguards and Article XIX of GATT does not include the condition of "unforeseen developments."

(e) Rebuttal Arguments Made by the European Communities

4.196 The **European Communities** made the following arguments in rebuttal:

4.197 In its reply to the Panel's question on Article XIX, Korea correctly refers to the interpretative criteria set out in Article 31 of the Vienna Convention.[85] Their application, to the extent that it is correct, does not however improve Korea's case.

4.198 When examining the *text* of the provisions to be interpreted, Korea, which seems to focus exclusively on that of the Agreement on Safeguards, reiterates the same basic position: because the "unforeseen developments" requirement was not repeated in the Agreement on Safeguards, it cannot be applied "in accordance with" that Agreement and therefore has been modified (hence repealed) by the "new package" of rules resulting from the Uruguay Round negotiations.

4.199 The European Communities submit that lack of repetition does not amount to modification or abrogation, certainly not in the current WTO system. The Appellate Body has reconstructed the relationship between GATT and the other Annex 1A Agreements and has set the threshold below which a Member cannot arbitrarily diminish its obligations under the WTO, notably under GATT.

4.200 The European Communities consider that lack of repetition rather means that the Agreement on Safeguards has not elaborated on this particular requirement, which did not need special "clarification and reinforcement" in accordance with the agreement's avowed objectives. The Agreement on Safeguards does not, by its terms, represent the exclusive source of the WTO safeguards regime and the "unforeseen developments" requirement remains in force elsewhere in the WTO system.

4.201 With respect to the provisions of the Agreement on Safeguards upon which Korea specifically relies the European Communities asserted that the full text of Article 2.1, which is referred to by Korea, can clarify its real meaning:

> "1. A Member may apply a safeguard measure to a product only if that Member has determined, pursuant to the provisions *set out below*, that such product is being imported into its territory in such increased quantities, absolute or relative to domestic production, and under such conditions as to cause or threaten to cause serious injury to the domestic industry that produces the like or directly competitive products." (emphasis added)

If some of the requirements of Article XIX of GATT are not even referred to it is hardly surprising that they are not elaborated upon in the provisions of the Agreement on Safeguards "set out below". Article 2.1 therefore adds nothing to Korea's case and by quoting it Korea falls in a rather circular argument.

4.202 With respect to the *object and purpose* of the provisions in question, Korea, again focusing on the Agreement on Safeguards, equally fails to support its case.

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[85] Article 33 of the Vienna Convention on the Law of Treaties (1155 U.N.T.S 332) reads*:* "1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."

4.203 Korea rightly recalls that the objectives of that Agreement are to "improve and strengthen the safeguard regime", and effectively summarizes them as "to introduce changes to the GATT regime that improve and strengthen the multilateral trading system". The European Communities argue that, Korea has not yet demonstrated, how elimination of a requirement for the imposition of safeguard measures would *weaken*, rather than *strengthen*, the multilateral safeguards regime and would "completely undermine" the above-mentioned objectives.[86]

4.204 As to the "*practice*" of some WTO Members the European Communities first observes that in order to reconstruct the "object and purpose" of a treaty in terms of the Vienna Convention that practice is irrelevant. The "practice in the application of the treaty" is relevant under Article 31.3(b) of the Vienna Convention as an *autonomous* interpretative tool, not to identify object and purpose.

4.205 Furthermore the practice which is relevant under the Vienna Convention is the one "which establishes the agreement of the parties" on the interpretation or the application of a given treaty provision. Korea has instead only quoted implementing legislation of a few WTO Members.[87] Moreover, that unilateral practice does not establish the agreement of all WTO Members on the alleged repeal or "disappearance" of the "unforeseen developments" requirement. Domestic implementing legislations of other Members expressly refer to that requirement.[88]

4.206 Last, the European Communities recalled that they are not challenging Korea's legislation *per se*, but rather the application of a safeguard measure in a specific case, and inasmuch as it understands that Korea's legislation does not require Korean authorities to violate Article XIX requirements the European Communities took no position on their conformity with that Article.

(i) The Relationship between GATT and the Other Annex 1A Agreements in the WTO System

4.207 The European Communities argue that the relationship between GATT and the other Annex 1A Agreements provisions has, on the one hand, been regulated in the WTO system itself, and, on the other hand, all the forms of this relationship have already been addressed in dispute settlement. Both WTO provisions and Panel and Appellate Body Reports make clear that as a rule GATT and the other Annex 1A

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[86] Eliminating the "unforeseen developments" requirement would rather frustrate the other Agreement on Safeguards' objective to "re-establish multilateral control over safeguards and eliminate measures that escape such control." (*See* the Agreement on Safeguards, Preamble, para 2).

[87] The EC would note in respect of its domestic legislation, quoted by Korea as an example of derogation from Article XIX of GATT, that Article XIX is repeatedly recalled in the preamble of Council Regulation (EC) No 3285/94 of 22 December 1994, inter alia in the following terms*:* "Whereas the Agreement on Safeguards meets the need to clarify and reinforce the disciplines of GATT, and specifically those of Article XIX" (para 4 of the statement of reasons).

[88] *See, e.g.,* Japan (WTO Doc. G/SG/N/1/JPN/2, 17 July 1995); Costa Rica (WTO Doc. G/SG/N/1/CRI/1, 30 March 1995); Norway (WTO Doc. G/SG/N/1/NOR/3, 2 February 1996); and also a more recent Member, Panama (WTO Doc. G/SG/N/1/PAN/1, 9 April 1998). That not all WTO Members accept that the "unforeseen developments" clause is no longer in force is clear when some of those Members ask other Members about the reasons for not including the requirement in their legislations and the implications thereof (*See, e.g.,* WTO Doc. G/SG/Q1/IND/8, *Follow-up Questions Posed by JAPAN regarding the Notification of INDIA,* 25 September 1998).

Agreements apply cumulatively. It has also been made clear that to this effect it is not necessary that an Agreement in Annex 1A either repeat or specifically provide that a given provision of GATT is applicable although not repeated in its text. Thus, the rule is rather the opposite of that put forward by Korea in its First Written Submission.

4.208 The European Communities consider that already the *Brazil - Dessicated Coconut* Panel Report, upheld by the Appellate Body, supports their view that an express provision is not required, but rather that GATT and the Agreement on Safeguards

> "represent an *inseparable package* of rights and disciplines that must be considered *in conjunction*".[89]

On the status of GATT in the WTO system, the same Panel considered:

> "It is evident that both Article VI of GATT and the SCM Agreement have force, effect and purpose within the WTO Agreement. That GATT has not been superseded by other Multilateral Agreements on Trade in Goods ("MTN Agreements") is demonstrated by a general interpretative note to Annex 1A of the WTO Agreement. (footnote omitted) The fact that certain important provisions of Article VI of GATT are neither replicated nor elaborated in the SCM Agreement further demonstrates this point.[69]
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> _____
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> [69] For example, the SCM Agreement does not replicate or elaborate on Article VI:5 of GATT, which proscribes the imposition of both an anti-dumping and a countervailing duty to compensate for the same situation of dumping and export subsidization, nor does it address the issue of countervailing action on behalf of a third country as provided for in Article VI:6(b) and (c) of GATT. If the SCM Agreement were considered to supersede Article VI of GATT altogether with respect to countervailing measures, these provisions would lose all force and effect. Such a result could not have been intended."[90]

The European Communities submit that with the interpretation of the Agreement on Safeguards which they proposes Korea is unduly restricting the scope of its obligations under the *whole* of the WTO "package".

4.209 As the Appellate Body observed still in the *Brazil - Dessicated Coconut* case:

> "The General Interpretative Note to Annex 1A was added to reflect that the other goods agreement in Annex 1A, in many ways, represent a *substantial elaboration* of the provisions of the GATT, and to the *extent* that the provisions of the other goods agreements *conflict* with the provisions of the GATT 1944, the provisions of the other goods agreements *prevail*. This does *not mean*, however, that the other goods

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[89] Panel Report, para 227, recalled in Appellate Body Report, *supra*, footnote 16, at 179 (emphasis added). The Panel concluded for the non-separability of Article VI of GATT and the SCM Agreement in para 257 of its Report.

[90] Panel Report, para 227.

> agreements in Annex 1A, such as the *SCM Agreement*, *supersede* the GATT".[91]

4.210 Thus, the Appellate Body recognized that in the relationship between GATT and the other goods agreements in Annex 1A, the prevalence of the latter is only to the extent of the conflict and that otherwise this entails no "supersession". This is otherwise consistent with the principle of effective interpretation of treaties, which was also recognized by the Appellate Body, according to which every provision should be given its meaning and effect.

4.211 In *Brazil - Dessicated Coconut* the Panel had already stated that failure to repeat a provision is not dispositive and does not allow a departure from cumulative application of GATT and other Annex 1A Agreements.[92] The Appellate Body in *EC - Bananas* made this point further clear when it had to decide whether both Article X:3(a) of GATT and Article 1.3 of the Agreement on Import Licensing Procedures applied to the European Communities import licensing procedures.[93] Notwithstanding the fact that the Appellate Body found that "there are distinctions between [the] two articles" (that is, that the two provisions read differently), and at the same time that they have "identical coverage"[94] (that is, regulate the same aspect of the same case in point), the Appellate Body did not consider that they conflicted and thus that the Interpretative Note to Annex 1A applied. As a consequence, it found that both Article X of GATT and Article 1.3 of the Agreement on Import Licensing Procedures were applicable.[95]

4.212 The European Communities submit that the hypothesis considered in the Appellate Body Report in *EC - Bananas* is different from the one at issue in the present dispute. In fact the Agreement on Safeguards and Article XIX of GATT do not overlap, in the sense that the "unforeseen developments" requirement is additional and therefore *complementary* to the matter regulated in the Agreement on Safeguards. In any event, even if these provisions overlapped, the *EC - Bananas* case law makes clear that the GATT provision is not eliminated by the system, but rather remains in force and is applicable cumulatively with the Agreement on Safeguards.

4.213 The Appellate Body in *EC - Bananas* also addressed the relationship between Article XIII of GATT and the Agreement on Agriculture,[96] notably to decide "whether the provisions of the Agreement on Agriculture allow market access concessions on agricultural products to deviate from Article XIII of GATT".[97] The European Communities had argued in this respect that concessions made pursuant to the Agreement on Agriculture prevailed over Article XIII of GATT, based on

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91 *See, Brazil - Measures Affecting Desiccated Coconut*, supra, footnote 16, at 179 (italics in original, emphasis added).

92 Panel Report, para 227.

93 *See,* Appellate Body Report on *EC - Bananas*, 9 September 1997, supra, footnote 12, paras 199 ff.

94 *Ibid.*, para 203.

95 *Ibid.*

96 *Ibid*., paras 153 ff.

97 *Ibid*., para 155.

Articles 4.1 and 21.1 of the former agreement.[98] The Appellate Body however upheld the Panel's conclusion that the Agreement on Agriculture

> "does not permit the European Communities to act inconsistently with the requirements of Article XIII of GATT." [99]

4.214 The European Communities submit that, likewise, the Agreement on Safeguards does not authorize Korea to act inconsistently with the requirements of Article XIX of GATT. Indeed the contrary is the case since Article 11.1(a) requires Members to apply measures "in accordance with this Agreement."

4.215 The reasoning of the Appellate Body sheds light as to what is required for finding a derogation from GATT in another Annex 1A Agreement. When reviewing Article 4.1 of the Agreement on Agriculture, the Appellate Body observed:

> "we do not see anything in Article 4.1 to suggest that market access concessions and commitments made as a result of the Uruguay Round negotiations on agriculture can be inconsistent with the provisions of Article XIII of the GATT. (...) If the negotiators had intended to permit Members to act inconsistently with Article XIII of the GATT, they would have said so explicitly. The *Agreement on Agriculture* contains several specific provisions dealing with the relationship between articles of the *Agreement on Agriculture* and the GATT. For example, Article 5 of the *Agreement on Agriculture* allows Members to impose special safeguards measures that would otherwise be inconsistent with Article XIX of the GATT and with the *Agreement on Safeguards*. In addition, Article 13 of the *Agreement on Agriculture* provides that, during the implementation period for that agreement, Members may not bring dispute settlement actions under either Article XVI of the GATT or Part III of the *Agreement on Subsidies and Countervailing Measures*. With these examples in mind, we believe it is significant that Article 13 of the *Agreement on Agriculture* does not, by its terms, prevent dispute settlement actions relating to the consistency of market access concessions for agricultural products with Article XIII of the GATT. As we have noted, the negotiators of the *Agreement on Agriculture* did not hesitate to specify such limitations elsewhere in that agreement; had they intended to do so with respect to Article XIII of the GATT, they could, and presumably would, have done so. We note further that the *Agreement on Agriculture* makes no reference to … any 'common understanding' among the negotiators of the Agreement on Agriculture that the market access commitments for agricultural products would not be subject to Article XIII of the GATT."[100]

4.216 By this reasoning the Appellate Body set the standard which is required to find a derogation from GATT: unless *express derogating terms* are found in an Annex 1A Agreement, no action inconsistent with GATT is allowed, even if

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98 *See,* Appellate Body Report on *EC - Bananas*, *supra*, footnote 12, para 153.
99 *Ibid.*, para 158.
100 *Ibid*., para 157 (italics in original, underlined added).

"pursuant to" an Annex 1A Agreement. This is exactly the opposite of what Korea proposes when arguing that failure to repeat the "unforeseen developments" requirement in the Agreement on Safeguards authorizes to disregard such requirement.

4.217 The Appellate Body went further and also provided genuine examples of derogation from GATT found in the Agreement on Agriculture, all of which are drafted in explicit terms, very different from those of the Agreement on Safeguards. The European Communities note that the Appellate Body considered that measures authorized under one of these derogations, the special safeguard clause, would otherwise have been inconsistent with both Article XIX *and* the Agreement on Safeguards.

4.218 In the light of the foregoing, the European Communities consider that the language of the Agreement on Safeguards is not explicitly derogating from GATT, and therefore the standard set out by the Appellate Body is not met in the present case. Accordingly, Korea is not allowed to "act inconsistently with the requirements of" Article XIX of GATT, even if its measure had been adopted "pursuant to", or "in accordance with", the Agreement on Safeguards.

4.219 The Appellate Body further considered[101] Article 21.1 of the Agreement on Agriculture, which expressly regulates the relationship with GATT in the following terms:

> "The provisions of GATT and of other Multilateral Trade Agreements in Annex 1A to the WTO agreement shall apply *subject to the provisions of this Agreement.*" (emphasis added)

In spite of the explicit and strong language of that provision, the Appellate Body could still reach the conclusion that the Agreement on Agriculture does not permit a WTO Member to act inconsistently with the requirements Article XIII of GATT.

4.220 The European Communities submit that a different conclusion cannot be warranted in the present case. The provisions of the Agreement on Safeguards referred to by Korea do not even include language as strong as the one emphasized above[102], and aim more at restricting Members' conduct (Article 2.1, Article 11.1) or at setting out the general scope of the Agreement (Article 1) than at regulating the relationship with GATT.

4.221 In the light of the foregoing the European Communities reiterate that the Agreement on Safeguards does not include an express derogation from GATT. Therefore, it does not authorize WTO Members, including Korea, to act inconsistently with the requirements of Article XIX, and notably with the "unforeseen developments" requirement.

4.222 The fourth form of relationship between the provisions of GATT and those of other Annex 1A Agreements is one of conflict, not solved a priori by the system

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[101] *See,* Appellate Body Report on *EC - Bananas*, *supra*, footnote 12, para. 155.

[102] In the *EC - Bananas* case the United States argued that the language of the Agreement on Agriculture could not authorize a Member to act inconsistently the requirements of GATT, and is now arguing that mere failure to repeat the "unforeseen development" clause in the Agreement on Safeguards or the requirement to adopt measures "in accordance with" such agreement is sufficient to entail "subsumption" of Article XIX of GATT. The EC considered it difficult to see how these positions can be reconciled.

itself by a derogation rule. The *General Interpretative Note to Annex 1A* governs all cases not expressly regulated in the following terms:

> "In the event of a *conflict* between a provision of the General Agreement on Tariffs and Trade 1994 and a provision of another agreement in Annex 1A … , the provision of the other Agreement *shall prevail* to the extent of the *conflict*." (emphasis added).

4.223 The Appellate Body had most recently an opportunity to clarify the meaning of this criterion of relationship - conflict - in *Guatemala - Anti-Dumping Investigation Regarding Portland Cement from Mexico*. The Appellate Body made clear, in respect of dispute settlement provisions, that

> "[a] special or additional provision [laid down in a "covered agreement"] should only be found to prevail over a provision of the DSU in a situation where adherence to the one provision will lead to a violation of the other provision, that is, in the case of a *conflict* between them". "[i]t is only where the provisions of the DSU and the special or additional rules and procedures of the covered agreement *cannot* be read as *complementing* each other that the special or additional provisions are to *prevail*."[103]

4.224 In the EC view, it is precisely in terms of "prevalence" and "conflict" that the *General Interpretative Note to Annex 1A* to the WTO Agreement is drafted.

4.225 The European Communities maintain that Korea has not shown how Article XIX:1(a), to the extent that it requires that the increase in imports and the conditions thereof must result from "unforeseen developments", could be said to be in conflict with the provisions of the Agreement on Safeguards. Clearly, the drafters of Article XIX thought that it was possible to meet all these requirements, since they cumulated them in the same provision.

4.226 In a case where a conflict cannot be shown, the Appellate Body confirmed that special and additional provisions apply together with the basic GATT provisions and complement each other.[104] Accordingly, it reversed the Panel's finding that Article 17 of the *Anti-Dumping Agreement* "provides for a coherent set of rules for dispute settlement specific to dumping cases ... that replaces the more general approach of the DSU."[105]

4.227 In summary, in the EC view, the relationship between GATT and other Annex 1A Agreements is exhaustively regulated in WTO rules, as interpreted in Panel and Appellate Body decisions. That relationship can be expressed in terms of cumulation (the normal situation); differences (speciality); express derogation (conflict solved *a priori* by the Drafters of the WTO Agreement); conflict. Only in

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[103] *See,* Appellate Body Report on *Guatemala - Anti-Dumping Investigation Regarding Portland Cement from Mexico*, *supra*, footnote 61, para 65 (italics in original, underlined added).

[104] The Appellate Body addressed another specific derogation clause embodied in the WTO system - namely Article 2.1 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* ("the DSU"), regulating conflicts between the DSU and specific dispute settlement rules procedures in the "covered agreements". As it found that the criterion laid down therein (the existence of a "difference" between general and special rules) was not met, it confirmed that general and special rules and procedures had to "apply together" (para 65 of the Report).

[105] *See,* the Appellate Body Report, para 68 (italics added).

the latter two hypotheses listed do the provisions of other Annex 1A Agreements prevail over those of GATT. The use of the term "subsumption" merely confuses the issue. If this term means derogation or conflict, then the Agreement on Safeguards prevails. If not, it does not. In the case of the Agreement on Safeguards and Article XIX of GATT no case of derogation or conflict has been identified and therefore Article XIX and the Agreement on Safeguards apply cumulatively. Korea has not demonstrated that a conflict exists, and therefore that it was justified in not examining whether the increase in imports of SMPP was the result of "unforeseen developments". Accordingly, the Panel should find that it violated Article XIX:1(a) of GATT as it did not proceed to that examination before imposing the safeguard measure on SMPP at issue in this dispute.

(f) Rebuttal Arguments Made by Korea

4.228 **Korea** makes the following rebuttal arguments:

4.229 Korea considers that the applicable law in this dispute is the Agreement on Safeguards. Korea considers that the provisions in Article XIX of GATT regarding "unforeseen developments" and "of the effect of the obligations incurred" are no longer part of the package of rights and obligations applicable to the imposition of safeguard measures. For the reasons set out in Paragraphs 4.170-4.195.

4.230 Korea expressed puzzlement with the EC statement that:

> "Unlike increased imports, other conditions, injury and causation, the existence of unforeseen circumstances is something within the knowledge of governments and does not require investigation involving economic operators. It is of interest to note that the requirement that the increased imports result from trade liberalization is also not mentioned in the Agreement on Safeguards(liberalization is also of course a matter within the knowledge of governments). Both these factors either exist or do not and do not need an investigation to be established."

4.231 Korea noted that, under the EC logic, "unforeseen developments" or "of the effect of the obligations incurred" either exist or do not exist, are strictly within the "knowledge" of each Member, and do not need an investigation to be established. Under this articulation, presumably, the only basis for the Panel to find that Korea violated Article XIX of GATT is if the factors "do not exist." As an alternative argument, Korea respectfully submits that such factors exist:

(a) the increased imports resulted from "unforeseen developments" because Korea did not foresee that the European Communities would take the unprecedented step of emptying its inventories of SMPP on the Korean market in order to take advantage of the lower Korean tariff on SMPP versus milk powder negotiated pursuant to the Uruguay Round; and

(b) the increased imports resulted from "the effect of the obligations incurred" because they resulted from the tariff concessions negotiated under the Uruguay Round and GATT balance-of-payments ("BOP") process.

(g) Additional Arguments by the European Communities Made at the Second Meeting of the Panel with the Parties

4.232 At the second meeting of the panel with the parties, the **European Communities** observed that:

4.233 Korea both dismissed the "unforeseen development" requirement as repealed by the Agreement on Safeguards, and tried to justify its measure under that clause. As the European Communities have constantly said, and Korea has not challenged, it is hard to see how a deep imbalance in the tariff bindings of two competing products like SMPP and milk powder would not lead to a relative change in imports. The European Communities would also recall in this connection that in cases where a WTO Member miscalculated its concessions and is facing difficulties as a result of its tariff commitments it is entitled to negotiate and modify its schedule under Article XXVIII of GATT. It may not however use safeguard measures to achieve this result where the conditions for their application are not met.

4.234 As to the negotiating history of the Agreement on Safeguards, the European Communities observed the following.

4.235 Korea's view is that the requirement of unforeseen developments in Article XIX was in conflict with the Safeguards Agreement and therefore not applicable was supported by Mr Didier in a book published in 1997 where he reported that an early draft contained a provision "that there has been an unexpected, sudden and large increase in the quantity of such product being imported" but that this was later dropped.

4.236 Mr Didier considered that this provision related to the requirement of unforeseen developments in Article XIX. Korea argues from this that there was an intention to delete the requirement of unforeseen developments. It is interesting to note that later in the same contribution Mr Didier develops his thesis further. He considers that there is a need for a requirement of unforeseen developments since it cannot be any increase of imports which can be argued to cause injury which should be allowed to justify safeguard measures, but only increases which result from abnormal or unexpected situations.[106]

4.237 In fact, a closer look at the deleted draft text demonstrates that it had nothing to do with the requirement of unforeseen developments. Mr Didier was mistaken and could have saved himself the trouble of trying to invent a replacement for "unforeseen developments". The draft in fact referred to an *unexpected increase of imports* not of unforeseen developments *leading to* an increase in imports.

4.238 One way of understanding the requirement of unforeseen developments is to consider the continuum of causality starting with trade liberalization, running into unforeseen developments which result in increased imports which occur under conditions which are such that serious injury results. This starts with loss of sales, continues with loss of sales and production, falling capacity utilization, losses and finally unemployment.

[106] Pierre Didier, *Les principaux accords de l'OMC et leur transposition dans la Communauté Européanne* (Bruyland, 1997) p. 272, where reference is made to the need to "limiter la prise de mesures aux cas sinon anormaux, du moins imprevus".

4.239 In fact one might say that unforeseen developments is a defining feature of safeguard measures since it defines the circumstances in which they may become justified. As Korea said, Article 1 of the Safeguard Agreement expressly refers Article XIX as defining what a safeguard measure is.

4.240 In other words, Article XIX tells you what a safeguard measure is and the Safeguard Agreement tells you how to apply it. The consequence of this was however not mentioned by Korea. It is that the Safeguard Agreement is not exhaustive.

(h) Additional Arguments by Korea Made at the Second Meeting of the Panel with the Parties

4.241 At the second meeting of the panel with the parties, **Korea** further advanced its arguments under Article XIX:1(a) as follows:

4.242 Korea has pointed out that this requirement was omitted from the Agreement on Safeguards, and maintains that it no longer applies. The European Communities refer to Article XIX GATT, and claims that the obligation to show "unforeseen developments" still exists.

4.243 First, if one looks at the Agreement on Safeguards, it is clear that it was meant to strike a new balance and move beyond Article XIX GATT, which had proved to be difficult to apply in practice. In its first Article, the Agreement states that it:

> "establishes rules for the application of safeguard measures which shall be understood to mean those measures provided for in Article XIX of GATT."[107]

In other words, Article XIX GATT tells one what a safeguard measure is, and this new Agreement tells one how ('the rules for the application') to take those measures.

4.244 Second, in furtherance of the above purpose, Article 2 of the Agreement then goes on to lay out the 'conditions' for taking safeguard measures. Interestingly, it repeats almost verbatim what was said in Article XIX:1(a) GATT, except that:

(a) it removes some language, specifically the "unforeseen developments" language and the requirement to show that the difficulties were the "result of ... the effect of the obligations incurred by the contracting party under this Agreement, including tariff concessions"; and

(b) adds some other language: that the increase in quantities of imports can be either "absolute or relative to domestic production"; and

(c) makes explicit that the measures must be non-discriminatory, *i.e.*, the safeguard should apply to imports from all sources.

4.245 Where a text is adopted almost word-for-word, but makes certain omissions and additions to it, it stands to reason that those omissions and additions were deliberate. The preparatory work to the Agreement on Safeguards further supports this conclusion. According to the respected academic Pierre Didier, *"a 1990 draft of an agreement included ['unforeseen developments'] and amplified it by imposing the*

[107] *See,* Article 1 of the Agreement on Safeguards.

obligation to establish an 'unforeseen, sudden and significant increase'. Both the United States and the EU rejected this terminology as being too difficult or restrictive to apply."[108] The entire reference to "unforeseen developments" was then dropped. However, now the European Communities want to characterize omission of the "unforeseen developments" criteria as a mere "failure to repeat" that language. Why would this deletion have happened, and why would the European Communities argue that it was too difficult and restrictive to apply if the obligation to consider "unforeseen developments" remained via Article XIX?

4.246 Third, contrary to the EC assertions, Korea considers that the removal of the obligation regarding "unforeseen developments" was intended to strengthen the multilateral safeguard regime. The European Communities contend that Korea has not demonstrated why this would be the case. As stated above, both the United States and the EU considered that the "unforeseen developments" requirement was too difficult and restrictive to apply, and Korea seriously doubts whether it still served in state practice. The inability of Members to determine the scope of their rights under Article XIX led to the proliferation of "grey area" measures. By improving the safeguard regime and eliminating unworkable obligations, the drafters intended to strengthen the safeguard regime by ensuring that Members resorted to emergency action under the Agreement on Safeguards, rather than use trade-disruptive and non-transparent "grey area" measures.

4.247 Fourth, the European Communities assert that if the drafters had wanted to deviate from Article XIX, they had to do so expressly, and cites the *EC - Bananas*[109] Appellate Body report as support for this contention. Korea notes that *EC - Bananas* case dealt with a different agreement, the Agreement on Agriculture, in which the drafters made express derogations. An example is Article 5 of the Agreement on Agriculture, although, Korea noted that Article 5 only makes an express derogation from Article II:1(b) GATT, not from Article XIX and the Agreement on Safeguards.

4.248 However, nowhere in the Agreement on Safeguards is there an express derogation. While the Agreement is full of fundamental changes (see, for example, the requirement to wait three years before retaliating against certain safeguard measures[110] (which is contrary to Article XIX:3(a)), or the requirement not to reduce the quantity of imports below that of a representative past period (which is contrary to Article XIX:1(a))[111], the Agreement did not need to expressly signal every derogation. Any doubt as to the precedence of those provisions over the provisions of Article XIX GATT is resolved by the *General Interpretative Note to Annex 1A* of the WTO. Indeed, if express derogations were required, one would wonder why this Interpretative Note was included.

4.249 Furthermore, the European Communities fail to mention that the Appellate Body in *EC - Bananas* only addresses the situation where the relevant WTO Agreement does not specifically deal with the subject matter of the relevant Article under GATT. In its Second Submission, the European Communities quoted a lengthy

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[108] *Les pricipaux accords de L'OMC et leur transoposition dans la Communaute Europeene* (Bruyland, 1997) pp.271-272

[109] Appellate Body Report on *EC - Bananas*, supra, footnote 12, at para. 155.

[110] Article 8(3) of the Agreement on Safeguards.

[111] Article 5(1) of the Agreement on Safeguards.

paragraph from the Appellate Body's report in *EC - Bananas*. The European Communities, however, tellingly omitted the second sentence of the paragraph that states that *'[t]here is nothing in Articles 4.1 or 4.2, or in any other Article of the Agreement on Agriculture, that deals specifically with the allocation of tariff quotas on agricultural products.*' In other words, no Article of the Agreement on Agriculture addressed the subject matter of Article XIII of GATT. The Appellate Body went on to conclude *'Therefore, the provisions of the GATT, including Article XIII, apply to market access commitments concerning agricultural products, except to the extent that the Agreement on Agriculture contains specific provisions dealing specifically with the same matter.'* [112] (emphasis added).

4.250 Here, the Agreement on Safeguards does explicitly deal with the conditions for adopting safeguard measures, under the very heading "conditions". The Agreement on Safeguards specifically lays out the conditions for adopting a safeguard. "Unforeseen developments" is *not* one of them.

4.251 Furthermore, if one reads the relevant texts according to the European Communities position, there *would* be a conflict between Article XIX and the Agreement on Safeguards. If one adheres to Article 2 of the Agreement on Safeguards and adopts a safeguard measure without meeting the "unforeseen developments" requirement, one would be in conformity with the Agreement on Safeguards but in violation of Article XIX. The General Interpretative Note to Annex 1A of the WTO clearly provides that in case of conflict between the GATT and an Agreement (like the Agreement on Safeguards), it is the Agreement, not the GATT, that takes precedence.

4.252 In that regard, this case is not the same as *Guatemala - Anti-dumping Investigation Regarding Portland Cement from Mexico*[113], to which the European Communities refer. That case involved the overall rules applying to dispute settlement in the WTO and the specific rules applying to anti-dumping, and the Appellate Body found that both sets of rules fit together to form a 'comprehensive, integrated dispute settlement system for the *WTO Agreement*.'[114] Even there, the Appellate Body said that if there were a conflict between the two sets of rules, the special anti-dumping rules would prevail in case of conflict. The Appellate Body clarified that a conflict would exist where *"adherence to one provision will lead to a violation of the other provision"*.[115] Korea believes that here, such a conflict exists.

4.253 Finally, Korea questioned whether the European Communities even really believed in its own argument, noting that it did not include the "unforeseen developments" requirement in its own rules for the application of safeguard measures.[116] Its officials proceed with a set of rules that tell them everything they

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[112] Appellate Body Report on *EC - Bananas*, *supra*, footnote 12, at para. 155.

[113] Appellate Body Report on *Guatemala - Anti-dumping Investigation Regarding Portland Cement from Mexico*, *supra*, footnote 61.

[114] Appellate Body Report on *Guatemala - Anti-dumping Investigation Regarding Portland Cement from Mexico*, *supra*, footnote 61, para. 66.

[115] Appellate Body Report on *Guatemala - Anti-dumping Investigation Regarding Portland Cement from Mexico*, *supra,* footnote 61, para. 65.

[116] EC Regulation 3285/94 on the common rules for imports, OJEC 1994 L349/53.

need to show in order to adopt a safeguard measure, yet that regulation does not mention or even refer to a couple of extra important requirements.

4.254 To shift attention from the discrepancy between its argument now and its own implementation of the Agreement on Safeguards, the European Communities refer to the legislation of a few other countries in which the "unforeseen developments" requirement was included. However, it is not disputed that WTO Members are permitted to adopt rules that are *more restrictive* of their use of safeguard measures than required by the WTO rules. What is at issue is what those WTO rules require. Korea maintains that those rules do not condition adoption of a safeguard measure on a showing of "unforeseen developments."[117]

D. Claim under Article XIX:1(A) of GATT and Article 2.1 of the Agreement on Safeguards

(a) Claim by the European Communities

4.255 The **European Communities** claim that by failing to analyze the conditions under which the imported products enter the import market Korea has violated its obligations under Article XIX:1(A) of GATT and Article 2.1 of the Agreement on Safeguards. The following are the EC arguments in support of this claim:

4.256 Recalling and developing Article XIX:1(a) of GATT, Article 2.1 of the Agreement on Safeguards provides that

> "A Member may apply a safeguard measure to a product only if that Member has determined, pursuant to the provisions set out below, that such product is being imported into its territory in such increased quantities, absolute or relative to domestic production, and *under such conditions* as to cause or threaten to cause serious injury to the domestic industry that produces like or directly competitive products." (emphasis added).

4.257 In this respect the European Communities observe that, as they did with the "unforeseen developments" clause, by including a reference to the conditions of importation in the text of Article XIX:1(a) and of Article 2 of the Agreement on Safeguards, the drafters of both agreements have excluded that the volume and rate of increase of the imports be in itself sufficient to justify safeguard action.

4.258 However, Korea limited its consideration to the increase in imports and failed to examine under which conditions these occurred and in particular the prices at which the product was imported. The European Communities therefore submit that Korea failed to comply with its obligations under Article XIX:1(a) and Article 2 of the Agreement on Safeguards, to address whether the conditions under which importation of the products being investigated occurred were of such nature as to

[117] However, "unforeseen" factors were present in this case, as the Korean Government did not foresee that the EC would dramatically shift the balance of exports from milk powder to SMPP in order to take advantage of the Korean tariff structure. According the EC's formulation of "unforeseen circumstances", the existence of such factors is simply a question of fact, and will justify the imposition of a safeguard measure provided all other required conditions are present.

cause serious injury to the domestic industry producing like or directly competitive products.

4.259 At the first meeting of the panel with the parties, the **European Communities** further advanced their arguments under Article XIX:1(a) of GATT and Article 2.1 of the Agreement on Safeguards as follows:

4.260 By requiring that serious injury result both from an increase in imports and from the conditions under which this increase takes place, Article 2 of the Agreement on Safeguards clearly indicates that those "conditions" also need to be assessed. Among them, the European Communities asserted that import prices and their impact on domestic prices are clearly in the forefront.

4.261 In its April Notification to the Committee on Safeguards Korea attempts to dispose of this requirement in two lines reading "Although the sales price of imported products rose by 381 Won/kg during the period under investigation, the sales price of domestic milk powder dropped by 360 Won/kg." When reviewing the price conditions in its First Submission the European Communities, meant that in the EC view this was insufficient and Korea had failed to indicate whether and how import prices depressed or otherwise adversely affected those of domestic products.

4.262 In response to a question by the Panel[118], the **European Communities** further clarified that they believe that among the conditions to be considered under Article 2.1 price is paramount but other conditions such as superior quality or advertising can also be imagined in certain cases.

(b) Response by Korea

4.263 In response to a question by the Panel[119] **Korea** argued that the "under such conditions" language contained in Article 2.1 of the Agreement is merely part and parcel to the causality requirement that must be demonstrated under Article 4 of the Agreement on Safeguards. This language does not impose any separate or distinct obligation.

4.264 The special safeguard provision of the Agreement on Textiles and Clothing (ATC) supports this interpretation. Article 6 of the ATC states that a Member must demonstrate that "a particular product is being imported into its territory in such increased quantities as to cause serious damage, or actual threat thereof, to the domestic industry." The drafters did not consider it necessary to add the term "under such conditions," although a finding of causation is presumably still required. In addition, the superfluous nature of the language "under such conditions" is also supported by the fact that the Guide to GATT Law and Practice prepared by the GATT/WTO Secretariat refers to all other language except "under such conditions" in analyzing identical language under Article XIX of GATT 1947.

[118] The Panel recalls that the question was*:* "What factors, other than price, can be considered under the proposition 'under such conditions as to cause or threaten to cause injury ... ', mentioned in paragraph 2.1 of the Agreement on Safeguards?"

[119] The Panel recalls that the question was*:* "What factors, other than price, can be considered under the proposition 'under such conditions as to cause or threaten to cause injury ... ', mentioned in paragraph 2.1 of the Agreement on Safeguards?"

4.265 The object and purpose of the Agreement on Safeguards is to accord Members the right to impose a safeguard measure as a last resort when increased imports are causing injury or threat of injury to a particular domestic industry. The Agreement does not specify that causation must be based solely on price undercutting or on any other factor. Increased imports may displace competing domestic products, and cause injury to a particular domestic industry, for a wide range of reasons, including image, quality, style, structure of the industry, technical assistance, etc. A Member could also find causation when the prices of imports are increasing, because the prices of domestic products may still be selling at a loss or at a level that gives insufficient return on investment. Provided a Member demonstrates that increased imports are causing serious injury or threat thereof to the domestic industry and provided it discounted injury potentially caused by other factors, the panel should find that such Member satisfied its obligations under Articles 2 and 4 of the Agreement on Safeguards.

(c) Rebuttal Arguments Made by the European Communities

4.266 The **European Communities** made the following arguments in rebuttal:

4.267 Korea has not rebutted EC claim that it did not analyze the impact of import prices on the domestic prices of raw milk and milk powder and, to the extent that it gathered information in this respect, this information could not support a finding that the conditions under which imports increased were such as to cause serious injury. Furthermore, Korea did not indicate any other prevailing "conditions" that it considered relevant under Article 2.1 of the Agreement on Safeguards, but simply omitted to review whether that provision was fulfilled. In its reply to the Panel's questions, the European Communities has indicated what those factors, in addition to prices, can be, for instance, the quality of the imports or their promotion on the importing market could also be relevant, as could *e.g.,* the rapidity of market penetration (as opposed to market share).

4.268 Although there is a table in Korea's Notification of 24 March giving prices of domestic milk powder and imported SMPP, Korea has failed to conduct any analysis of these prices. The European Communities consider that it is not sufficient simply to compare these prices. The products involved in this case, raw milk, milk powder and SMPP are substitutable and competing to some extent but still have different characteristics and different uses. Indeed, Korea asserts that, "most Korean users of milk powders state … that the domestic products are of higher quality than the imported SMPP." Furthermore, the KTC investigation report highlights the differences between these products in relation to their end uses. It is stated in the report that the Food Industry Handbook allows different end uses for them. No analysis is given of the proportion of the market held by the products for which SMPP can be used, in comparison with the products for which milk powder can be used or with those produced from raw milk. The conclusion is that a direct comparison cannot be made between milk powder and SMPP, firstly because of the different characteristics of the products and secondly because of the different opportunities for their end use. Korea is wrong to assume price undercutting on the part of SMPP imports simply because they were available at a lower price than domestic milk powder. No mention is made in Korea's Notification or the KTC Report of how the differences in the two products, both in terms of inherent

characteristics and end use, were taken into account in the price comparison. Indeed, comparing the price differences between domestic milk powder and imported SMPP is analogous to comparing prices between butter and margarine. In many markets the price of these competing and substitutable products will be very different.

4.269 In the response to questions by the Panel[120] posed at the second meeting, the **European Communities** further clarified their arguments as follows:

4.270 The "under such conditions" requirement must primarily be related to the imported products and not to the domestic market. Semantically, the term "under such conditions" in Article 2.1 relates to the imported product and not to the state of the domestic market or the industry which are susceptible to be affected by the increased imports. One of the conditions of imports which is always present and always relevant is price.

4.271 It is clear from the presence of the word "and" in Article 2.1 that "under such conditions" constitutes a separate requirement from imports being "in such increased quantities".

4.272 The conditions under which the imports occur, together with increased imports, are at the beginning of the causality continuum which terminates in the injury. In fact they are not quite at the beginning, they come after trade liberalization and unforeseen developments. The important point is that the increased imports and the "such conditions" causally precede the injury. Accordingly, the criteria which are relevant for establishing the conditions under which imports take place are not the same as the ones determining the causal link. In other words, the criteria examined under this concept of "under such conditions" relate to the objective existence of certain conditions whereas causality requires a reasoned analysis of cause and effect between increased imports and those conditions on one side and injury on the other side. Concretely, the examination of the concept of "under such conditions" will require an examination of prices whereas an examination of the causal link will require an examination of the way in which those prices cause injury to the domestic industry. The existence of low-priced imports by itself is not injury, it is only a circumstance susceptible to lead to injury.

(d) Rebuttal Arguments Made by Korea

4.273 **Korea** makes the following rebuttal arguments:

4.274 Article 2 of the Agreement on Safeguards (*Conditions*) provides that a Member may apply a safeguard measure to a product if*:*

> "that Member determine[s], *pursuant to the provisions set out below*, that such product is being imported into its territory in such increased quantities, absolute or relative to domestic production, and under such conditions as to cause or threaten to cause serious injury to the

[120] The Panel recalls that the questions were*:* "Article 2 of the Safeguard Agreement refers to 'under such conditions'. Does 'under such conditions' refer to criteria related to the imports? the domestic market? or both?" "Does 'under such conditions' constitute a separate requirement from the increased imports causing injury?" "What is the difference between the criteria examined under the concept 'under such conditions' and those to be examined under the causal link?

domestic industry that produces like or directly competitive products." (Emphasis added)

4.275 Korea complied with the conditions established under Article 2 because it complied with Articles 4.2(a) and (b) in making its determination of serious injury and causal link, with Article 5 in applying the safeguard measure, and with Article 12 in properly notifying and consulting with the Committee on Safeguards and interested Members.

4.276 In response to questions by the Panel[121] posed at the second meeting, **Korea** further clarified its arguments as follows:

4.277 In Korea's view the language "under such conditions" can only be interpreted as relating to imports.

4.278 Korea considers that "under such conditions" is part and parcel of the causality analysis. This language does not impose any separate or distinct obligation on the investigating authorities.

4.279 Korea is of the view the criteria examined by the investigating authorities under the concept "under such conditions" are not different from those examined under causal link. In other words, it is the conditions under which imports enter a market that link such imports to the serious injury to the domestic industry.

E. Korea's Application of Safeguard Measures to Agricultural Products

(a) Submission by Korea

4.280 **Korea** makes the following submission concerning the nature of the Korean dairy industry, and the application of a safeguard measure to an agricultural product:

4.281 The Agreement on Safeguards is the general safeguard mechanism under the WTO system, and its provisions are applicable to most products covered by the WTO system. Other safeguard measures are applicable to sectors that raise specific or unique issues, most notably, textiles and agricultural products. These other safeguard measures are designed to provide the appropriate degree of sensitivity required by those sectors or products. The Agreement on Safeguards inevitably does not afford the same sensitivity to the agricultural sector as the Agreement on Agriculture.

4.282 Article 5 of the Agreement on Agriculture recognizes the unique nature of agricultural markets and how even short term and relatively minor increases in imports can produce dramatic dislocations in the relevant industry. As a consequence, Article 5 has a much lower threshold for action than the Agreement on Safeguards. However, Korea was unable to invoke Article 5 of the Agreement on Agriculture to remedy serious injury to its dairy markets caused by increased imports. Instead, Korea followed the procedures under the Agreement on Safeguards and still concluded that serious injury had been caused to its domestic industry, even though

[121] The Panel recalls that the questions were: "Article 2 of the Safeguard Agreement refers to 'under such conditions'. Does 'under such conditions' refer to criteria related to the imports? the domestic market? or both?" "Does 'under such conditions' constitute a separate requirement from the increased imports causing injury?" "What is the difference between the criteria examined under the concept 'under such conditions' and those to be examined under the causal link?

the standards for the imposition of safeguard measures under the Agreement on Safeguards are higher than those under the Agreement on Agriculture.

*(b) Response of the **European Communities***

4.283 The **European Communities** respond to Korea's submission as follows:

4.284 The European Communities consider that evaluating whether Korea's measure would have been consistent with the Agreement on Agriculture, and notably its Article 5, falls outside the terms of reference of this Panel. In any event, Korea cannot compensate the fact that it could not invoke the safeguard provision of the Agreement on Agriculture by arbitrarily lowering the standard of Article XIX of GATT and of the Agreement on Safeguards. Furthermore, quantitative measures, and for four years, are clearly not contemplated in Article 5 of the Agreement on Agriculture.

(c) Rebuttal Response of Korea:

4.285 **Korea** makes the following rebuttal arguments:

4.286 As the general system of rules for imposing safeguard measures, the Agreement on Safeguards will be applied to a number of different product sectors and, thus, has a degree of flexibility built into its structure and individual terms.

4.287 Certain injury criteria relevant to industrial or manufactured products may not be relevant when applied to agricultural products because those criteria are not of an objective and quantifiable nature having a bearing on the situation of the particular agricultural industry, *i.e.*, they do not reflect the unique nature of the agricultural sector.[122]

4.288 If particular criteria listed in Article 4.2(a) of the Agreement on Safeguards are not relevant to a specific agricultural sector, Members should be accorded the flexibility to examine other listed criteria that more fully take into account the unique or specific nature of the products and industry under examination. Members should also be allowed to take into account unlisted criteria that are relevant to the industry under examination.[123]

4.289 At the second meeting of the panel with the parties, Korea further advanced its arguments regarding the Agreement on Agriculture as follows:

4.290 Korea's purpose in referring to the Agreement on Agriculture, and Article 5 in particular, was to show that:

(a) in any investigation of any industry under the Agreement on Safeguards, the products and industry in question need to be carefully considered and any specific aspects identified need to be factored into the relevant determinations of serious injury and causation. Certain

[122] Article 4.2(a) requires an evaluation of "all relevant factors of an objective and quantifiable nature having a bearing on the situation of that industry". This appears to permit an investigation that takes into account the specific nature of the industry.

[123] In light of the fact that Article 4.2(a) of the Agreement on Safeguards uses the term "in particular", factors other than those set forth in Article 4.2(a) may be used to determine injury to a particular sector, such as agriculture.

injury criterion may be relevant in one case but not in others. This view is shared by the Government of the United States

(b) due to circumstances beyond its control, Korea was required to investigate the dairy industry under the Agreement on Safeguards, as opposed to the Agreement on Agriculture. The Government of Korea undertook a full and proper investigation of its dairy industry under the Agreement on Safeguards, but would under normal circumstances have been able to use the specific provisions of the Agreement on Agriculture. Korea does not claim that it could replace the higher investigation standards of the Agreement on Safeguards with the lower standards of the Agreement on Agriculture, and the Panel must be clear that the Korean competent authorities complied fully with the requirements of the Agreement on Safeguards, and in no way referred to the standards applicable under the Agreement on Agriculture.

F. Claim under Article 4.2(A) of the Agreement on Safeguards

(a) Claim by the European Communities

4.291 The **European Communities** claim that Korea violated Article 4.2(a) of the Agreement on Safeguards by failing to show that serious injury occurred to the domestic industry. The following are the EC arguments in support of that claim:

(i) The Definition of the "Domestic Industry"

4.292 Article 4.1.(c) of the Agreement on Safeguards provides that:

> "in determining injury or threat thereof, a "domestic industry" shall be understood to mean the producers as a whole of the like or directly competitive products operating within the territory of a Member, or those whose collective output of the like or directly competitive products constitutes a major proportion of the total domestic production of those products."

4.293 For the purposes of its safeguard investigation, Korea defined[124] the "domestic industry" as:

> "the industry that produces raw milk and milk powder. These products are directly competitive with the imported products under investigation. Raw milk producers consist of dairy farming households and milk processing companies which directly operate their own dairy farms; milk powder producers are livestock co-operatives and milk processing companies, including producers, who commission processing to third parties because of the absence of facilities for manufacturing milk powder."

4.294 The European Communities agree with Korea that this is an appropriate definition of the domestic industry. Production of raw milk and milk powder are

[124] *See,* Paragraph III.2 of the Notification of 1 April 1998, G/SG/N/10/KOR/1/Suppl.1 (Exhibit EC-10).

interconnected and complementary activities. Not only does each depend on the other to be able to conduct its own business, but many raw milk producers are also milk powder producers or own milk powder producers (the livestock cooperatives are owned by dairy farmers).

4.295 The European Communities however take issue with the fact that Korea did not apply this domestic industry definition consistently for its determination of serious injury. Some injury factors were either examined only for the raw milk industry and others only for the milk powder industry. In many cases there is not even any explanation as to why only part of the domestic industry was examined and the only apparent explanation is that examination of the other part would not have supported a finding of serious injury. In other cases, the evaluation of the injury factors is flawed for other reasons. The incomplete examination of the injury factors arising out of the inconsistent application of the domestic industry definition and the other errors committed by Korea in the evaluation of injury factors renders the determination contrary to Article 4.2(a) of the Agreement on Safeguards.

(ii) Failure to Examine Correctly all Relevant Factors of an Objective and Quantifiable Nature Having a Bearing on the Situation of the Domestic Industry

4.296 Article 4.2.(a) of the Agreement on Safeguards requires that the serious injury investigation evaluate all relevant factors of an objective and quantifiable nature having a bearing on the situation of the domestic industry, in particular the rate and amount of the increase in imports of the product concerned in absolute and relative terms, the share of the domestic market taken by increased imports, changes in the level of sales, production, productivity, capacity utilization, profits and losses, and employment.

4.297 This provision lays down the principle that an injury investigation must be *complete ("all* relevant factors"). Only factors that are not relevant, or not objective or quantifiable, or do not have a bearing on the situation, may be excluded. Clearly, it is necessary to examine a factor before it can be considered that it is not relevant, or not objective or quantifiable, or does not have a bearing on the situation. The European Communities note that this position has been supported in two recent Panel reports[125] which dealt with the standard of "serious damage" set forth in Article 6.3 of the ATC.[126] Both Panel reports stressed the obligation to examine each of the enumerated injury factors. In the *US - Underwear* case, the Panel criticized the United States for providing inconsistent and inadequate information. The Panel in the *US - Shirts and Blouses* case stated that "at a minimum, the importing Member must be able to demonstrate that it has considered the relevance or otherwise of each of

[125] *See,* Panel report in *US - Shirts and Blouses*, *supra*, footnote 45; *US - Underwear.* Both Panel reports were subject to review by the Appellate Body which did, however, not rule on the standard of serious damage.

[126] "In making a determination of serious damage, [...] the Member *shall examine* the effect of those imports on the state of the particular industry, as reflected in *changes in such relevant economic variables as* output, productivity, utilization of capacity, inventories, market share, exports, wages, employment, domestic prices, profits and investments; none of which, either alone or combined with other factors, can necessarily give decisive guidance." (emphasis added)

the factors listed [...]".[127]Since the United States did not examine eight of these factors in the context of the particular industry without giving any explanation for not doing so, the requirements of Article 6 of the Agreement on Textiles and Clothing were not respected.[128]

4.298 Even though the wording of Article 6.3 of the Agreement on Textiles and Clothing is slightly different from Article 4.2 (a) of the Agreement on Safeguards, both provisions nevertheless contain a list of injury factors which shall be evaluated by the investigating authority. Therefore, in accordance with the rationale stated in the above Panel reports, the European Communities submit that, at a minimum, a serious injury determination under the Agreement on Safeguards must demonstrate that the relevance or otherwise of each of the factors listed in Article 4.2(a) of the Agreement on Safeguards was considered. The European Communities would further submit that that provision requires each injury factor to be properly analyzed unless it is explained for what reason the injury factor may be disregarded.

4.299 With respect to each of the factors set out in Article 4.2(a), the European Communities made the following arguments:

(a) Rate and amount of the increase in imports in absolute and relative terms

4.300 This factor was not fully examined by Korea with regard to the products which were finally covered by the measures. Paragraph IV.2 of the Notification of 1 April 1997, merely explains that there was an increase in absolute and relative terms for products within the headings of the Harmonized Tariff Schedule of Korea 0404.90.0000 and 1901.90.2000. However, Korea excluded certain products from the scope of the measure such as milk mineral (calcium) concentrated product, Chilean special products and raw material for production of Cerelac of Nestlé. No allowance is made for these excluded products in assessing the increase of imports. Indeed, during the dispute settlement consultations, Korea stated that it was not even in a position to give a reasonable estimate of the volume of the excluded products during the investigation period. Furthermore Korea did not consider the increase in imports in relation to the decline in imports of milk powder, which is a like product.

(b) Share of the domestic market taken by increased imports

4.301 This requirement was examined by Korea in Paragraph IV.3.4. of the Notification of 1 April 1997 where it is explained that the total market share of domestic raw milk and milk powder declined some 5.7 percentage points from 91.1 per cent to 85.4 per cent during the investigation period. Although this is one of the factors on which Korea subsequently relies to conclude that there was serious injury in its conclusion (Paragraph IV.4 of the Notification of 1 April 1997), there is no explanation of why such a small decrease in market share should be a cause for concern, let alone supportive of a serious injury finding. The only comment made in the Notification of 1 April 1997 is designed to excuse the small increase in market

[127] *See, US - Shirts and Blouses*, *supra*, footnote 45para. 7.26.
[128] *See, id.* at para. 7.52.

share from 1995 to 1996 as being "a temporary phenomenon triggered by sales of milk powder below manufacturing cost in order to reduce inventories which was incurring storage costs and expenses".

(c) Changes in the level of sales

4.302 This factor was to some extent examined in Paragraph IV.3.3 of the Notification of 1 April 1997 in the form of an examination of "consumption of domestic raw milk (including milk powder)". Again this was remarkably stable at 1,844,463 tons in 1993, 1,947,128 tons in 1994, 1,947,965 tons in 1995, and 984,934 tons during the first half of 1996 (presumably equivalent to 2 times 984,934, that is 1969,868, tons for a full year). Korea states that there was a decrease in 1996, but this seems to be an error on its part.

(d) Production

4.303 This factor was examined by Korea. As explained in Paragraph IV.3.1 of the Notification of 1 April 1997, production of raw milk and milk powder increased 3.2 per cent in 1994, 4.2 per cent in 1995 and 4.4 per cent during the first half of 1996. Korea does not attempt to present this as "serious injury" but merely to explain it away by stating that

> "the production of raw milk cannot be temporarily reduced without resorting to the slaughter of dairy cows. Rather than reducing the size of their herds - the average size of which is quite small - Korean dairy farmers continue normal levels of raw milk production even during periods of weak demand, since excess raw milk is supplied to the livestock co-operatives for conversion into milk powder."

4.304 In the EC view Korea's explanation is not credible. Korea is not describing a "temporary" increase in production but a continuous increase over a period of three years. Not only can production be adjusted by varying the use of feed and additives and other technology, dairy cows have in any case a useful life of eight to ten years which means that 10 to 12 per cent are inevitably retired or slaughtered every year. Production can be reduced when necessary even in dairy farms and the fact that it nonetheless continues to increase in Korea demonstrates that there can be no serious injury.

(e) Productivity

4.305 This factor was examined only concerning the raw milk industry. According to Paragraph IV.3.2 of the Notification of 1 April 1997, productivity of dairy farmers has "slightly increased". In fact, productivity in Korean dairy farms has been quite significant. Again, Korea attempts to explain this away with some remarkable reasoning, stating that :

> "This indirect indication of increased productivity is found to be the result of advances in technology, not of changes in the market condition. The fact that the domestic industry stagnated in spite of increased productivity, indicates that the injury to the domestic industry was caused not by its internal factors but by external factors, *i.e.*, increased imports."

In effect, Korea assumes the conclusion to which it wishes to arrive at (injury or "stagnation") in order to explain away a positive factor and attribute the assumed stagnation to imports.

4.306 A further defect in this Paragraph of the Notification of 1 April 1997 is that productivity was not evaluated at all regarding the milk powder industry but an "explanation" is given for its absence since it is stated that

> "Because the production of milk powder is greatly affected by the supply and demand of raw milk, and as production facilities cannot accommodate drastic changes in the short term, a review [of] productivity can be replaced by a review of the production level."

This explanation is, however, in the EC view insufficient, because, contrary to this explanation, productivity is a distinct factor listed in Article 4.2.(a) of the Agreement on Safeguards. The examination of this factor cannot be replaced by the examination of another factor.

4.307 In reality, the productivity of the milk powder industry can be expected to have increased since its total production has increased and there is no indication that the installed production capacity has been increased.

4.308 In the EC opinion examination of the injury factor of productivity does not support a serious injury finding, but rather the reverse.

(f) Capacity utilization

4.309 This factor was also addressed only concerning the raw milk industry. According to Paragraph IV.3.2 of the Notification of 1 April 1997, "capacity utilization was always 100 per cent in the raw milk industry since raw milk is produced by dairy cows, which cannot be left idle like some other form of production."

4.310 The European Communities maintain that this is not a serious examination of the injury factor. A farm which can support 100 cows can choose to only have 80, if economic conditions require this. Capacity utilization in the milk powder industry is not even mentioned. In reality, Korea has simply not examined capacity utilization for the domestic industry at all.

(g) Profits and losses

4.311 Profitability of the raw milk industry was examined by Korea in terms of the profit or loss per unit of production in Paragraph IV.3.9 of the Notification of 1 April 1997 and in the form of a "financial analysis" in Paragraph IV.3.10 of the Notification of 1 April 1997, but in both cases only in respect of the milk powder industry.

4.312 Korea considered exclusively the financial condition of the co-operatives and the milk powder operations of the milk processing companies and neglected to consider the profitability of dairy farmers. This gives a misleading picture because one of the most significant factors governing the profitability of the dairy cooperatives and milk processing companies is the price which they must pay for their raw material, and this price is inversely related to the profitability of the dairy farmers. For example, a 20 per cent increase in the guaranteed milk price would give a considerable increase in profitability to the dairy farmers but would severely

squeeze the operating margins of the dairy cooperatives milk and processing companies.

4.313 The "financial analysis" in Paragraph IV.3.10 of Korea's Notification of 1 April 1997 reviews the turnover and operating profit/loss of two large co-operatives and four milk processing companies.

4.314 The profitability of these companies varies enormously. Of the two co-operatives referred to by Korea in its Notification of 1 April 1997, Seoul Dairy was making large and increasing profits, whereas Pusan-Kyungnam Dairy Co-operative was making large and increasing losses. If the figures for Seoul dairy were combined with those of any co-operative other than Pusan-Kyungnam Dairy Co-operative the picture would have been of large and increasing profits.

4.315 Similarly, in the case of the milk processing companies, Korea has omitted from its sample the second and third largest amongst them in terms of milk powder production, Maeil and Namyang, which coincidentally are extremely profitable.

4.316 The European Communities therefore conclude that Korea's examination of the profitability of the domestic industry is not in conformity with Article 4.2(a) of the Agreement on Safeguards since it does not examine the whole of an interconnected industry.

(h) Employment

4.317 This factor was only examined by Korea with regard to raw milk producers in Paragraph IV.3.6 of the Notification of 1 April 1997, where it is shown that the number of dairy farmers is slowly decreasing. The European Communities would observe however that within the context of increasing production of dairy farms, this is indicative of a healthy consolidating industry and certainly not of serious injury.

4.318 There is no evaluation of the employment injury factor with regard to the milk powder industry. Korea merely states that employment of milk powder industry is difficult to evaluate. However, this statement is clearly insufficient since at least a reasonable estimate would have to be provided in an acceptable serious injury investigation; the investigating authority is obliged to collect such data or explain why reliable collection is impossible.

(i) Other factors

4.319 Korea examined and referred to other factors in its conclusion that are not contained in the list in Article 4.2(a) of the Agreement on Safeguards.

4.320 The first of these is sales prices, which is examined by Korea in Paragraph IV.3.7 of the Notification of 1 April 1997, but only with regard to milk powder, it being stated that the price of raw milk is kept stable by the government (in fact it is regularly increased).Korea states that:

> "The sales price of milk powder by the livestock cooperatives (periodic average price) fell from 5,354 Won/kg in 1993 to 5,294 Won/kg in 1994, increased slightly to 5,388 Won/kg in 1995, and decreased sharply to 4,994 Won/kg during the first four months of 1996. There was no correlation between such change and seasonal factors."

4.321 Objective examination of these figures shows remarkable stability in the price obtained, there being an *increase* over the three years 1993 to 1995. Only in 1996 is

there a decrease. Korea forgets to mention in this regard the special factor which it stressed when explaining away the increased market share of the domestic industry in 1996 - that this was "a temporary phenomenon triggered by sales of milk powder below manufacturing cost in order to reduce inventories which was incurring storage costs and expenses".[129] Thus the European Communities conclude that it is apparent that sales prices of raw milk are increasing and the sales price of milk powder is stable, except for "a temporary phenomenon" in 1996. This does not support a serious injury finding.

4.322 The second additional injury factor considered by Korea in its conclusion is the level of inventory of domestic milk powder.

4.323 The evolution of inventory is described in Paragraph IV.3.5 of the Notification of 1 April 1997. It is explained that:

> "Inventories of domestic milk powder totalled 4,509 tons at the end of 1993, 1,517 tons in 1994, 6,565 tons in 1995 and 14,994 tons at the end of June of 1996, reflecting inventory ratios of 2.4 per cent in 1993, 0.8 per cent in 1994, 3.3 per cent in 1995, and 13.0 per cent during the first half of 1996 vis-à-vis the total demand. The total value of inventories of milk powder at the end of June 1996 was estimated at 92,633 million Won (about US$122 million)."

Thus inventories increased from a low level from the end of 1995, the total in 1996 being still only 13 per cent. Korea does not say on what basis these figures are calculated but assumes they all relate to an annual figure for total demand for milk powder (not just milk). This is still only about one and a half month's milk powder supply and the European Communities consider this not to be a high level and certainly not indicative of serious injury. No explanation is given by Korea as to why this level of inventory should be considered undesirable. In fact at their peak level in May 1996 milk powder stocks were equivalent to less than one month's domestic milk production.

4.324 According to Article 4.1(a) of the Agreement on Safeguards, serious injury shall be understood to mean a significant overall impairment in the position of the domestic industry.

4.325 In the EC view Korea's determination of the existence of serious injury cannot be justified by the injury factors which it cites in this regard, even if they could be considered complete and to the extent that they may be considered correct.

4.326 Korea's conclusion on serious injury is set out in Paragraph IV.4 of the Notification of 1 April 1997 as follows:

> "It was determined that the domestic industry was suffering serious injury based on, *inter alia*, the following facts*:* the market share of domestic raw milk decreased between 1993 and June 1996*:* inventory of domestic milk powders grew from 4,509 tons in 1993 to 14,994 tons in June 1996; sales price witnessed a drop while manufacturing costs increased; livestock cooperatives' ordinary income steadily decreased and registered a huge loss in the first half of 1996; seven livestock cooperatives had a debt to equity ratio exceeding 1,000 per

[129] Para. IV.3.4. of the Notification of 1 April 1997.

cent while six cooperatives depleted their paid-in-capital; and employment decreased."

4.327 With respect to the factors cited by Korea the European Communities make the following arguments:

- Market share - The European Communities submit that a decline of 5.7 percentage points from 91.1 per cent to 85.4 per cent during the investigation period cannot be considered supportive of a finding of serious injury.
- Increase in inventory - The European Communities do not consider, and find no explanation by Korea why, an inventory level equivalent to one and a half months total demand can be considered supportive of a finding of serious injury. The increase of inventory occurred at the end of 1995.
- Sales price drop while manufacturing costs increased - The European Communities assume that Korea is not suggesting that the increase in manufacturing costs can be blamed on imports, according to Korea's own data, sales prices of raw milk are increasing and the sales price of milk powder is stable, except for what it has termed a "temporary phenomenon" in 1996. This is therefore also not supportive of a finding of serious injury. In this connection the European Communities would stress that the price of imported SMPP or a price difference between it and domestic milk powder are not identified as an element of alleged serious injury. Indeed, it could not have been since Korea, for its own reasons, did not investigate prices or price differences or indeed the price relationship between SMPP and the different categories of milk powder (skimmed and whole). The prices which are given in the table on page 11 of the Notification of 1 April must represent some kind of average of various categories of product and are in any event not comparable between imports and domestic products.
- The financial situation of certain livestock co-operatives. The European Communities note that the situation of these livestock co-operatives cannot be considered to support a finding of serious injury for the domestic industry as a whole which consists not only of the livestock co-operatives but also of milk processing companies and dairy farmers.
- Decrease in employment. The European Communities note that this finding relates exclusively to the dairy farmers and, since their production has increased, is indicative of a healthy consolidating industry and certainly not of serious injury.

4.328 Korea does preface its list of injury factors on which it based its determination with the words "in particular". However, none of the other factors support the determination. Indeed, the limited data supplied by Korea does not show an industry in distress. Several injury indicators in fact pointed at a positive development and were disregarded by Korea.

4.329 The domestic industry in this case is characterized by increasing production and productivity. The only information available on employment is the gradual decrease in the number of dairy farmers, which is a positive indicator in the light of increasing production and is also an objective of Korean government policy. Furthermore, since production and prices of raw milk increased, domestic sales must have increased in 1995 and the first half of 1996. Market share of raw milk and milk

powder fell by only 5.7 percentage points from 1993 until 1995 but increased again in 1996. Korea itself stated that this was only a temporary phenomenon, but, in any event, such a small decrease cannot be accepted as an indicator of a significant overall impairment of the industry.

4.330 The only clearly negative factor is the difficult financial situation of some of the dairy cooperatives. However, the financial position of these companies appears to be very variable and in any case is of lesser importance than the raw milk industry, even according to the incomplete and inconsistent investigation conducted by Korea.

4.331 The European Communities consider that on the basis of the limited data provided by Korea, the picture that emerges is that even if the domestic industry is consolidating (a feature which it shares with many other OECD countries), it is nonetheless healthy. There is no evidence of a "significant overall impairment of the domestic industry" which would be required to support a finding of serious injury.

4.332 Therefore the European Communities conclude that Korea violated Article 4.2(a) of the Agreement on Safeguards by making a determination of serious injury which is unsupported by the facts.

(b) Response by Korea

4.333 **Korea** responds to the EC arguments as follows:

4.334 In order to impose a safeguard under Article 2 of the Agreement on Safeguards, Korea must show that:

(i) a product is being imported into its territory in such increased quantities;

(ii) as to cause or threaten to cause serious injury;

(iii) to a domestic industry;

(iv) producing a like or directly competitive product.

4.335 In its attempts to depict the Korean dairy industry as being healthy, the European Communities provide the Panel with incorrect or misleading facts and unsubstantiated allegations. The European Communities even engage in the selective use of evidence and also discards the relevant parts of the evidence when they do not suit its purpose.

4.336 When it cannot produce evidence in support of its contention, the European Communities conveniently claim that Korea did not consider various serious injury criteria. In the view of Korea, the EC claim that Korea did not take into account certain injury criteria may stem from its failure to examine the investigation report[130] and related documents[131] which were made publicly available at the time of the public hearing. However, it is clear that during the course of the Article 12 and Article XXII negotiations, all the issues considered by Korea in its investigation, and

[130] Korea made the results of the injury investigation publicly available and the EC obtained a copy thereof. The Korean version was translated into English by the EC and was referred to many times during the consultations. Korea even took the step to point out numerous translation errors for the benefit of the EC during the prior consultations.

[131] Korea made public the interim investigation report which was used and distributed at the public hearing to determine whether a safeguard measure should be applied, at which the Netherlands Embassy official, Agriculture Counsellor A C van Arnhem was present.

reported to the Committee of Safeguards and the Members, were exhaustively discussed with the European Communities.

4.337 A review of the investigation report and the interim report shows that Korea considered all relevant factors "of an objective and quantifiable nature having a bearing on the situation of that industry." As the industry in question was an agricultural one and given the unique nature of agriculture recognized by the WTO Members, Korea examined the following criteria during its investigation. These elements taken together as a whole, pointed to an industry suffering serious injury.

(i) Domestic Industry and Like or Directly Competing Products

4.338 Korea determined that the "domestic industry" under investigation was the industry that produces raw milk and milk powder. These products are directly competitive with the products under investigation[132]. As established by the relevant Korean law, and consistent with the Agreement on Safeguards, the investigation discounted the import activities of the "domestic industry". Korea notes that the European Communities agree with this definition of "domestic industry" and does not appear to dispute its definition of "directly competitive products".

(ii) Increase in Imports

4.339 During the investigation period (January 1993 - June 1996), imports of SMPP increased as follows:[133]

IMPORTS OF SMPP

Year	*Amount (tonnes)*	*Per cent Increase*
1993	3,217	
1994	15,561	384%
1995	28,007	80%
1996 (1-6)	16,320	16.9%

Based on the above data, Korea found that imports increased in absolute terms during the period of investigation.

4.340 There was also a significant increase in imports of SMPP relative to domestic production of raw milk, as evidenced by the following:[134]

IMPORTS OF SMPP RELATIVE TO DOMESTIC PRODUCTION

Year	***Annual Growth Rate of Raw Milk Production***	***Annual Growth Rate of Imports of SMPP***
1994	3.2%	384%
1995	4.2%	80%
1996 (1-6)	4.4%	16.9%

[132] *See,* Notification, paragraph III.2.
[133] *See,* Notification IV.2.
[134] *See,* Notification, paragraphs IV.2 and IV.3.1.

(iii) Serious Injury

(a) Profit and loss of the domestic industry, declining prices, and sales below production costs

4.341 During the period of investigation, the livestock cooperatives incurred an operating loss of 755 million Won in 1993, 622 million Won in 1994, 1,244 million Won in 1995, and 681 million Won in the first four months of 1996 from their milk powder operations, representing an annual loss rate (defined as operating loss over net revenue) of -6.3 per cent, -6.5 per cent, -10.7 per cent, and -29.5 per cent, respectively. Given that dairy farmers owned and capitalized the livestock cooperatives, these losses reflect injury to the dairy households.

4.342 Similarly, the processing companies experienced losses from their milk powder operations.[135] The difference between sales price and production cost *per* kilogramme (periodic average price) was as follows:[136]

PROFIT\LOSS FROM MILK POWDER BUSINESS

Year	*Profit\Loss per kg (Won)*
1993	196
1994	-130
1995	-472
1-6/1996	-1,184

4.343 In the raw milk sector, Korea suggests a reference price for raw milk to promote fair transactions between individual dairy farmers and large users, such as the processing companies. Using the suggested reference price as a surrogate, however, the dairy farms experienced a declining profit margin during the investigation period.

PRICE AND PRODUCTION COST OF RAW MILK

	1993	*1994*	*1995*	*1996*
Reference Price (Won/100kg)	41,400	41,400	41,400	45,600
Prod. Cost (Won/100kg) [137]	40,084	38,861	41,255	46,499
Difference	1,316	2,539	145	-899

The above figures show that the difference between the suggested reference price and production cost had declined until 1996 when this price did not even cover production costs. The combination of this declining profit margin and the

[135] *See,* Notification IV.3.10.b.ii.
[136] *See,* Notification IV.3.7, and the table on page 11 thereof.
[137] Source: NLCF. These production costs were obtained by surveying 150 dairy farms.

compensatory practice of providing 70-80 per cent in cash and the rest in kind for purchases of raw milk by the cooperatives during difficult periods aggravated the weak financial condition of the dairy farms.

4.344 In the milk powder sector, the price is set by market forces. During the period of investigation, with the exception of 1993, domestic milk powder prices were less than production costs. This loss grew larger each year.

PRICE AND PRODUCTION COST OF KOREAN MILK POWDER

	1993	***1994***	***1995***	***1996***
Sales Price (Won/kg)	5,354	5,296	5,388	4,994
Prod. Cost (Won/kg)	5,158	5,426	5,860	6,178
Profit\Loss	196	-130	-472	-1,184

Korea is not suggesting that the increase of manufacturing cost can be blamed on imports. However, the low price of imports had a suppressing effect on the price of domestic raw milk and milk powder, suppressing the price of raw milk to levels that in 1996 did not even cover the production costs.

4.345 Korea determined that these sales below costs indicated serious injury to the domestic industry, especially given that both milk powder producers and dairy farmers (by virtue of their ownership of the cooperatives) share in the losses from such sales.

(b) Increase in inventory

4.346 Korea determined that inventories of milk powder increased and remained at high levels during the period of investigation.[138]

INCREASE IN INVENTORY

Year	*Inventory (tonnes)*	*Per cent Increase*	*Inventory Ratio in Months*[139]
1993	4,509		4.4
1994	1,517	-66.4%	1.5
1995	6,565	332.8%	7.4
1996 (1-6)	14,994	342.7%	8.1

The total value of inventories as of June 1996 was estimated at 92,633 million Won (about US$122 million).[140]

4.347 Given the unique nature of dairy industries generally and the Korean dairy industry specifically, as discussed in detail above, Korea considered that the accumulation of inventories indicated serious injury to the domestic industry.

[138] *See,* Notification, IV.3.5.
[139] Inventory ratio is defined as the inventory amount divided by the production of milk powder.
[140] *See,* Notification, IV.3.5.

(c) The rise in unemployment

4.348 During the period of investigation, the number of dairy farms declined by approximately 20 per cent, from 28,219 in 1993 to 22,725 in 1996. This decline occurred even though Korea sought to assist the domestic industry by providing long-term loans of up to 300 million Won[141] *per* farm to improve the industry's competitiveness. Unemployment rose despite the fact that virtually all 28,219 dairy farms obtained long-term loans.[142]

(d) Debt-to-equity ratio and capital depletion

4.349 Prior to the increased imports of SMPP in 1993, the domestic industry derived profit from selling raw milk, and producing milk powder. As a result of the circumvention of the 220 per cent agreed tariff rate on milk powders, and the import into Korea of SMPP at a 40 per cent tariff rate, loss began to accumulate rapidly in the Korean livestock cooperatives. The table below shows the losses accruing to livestock cooperatives from production of milk powder, and its overall contribution to their annual debt.

PERCENTAGE OF DEBT INCURRED BY COOPERATIVES FROM THEIR MILK POWDER OPERATIONS

(Unit: million Won)

	1991	***1992***	***1993***	***1994***	***1995***	***1996***
Annual Debt (A)	12,010	10,364	82,560	43,630	42,267	32,543
Profit and Losses from Milk Powder Business (B)	1,814	2,240	482	-330	-1,651	-12,502
Ratio (B/A)	15.1%	21.6%	0.6%	-0.8%	-3.9%	-38.4%

(e) Inability to invest in research and development

4.350 The continued loss by cooperatives caused by SMPP further exacerbated and accelerated the underinvestment in new facilities at a time when the cooperatives needed to upgrade facilities and equipment to remain competitive. Their inability to attract investment is what led Korea to provide financial assistance through the Livestock Development Fund[143] under the Dairy Cow Competitiveness Enhancement Programme.

4.351 Because the livestock cooperatives were unable to operate at a reasonable profit level, they could not make the necessary investments in research and

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[141] Approximately US$220,000 based on October 1998 exchange rates.

[142] Source: MAF. The objective of the loan programme was not to "consolidate" or "rationalize" the industry, since Korea provided financial assistance to keep dairy farms in the business. The long-term loans were not provided, for example, to encourage the dairy farmers to relocate and find other livelihood, given that the loans were earmarked solely for dairy business purposes and that the farmers had to repay the loans even if they ceased to operate in the dairy business.

[143] Funds are established and operated by the government to provide assistance to specific sectors which cannot attract investments.

development. Thus, the domestic industry produces only two types of milk powder (skimmed and whole) and has not been able to expand into the production of the other diverse forms of milk powders and milk powder preparations which are produced by exporting nations.

(f) Loss of market share

4.352 The share of the domestic market occupied by both domestic raw milk and milk powder producers fell during the period of investigation from 91.1 per cent to 85.4 per cent, with only a slight increase in the first half of 1996 attributable to below cost sales of domestic milk powder made as a defensive measure to alleviate the financial burden.

4.353 Given the unique nature of agricultural sectors generally and the Korean dairy industry specifically, Korea considered that the decline in market share for both raw milk and milk powder during the period of investigation indicated serious injury to the domestic industry.[144]

4.354 When the market share figures of raw milk and milk powder are disaggregated, the proportion of the consumption of milk powder in Korea taken by SMPP increased dramatically.

MILK POWDER MARKET SHARE OF SMPP

Year	*Market Share*
1993	10.7%
1994	38.4%
1995	60.6%
1996 (1-6)	69.4%

4.355 It is important to note that any increase in market share of SMPP must be correlated to the rate of increase in milk powder consumption in Korea. In this regard, total consumption of milk powder increased by 34.3 per cent in 1994, 14.1 per cent in 1995, and 14.5 per cent for the first six months of 1996.[145] Given the low prices of imported SMPP and their functional substitutability with Korean raw milk and milk powder, an increase in Korean consumption effectively only benefits suppliers of the cheaper imported SMPP. As the increase in imports of SMPP displaces both domestically-produced raw milk and milk powder, it is to the direct detriment of the Korean cooperatives and dairy farmers.

(g) Consumption

4.356 The consumption of domestic raw milk (including milk powder) was 1,844,463 tonnes in 1993, 1,947,128 tonnes in 1994, 1,947,965 tonnes in 1995, and 984,934 tonnes during the first half of 1996, reflecting a distinct decreasing trend

[144] For reference, see the recent US International Trade Commission report in *Wheat Gluten*, Inv. No. TA-201-67, USITC Pub. No. 3088 (Mar. 1998) at I-16 and II-25, where the US ITC found serious injury even though the overall increase in the market share of imports was 8.8 per cent.

[145] Source: MAF.

from 5.6 per cent in 1994, to 0.0 per cent in 1995, and to -2.0 per cent during the first half of 1996. Consumption of domestic milk powder decreased relative to the total milk powder consumption during the period of investigation. The domestic milk powder consumption rate was 40 per cent in 1993, 30 per cent in 1994, 23 per cent in 1995, and 28 per cent in the first six months of 1996.[146]

4.357 The consumption of white milk (only produced from Korean raw milk), the predominant end use of raw milk fell, with the exception of 1994, during the investigation period, from 1,287,000 tonnes in 1993, to 1,374,000 tonnes in 1994, to 1,319,000 tonnes in 1995, and to 610,000 tonnes for the first six months of 1996. The fall in consumption resulted in a decline of market share of white milk by nearly 10 per cent from 63 per cent to 53.7 per cent between 1993 and the first six months of 1996.[147]

4.358 On the other hand, the consumption of flavoured and fermented milk (which primarily use the cheaper imported SMPP) increased during the investigation period. Flavoured milk increased from 123,000 tonnes in 1993, to 176,000 tonnes in 1994, to 255,000 tonnes in 1995, and to 133,000 tonnes for the first six months of 1996, representing an increase rate of 43.5 per cent in 1994, 44.6 per cent in 1995, and 10 per cent in the first six months of 1996. The market share of flavoured milk increased from 6 per cent to 11.7 per cent during the period of investigation. The consumption of fermented milk surged from 466,000 tonnes in 1993, to 525,000 tonnes in 1994 to 539,000 tonnes in 1995 to 297,000 tonnes in the first six months of 1996. The annual increase rate was 12.7 per cent in 1994, 2.8 per cent in 1995, and 7.3 per cent in the first six months of 1996. The market share of fermented milk increased from 22.8 per cent in 1993 to 26.2 per cent in the first six months of 1996. Korea determined that the import of the cheaper SMPP was the primary reason for the processing companies to increase the production of flavoured and fermented milk and curtail the production of white milk that can only be produced from domestically-produced raw milk.[148]

4.359 Korea considered that the data above indicated that consumption of downstream products made from Korean raw milk and milk powder were declining, resulting in an overall decline in the consumption of domestic raw milk and milk powder.

(h) Productivity and capacity utilization

4.360 Korea asserted that capacity utilization is an example of an injury criterion which is relevant to industrial goods but is not necessarily useful in assessing serious injury to an industry in the agricultural sector. In the case of industrial goods such as autos, a high capacity utilization ratio of plants would be regarded as a positive

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[146] *See,* Notification IV.3.3. The consumption of domestic milk powder increased in the first half of 1996 because the price fell from a high of 5,388 Won/kg in 1995 to a low of 4,994 Won/kg in the first six months of 1996. The fall in the price is attributable to an acute rise in inventory from 6,565 tonnes in 1995 to 14,994 tonnes in the first half of 1996, an increase of 342.7 per cent, caused by the single largest increase between 1995 and 1996. The sharp increase in inventory amount compelled the cooperatives to sell milk powder at below production cost. Source: MAF.

[147] Source: MAF

[148] Source: MAF

indicator for the industry. This, however, is not the case in the raw milk/milk powder industry.

4.361 Korea emphasized that capacity utilization of *both* the raw milk *and* milk powder sectors was fully considered in the serious injury determination. Korea fails to understand the basis on which the European Communities claim that there is "no examination of capacity utilization" in view of the fact that the interim investigation report explicitly dealt with that issue.[149]

4.362 After considering capacity utilization for the milk powder sector, Korea determined that this element did not accurately reflect the condition of the domestic industry because the unused portion of raw milk became larger as SMPP replaced raw milk, livestock cooperatives' and processing companies' intake of the unsold raw milk quantity for conversion into milk powder increased, thereby increasing the milk powder industry's capacity utilization; however, despite the increase in capacity utilization, the raw milk converted into milk powder became unsaleable inventory. Thus, capacity utilization was not a suitable criterion for injury determination purposes and the investigating authority placed less emphasis on this factor than other injury elements.

4.363 In connection with capacity utilization of raw milk, the investigating authority found that the rate of utilization was 100 per cent, since all cows had to be milked. Here again, however, like the milk powder sector, high capacity utilization does not signal a healthy industry. Raw milk had been substituted for by cheaper SMPP imports and the excess (*i.e,* unsold) raw milk, due to its perishability, was turned into unsaleable milk powder inventory. Accordingly, after due consideration, Korea discounted capacity utilization in determining the existence of serious injury to the domestic industry.

(i) Production

4.364 Korea considered the raw milk and milk powder production data in its injury analysis and concluded that it was not an appropriate measure for determining the state of the domestic industry. It is true that raw milk production rose by 3-4 per cent during the investigation period. However, the excess raw milk was not consumed and thus became milk powder inventory.

4.365 The demand for flavoured and fermented milk products also increased, but such products were largely made from the cheaper imported SMPP which displaced the domestically-produced raw milk and milk powder.

4.366 In response to a question by the Panel[150], **Korea** further clarified certain aspects of the injury investigation concerning the calculation of the manufacturing costs for the domestic industry:

4.367 The figures of the production costs of raw milk were calculated by adding the costs for feed, hired labour, depreciation, family labour, interest, and for

[149] *See,* Exhibit Korea-5. A copy of the interim investigation report was publicly available to everyone and was distributed to all attendants of the public hearing, including the Agriculture Counsellor A C Van Arnhem of the Netherlands Embassy.

[150] The Panel recalls that the question was*:* "In Korea's first submission, you refer to "production costs of raw milk." Could you please provide evidence on how these calculations were performed. Could you also do the same for "production costs of Korean milk powder"."

miscellaneous items such as veterinary services and medicines, and by subtracting income from by-products. The annually published and publicly available "Annual Report of Livestock Production Cost Survey" by NLCF contains detailed figures for the production costs of raw milk. These figures are as follows:

PRODUCTION COST OF RAW MILK (WON/100KG)

	1993	1994	1995	1996
Feed	18,209	18,730	20,028	22,432
Hired labour	303	362	536	612
Depreciation	7,067	7,256	7,395	7,538
Family labour	14,382	13,264	13,975	14,816
Interest	6,188	5,116	5,935	6,472
Miscellaneous	3,012	3,322	3,604	3,934
By-products	9,077	9,189	10,218	9,305
Production costs	40,084	38,861	41,255	46,499

4.368 Data for production cost of Korean milk powder was calculated by the total manufacturing cost over amount of production of milk powder produced by the NLCF, which appear in pages 46 and 54 of the OAI Report. Total cost of manufacturing consists of raw material cost, labour cost and other expenses as is shown in the following Table, reproduced from pages 46 and 54 of the OAI Report.

TOTAL MANUFACTURING COST OF THE NLCF (UNIT*:* MILLION WONS, WON/KG)

	1993	1994	1995	1996.1.-4.
Total manufacturing cost (A)	16,917	13,576	20,491	18,911
- raw material cost (B)	13,996	11,428	16,992	16,209
- labour cost (C)	1,181	961	1,451	772
- other expenses (D)	1,740	1,187	2,047	1,931
Raw material cost/total manufacturing cost (%, B/A)	82.7	84.2	82.9	85.7
Amount of production (E, tonnes)	13,512	9,495	15,719	10,401
Per unit manufacturing cost (F)	5,158	5,426	5,860	6,178
Sales price (G)	5,354	5,294	5,388	4,994
Difference in prices (G-F)	197	-132	-472	-1,184

4.369 With regard to the exclusion of certain products from the final measure **Korea** in answer to a question by the Panel[151] made the following arguments:

[151] The Panel recalls that the question was: "In paragraph 51 of Korea's oral statement to the first meeting of the Panel, you appear to refer to some products which would have been excluded from the application of the final safeguard measure. Is this statement accurate? Were any of these products (or any other products) excluded by Korea when it conducted its investigation, in particular, for the injury analysis? If so, please explain the methodology Korea used in doing so as well as the criteria it used to perform such assessment."

4.370 The precise amount of products excluded and the methodology used to exclude them are set out on page 7 of the OAI Report. The European Communities obtained a copy of the OAI Report at the KTC's Public Hearing on 20 August 1996. The European Communities provided the Government of Korea with a translation during the consultations. Thus, the European Communities has already had access to the figures at issue.

4.371 Based on the analysis of the exporters' responses, the OAI concluded that certain items falling under the same HS code number as that of the SMPP should be excluded from the application of the safeguard measure on the ground that:

- they were not simple mixtures of whey powder or starches with milk powder prepared solely for the purpose of evading comparatively high tariffs;
- they were commonly traded products, and not exclusively targeted at countries with high negotiated tariffs such as Korea; and
- the import volume was very small.

4.372 Also in response to a question of the Panel[152] **Korea** offered the following clarification on the relation between SMPP imports and milk powder imports:

4.373 Korea's notification of 24 March 1997 and the OAI Report provide the import figures for SMPP at the second paragraph of section IV.2. It also provides the equivalent figures for imports of milk powder in paragraph V.2.2 of the same Notification.

	Imports of milk powder	Imports of SMPP	Total imports	SMPP's share of total imports
1993	14,843	3,217	18,060	17.8%
1994	11,581	15,561	27,142	57.73%
1995	7,576	28,007	35,583	78.78%
1996 (1-4)	583	16,320	16,903	96.6%

4.374 The volume of total imports of milk powder and SMPP increased by approximately 90 per cent over the investigation period, and within that total increase, SMPP's share increased from 17.8 per cent to 96.6 per cent. Therefore, the conclusion that the increase in imports of SMPP far outweighs the decrease in imports of milk powder is evident.

4.375 The Panel also asked[153] **Korea** to clarify its arguments on the composition of the domestic industry and to summarize how the serious injury factors were

[152] The Panel recalls that the question was*:* "Please provide supporting evidence that the increased SMPP "far outweighed" the drop in imports of milk powder paying the agreed tariff rate."

[153] The Panel recalls that the question was*:* "Please provide the panel with a detailed explanation of the factors you used to identify one single domestic industry (composed of raw milk and milk powder). In addition, Article 4.1(a) provides "'serious injury' shall be understood to mean a significant overall impairment in the position of the domestic industry". Please provide a summary and clarification as to how the factors considered led to a determination of serious injury to the *whole of the domestic industry.*"

considered for the whole domestic industry. The following constitutes Korea's response:

4.376 Article 2-1 of Korea's Regulation on Relief of Injury to Domestic Industry Caused by Imports states:

> "(i) 'Domestic industry' shall mean all the domestic producers who produce products of the same kind as or products having directly competitive relations with imported goods concerned; or a group of the domestic producers of the above product whose collective production accounts for a major portion of the total domestic production.
>
> (ii) If a domestic producer concurrently takes part in the import of the product concerned, only his domestic production shall be included in the domestic industry. If a domestic producer turns out more than one product, only the production of the product concerned shall be considered as domestic industry under consideration."

4.377 The OAI Report in delineating the domestic industry states:

> "Domestic industry cited in this survey means natural milk industry and powdered milk industry which produce natural milk and powdered milk having direct competitive relations with imports. Natural milk producers include dairy farms and dairy firms that directly run ranches. Powdered milk producers are the NLCF and dairy firms and include those who have no powdered milk production facilities and produce powdered milk on a piecemeal basis."

4.378 The OAI's position is also reflected in the Notification of 24 March 1997.[154] In making this conclusion, the OAI considered overlapping commercial use among raw milk, milk powder, and SMPP, and resulting commercial competition among those products. The detailed analysis is also set out in the OAI Report.

4.379 In determining whether the *whole* domestic industry was suffering serious injury by reason of increased imports of SMPP, the competent authorities considered the relevant factors set out in Article 4.2(a) for the *whole* domestic industry. In instances where a factor was not relevant to a particular sector of the domestic industry (because it was not of an objective and quantifiable nature having a bearing on the state of that industry), the competent authorities explained the basis for disregarding this factor or the reason why this factor still provided an indication of injury to the *whole* domestic industry.

4.380 Korea evaluated the following factors as summarized in its first submission and explained in, *inter alia*, the OAI Report and the 24 March Notification*:*

(a) the rate and amount of the increase in imports of the product concerned in absolute and relative terms;[155]

(b) the share of the domestic market taken by increased imports[156];

(c) changes in the level of sales;[157]

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154 G\SG\N\10\KOR\1\Suppl.1, page 7.

155 OAI Report at Section V, Notification at Section IV.2.

156 OAI Report at Sections VI.2 (a) and (b), Notification at Section IV.3.4.

(d) production;[158]
(e) productivity;[159]
(f) capacity utilization;[160]
(g) profits and losses;[161] and
(h) employment.[162]

The competent authorities also considered additional relevant factors indicating serious injury including:

(i) inventory;[163]
(ii) investment;[164]
(iii) price;[165] and
(iv) other financial indicators including debt-to-equity ratios and capital depletion.[166]

4.381 Based on their evaluation of the above factors, the competent authorities considered that the whole domestic industry was suffering serious injury.

(c) Additional Arguments by the European Communities Made at the First Meeting of the Panel with the Parties

4.382 At the first meeting of the panel with the parties, the **European Communities** further advanced their arguments under Article 4.2(a) as follows:

(i) Industry Definition

4.383 Korean dairy farmers are characterized by having small farms (average 25 cattle per farm), high costs and low productivity and being subject to a high level of government intervention. In recent years there has been a decline in the number of dairy farms, but an increase in the number of cattle and in milk production, both absolutely and per head. This shows that the Korean dairy farmers are undergoing a

[157] OAI Report at Sections VI.2 (a) and (b) (sales were compared for the livestock cooperatives given the non-availability of sales for individual dairy farmers), Notification at Section IV.3.9 and 10.
[158] OAI Report at Sections VI.2 (a) and (b), Notification at Section IV.3.1.
[159] OAI Report at Section VI.2 (a), Notification at Section IV.3.2.
[160] *See,* Exhibit Korea-5 for the discussion of this in the OAI's Interim Report circulated at the public hearing. Further, the Notification of 1 April 1997 made it plain that capacity utilization was unhelpful in analyzing the serious injury to both the raw milk and milk powder sectors, and so was discounted.
[161] OAI Report at Section VI.2 (a) and (b) (the profits and losses were compared for the livestock cooperatives given the non-availability of profits and losses for individual dairy farmers), Notification at Section IV.3.10.
[162] OAI Report at Sections VI.2(a)(2) and (b)(5), Notification at Section IV.3.6.
[163] OAI Report at Section VI.2 (a) and (b), Notification at Section IV.3.5 (inventory in the raw milk sector was estimated by examining inventory in the milk powder sector).
[164] OAI Report at Sections VI.2(a)(3) and (b)(4).
[165] OAI Report at Sections VI.2(b)(3), Notification at Section IV.3.7 (given the non-availability of sales transaction price for raw milk, sales transactions of milk powder were used as a surrogate).
[166] OAI Report at Section VI.2, Notification at Section IV.3.10.

process of consolidation, similar to that of many other dairy producers in the most advanced economies, whereby the smallest, least efficient farms are being absorbed and investment for improvements is being targeted on the remaining larger, more efficient farms.

4.384 This process of rationalization and consolidation is encouraged by the Korean Government. Financial stimulus is given by the Dairy Cow Competitiveness Enhancement Programme introduced in 1994, under which the Korean Government gives loans to dairy farmers to improve their facilities. Korea has declined to give details of the level of expenditure committed to this programme. However, the success of governmental intervention can be seen by the facts*:* between 1993 and 1996 the number of dairy farms decreased by 22 per cent, but the number of dairy cattle increased by 1.6 per cent and milk production by 9.5 per cent.

4.385 Despite the fact that the Korean dairy farmers are still rather inefficient by international standards, Korean milk production has increased almost continuously for the past 20 years and rose by 17 per cent in the most recent five-year period for which figures are available (1991-96). Production is continuing to rise and it is anticipated that it will increase by a further 2-3 per cent in 1998.

4.386 These production increases are rendered possible by the system operated by the Korean Government, under which producers are guaranteed a very high price for their raw milk, for unlimited quantities and irrespective of domestic demand. Like the production, this guaranteed price has also regularly increased over the course of the last 20 years, so that Korean milk producer prices at the time of the safeguard investigation were among the highest in the world, second only to Japan during the period of investigation. Korea has admitted that the price of raw milk "is maintained at a stable level fixed by the government" and that the price of raw milk was also increased twice during the investigation reference period.[167] Although Korea terms these prices as "suggested", they are identical to the ones that it submitted to the OECD as domestic prices within the framework of OECD Members' reporting obligations.

(ii) Failure to Examine Correctly all Relevant Factors of an Objective and Quantifiable Nature Having a Bearing on the Situation of the Domestic Industry

4.387 The European Communities consider that the evaluation of injury factors conducted by Korea is incomplete in the following respects:

- for the *raw milk industry,* Korea failed to evaluate the profits and losses of the raw milk industry
- with regard to the *milk powder industry*, Korea did not examine productivity, and employment
- there is in reality no examination at all of capacity utilization.

4.388 In addition, the evaluation of many other factors is seriously flawed. These are:

[167] *See,* WTO Doc. G/SG/N/10/KOR/1/Suppl.1, 1 April 1997, p. 10, paragraph IV.3.7 (Exhibit EC-10).

- the rate and amount of the increase in imports of the product concerned in absolute and relative terms (inclusion of excluded products),
- changes in the level of sales (incorrect calculation),
- profits and losses (failure to exclude effects of other activities of the co-operatives)
- sales prices (failure to take account of the fact that 1996 below cost sales were a "temporary phenomenon")
- inventory (no reason why inventory levels indicated should be a cause for concern). This is a matter which the European Communities will clarify below.

4.389 Therefore the European Communities conclude that Korea violated Article 4.2(a) of the Agreement on Safeguards by making an incomplete and flawed evaluation of the injury factors.

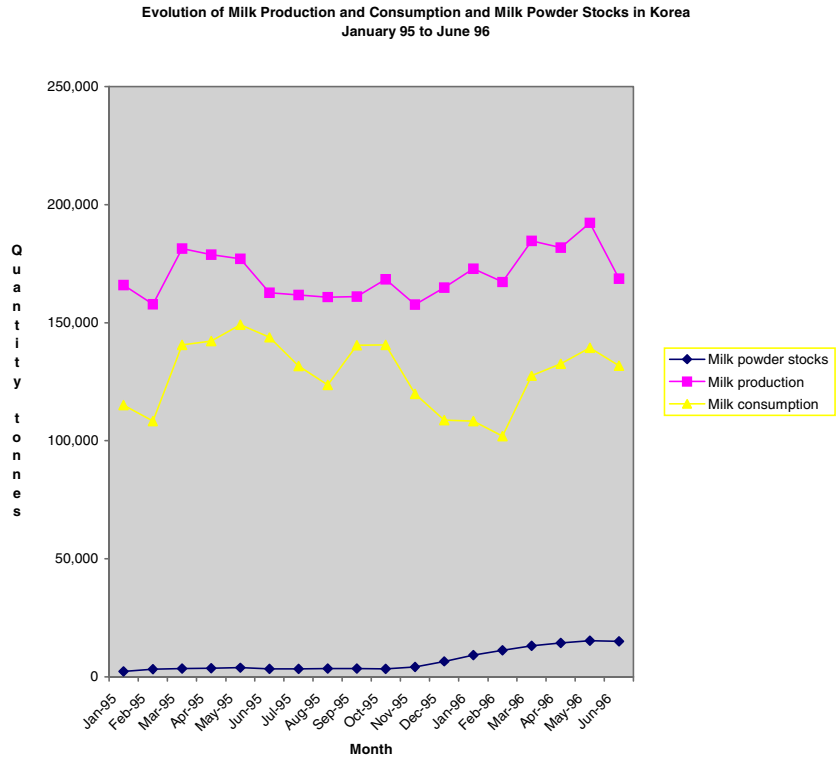
(a) Profitability

4.390 The European Communities noted that Korea supplied for the first time some data on profitability of dairy farmers in its First Written Submission. The European Communities considered that: first, Korea's late submission of information demonstrates that those data could indeed have been gathered and supplied, contrary to what Korea had claimed when the European Communities made their objections during the consultations, and second, the information which is now supplied confirms the EC case.

4.391 The European Communities asserted, based on Korea's data, that in 1994, which witnessed the imports' sharpest increase, farmers' profitability was also at its peak. The absence of correlation between increase in imports and profitability further demonstrates the absence of causal link between profitability and the increase in imports. In reality the profitability of Korean dairy farmers is determined by government decisions on the "reference price". Korea's table on price and production cost of raw milk shows that the decrease in profitability is due to an increase in production costs which of course has nothing to do with imports of SMPP.

(b) Inventory

4.392 Apart from the size of the stocks, the other important point is the timing of the increase. The European Communities presented the following graph:



4.393 The European Communities argued this graph shows very clearly that the increase in stocks occurred in November 1995 immediately following the serious decrease in consumption caused by the "pus milk" scandal. Moreover, the graph shows clearly that the increase in stocks coincided with steadily increasing milk production. In the light of the above, the European Communities reiterate their conclusion that the inventory level reported by Korea could not be considered "excessive", and that its origin is to be found in a cause which is very different from imports of SMPP.

(c) Employment

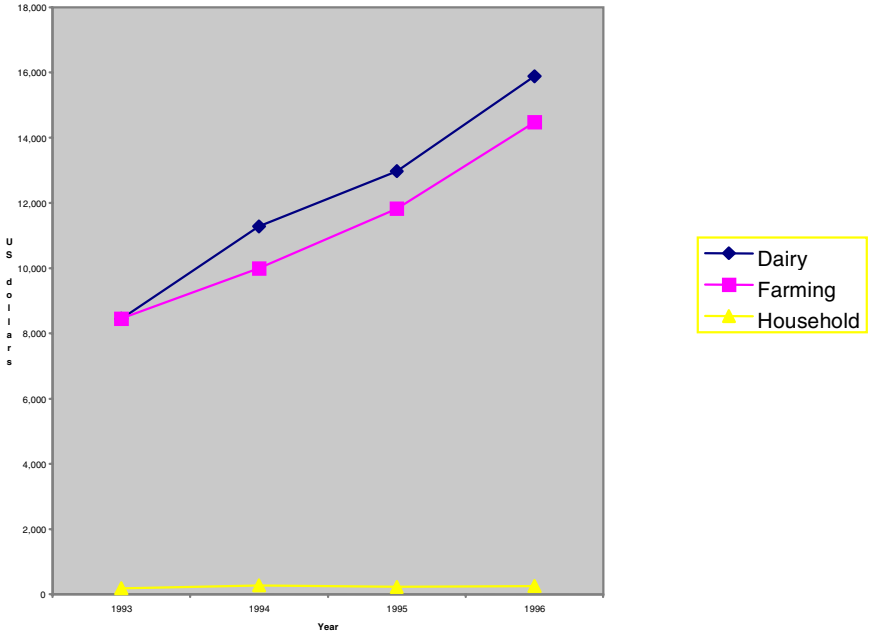
4.394 The figures given by Korea in connection with employment in fact only relate to the numbers of dairy farm households - which the European Communities take to mean farms. This of course is not a measure of employment, especially in a period where farms are consolidating and increasing in size (a development encouraged by Korean government policy).

4.395 The European Communities reiterated that employment is an injury factor expressly listed in Article 4.2 Agreement on Safeguards and Korea has completely failed to investigate it.

(d) Debt

4.396 The European Communities note with equal interest that in order to emphasize the problems of one part of its industry - farmers - which it omitted to consider in its determination, Korea is now able to supply data on their debt, and even comparing the household debt increase rate of dairy farmers with that of other farmers. The comparability of the debt level of dairy farmers and the other farmers is expressed in the graph below submitted by the European Communities:

Average Indebtedness



This graph, drawn from Korea's own data, shows that although there was an increase of indebtedness in 1994 (a year of high profits for the Korean dairy industry as we have just seen), the indebtedness of the dairy industry is following exactly the same trend as Korean farming generally.

4.397 The European Communities too recalled that an incentive to accumulate debt can also stem from the favourable credit conditions that Korea admits its dairy

industry can enjoy as a result of the Dairy Cow Competitiveness Enhancement Programme.

4.398 In the EC view the figures in the table on the percentage of debt incurred by cooperatives from their milk powder operations submitted show a declining trend in indebtedness throughout the investigation period of 1993 to 1996 which is a healthy trend. Also, the evolution of profits and losses shows no correlation to indebtedness. The figures do not correspond for example, the high profits in 1992 were followed by an increase of debt in 1993. But more fundamentally, Korea is comparing apples and pears by calculating a ratio of profits and losses from milk powder business by annual (that is presumably accumulated) debt corresponding to all business sectors of the co-operatives. The information is simply misleading and in no measure supports Korea's findings.

(e) Research and development

4.399 In the EC view Korea's First Written Submission contains a new and remarkable argument - that the ability of the domestic industry to invest in research and development was being impaired. There is no basis for this in the Notification and indeed no figures for such investment are given. The European Communities submit that this new attempt of justification of the finding of serious injury must be disregarded.

(f) Loss of market share

4.400 It is always possible to make figures appear more impressive by reducing the denominator and this is what in the EC view what Korea does in its First Written Submission by expressing imports of SMPP as a percentage of the milk powder market. The domestic industry definition covered all milk production and therefore the appropriate figures are for this market. The total market share of domestic raw milk and milk powder declined some 5.7 percentage points from 91.1 per cent to 85.4 per cent during the investigation period. The European Communities do not see how this can be considered indicative of serious injury.

(g) Consumption

4.401 In the EC view, Korea makes an admission in its First Written Submission when it stresses the importance of the switch in Korea from the consumption of "white milk" to the consumption of flavoured and fermented milk and that the latter is directly at the expense of the former. Korea suggests that since flavoured and fermented milk can be more easily manufactured using imported SMPP, this demonstrates serious injury. This is not the case. The trend identified by Korea demonstrates that the decrease in domestic milk production was at least partially caused by a change in consumer preferences in Korea. This is an additional factor contributing to the situation of the domestic industry which Korea failed to take into consideration under the second sentence of Article 4.2(b). This is an additional violation.

(h) Capacity utilization

4.402 Korea asserts that evidence of its investigation into this factor can be found in the KTC's Interim Report. This might be true, but it simply overlooks the point that

the factors leading to the imposition of a safeguard measure should be at the basis of the *final* decision, which is at issue in this procedure on "*Definitive* Safeguard Measures on Imports of Certain Dairy Products". In the absence of even a reference to the interim report on this aspect in the final measure, the European Communities fail to see how it could have been understood that the preliminary determination would not be, precisely a preliminary one but a definitive one

(d) Additional Arguments by Korea Made at the First Meeting of the Panel with the Parties

4.403 At the first meeting of the panel with the parties, **Korea** further advanced its arguments under Article 4.2(a) as follows:

4.404 As to the more general substantive points raised by an examination of serious injury and causation, Korea maintains:

(a) the Agreement on Safeguards does not require application of all the specific injury criteria set out in Article 4, but refers Members to criteria that should be considered if relevant, and of an "objective and quantifiable nature"

(b) the Agreement on Safeguards does not provide any indication as to how these criteria of injury are to be assessed. In the view of Korea, it is not possible to challenge a safeguard measure by examining individual injury criteria, since individual criteria need to be correlated to general trends and to other relevant criteria. For example, could an examination of changes in domestic production indicate anything about serious injury unless correlated to data concerning changes in imports and consumption?; and

(c) the Agreement on Safeguards does not require that a Member show causation in specific manner.

4.405 WTO Members should be allowed to set more onerous standards than the Agreement on Safeguards for the imposition of safeguard measures (as indeed the European Communities do). Korea only has to comply with Agreement on Safeguards. In its view, the consideration of this case, and the notification and consultation procedures were in full conformity with that Agreement.

4.406 Looking at the injury criteria it considered as relevant, objective and quantifiable, the Korean investigation concluded that the imports of cheap SMPP had increased, that serious injury had been suffered by the domestic industry, and that the serious injury was caused by the increased imports. The Korean investigation took into account a number of factors demonstrating a causal link between the increased imports and serious injury, and discounted factors that had an insignificant or limited effect.

4.407 More specifically, there was an increase in imports both in absolute and relative terms. In 1993, the amount of SMPP imported was 3,217 tonnes. The amount increased to 15,561 tonnes in 1994, 28,007 tonnes in 1995 and 16,320 during the first half of 1996. Based on the above data, Korea found that imports had increased during the period of investigation.

4.408 There was also a significant increase in imports of SMPP relative to domestic production of raw milk. While the annual growth rate of raw milk production was 3.2 per cent in 1993, 4.2 per cent in 1995, and 4.4 per cent in the first half of 1996, the

annual growth rate of SMPP was 384 per cent in 1994, 80 per cent in 1995, and 16.9 per cent in the first half of 1996.

4.409 Korea also undertook a profit and loss analysis of the Korean industry, which also showed serious injury. Both the raw milk and milk powder sectors of the Korean industry incurred heavy losses during the investigation period. As to the raw milk sector, the European Communities claimed in its First Submission that the dairy farmers of Korea are guaranteed a "very high price" by the Government. However, the reference price was only suggested and not guaranteed, and did not even cover the cost of production. For example, in 1996, the production price *per* 100 kg was 899 Won above the suggested reference price. The milk powder sector also showed a great loss. The slight profit of 196 Won *per* kg in 1993 turned into a heavy loss of 1,184 in 1996. There was also a significant rise in unemployment in the domestic industry due to the imports of cheap SMPP.

(e) Rebuttal Arguments Made by the European Communities

4.410 The **European Communities** made the following arguments in rebuttal:

(i) The Requirements of Article 4.2(a) Agreement on Safeguards

4.411 In essence, the **European Communities** complain that Korea should have investigated all the relevant facts, and not, as put forward by Korea, "the facts before it". The investigating authority must gather all the facts which are available in order to conduct an assessment of the facts as a whole. This is necessary to meet the requirements of Article 4.2 of the Agreement on Safeguards, notably that the authority must conduct an evaluation ("detailed analysis of the case under investigation") and that, in addition to it, it must engage in a "demonstration of the relevance of the factors examined").[168]

4.412 Korea omitted consideration of certain of the injury factors listed in Article 4.2(a). Also, certain conclusions drawn by Korea could not be supported by the facts listed, or could not logically follow from them. As a previous Panel once had the opportunity to note, it is not sufficient for an authority to refer to the evidence it considered and state its conclusion:

> "It was incumbent upon the investigating authorities to provide a reasoned opinion explaining how such facts and arguments had led to their finding." [169]

4.413 In addition, Article 4.2(a) of the Agreement on Safeguards and the precedents quoted in the EC First Written Submission[170] confirm that the standard of review is

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[168] *See,* Article 4.2(c) of the Agreement on Safeguards, summarizing this.

[169] *See,* Panel Report on *Brazil - Imposition of Provisional and Definitive Countervailing Duties on Milk Powder and Certain Types of Milk from the European Economic Community*, adopted by the Committee on Subsidies and Countervailing Measures on 28 April 1994, SCM/179, and Corr.1, para 286.

[170] *See,* Panel Report in *US - Shirts and Blouses*, 6 January 1997, *supra*, footnote 45, WT/DS33/R; *US - Underwear*, *supra*, footnote 33.

for the Panel to verify whether the investigating authority considered "all relevant facts", not "the facts before the investigating authorities".

4.414 Korea cannot excuse its failure to consider all the relevant facts and all the injury factors mentioned in Article 4.2(a) Agreement on Safeguards by claiming that it need only provide an adequate explanation of how the facts before it as a whole supported its determination. The European Communities submit that it is necessary, at a minimum, for a serious injury determination under the Agreement on Safeguards to demonstrate that the relevance or otherwise of each of the factors listed in Article 4.2(a) of the Agreement on Safeguards was considered. The European Communities would further submit that that provision requires each injury factor to be properly analyzed unless it is explained for what reason the injury factor may be disregarded. It is true that no injury factor "in isolation" can establish serious injury but that does not excuse a failure to examine them all.

(ii) Failure to Examine Correctly all Relevant Factors of an Objective and Quantifiable Nature Having a Bearing on the Situation of the Domestic Industry

(a) Profitability and prices

4.415 The 24 March 1997 Notification of Korea provided no information as to the profitability of its dairy farmers. It was only in its First Written Submission that Korea, for the first time, supplied data in this respect, and subsequently stated, in answer to a question by the European Communities, that surveys on production cost are implemented every year, including during the period of the KTC investigation. This, in the first place, shows that contrary to what Korea has said, it was possible to gather those data and meet the obligation to consider them in the investigation.

(1) Raw milk prices

4.416 The European Communities have explained their view that the "suggested price" for milk in Korea, although arguably not formally binding, has considerable practical force. The European Communities based its assumption on Korea's statement, in its 24 March Notification, that

> "The price of milk powder is subject to change according to market forces of supply and demand, although that of *raw milk* is *maintained at a stable level fixed by the government*".[171]

4.417 Additionally, the Dairy Industry Promotion Act states:

> "Article 3 (the Dairy Committee)
>
> (a) The Dairy Committee, which belongs to the Minister of Agriculture and Forestry, shall be established to deliberate on important matters for dairy industry promotion.
>
> (b) The organization, tasks and operations of the Dairy Committee shall be determined by Presidential Ordinance."

[171] *See* G/SG/N/10/KOR/1/Suppl.1, 1 April 1997, Section IV.3.7, p. 10 (emphasis added).

"Article13 (maintenance of prices)

> (1) The Minister of Agriculture and Forestry is able to decide specifications and appropriate prices of raw milk in consultation with the Dairy Committee."

"Article 14 (mediation of disputes)

> (1) In case there is a dispute concerning raw milk transactions, both parties or one party of the dispute are able to apply for mediation to the Minister of Agriculture and Forestry.
>
> (2) In case there is an application for mediation in accordance with the previous provision, the Minister of Agriculture and Forestry shall make a mediation and decision in consultation with the Dairy Committee.
>
> The details such as methods and procedures of the mediation stipulated in the previous provision shall be determined by Ordinance of the Ministry of Agriculture and Forestry."

4.418 Furthermore, if a particular milk processor is paying to dairy farmers less than the prices decided by MAF, dairy farmers have the legal right to take the milk processor to court on the basis of the Dairy Industry Act. In fact, a group of dairy farmers are presently carrying out legal action against Haitai Dairy on the grounds that they did not receive the guaranteed raw milk price decided by MAF under the Dairy Industry Act.[172]

4.419 The European Communities argue that Korea admits that the "suggested prices" are sufficiently reliable to justify a conclusion on the profitability of the raw milk producers, that is, dairy farms. Further strong supporting evidence that the price set by Ministry of Agriculture and Forestry ("MAF") is a guaranteed minimum price is found in the statistics for the production cost of milk powder supplied by Korea in answer to a question by the Panel. These were not previously made available.

4.420 Taking the 1993 figures in Korea's table as an example:

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[172] For example, the following article appeared in the Agriculture, Fisheries and Livestock News of October 19, 1998 (Exhibit EC-23).

> "Subject : The Ministry of Agriculture and Forestry (MAF) urged Haitai Dairy Co., Ltd. to pay unpaid prices of raw milk, 12.3 billion won (approx. US$ 9.8 million) as soon as possible.
>
> MAF has urged Haitai Dairy, which applied for the court mediation for rescheduling of debt repayment to the Suwon District Court, to pay raw milk prices, which are generally recognised as wages, as soon as possible. On October 15, 1998 Mr. Nam-Chul Kim, Director of the Livestock Administration Division of MAF stated 'Raw milk prices have to be generally recognised as wages' and 'when the payment of raw milk prices is continuously deferred, dairy farmers will have difficulties in keep a normal level of living, and will have difficulties in paying for animal feed, and will be eventually bankrupt.
>
> If Haitai Dairy does not pay for the prices of raw milk appropriately, the Government will be forced to take appropriate measures. In relation to this matter MAF asked the Suwon District Court to give cooperation so that the prices of raw milk for which payment is deferred will be paid regardless of the application for the court mediation for rescheduling of debt repayment."

- The manufacturing cost for milk powder (F in the table) is stated as 5,158 Won/kg.
- The proportion of this cost which is accounted for by the raw material is stated as 82.7 per cent, giving a price of 5,158 x 82.7 per cent = 4,266 Won/kg.
- Korea has stated that the ratio between milk powder and raw milk is 1:10 (*i.e.,* 10 units of raw milk are needed to produce 1 unit of milk powder).
- The price at which the raw milk producers sold to the milk powder companies can therefore be shown to be 4,266 ÷ 10 = 427 Won/kg.
- The MAF price for raw milk in 1993 was 394 Won/kg, so the milk powder companies were paying on average 8 per cent above the MAF price.

4.421 Performing this calculation for all of the relevant years gives the following results:

SELLING PRICE OF RAW MILK FOR MILK POWDER PRODUCTION, 1993-96

	1993	**1994**	**1995**	**1996 (1-4)**
Manufacturing cost (W/kg)	5,158	5,426	5,860	6,178
Raw material as % of total	82.7%	84.2%	82.9%	85.7%
Raw milk selling price	427	457	486	529
MAF price (W/kg)	394	394	414	431
Premium for raw milk sold for milk powder over the MAF price	+ 8.3%	+ 16.0%	+ 17.4%	+ 22.7%

4.422 based on this information, the European Communities observed:

- Firstly, actual raw milk sales prices, do respect the MAF prices *and on average are higher.*[173] Since the sale prices of raw milk for milk powder production would be expected to be at the lower end of the market, (Korea has stated that it is surplus raw milk production which goes for milk powder) prices for other purposes can be expected to be higher.
- Secondly, the Korean Government did in fact have available to it information on raw milk transaction prices, at least on an overall basis, which would have enabled it to include an examination of this in the safeguards investigation.

(2) Dairy farm profitability

4.423 Regarding the profitability of dairy farms, Korea indicated in the bilateral consultations with European Communities that this could not be examined by the

[173] *See,* WTO Doc. G/SG/N/10/KOR/1/Suppl.1, 1 April 1997, Section V.2.4, p. 17, where Korea describes the price set by the government as a "base price".

KTC investigation because this information was not available. In its First Written Submission Korea contradicts this by seeking to demonstrate the poor level of profitability of its dairy farms by using on the one hand the government "suggested" prices as a "surrogate" for actual transaction prices, and on the other hand production costs, which it now admits are "annually published and publicly available" in the 'Annual Report of Livestock Production Cost Survey'.

4.424 The EC assertion that "producers are guaranteed a very high price for their raw milk" is borne out, and even extended, by the additional information supplied by Korea. It is stated that "the MAF suggests the raw milk price reflecting changes in the production cost". This implies that MAF has knowledge of the production costs each year and uses them to set a "suggested price" which will guarantee a profit to dairy farmers.

4.425 Korea uses profitability figures to show the supposed injury caused to dairy farmers. However, these profitability figures are based only on MAF reference prices which, as has been shown above, are a minimum rather than a norm to be followed.

4.426 The European Communities maintain that the figures provided in Korea's table on price and production costs of raw milk may be misleading. The cost of raw milk production is compared there only with the MAF reference price. However, if the cost of production is compared with the price received for milk powder production, a very different picture emerges:

PROFIT MARGIN OF DAIRY FARMERS SELLING RAW MILK FOR MILK POWDER, 1993-96

	1993	**1994**	**1995**	**1996**
Reference price (W/kg)[174]	394	394	414	431
Production cost (Won/kg)	401	389	413	465
Sale price for milk powder	427	457	486	529
Difference: profit (W/kg)	+ 26	+ 68	+ 73	+ 64
Profit as % of production price	6.5%	17.5%	17.7%	13.7%

4.427 Based on this table, the European Communities assert that, at least as far as sales of raw milk for milk powder are concerned, these remained very profitable for the dairy farms throughout the KTC investigation period. In fact, at the very time when imports of SMPP increased significantly, in 1994 and 1995, the profitability of dairy farms in this area increased significantly too.

4.428 Therefore, not only was the profitability of dairy farmers significantly greater than Korea has indicated, but also there is no evidence of injury at the time when SMPP imports were increasing. Not only did Korea not properly investigate this issue when this was perfectly feasible, but it is also clear that the result of this investigation would have been that no injury was being caused to dairy farms.

[174] The reference prices shown in Korea's First Submission do not coincide with those submitted by Korea to the OECD. In this table the latter figures have been used.

4.429 Korea's reply to a question by the European Communities indicate the magnitude of government loans for each dairy farm - this also is newly supplied information.

KOREAN GOVERNMENT LOANS TO DAIRY FARMS, 1993-96

	No of dairy farms receiving loans	% of total dairy farms receiving loans	Total value of loans (million Won)	Average loan per household (Won)
1993	19,306	68.4%	3,911	202,000
1994	19,549	76.2%	69,402	3,550,000
1995	20,052	85.3%	72,936	3,637,000
1996	13,353	60.4%	91,959	6,887,000

This table shows that the vast majority of Korean dairy farmers[175] are in receipt of very generous loans, at a time when their operations were rather profitable. Also, there seems to have been a clear shift in government policy in 1996, lending substantially more money, but to only two-thirds of the number of farmers compared with the previous year.

(3) Milk powder prices and profitability

4.430 As regards *milk powder* prices, which are provided in the 24 March Notification[176], the European Communities recall that they show a remarkable stability and that the decrease in the first four months of 1996 is explained by Korea itself as a "temporary phenomenon", which therefore cannot, explain the reduction in profitability.

4.431 The table on the selling price of raw milk for milk powder production 1993-96, in the EC view clearly demonstrates that the problems facing the milk powder companies during the period of the KTC investigation stem principally from the increasingly high prices which they were having to pay for their raw material, prices which were increasing even faster than the guaranteed MAF price. This shows that any decline in profitability of the milk powder companies can be directly related to a corresponding increase in the profits of the dairy farmers, since the cost of the raw material accounted for between 82.7 per cent and 85.9 per cent of manufacturing costs in the period 1993-96.

4.432 Referring to the basic economic laws of supply and demand, one would conclude that this increase in the price of raw milk for milk powder production must be due to a shortage of supply of the raw material. This entirely reasonable hypothesis would serve to explain why Korean dairy companies increased their imports of SMPP during the KTC investigation period.

[175] It should also be noted that the above figures contradict the assertion by Korea that it sought to assist the domestic industry by providing virtually all 28,219 farms with loans to improve their competitiveness. At no time in the four years indicated above did the government provide loans to more than 20,052 farms, only 69.6 per cent of the total 28,219 farms quoted - this is, in the EC's view hardly "virtually all".

[176] *See,* WTO Doc. G/SG/N/10/KOR/1/Suppl.1, 1 April 1997, Section IV.3.7, p. 10.

4.433 In fact, Korea states that "the shortage of milk began to be eliminated from the end of 1994". This begs the question as to when the shortage actually ended (when was the end rather than the beginning of the end?) It also fails to explain why raw material prices for milk powder continued to rise so much after the end of 1994 and why over 7,500 tonnes of milk powder was imported in 1995, in addition to the increased imports of SMPP.

4.434 In conclusion, it is obvious to the European Communities that neither the imports of a given product nor their trends have any relation whatsoever with the production costs of the competing domestic products and therefore with any decrease in profitability resulting from an increase in such costs. Korea milk powder companies' profits are crucially dependent on the cost of the raw material. In the period 1993-96 they were paying a price significantly higher than the MAF price for their raw material. Profitability could have been very easily restored by reducing their raw milk purchase price, and it is not clear why this step was not taken.

(b) Employment

4.435 The European Communities observed that, in relation to dairy farms the only evidence brought forward is the decline in the number of farms. In its view, the European Communities have put forward to demonstrate that this is largely due to a consolidation and rationalization in the industry. None the less the questions remain. In Korea's reply to a question by the European Communities it is stated that "there is no difference between the terms 'dairy farms' and 'dairy households'". A number of points remain unclear, due to Korea's asserted failure to investigate basic data on this point, in particular:

- the number of people in the households who are actually employed on the farms;
- the number of people outside of the households who are employed on the farms;
- the number of people in the 'households' who can be considered as full-time farmers;
- the number of people in the households who are not full-time but generate the majority of their income from the farms;
- the age structure of the dairy farmers

4.436 Without an investigation of such data it is impossible to reach an appropriate conclusion on employment patterns in the dairy farms.

(c) Cheese imports

4.437 Another possible causal factor which was not examined in any way by Korea is the level of cheese imports. This is rather surprising in view of the statement in the OAI Report notes that cheese imports have "direct influence on consumption of domestic raw milk."[177] This is followed by the equally puzzling assertion that "considering the characteristics of the analysis, data on cheese imports was excluded", without giving any justification for such an exclusion.

[177] *See,* OAI Report, p. 16, footnote.

(f) Rebuttal Arguments Made by Korea

4.438 **Korea** makes the following rebuttal arguments:

4.439 As an initial matter, Korea notes that in conducting its analysis, the Korean authorities explained that:

> "[b]ecause the raw milk and milk powder are inextricably linked, it is useful to analyze both industries as a whole, and then examine the milk powder separately. Towards this end, the investigation team will first analyze the raw milk industry which includes milk powder industry and then conduct a separate analysis of the milk powder industry for the sake of clarity."[178]

(i) Imports of SMPP in Absolute and Relative Terms

4.440 Under Article 4.2(a) of the Agreement on Safeguards, the competent authorities must examine the rate and amount of the increase in imports of the product concerned in absolute and relative terms. The competent authorities stated that "[i]t is essential to examine whether the import of SMPP subject to investigation increased absolutely or whether they increased relatively compared to domestic production."[179] The Korean authorities examined imports of SMPP in absolute terms:

IMPORT OF SMPP SUBJECT TO INVESTIGATION[180]

(unit: tonnes, thousand dollars, %)

	1993	**1994**		**1995**		**Jan.-Aug. 1996**	
			Increase rate(%)		Increase rate(%)		Increase rate(%)
Quantity	3,217	15,561	384	28,007	80	22,140	16.9
Value	7,037	32,851	366	59,837	82	55,021	40.7

Source : Korea International Trade Association (KITA)

4.441 The Korean authorities noted an absolute increase from 3,217 tonnes in 1993 to 15,561 tonnes in 1994, 28,007 tonnes in 1995 and 22,140 tonnes in 1996 (Jan.-Aug.), reflecting an increased rate of 384 per cent in 1994 from the previous year, 80 per cent in 1995 and 16.9 per cent in the first six months of 1996.

4.442 The Korean authorities then examined imports of SMPP in relative terms:

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[178] OAI Report at 37. The competent authorities determined that milk powder and SMPP are not like products due to the differences in physical characteristics as SMPP contains on average 80 per cent milk powder. However, they are directly competitive products. The Government of Korea respectfully suggests that the Panel should compare SMPP with milk powder on a 1 to 1 basis, not just in relation to 80 per cent of SMPP as the EC contends in its First Submission. SMPP cannot be divided, whether commercially or actually, into milk powder and other ingredients.

[179] OAI Report at 32.

[180] OAI Report at 32. *See,* also Notification IV.2. Contrary to the EC's claim that Korea failed to remove the volume of "excluded" products before doing its calculations, Korea refers the Panel to the OAI Report at 7.

RELATIVE CHANGE OF IMPORT SHARE IN DOMESTIC DEMAND[181]

(unit *:* tonnes)

	1993	1994		1995		Jan.-Jun. 1996	
			Increase rate(%)		Increase rate(%)		Increase rate(%)
Total Demand (A)	2,025,063	2,218,738	9.6	2,303,795	3.8	1,153,964	-2.3
Production of raw milk	1,857,873	1,917,398	3.2	1,998,445	4.2	1,069,224	4.4
Import of SMPP (B)	3,217	15,561	384	28,007	80	16,320	16.9
Market Share of SMPP (B/A, %)	1.6	7.0	-	12.2	-	14.1	-

Source *:* MAF and KITA
Notes *:* Market share is computerized by using the figures calculated in terms of imported raw milk.

The table above indicates the relative increase in imports of SMPP was 384 per cent as compared to 3.2 per cent increase in the production of raw milk in 1994, 80 per cent as compared to 4.2 per cent in 1995, and 16.9 per cent as compared to 4.4 per cent in the first half of 1996.

(ii) Profits and Losses

4.443 The Korean authorities determined that it was not feasible to accurately calculate the income of all 23,000 Korean dairy households, which are, for the most part, small and unsystematic.[182] Because profits and losses of the dairy households were not available[183], the competent authorities used profit and loss information from the cooperatives' milk processing activities as a surrogate for the profits and losses of the domestic industry covering dairy households and livestock cooperatives. The aggregate ordinary profit of all 14 livestock cooperatives in milk processing activities decreased from 6,720 million Won in 1993, 4,721 million Won in 1994, 209 million Won in 1995 to -17,546 million Won during the first half of 1996, while the ratio of ordinary income (loss) to sales (expenditure) decreased from 1.4 per cent, 0.8 per cent, 0.0 per cent to -5.3 per cent, respectively.[184] As explained by the Korean authorities in the OAI Report:

> "[s]ince the livestock cooperatives, which are comprised of dairy households producing raw milk, distribute their profits to their

[181] OAI Report at 35. *See,* also Notification at IV.2 and IV.3.1.
[182] Notification at IV.3.10.a.
[183] Using the suggested reference price as a surrogate for the raw milk price, it should also be noted that dairy households experienced declining profit margins during the investigation period.
[184] Notification at IV.3.10.a.

members, the livestock cooperatives' profits and losses are directly linked to the raw milk producers' income.[185]

4.444 The Korean authorities examined whether the livestock cooperatives made sales below manufacturing costs and determined that the sales price of milk powder was higher than the manufacturing costs by 196 Won/kg in 1993. However, the cooperatives incurred losses of 132 Won/kg in 1994 and the negative margin grew larger to 472 Won/kg in 1995 and further to 1,184 Won/kg in the January-to-April period of 1996.[186]

PRICE AND PRODUCTION COST OF KOREAN MILK POWDER

(unit*:* Won/kg)

	1993	***1994***	***1995***	***1996(1-4)***
Sales Price[187]	5,354	5,294	5,388	4,994
Production Cost[188]	5,158	5,426	5,860	6,178
Profit\Loss[189]	196	-132	-472	-1,184

4.445 To complete the analysis of profit and loss of the entire domestic industry, the Korean authorities also examined the profit and loss statements for milk processing companies that produce a majority of milk powder within this sector. Additionally, they reviewed profit and loss data for two livestock cooperatives which also account for a majority of milk powder production within this sector[190].

4.446 The authorities examined sales and gross profit(loss), operating loss, and ordinary loss.[191] Non-confidential information regarding this examination included (a) a decreasing trend in the two cooperatives' net turnover from milk powder operations from 11,937 million Won in 1993, 9,533 million Won in 1994, 11,589 million Won in 1995, and to 2,310 million Won during the first four months of 1996[192], (b) a decrease in the turnover from milk powder operations of the milk processing companies from 21,010 million Won in 1994 to 19,750 million Won in 1995[193], (c) an increase in operating losses from the milk powder operations of the

[185] OAI Report at 41. *See,* also Notification at IV.3.10.a. In its response to a question by Korea, the EC states that the price paid by the cooperatives for milk powder is inversely related to the profitability of dairy farmers. Korea submits that where, as in this case, the cooperatives are required to purchase raw milk from dairy farmers at a price that is unprofitable for the farmers (either because the price is below cost or because the payment is in part in the form of milk powder) and convert the raw milk into unsaleable inventory, no such inverse relationship exists.

[186] OAI Report at 54. *See,* also Notification at IV.3.8-.9.

[187] OAI Report at 47.

[188] OAI Report at 53

[189] *Ibid.*

[190] OAI Report at 50. *See,* also Notification at IV.3.10.b. Contrary to the EC's erroneous observations in its First Submission where it states that 'Korea's examination of the profitability of the domestic industry is not in conformity with Article 4.2(a) of the Agreement on Safeguards since it does not examine the whole of an interconnected industry', the Korean authorities carried out a profit and loss analysis covering the *entire* domestic industry.

[191] OAI Report at 50.

[192] Notification at IV.3.10.b.i.

[193] *Ibid.*

livestock cooperatives from 755 million Won in 1993, 622 million Won in 1994, 1,244 million Won in 1995, and 681 million Won in the first four months of 1996,[194] and (d) an increase in corresponding operating losses sustained by milk processing companies from 680 million Won in 1994 to 1,330 million Won in 1995.[195]

4.447 In conclusion, the competent authorities considered the profit and loss of the dairy households by looking at the profit and loss of the livestock cooperatives to which they belong and of which they are shareholders. Because livestock cooperatives are owned by dairy farmers who contribute to the paid-in capital, the health of the dairy households may be considered through the financial position of the livestock cooperatives. Facts set out in the OAI Report indicated that the livestock cooperatives incurred serious losses during the investigation period. Therefore, the OAI found that the depression in domestic prices caused by the imports of cheap SMPP prevented the livestock cooperatives from increasing their sales prices.[196] By the same token, milk processing companies incurred losses because their milk powder was more expensive than SMPP[197].

(iii) Sales and Sales Price

4.448 As the European Communities correctly indicated in their first submission, the competent authorities examined changes in the level of sales based on an examination of consumption information for domestic raw milk. The consumption of domestic raw milk was:

> "1,844,463 tons in 1993, 1,947,128 tons in 1994, 1,947,965 tons in 1995, and 984,934 tons in the January-June period of 1996. The consumption increase rate was 5.6 per cent for 1994, 0.0 per cent for 1995, and -2.0 per cent for the January-June period of 1996.[198]"

4.449 The Korean authorities also examined prices for the entire domestic industry. Because Korea recommends a reference price for raw milk, while the price for milk powder varies in accordance with changes in supply and demand in the market,"[199] the Korean authorities reviewed the price of milk powder. However, it should be noted that any impact of declining domestic milk powder prices adversely affected the entire domestic industry, since raw milk producers own the livestock cooperatives.[200] The authorities identified the following trend in nominal prices:[201]

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[194] Notification at IV.3.10.b.ii.

[195] *Ibid.*

[196] OAI Report at 62.

[197] *Ibid.*

[198] OAI Report at 38. *See,* also Notification at IV.3.3.

[199] OAI Report at 48. *See,* also Notification at IV.3.7.

[200] Korea refers the Panel to the more detailed discussion of prices in the context of causal link below.

[201] In its Response to a question by Korea, the EC states that "it does not entirely understand what is meant by Korea with the term 'real price'. The real price of a product is its price adjusted by the rate of inflation which reflects, for example, increases in production costs. In developing countries like Korea, which have annual inflation rates of several percent, what really matters is the trend of the real price, rather than its nominal price. Real price of domestic milk powder declined substantially during the investigation period.

CHANGES IN SELLING PRICES OF DOMESTIC MILK POWDER[202]

(unit*:* Won/kg.)

	1993	1994	1995	1996. 1-4
Prices	5,354	5,294	5,388	4,994

Data: Provided by NLCF to the KTC.
Note: According to the *Dairy Handbook*, whole milk powder price, which stood at 5,100 Won/kg. in 1993 declined to 4,700 Won/kg. in 1994.

4.450 The Korean authorities also examined price data from May to August 1996 and determined based on confidential data that the most recent prices for domestic whole milk powder ranged from 2,900 to 4,500 Won/kg and skimmed milk powder from 3,800 to 4,200 Won/kg.[203] The OAI Report considered and evaluated the decline in prices, but given the confidentiality attached to actual sales prices could only publish the following table:

TREND OF DOMESTIC MILK POWDER PRICES[204]

	Date	Seller (Cooperative)	Buyer (Firm)	Price (Won/kg.)	Volume (kg.)
Whole Milk Powder	96-8-24	Seoul Milk Producers	Urimil Co.	x,xxx	Xx
	96-7-29	Chongju Milk Producers	Haptong Co.	x,xxx	x,xxx
	96-4-27	Kwangju/Chonnam	Puch'on Co.	x,xxx	x,xxx
	96-7-4	Kwangju/ Chonnam	Ugwang Co.	x,xxx	xx,xxx
	96-5-31	Kyongnam Dairy	Sobu Co.	x,xxx	x,xxx
	96-7-29	Kyongnam Dairy	Sobu Co.	x,xxx	x,xxx
Skimmed Milk Powder	96-5-29	Taebaek	Sejin Co.	x,xxx	xx,xxx
	96-8-26	Umsong	Namyang co.	x,xxx	xx,xxx

Data: Provided by NLCF to the KTC.

4.451 In conclusion, the Korean authorities determined that the decline in sales of domestic products would have been much higher and more rapid had the Korean milk powder producers not sold milk powder at below production cost.

[202] OAI Report at 48. *See,* also Notification at IV.3.7 (including the price comparison table).
[203] OAI Report at 48.
[204] *Ibid.*

4.452 Regarding the suggested reference prices for raw milk Korea stated that the NLCF recognizes the suggested reference price for raw milk established by the Government of Korea. This scheme in no way guarantees the Korean dairy farmer a profit[205]. Indeed, in certain years, the price suggested by the Government of Korea was lower than the average production cost of the Korean dairy farmer[206]. Further, in times of difficulty, it is normal for the livestock cooperatives to pay dairy farmers partially in kind. This usually takes the form of 70-80 per cent cash and up to 20-30 per cent milk powder[207].

4.453 Korea considers that the EC's statement that "producers are guaranteed a very high price for their raw milk" is misleading. The price suggested by the Government of Korea, particularly when compared to the production cost, is not very high. Furthermore, the Korean government does not impose a guaranteed price, but only provides a suggested reference price to facilitate a fair transaction between individual dairy farmers and large users of raw milk, such as processing companies. This price is forecasted by the government taking into account inflation and production costs. It does not necessarily result in a price that covers production costs, which was the case in 1996.

4.454 The Korean government does not set a guaranteed price, but only provides a suggested reference price. In addition, dairy farmers may sell a virtually unlimited quantity of their production, but when the market for milk powder declines and inventories rise, as was the case during the investigation period, cooperatives often pay for raw milk in a combination of cash and milk powder[208].

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[205] *See* Notification Pursuant to Article 12.1.(C) of the Agreement on Safeguards, G/SG/N/10/KOR/1/Suppl. 1, (1 April 1997), Paragraph V.2.4. *See* also EC's First Submission, Exhibit EC-10.

[206] It is important to note that the prices suggested by the Government of Korea, while slowly increasing, do not fully reflect the increase in the prices within Korea. Therefore, the real price equivalent has in fact declined. For the period 1982-1996, farmers, including dairy households saw an increase of 81.1 per cent in the cost of their inputs (as a result of inflation), while the government suggested price for raw milk only increased by 37.7 per cent. *See* Korean National Statistical Office, *Major Statistics of the Korean Economy, 1998.3,* p.151.

[207] *See*, for example, the *Livestock Farming Newspaper* dated 30 April 1996 (*See* Exhibit Korea-1) noted that:

> "Financial difficulties facing small-scale dairy cooperatives have been aggravated due to the increased milk stockpile, so that most of them are paying partly in milk powder for purchases of raw milk', said an official of the NLCF.
>
> He added 'For example, recently Kyungnam Dairy Cooperative and Pusan-Kyungnam Milk Cooperative are making payments in kind for up to 20 per cent of their purchases of raw milk. If the milk powder stockpile continues to increase, dairy cooperatives will have to pay in milk powder and not in cash.'
>
> In addition, he urged the Government to establish policy measures for reducing the current huge milk powder stocks."

[208] The percentage increase in the membership of the NLCF increased during the investigation period. This increase was a direct result of the increase in imports of SMPP, since as these replaced Korean raw milk, farmers that had sold raw milk directly to processing companies were now faced with stiff competition from SMPP. In order to get rid of the raw milk, they had to sell to cooperatives, and in order to sell to cooperatives, they had to be members of those cooperatives.

(iv) Employment

4.455 The Korean authorities found that the number of dairy households declined during the investigation period as seen in the following table:

CHANGES IN THE NUMBER OF DAIRY HOUSEHOLDS[209]

	1993	1994		1995		1996. 1-6	
			Increase Rate (%)		Increase Rate (%)		Increase Rate (%)
Number of Dairy Households	28,219	25,667	-9.4	23,519	-8.4	22,725	-3.9

4.456 Contrary to the EC claims, the reduction in the number of dairy households is not a result of any Korean Government programmes. Indeed, the dairy households were provided with loans from the Livestock Development Fund to maintain their competitiveness:[210]

4.457 With respect to domestic milk powder production, the Korean authorities stated:

> "As the milk powder production became automated, the number of workers employed in milk powder production decreased over the years. Currently, very few people are fully employed for the exclusive purpose of engaging in milk powder production. Workers producing other dairy products are used temporarily, when needs arise, to engage in milk powder production. Accordingly, employment and wage are insignificant factors in operating milk powder business.[211]"

4.458 Therefore, because unemployment increased in the raw milk sector and was an insignificant factor in the milk powder sector, the Korean authorities considered that employment declined during the period of investigation for the whole domestic industry.[212]

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[209] OAI Report at 40. *See,* also Notification at IV.3.6.

[210] Loans were not provided to consolidate or rationalize the industry since these loans were not provided to encourage dairy farmers to relocate and find other means of livelihood. The loans were paid exclusively for dairy business purposes and the farmers had to repay the outstanding loans amounts once they left the dairy industry. The EC's reference to the Dairy Industry Plan which sought to reduce the size of the Korean dairy industry by 5.9 per cent is irrelevant since the Plan only took effect in August 1997 and the investigation of the dairy industry in this case ended in October 1996.

[211] OAI Report at 49. *See,* also Notification at IV.3.6.

[212] Contrary to the EC's contentions, the Korean authorities did investigate employment for the whole domestic industry and considered that declining dairy farming households properly represented declining employment in the Korean dairy industry. In response to a question by Korea, the EC tells Korea how to interpret its data on dairy households and essentially refers to any examination of a factor that differs from how the EC would have examined such factor as the failure to examine the factor at all. Korea considers that the Panel should not evaluate this case based on the EC's view of how the EC itself would have conducted the investigation.

(v) Inventory

4.459 For the domestic industry as a whole, the Korean authorities examined changes in the level of inventory. The authorities stated:

> "The amount of domestic milk powder in inventory was 4,509 tons at the end of 1993, 1,517 tons at the end of 1994, 6,565 tons at the end of 1995, and 14,994 tons at the end of June 1996. As such, the inventory rate of raw milk which slightly decreased from 2.4 per cent in 1993 to 0.8 per cent in 1994 increased to 3.3 per cent in 1995 and further to 13.0 per cent in the January-June period of 1996. The total value of raw milk inventory as of June 1996 is 92,633,000,000 Won."[213]

4.460 Increase of milk powder inventory is clear evidence of serious injury in this case not only to the milk powder industry, but also to the entire domestic industry. As explained above, raw milk that is not consumed has to be converted into, *inter alia,* milk powder. Conversion only increases supply and inventory of milk powder. Therefore, increased milk powder inventory not only indicates oversupply of milk powder but also demonstrates displacement of domestic raw milk by cheap imported SMPP, thus signifying serious injury to the entire domestic industry.

4.461 The Korean authorities then presented the supply and demand for raw milk (including milk powder) as follows:

SUPPLY AND DEMAND OF RAW MILK (INCLUDING MILK POWDER)[214]

	1993	**1994**		**1995**		**1996. 1-6**	
			Increase Rate (%)		**Increase Rate (%)**		**Increase Rate(%)**
Total Demand (A)	2,025,063	2,218,738	9.6	2,303,795	3.8	1,153,964	-2.3
Domestic Raw Milk Consumed (B)	1,844,463	1,947,128	5.6	1,947,965	0.0	984,934	-2.0
Production (D)	1,857,873	1,917,398	3.2	1,998,445	4.2	1,069,224	4.4
Inventory (E) (in terms of Raw Milk)	4,509 (45,090)	1,517 (15,170)	-65.4	6,565 (65,650)	332.8	14,994 (149,940)	342.7
Inventory Rate (E/A, %)	2.4	0.8	-	3.3	-	13.0	-

[213] OAI Report at 38. *See,* also Notification at IV.3.5.
[214] OAI Report at 39.

	1993	1994		1995		1996. 1-6	
			Increase Rate (%)		Increase Rate (%)		Increase Rate(%)
Domestic Raw Milk's Market Share (B/A, %)	91.1	87.8	-	84.6	-	85.4	-

Data: MAF

Notes: 1) Total demand reflects demand for raw milk, imported milk powder, SMPP, and milk powder in stock.

2) Inventory, inventory rate and the consumption amount are calculated based on the amount of milk powder calculated in terms of the conversion ratio when converting milk powder to raw milk.

4.462 The increased inventory incurred a significant amount of costs.[215] Even if depreciation is disregarded, the cost of inventory amounted to 17.3 billion Won (approximately US$21.6 million) during the investigation period. The inventory costs during the first six months of 1996 alone were 5.8 billion Won (approximately US$7.3 million), and the domestic producers were compelled to incur the full inventory cost because, unlike the European Communities, Korea does not subsidize the inventory costs of milk powder.

(vi) Investment

4.463 The Korean authorities evaluated investment in the raw milk and milk powder sectors of the domestic industry. The only investment information for the raw milk sector was based on the amount allocated to dairy farmers by the Dairy Cow Competitiveness Enhancement Programme.[216] This project was necessary because of the inability of the raw milk sector to attract investment.[217] The authorities also evaluated investment in the livestock cooperatives as an indicator of injury to the whole industry, given the ownership of the cooperatives by the raw milk producers.[218] The authorities' evaluation showed, *inter alia*, that total investment, which includes research and development, declined significantly over the investigation period and that there was virtually no investment made in the milk powder industry for purposes of expanding production facilities.[219]

(vii) Share of the Domestic Market Taken by SMPP

4.464 The Korean authorities examined the share of the total domestic market (consisting of domestic raw milk, domestic milk powder, imported milk powder, and

[215] Notification at IV.3.4
[216] OAI Report at 40.
[217] *Ibid.*
[218] OAI Report at 49.
[219] *Ibid.* Contrary to the EC's Oral Statement, page 49 of the OAI Report shows that consideration of investment was not "new and remarkable".

imported SMPP), and found that the share of the domestic market taken by SMPP increased by 12.5 per cent during the investigation period.[220]

4.465 Korea would like to clarify one point that may have caused confusion in interpreting the actual market share of SMPP in the Korean domestic market. According to the figures set out on page 58 of the OAI Report, the market share of SMPP increased from 1.6 per cent in 1993 to 7 per cent in 1994, 12.2 per cent in 1995 and 14.1 per cent in the first six months of 1996. This represents a net increase in the market share of 12.5 per cent during the investigation period. Because the product under investigation is only SMPP, the table at page 58 of the OAI Report represents an accurate measure of SMPP's share of the total market. While the market share of SMPP increased from 1.6 per cent to 14.1 per cent during the investigation period, the market share of imported milk powder *and* SMPP increased by 5.7 per cent[221](although the market share of SMPP increased by 12.5 per cent the market share of imported milk powder decreased by 6.8 per cent). This is reflected in the Table on page 17 of the OAI Report. However, as the product under investigation is SMPP, only the market share of SMPP must be emphasized, not the combined market share of imported milk powder and SMPP.

(viii) Capacity Utilization

4.466 The Korean authorities examined capacity utilization for both the raw milk and milk powder sectors of the domestic industry in the interim injury investigation report. In both sectors, capacity utilization was discounted in determining serious injury because it was considered of limited relevance, *i.e.*, it was not "of an objective and quantifiable nature having a bearing on the state of that industry", and was therefore omitted from the final OAI Report. For the raw milk sector, "[c]apacity utilization was always 100 per cent since raw milk is produced by dairy cows, which cannot be left idle like some other forms of production."[222]

4.467 For the milk powder sector, the authorities examined capacity utilization in their interim report[223] but determined that this factor had limited relevance because:

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[220] OAI Report at 58. Korea agrees with the United States comment in its third party oral submission that "Article 4.2(a) contains no numerical test or threshold requirement for market penetration, explicit or implied. Instead, Article 4.2(a) requires that the competent authority evaluate 'all relevant factors,' of which the percentage share of the domestic market is only one.". Korea cited the *United States Wheat Gluten* case in its first submission to highlight the fact that a low market penetration rate does not preclude competent authorities from making an affirmative serious injury finding based on all relevant factors and such a low rate may even be significant based on "the nature of the product and the nature of competition in the market.

[221] The EC simply alleges, whether erroneously or intentionally, that a decline of 5.7 per cent points (in market share) cannot be considered supportive of a finding of serious injury. The allegation is totally wrong in that the number of 5.7 per cent refers to the imported milk powder and SMPP combined, not the product subject to injury investigation, namely the SMPP.

[222] Notification at IV.3.2. *See,* also OAI Report at 36 ("The collection of raw milk from dairy farmers does not change simply because there is a change in demand."). The EC states that the Korean authorities' examination of capacity utilization was, in its view, not "serious" because a Korean dairy farmer with 100 cows "can choose to only have 80, if economic conditions require this." Korea does not consider that the slaughtering of 20 per cent of Korea's dairy cows is a viable remedy to the serious injury caused by increased imports of SMPP from the EC.

[223] *See,* Exhibit Korea-5.

> "Raw milk, milk powder and SMPP can be used as raw materials to produce fermented milk, flavoured milk, ice cream and other marketable milk products. An increase in SMPP affects the amount of domestic milk powder consumed and also impacts the milk powder inventories and prices. An increase in the import of SMPP also affects the amount of raw milk consumed which in turn affects the milk powder inventories and prices.[224]"

4.468 In other words, "the absolute increase of [SMPP] led to a drastic increase in the surplus of raw milk, all of which was then converted into milk powder." [225] The necessity of converting excess raw milk to milk powder means that high capacity utilization rates do not necessarily indicate an absence of injury, especially when the milk powder remains as unsold inventory. Therefore, capacity utilization was considered to have only limited relevance as an injury factor.

(ix) Production and Productivity

4.469 The Korean authorities examined production information for the whole domestic industry, stating that:

> "[t]he production amount of domestic raw milk [including milk powder] was 1,857,873 tons in 1993, 1,917,398 tons in 1994, 1,998,445 tons in 1995, and 1,069,224 tons in the January-to-June period of 1996. The increase rate was 3.2 per cent for 1994, 4.2 per cent for 1995, and 4.4 per cent for the January-June period of 1996."[226]

4.470 The authorities reasoned that an increase in production in the domestic industry does not necessarily indicate the existence or absence of injury. As they stated:

> "The production of raw milk cannot be temporarily reduced without resorting to the slaughter of dairy cows. Rather than reducing the size of their herds - the average size of which is quite small - Korean dairy farmers continue normal levels of raw milk production even during periods of weak demand, since excess raw milk is supplied to the livestock cooperatives for conversion into milk powder.[227]

4.471 Milk processing companies decreased their purchases of raw milk from dairy households, while increasing their purchase of cheaper SMPP. As milk processing companies curtailed their purchases of domestic raw milk, Korean dairy households were forced to turn to the livestock cooperatives, which were obliged to collect the unsold raw milk produced by their member dairy households. In short, the absolute

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[224] OAI Report at 37.
[225] Notification at IV.3.1. Contrary to the EC's contention, the Korean authorities examined the relevance of capacity utilization during its investigation
[226] OAI Report at 38. *See,* also Notification at IV.3.1.
[227] Notification at IV.3.1.

increase of SMPP led to a drastic increase in the surplus of raw milk, all of which was then converted into milk powder.[228]"

4.472 As to productivity, given the nature of the industry, the authorities evaluated this criterion in terms of production for the whole domestic industry.[229] Productivity alone was considered of limited relevance because the increase of "productivity" in the *raw milk sector* (*i.e.*, increased production of raw milk despite the declining number of dairy households) was attributable to advances in technology[230] and because the increased "productivity" in the *milk powder sector* (*i.e.,* increased production compared to stable factors of production) was attributable to the fact that increased amounts of raw milk were required to be converted into milk powder, which remained as unsold inventory.[231] In the dairy industry, increased productivity in the milk powder sector, in fact, suggests injury to the whole domestic industry.

4.473 Contrary to the EC claims, the authorities examined productivity for the whole domestic industry. Moreover, the authorities did not "replace the examination" of one factor with another. The authorities examined productivity and determined that it was not strictly relevant (*i.e.,* not of an objective and quantifiable nature having a bearing on the situation of that industry).

4.474 Thus, the Korean authorities considered production and properly concluded that changes in productivity were not appropriate indicators of serious injury because it was not possible to curtail production of raw milk without slaughtering cows, and so any surplus had to be converted, *inter alia,* into milk powder.

(g) Additional Arguments by the European Communities Made at the Second Meeting of the Panel with the Parties

4.475 At the second meeting of the panel with the parties, the **European Communities** further advanced their arguments under Article 4.2(a) as follows:

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[228] Notification at IV.3.1. *See,* also OAI Report at 36-38. In its First Submission, the EC argues that the Korean competent authorities' reasoning is, in its view, not credible. The EC contends that technology (feed, additives, etc.) exists to vary production and 10-12 per cent of dairy cows are retired or slaughtered every year. Through these means, the EC considers that dairy farms can reduce production whenever necessary. Korea considers that the EC is again simply conducting its own unsubstantiated investigation of Korea's dairy industry. The EC ignores the fact that in Korea's relatively underdeveloped dairy industry composed of approximately 23,000 individual dairy households, any potential technological advancement is used to increase production, and dairy cows cannot be slaughtered "when necessary" in response to increased SMPP imports. Moreover, although it is feasible to reduce the production capacity of cows through reduction of feed, the EC fails to point out that once a cow's output has been reduced in this way, it is almost impossible to increase it again.

[229] *See,* OAI Report at 38; Notification at IV.3.2.

[230] Technological advancements include, *inter alia*, construction of open sheds equipped with fan ventilation systems to keep temperatures at an optimum level, use of milking machines to collect milk, including installation of pipelines to collect milk, and use of total mixed ration (TMR) system to provide adequate nutrition to cows. Dairy cows are very sensitive to temperature and their production varies according to their surrounding temperature. At a temperature ranging between 4 and 27 degrees Celsius, dairy cows produce an optimum amount of milk, approximately 25 kg. If the temperature increase to 30 degrees or above, output is reduced to 80 per cent. At 40 degrees or above, it falls to 40 per cent. *See, United States Feed Grains Council, Dairy Feeding Guide* at 117.

[231] *Ibid.*

(i) Profitability

4.476 The **European Communities** reiterated their view that Korea did not investigate the profitability of dairy farmers during its investigation, only the profitability of the milk powder producers.

4.477 In reply to the EC complaints during the consultations, Korea claimed both then and subsequently in its Notification of 24 March 1997[232], that *it could not carry out* a profitability analysis for the dairy farmers because they were too numerous. However, in its first written submission it produced for the first time a comparison of prices and production costs based on a survey of 150 dairy farmers which showed high profits in 1994 declining to a small loss in 1996 because a steadily increasing reference price did not keep up with the increase in production costs. Furthermore Korea admitted that production costs are calculated and published on an annual basis (in the 'Annual Report of Livestock Production Cost Survey') and that the "suggested reference price" is set with the aim of covering the costs of production.

4.478 In the EC view this proves that Korea did have access to the information and therefore could have investigated profitability of dairy farmers.

4.479 The European Communities do not accept Korea's reasoning, that the livestock co-operatives' profits and losses are directly linked to the raw milk producers' income because the dairy farms own the cooperatives. In fact, the livestock cooperatives' profits have an *inversely proportional relationship* to the income of the dairy farmers. If the price of raw milk increases, dairy farmers make more profit and milk powder producers and livestock cooperatives make less.

4.480 Korea also provided data showing the manufacturing cost of milk powder and the percentage represented by raw milk. This allows calculation of the average price obtained for this raw milk by the dairy farmers. This calculation shows that dairy farmers were obtaining more than the suggested price and that this positive margin was increasing over the period a healthy situation for dairy farmers. Of course the figures can be adjusted to take into account other costs but, they will still show a margin over the suggested price.

4.481 Admittedly these deduced prices only relate to sales for milk powder production. But Korea itself insists that only surplus milk which cannot be disposed of in sales of fresh milk is sold for milk powder. Accordingly, the dairy farms must have been obtaining even better prices for their other milk sales.

4.482 The EC table on the profit margin of dairy farmers selling raw milk for milk powder shows the profit levels of the dairy farms for sales of raw milk for milk powder, which would tend to represent the lowest price received for raw milk. Rather than a profit situation degenerating into loss, as Korea has claimed in its own figures, this Table shows precisely the opposite, that dairy farms were becoming increasingly profitable during the investigation period.

4.483 From another perspective the tables on selling price of raw milk for milk powder, above at paragraph 4.426, production and profit margin of dairy farmers selling raw milk for milk powder, show that the steadily increasing profit levels obtained by the dairy farms were squeezing the margins of the milk powder companies and reducing their profitability.

[232] *See,* paragraph 3.10(a) at page 12.

4.484 By only looking at the profitability of the small part of the domestic industry that was losing money to the larger part which was profiting at its expense, Korea has failed to properly examine profitability and its injury finding cannot be considered in conformity with the Agreement on Safeguards.

(ii) Employment

4.485 In he EC view the number of dairy farms cannot be taken as a measure of employment as Korea has done. This is especially so in view of the fact that the number of cows per farm and productivity were increasing - *i.e.,* the industry was consolidating. As the European Communities pointed out this is a perfectly healthy development.

4.486 Korea has not responded to this objection and persists in confusing the number of dairy households (that is farms) with employment levels in dairy farms.

4.487 In the EC view, therefore Korea has not properly examined employment.

(iii) Investment

4.488 Investment was not identified as an injury factor in Korea's 24 March Notification but the EC comments on it because it features in Korea's submissions to the Panel.

4.489 There are numerous inadequacies in this attempt to justify a finding of injury *ex post facto* on the basis of investment. For example, Korea states that the losses suffered by cooperatives led to their inability to attract investment and this led Korea to provide financial assistance through the Livestock Development Fund. However, Korea later states that "the only investment information for the raw milk sector was based on the amount allocated to *dairy farmers* by the Dairy Cow Competitiveness Enhancement Programme. (footnote omitted) This project was necessary because of the inability of the raw milk sector to attract investment." In the EC view the economic data relied upon by Korea seems to change from one submission to the next.

(iv) Livestock Cooperatives' Volume of Raw Milk Collected

4.490 Korea claims that dairy farms were forced to turn to the livestock cooperatives, which were obliged to collect the unsold raw milk. Membership of NLCF increased from 85 to 99 per cent over the investigation period.

4.491 In fact, analysis of the figures provided by Korea shows that the increased purchases of raw milk by the livestock cooperatives were due primarily to increases in their membership, and that the proportion of their members milk which they actually collected *declined* steadily between 1993 and 1996, as shown in the table below.

	1993	1994	1995	1996
Proportion of dairy farmers who are NLCF members (A)	85.5%	91.2%	93.3%	99.9%
Proportion of raw milk production collected by NLCF (B)	41.36%	42.80%	44.30%	45.30%
Proportion of NLCF members' milk collected by NLCF (= B÷A)	**48.4%**	**46.9%**	**47.5%**	**45.3%**

The percentage of milk collected by cooperatives is calculated as a percentage of total milk production and increases from 41.36 per cent to 45.3 per cent over the reference period. This is in fact a lower proportionate increase than the increase of the Membership and therefore demonstrates that the proportion of milk collected by the cooperatives was declining. Consequently there cannot have been any change in the ability of dairy farms to dispose of their milk to other purchasers at prices well above the suggested price. Again in the EC view this does not suggest injury but rather the contrary.

(v) Production and Productivity

4.492 The European Communities refer to Korea's second written submission where Korea states that

> "Productivity alone was considered of limited relevance because the increase of "productivity" in the *raw milk sector* (*i.e.,* increased production of raw milk despite the declining number of dairy households) was attributable to advances in technology and because the increased "productivity" in the *milk powder sector* (*i.e.,* increased production compared to stable factors of production) was attributable to the fact that increased amounts of raw milk were required to be converted into milk powder, which remained as unsold inventory. In the dairy industry, increased productivity in the milk powder sector, in fact, suggests injury to the whole domestic industry."

4.493 In the EC view this paragraph shows injury (if such it is) caused by one part of the industry (the raw milk producers who were increasing production) to another (the cooperatives who were obliged to buy milk at fixed prices).

4.494 This injury (if such it is) is not caused by imports but technological advances, according to Korea.

4.495 This technological advances increase the production and profitability of dairy farms and contributes to producing a surplus of milk at a time of declining consumption at least in 1995-96. This in turn is what has led to an increase in milk powder inventories.

4.496 The effect of increasing production of raw milk colliding with its decreasing consumption and a stable level of imports of SMPP has been graphically illustrated by the European Communities. A remarkable coincidence is evident between the decrease in consumption starting in November 1995 and the increase in stocks.

(vi) Price Relationships

4.497 A fundamental criticism of Korea's determination is that it has not conducted an investigation into the prices of the imported products and their possible effect on the domestic industry.

4.498 Korea claims that it did examine prices and "undercutting" and refers to page 62 of the OAI Report (English version). The figures presented there show SMPP at half the price, tonne for tonne, of domestic milk powder. But, In the EC view this is like comparing the prices of butter and margarine. It is clear that the characteristics and uses of a product like the domestic one, pure milk powder, cannot be the same as that of a product like the imported one, SMPP, which is only a mixture containing milk powder. Indeed Korea asserts that "most Korean users of milk powders state ... that the domestic products are of higher quality than the imported SMPP." Not only are the characteristics of the products different but so also are their uses. Korea admits that "SMPP was an effective substitute for domestic raw milk and milk powder in most industrial uses", but not in all.

4.499 These differences clearly have an impact on pricing decisions for both products. However Korea made no analysis of the extent to which substitution may take place or what the proper price relationship should be.

4.500 It is accepted that the products compete but so for example do Whisky and Sochu. That does not make them of equal value.

(h) Additional Arguments by Korea Made at the Second Meeting of the Panel with the Parties

4.501 At the second meeting of the panel with the parties, **Korea** further advanced its arguments under Article 4.2(a) as follows:

4.502 Korea asserted that the European Communities raised two fundamentally inconsistent arguments:

(a) that the OAI Report is *not* the appropriate source of relevant information for review of Korea's obligation, yet the European Communities seek to make arguments in relation to Korea's failure to comply with Articles 2 and 4; and

(b) that this report "has only been made recently available".

If the OAI Report is *not* a relevant source of material for its review, why does the European Communities complain that they have only just received that Report (which Korea maintains is untrue), and what relevance do arguments under Articles 2 and 4 relating to establishment of the increase in imports, serious injury and causal link between the two have if the investigation undertaken by the Korean authorities is not at issue?

4.503 Regarding the EC specific arguments on Article 4.2(a) and (b), Korea notes the perils inherent in permitting a Member to substitute its own analysis and conclusions for that already undertaken by the investigating authority of another Member. Such investigations require an analysis of complicated factual, legal and economic issues, and these are simply not amenable to second-guessing by any third party, least of all a complainant.

4.504 In Korea's view the European Communities build a major part of their Rebuttal Submission around their calculation of the price of raw milk from the price of milk powder produced by the NLCF. This analysis calls for a number of comments:

(a) First and most importantly, there is no reliable way of arriving at an accurate or appropriate transaction price for raw milk in Korea, since there are more than 20,000 vendors. As noted at page 41 of the OAI,

Section IV.3.10a of the Notification, this is why the OAI did not undertake such a calculation. Korea is not seeking to arrive at a more accurate selling price for raw milk than that arrived at by the European Communities, but is simply seeking to show that it is not possible to arrive at an accurate figure, and any attempt will not be a basis for a rational analysis;

(b) However the European Communities make their calculations, the reality is that it is not feasible to produce "actual raw milk sales prices". Such prices are only found in the individual contracts between the dairy farmers and their purchasers, and are not disclosed to third parties. It strains credibility for the European Communities to assert that "the Korean Government did in fact have available to it information on raw milk transaction prices, at least on an overall basis";

(c) Even if the Panel considers that it is possible to adopt the broad methodology attempted by the European Communities, which Korea does not, then looking specifically at the EC table on the selling price of raw milk for milk powder production, see paragraph 4.420, Korea notes that the European Communities have assumed, incorrectly, that the NLCF's "raw material cost" is identical to the cost of raw milk. The NLCF's "raw material" cost includes several elements of cost which were incurred after the purchase of raw milk from the farmer, and so cannot form part of the farmers' selling price. In order to begin to work back from the NLCF's manufacturing cost to the price of raw milk paid to the farmer, these subsequent costs would need to be deducted. The two most significant costs are collection (including transportation from the farm to the NLCF's production facility), and the cost of packaging the finished milk powder. In 1993[233], for example, the NLCF reported that its collection cost (including transportation) of raw milk from the farm to its milk powder production facilities was 40.6 Won/kg. Further, in the same year, the NLCF packaging cost was 5.9 Won/kg. In order to eliminate these two elements from the "raw material cost" of the NLCF, it is necessary to deduct approximately a further 10.9 per cent from the "raw material cost". After such deduction, and on the basis of the EC methodology (which Korea reiterates is not an appropriate method to derive the selling price of raw milk), the prices paid by the NLCF to farmers for their raw milk often did not exceed the MAF suggested reference price; and

(d) Finally, farmers occasionally are paid by the NLCF in milk powder as opposed to cash. While such payments in kind reduce the farmers' feed costs, they also affect their cash flow derived from the selling price, and so this also needs to be taken into account in assessing the validity of the EC calculations.

[233] Korea understands that this method would need to be applied to all other years.

4.505 Further, the errors in methodology noted above in relation to calculation of price are then brought forward into the discussion on profitability, where further assumptions Korea views as spurious are added into the process. As Korea has consistently pointed out, there is no reliable data available on the profitability of Korean dairy farmers. The information provided in Korea's First Submission, and seized upon by the European Communities as some form of *ex post facto* reasoning, was only provided to rebut the EC claims about "guaranteed profits" for dairy households. It cannot be construed as a basis for calculating the profitability of Korean dairy farmers. In quoting Korea's answers to the Panel's questions, and in its suggestion that either Korea engaged in *ex post facto* analysis, or failed to use all available evidence, the European Communities appear to have forgotten or omitted to refer to Korea's answers to the EC questions, which also deal with profitability where Korea clearly and unequivocally states that:

> "Korea provided the information on production costs to rebut the EC characterization of the suggested reference price as a price 'under which producers are guaranteed a very high price for their raw milk, irrespective of how much they produce and irrespective of domestic demand'."

4.506 The European Communities assert that they understand the data better than the Korean authorities', arguing that "MAF has knowledge of production costs each year." This is untrue. Through the NLCF, the MAF has access to an annual survey of 150 dairy farmers' production costs. However, this is not a comprehensive data series, and certainly not one that the Korean authorities felt they could use in investigating serious injury caused by imports of SMPP. Korea wonders whether, had it used this sample of 150 dairy farms, the European Communities would now be arguing that 150 farms was unrepresentative.

4.507 Further on profitability, the European Communities assert that "this increase in price of raw milk for milk powder production must be due to a shortage of supply of the raw material." Korea notes:

(a) that inflation, a common phenomenon in a number of countries, including in EU Member States caused increases in actual price. Even if the nominal price of raw milk increased, its real price adjusted by the overall inflation rate might have fallen, reflecting excess supply of raw milk as a result of the increase in imports of SMPP; and

(b) milk powder inventory levels never fell below 1.5 months of supply, and were usually much higher.

Therefore, in Korea's view the EC conclusion is entirely inaccurate.

4.508 Finally, on profitability, the European Communities appear to argue that the milk powder producers could have reduced or eliminated the serious injury by reducing their raw milk purchase price. While, this sounds easy, it would have involved increasing the serious injury to Korean dairy farmers, and Korea finds it unacceptable to be offered advice on operation of free markets in dairy products from the regulator of one of the most protected dairy markets on earth.

4.509 The European Communities attempt to show that the suggested reference price for raw milk in Korea is more than a mere suggestion, and cites various examples. As Korea has consistently stated the Government price for raw milk is a suggested reference price and is not binding upon any parties. The European

Communities cite Article 13 of the Dairy Industry Promotion Act. This merely establishes the framework in which the suggested reference price can be established. It does not provide any compulsion or impose any sanction on any party that fails to follow such a suggested reference price. Therefore, while the DIPA establishes that a suggested reference price can be set, dairy farmers and milk processing companies remain free at all times to establish their own prices at which they buy and sell raw milk.

4.510 In Korea's view the European Communities seek to re-investigate the issue of milk powder stocks. The European Communities graph on milk powder inventories,[234] is based on three erroneous arguments:

(a) Although the milk powder stocks increased abruptly during November 1995 to December 1995, the increase since January 1996 reflected other factors including the effects of increased imports of cheap SMPP;

(b) actual consumption of milk returned to around the historic three year average as from early 1996;

(c) the statistical and econometric models used by the OAI showed that the effect of the "milk quality" controversy disappeared as from January 1996. Use of the econometric causality tests showed that the import of cheap SMPP was the cause of the increase in milk powder inventory during the entire investigation period.

4.511 During the investigation, the OAI concluded that, although the "milk quality" controversy had an impact on milk powder inventory for a few months, it was the import of cheap SMPP that caused the increase in inventory during the investigation period.

4.512 In Korea's view, the European Communities purport to understand the status of loans to dairy farmers better than the Korean Government. Korea reiterates that during the course of the investigation period "virtually all" farms received the loan. Korea provided information on the loans provided to dairy farmers during the period of investigation. During this period, the Livestock Development Fund made almost 72,000 individual loans to 28,000 dairy households. The recipients of loans in one year do not necessarily need or apply for a loan in subsequent years. Therefore, while there was no year in which loans were made to all 28,000 households, during the period of investigation, loans were made to "virtually all" households. Further, loans were not given to dairy farms for the purpose of leaving the dairy industry, but to virtually all dairy households for the purpose of improving their competitiveness, thus ensuring they have an option to remain in the Korean dairy industry.

4.513 The European Communities again seek to fulfil the role of investigating authority by arguing that Korea "failed to tackle [employment] in an adequate manner." As Korea has noted repeatedly, data on changes in the employment of individuals in the Korean dairy industry is simply not available, and so the Korean authorities used changes in the number of dairy households as a surrogate. The EC suggested analytical framework is simply not applicable to the Korean dairy industry. The framework, while possibly appropriate for a large-scale dairy farm in the

[234] Exhibit EC-26.

Netherlands or Denmark, ignores the fact that Korean dairy farms are on the whole small scale family businesses, and represent one part of the economic activity of some members of that family. It is not possible to determine how much time each person spends working on that business, and what proportion of that time is devoted to dairy production, and therefore Korea believes that the EC arguments do nothing to prove that Korea failed to comply with its obligations under Article 4.

4.514 Korea understands the European Communities to be arguing that, in addition to the comparison of any quality differences between milk powder and SMPP in establishing "like" or "directly competitive product", the Korean authorities were also required to take any differences in quality into account in assessing price undercutting. Korea notes that the Korean authorities took the quality differences into account in deciding that milk powder and SMPP were directly competitive, which the European Communities appear not to dispute. Had Korea found that the products were not directly competitive, no further investigation would have taken place.

4.515 During the course of the second meeting of the parties, Korea provided two rebuttals to the inferences drawn by the European Communities from the table in paragraph 4.491 relating to the volume of raw milk collected by livestock cooperatives. First, the figures provided cannot be used to provide any reliable conclusion, since the figure of 45.3 per cent provided for in the second row for 1996 is a half-year figure, whereas all other figures provided are full year figures. Second, even if the figures could provide a reliable basis for the analysis proposed by the European Communities, they do not reflect the EC conclusion. The proportion of NLCF members milk collected by the NLCF does not "decline steadily between 1993 and 1996", since the figures for 1995 show an increase over 1994.

G. Claim under Article 4.2(B) of the Agreement on Safeguards

(a) Claim by the European Communities

4.516 The **European Communities** claim that Korea violated Article 4.2(b) of the Agreement on Safeguards because it failed to show the existence of a causal link between the increased imports and the serious injury to the domestic industry. The following are the EC arguments in support of this claim:

(i) The Inadequacies of Korea's Analysis under the First Sentence of Article 4.2(b) of the Agreement on Safeguards

4.517 In the EC view, Korea's attempted demonstration of causal link was as follows:

(a) It described the rising market share of SMPP out of total domestic consumption (domestic raw milk (including milk powder), imported milk powder, and SMPP) and the even more rapidly rising market share when compared with domestic and imported milk powder and SMPP. (Paragraph V.1.1 of the 1 April 1997 Notification).

(b) It recalled the stable level of prices for imported SMPP and the allegedly falling prices for domestic milk powder using the same figures as in Paragraph IV.3.7 of the Notification (which are discussed in Section C.3(c)(ix) above) and claimed that as the share of imported

products in total consumption increased, the sales price of domestic milk powder dropped and that therefore increased imports of the products subject to investigation caused the price of domestic milk powder to drop. (Paragraph V.1.2 of the 1 April 1997 Notification).

(c) It next described the slow increase in the share of livestock co-operatives' raw milk collection in Korea increased (from 40.56 per cent in 1990 to 41.14 per cent in 1991, 40.19 per cent in 1992, 41.36 per cent in 1993, 42.80 per cent in 1994, 44.30 per cent in 1995, and 45.30 per cent for the first four months of 1996) and alleged that this was because milk processing companies reduced purchases of domestic raw milk and purchased more imported products. It concluded that increased imports of the products subject to investigation had an adverse effect on the "white market milk" sector.

(d) It finally alleged that the price difference between the imported and domestic products forced domestic producers to decrease their price to the point of sales below cost, and to stockpile excess inventory of unsold milk powder. For good measure it alleges that increasing competition from imported products caused the number of dairy farmers to decrease.

(a) The rising market share of SMPP

4.518 It is true that the market share of SMPP as measured by Korea was rising. The figures given are however, in the EC view misleading because the total production used to calculate market share (the denominator of the fraction in the calculation) included in each case imported milk powder. Much of the increase of imports of SMPP was at the expense of imported milk powder. Including imported milk powder in the denominator means that a simple substitution of SMPP for imported milk powder with no loss of sales or market share for domestic products would give a result showing an increase of market share for SMPP. A more accurate presentation is that given by Korea in Paragraph IV.3.4 of the 1 April 1997 Notification.

(b) The falling prices for domestic products

4.519 The price of imported SMPP was stable during the reference period as was the price of domestic milk powder except for what Korea itself describes the temporary phenomenon at the beginning of 1996. Korea's claim that increased imports of SMPP coincided with falling price of domestic products and its deduction that the first caused the second are in the EC view demonstrably false.

4.520 The European Communities recalled Korea's precise reasoning:

> "Analysis showed that as the share of imported products in total consumption increased, the sales price of domestic milk powder dropped from 5,354 Won/kg in 1993 to 4,994 Won/kg for the four months of 1996. Thus, increased imports of the products subject to investigation caused the price of domestic milk powder to drop."

Korea's case is that increased *market share* for SMPP caused a decrease in the *price* of domestic milk powder. It is not arguing that low *prices* for SMPP caused a decrease in the *price* of domestic milk powder. This is logical to the extent that it did not identify low prices for SMPP as an injury factor in its examination or its

conclusion in Paragraph IV.4 of its Notification of 1 April 1997. To have established low or falling prices for imported SMPP as an injury factor, Korea would have had to carry out a price investigation which it did not for its own reasons.

4.521 It is true that the share of imported products (that is SMPP) increased. However, this increase occurred throughout the period whereas the sales price of domestic milk powder only dropped at the *end* of the period. Therefore Korea's statement that they dropped at the same time is incorrect.

4.522 According to Korea's own figures, the price in 1995 was 5,388 Won/Kg, which represents an *increase* over 1993 and 1994. The whole decrease on which Korea is relying occurred in the first four months of 1996, during what it has itself termed a "temporary phenomenon". The deduction of causality which relies purely on the supposed simultaneity of the effects described is therefore incorrect and unjustified. In fact in the EC view the correct conclusion is the opposite*:* that is there is no causal relation between the increase in market share of imported SMPP and the decrease in price in domestic milk powder which occurred at the beginning of 1996.

(c) The increase in the share of livestock co-operatives' raw milk collection in Korea

4.523 The figures given by Korea on this point show a slowly but steadily rising proportion of raw milk collection by co-operatives from 1990 to 1996. This establishes the opposite of what Korea seeks to prove because increases in imports of SMPP did not affect a trend which already existed before their liberalization.

(d) Imports forced domestic producers to decrease their prices to below cost and reduce the number of dairy farmers

4.524 The prices of domestic milk powder as well as imported SMPP were stable except for the temporary phenomenon at the beginning of 1996. The fact that domestic sales came to be made below cost is entirely due to the increase in the cost of production which obviously has nothing to do with imports (but was due to government imposed price increases for raw milk from dairy farmers).

4.525 There is a suggestion for the first time in Paragraph V.1.4 of the Notification that a "price difference" between imported SMPP and domestic milk powder was relevant to the analysis of the causal link. This is inconsistent with all the previous arguments of Korea and in particular with its failure to identify the prices of SMPP or even a price difference between SMPP and domestic milk powder as an injury factor.

4.526 Also, imports had no effect on the number of dairy farmers since they received guaranteed and rising prices for their milk and increased their production and productivity. The reduction in numbers was due to healthy consolidation and the increase in the size of farms in accordance with Korean government policy.

(ii) The Problems of the Domestic Industry were due to Other Factors - Second Sentence of Article 4.2(b) of Agreement on Safeguards

4.527 The European Communities consider that any problems the domestic industry may have had were due to other factors than imports of SMPP and most notably the high and increasing price guaranteed to Korean dairy farmers for their milk by the

Korean Government. Korea claims to examine these factors in Paragraph V.2 of its Notification of 1 April 1997. However, in the EC view, Korea's examination of other factors that could have caused or contributed to any problems of the domestic industry is incomplete, the European Communities also believes Korea should have considered the extent to which Korean domestic industry itself imported SMPP and benefited therefrom. Korea's assumption that such imports by the domestic industry could be considered to cause injury to that same domestic industry requires at the very least a justification - which Korea has nowhere provided.

(a) Milk quality scandal

4.528 Korea deals with this issue in Paragraph V.2.1 of its Notification of 1 April 1997 as follows:

> "After examining the facts related to the controversy which occurred from October to November 1995, it was acknowledged that this incident did reduce the demand for market milk, though only temporarily. It was determined that the controversy ceased to be a cause of reduced market milk demand in January 1996. The quality dispute affected only three months of consumption out of an investigation period totalling 42 months. No evidence was submitted by any of the parties concerned which demonstrated that the injury caused by the quality dispute was as serious or persistent as that caused by increased imports."

However, in the EC view there was a much greater and more persistent effect on consumption of milk in Korea and stocks than claimed by Korea. The rise of inventory occurred at exactly the time the milk quality scandal erupted and that therefore the milk quality scandal was the major cause of the increase in milk powder stocks in Korea in early 1996.

4.529 The European Communities note that even Korea admits that there was an effect both on consumption and stocks. It rejects the analysis of these effects by other parties but fails to make any analysis itself or to make any allowance for them in its own determination and in particular to examine how it might have effected the state of stocks and sales of milk powder in the first four months of 1996 on which Korea relies so heavily throughout its Notification (a price decrease and increased sales of milk powder by domestic producers which Korea describes as a "temporary phenomenon").

(b) Effect of reduced imports of milk powder

4.530 Korea examines this issue in Paragraph V.2.2 of its Notification of 1 April 1997. It constitutes in effect an attempt to deal with the objections to Korea's presentation of the "increasing market share of SMPP".

> "It has been noted that the increase in imports of the products under investigation contributed to a reduction in imports of milk powder from 14,843 tons in 1993, 11,581 tons in 1994, 7,576 tons in 1995, to 583 tons in the first half of 1996. However, it has also been noted that there is an important difference between the imports of the products under investigation and those of milk powder. The milk powder imported by ROK in 1993-1994 was to supplement the shortage of

> domestic raw milk and milk powder, and was allocated to users at reasonable prices."

Thus, Korea admits a simultaneity between the decline of imports of milk powder and the increase in imports of SMPP but attempts to show that the imports of milk powder were not damaging while imports of SMPP were. However, it is fundamental to Korea's safeguard measure (see Paragraph III.1 of the Notification of 1 April 1997) that SMPP is a "directly competitive product" for raw milk and milk powder and that it was used for the same purposes. If imported milk powder was apt to "supplement the shortage of domestic raw milk and milk powder" then so should imported SMPP.

4.531 Korea also alleges that milk powder "was allocated to users at reasonable prices", and suggests that SMPP was not. However, Korea's Notification is noteworthy for its absence of any price analysis and the Korea's injury determination in Paragraph IV.3.4 of the Notification of 1 April 1997 makes no reference to low prices for SMPP. Korea cannot therefore rely on differences of prices which it has not investigated in its consideration of causal link.

(c) Review of demand

4.532 In paragraph V.2.3.6 of the Notification of 1 April 1997 Korea examines demand. The European Communities disagree that the demand trends for processed products can be dismissed as Korea does in that paragraph V.2.3.6. A substantial part of the increased imports may well have been used for processing into other dairy products such as ice cream, confectionery, yoghurt, cheese because of increased demand for these products. Korea admits that production and consumption of certain dairy products increased during the investigation period, but has declined to give precise figures, so this cannot be comprehensively verified. Instead Korea rather peremptorily concludes that, "no connection could be established between the effect on these dairy products and injury to domestic industry".[235] The logic behind this conclusion is not clear, since it is based on the prior assumption that the raw milk and milk powder industry has suffered serious injury.

(d) Review of government price decisions

4.533 The brevity of Korea's examination of this issue in Paragraph V.2.4 of the Notification of 1 April 1997 belies its importance. It can be quoted in full:

> "The price of raw milk is determined by the government by taking into account production costs, influence on domestic commodity prices, domestic supply and demand, etc. The price set by the government is not an obligatory price but rather a base price for contracts between dairy farmers and milk processing firms. Therefore, this did not affect the domestic industry adversely. If the government had not set a base price and the livestock cooperatives had refused to collect raw milk, dairy farmers would have been directly injured."

[235] Notification of 1 April 1997, p.17, para. 2.3.6.

4.534 The point about government price increases for raw milk is that they are likely to increase costs and supply beyond what the market for milk powder can bear and will give rise to precisely the difficulties of increasing stocks and pressure on margins for processing companies that are in evidence here. That is why the issue should have been examined seriously by Korea.

4.535 The European Communities do not know what Korea means by the term "base price". It has always understood the price set by the Korean Government to be always followed in practice. However, Korea has itself stated elsewhere in the same Notification that the price of raw milk "is maintained at a stable level fixed by the government" and that the price of raw milk was also increased twice during the investigation reference period.[236]

4.536 The European Communities submit that the last sentence of this Paragraph V.2.4 appears to be an admission that dairy farmers have not been injured since the government has set a base price and the livestock cooperatives have not refused to collect raw milk.

(e) Other factor - Imports of SMPP by the domestic industry

4.537 Korea did not consider the effect of imports of SMPP by the domestic industry during the period of investigation. This is an essential condition for establishing a causal link. Since Korea failed to address this issue it cannot be determined whether, even if it is assumed that injury was suffered by the Korean industry, a causal link can be established between increased imports and the condition of the domestic industry.

4.538 The European Communities submit that any problems that domestic industry may have been suffering are not caused by imports of SMPP but by other factors and in particular by the inevitable conflict between a government policy of fixing and regularly increasing the domestic price for raw milk paid to dairy farmers causing increased production and a higher cost of milk for milk processors and co-operatives with insufficiently rising domestic demand. By wrongly attributing these problems to imports of SMPP on the basis of an inadequate and incomplete investigation of causal link, Korea has violated Article 4.2(b) second sentence.

(b) Response by Korea

4.539 **Korea** responds to the EC arguments as follows:

(i) Consideration of Causation

4.540 Korea established a clear and strong causal link between the increased imports of SMPP and the serious injury suffered by the domestic industry.[237] This link relies on an understanding of the relationship between the supply of raw milk and the production of milk powder. Korea found that the increased imports of the cheaper SMPP replaced raw milk and domestic milk powder in a number of key uses.

[236] Notification of 1 April 1997, p. 10, para IV.3.7.
[237] *See,* Notification V.

Demand for domestic products decreased as a result of an increase in the import of cheaper SMPP, which in turn suppressed the sales price of domestic products. Further, the reduction in demand for domestic products resulted in more raw milk having to be collected by the livestock cooperatives to be turned into milk powder. As the demand and price of milk powder had been suppressed by the imports of SMPP, both losses and inventory increased, with the consequent inability to operate at a reasonable level of profit, increase of debt, and failure by the cooperatives and farmers to invest in the dairy industry.

4.541 Korea determined that increased imports of SMPP gained a significant proportion of the Korean milk powder market at the expense of domestic milk powder.[238]

MILK POWDER MARKET SHARE OF SMMP

	1993	***1994***	***1995***	***1996 (1-6)***
Total Consumption in the Milk Powder Market (tonnes) (A)	30,181	40,532	46,254	23,532
Imports of SMPP (tonnes) (B)	3,217	15,561	28,007	16,320
SMPP's Share of the Milk Powder Market (%)(B/A)	10.7	38.4	60.6	69.4

4.542 Korea also determined that increased imports were significantly undercutting the prices of domestic producers.[239]

PRICE COMPARISON BETWEEN DOMESTIC PRODUCTS AND SMPP

	1993	***1994***	***1995***	***1996 (1-4)***
Price of Raw Milk[240] *(Won/kg) (A)*	4,100	4,100	4,100	4,560
Price of Domestic Milk Powder (Won/kg) (B)	5,354	5,296	5,388	4,994
Price of SMPP in Korea (Won/kg) (C)	2,590	2,500	2,530	2,971
Difference (C-A)	-1,510	-1,600	-1,570	-1,589
Difference (C-B)	-2,764	-2,796	-2,858	-2,023

This wide price differential between domestic milk powder and imported SMPP forced Korean producers to lower their price of domestic milk powder to levels that eventually could not even cover costs.

4.543 In addition to the suppression of prices for both raw milk and domestic milk powder and the attendant losses connected with this suppression, SMPP imports increasingly displaced domestic inputs in the production of downstream products. During the investigation period, Korea determined that consumption of flavoured and

[238] *See,* Notification V.1.1.
[239] *See,* Notification V.1.2.
[240] The price of raw milk was calculated by taking into account that 10 units of raw milk are used to produce one unit of milk powder.

fermented milk, which use the cheaper imported SMPP, increased at the expense of white milk, which can only be made from domestic raw milk[241].

CHANGE IN MARKET SHARE FOR MILK PRODUCTS

	1993	*1994*	*1995*	*1996.1-6*
White Milk	63.0%	61.4%	57.8%	53.7%
Flavoured Milk	6.0%	7.9%	11.2%	11.7%
Fermented Milk	22.8%	23.5%	23.6%	26.2%

Prior to the market liberalization in 1993, the production of flavoured milk remained constant. It is only after the surge in imports of SMPP into the Korean market that the production of flavoured milk increased at the expense of white milk. Looking at the production ratio of Korean white milk and comparing it to the increase in production of flavoured milk, the effect of SMPP imports on consumption of domestic raw milk is pronounced.[242]

CHANGES IN MARKET SHARE OF WHITE MILK AND FLAVOURED MILK

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996(1-6)*
White Milk	92.9%	92.4%	92.4%	91.3%	88.6%	83.8%	82.1%
Flavoured Milk	7.1%	7.6%	7.6%	8.7%	11.4%	16.2%	17.9%

Indeed, the usage rate of imported SMPP by the five leading processing companies which manufacture final dairy products using SMPP showed a significant increase:[243]

USAGE RATE OF SMPP BY PROCESSING COMPANIES

Year	*Usage Rate*
1993	3%
1994	23.8%
1995	29%
1996 (1-4)	53.3%

The impact of SMPP's replacement of domestic raw milk and milk powder can also be witnessed in the decreased profitability of the livestock cooperatives, which are owned by dairy farmers. Their decreased income had repercussions on other elements affecting the overall health of the domestic industry, including, for example, profitability, inventory, employment and the inability to invest in research and development.

4.544 Further, during the period of investigation, imports of SMPP increased at a more rapid rate than the decline in imports of skimmed and whole milk powder.

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241 Source: MAF

242 *See,* Notification V.1.3.

243 Source: MAF

DIFFERENCES IN THE VOLUME OF IMPORTED MILK POWDER AND SMPP
(UNIT: TONNES)

Year	*Imported Milk Powder*	*SMPP*[244]	*Difference*
1993	14,843	3,217	-11,626
1994	11,581	15,561	3,980
1995	7,576	28,007	20,431
1996 (1-6)	583	16,320	15,737

4.545 Against this background, Korea reached the conclusion that serious injury to the Korean dairy industry had been clearly caused by the increased imports in that:

(a) Korean market share of raw milk and milk powder decreased;

(b) Market share of Korean white milk (which can only be made from domestic raw milk) declined, while market share of flavoured and fermented milks (which can, and did, use imported milk powder) increased;

(c) Under normal market conditions, milk processing companies purchase raw milk and domestic milk powder as inputs for the production of end products. Because raw milk is perishable, excess raw milk not sold to the domestic market, or used by the processing companies, must be sold to the cooperatives for conversion into milk powder. During the investigation period, the processing companies increasingly replaced raw milk and domestic milk powder with much cheaper SMPP. As a result, excess raw milk was converted into unsaleable milk powder which remained in inventory and accumulated to high levels;

(d) As inventory levels increased, the livestock cooperatives were compelled to sell the milk powder stock at prices below their production costs and saddled with a heavier debt load that in turn contributed to the higher leverage ratio and further depletion of capital;

(e) The membership of the NLCF increased during the investigation period. This increase was a direct result of the increase in imports of SMPP, since, as these replaced Korean raw milk, farmers that had previously sold raw milk directly to processing companies were now unable to do so because they were faced with stiff competition from the cheaper imported SMPP. In order to find an outlet for the raw milk, they had to sell to cooperatives, and in order to sell to cooperatives, they had to be members of those cooperatives;

(f) As Korea has no developed export market for the accumulated milk powder, and in any case would be price-uncompetitive when compared to the subsidized or dumped milk powder available in the

[244] *See,* Notification IV.2.

world market, there was no effective outlet for this inventory, thus only having a suppressive effect within Korea;

(g) The losses incurred by Korean milk powder producers were substantial and increased over the investigation period. These losses were in large part attributable to price suppression and displacement of raw milk and milk powder by the imports of the cheaper SMPP;

(h) As a direct result of the above, average household debt of dairy farmers doubled during the investigation period, and despite the long-term loans (which were unrelated to an increase or decrease in production) provided to virtually all dairy farmers, employment of Korean dairy farmers fell by approximately 5,500 households. The decrease in the number of farms was propelled by the cooperatives' inability to compensate fully the dairy farmers for their raw milk, because SMPP was replacing domestic products, causing a rise in inventory and decreasing profits. During difficult periods, including during the investigation period, the livestock cooperatives are required to purchase raw milk from dairy farms and pay 70-80 per cent in cash and the remainder in milk powder, further exacerbating the harm to operating margins of the dairy farms;[245]

(i) The severe revenue problems suffered by the cooperatives were in large part passed onto the farmers. These problems caused disinvestment and severely limited investment in dairy production techniques and R&D in the milk powder sector, which produces only two types of milk powder, as compared to the multitude of milk powder types produced by the major exporting countries.

(ii) Other Potential Causal Factors Analyzed and Discounted

4.546 In addition, Korea considered other factors which could have been a cause of the serious injury noted above.[246] Korea undertook an extensive analysis of the effect of the "milk quality" controversy on inventory. It rejected the analyses suggested by both the KFIA[247] and the exporters, and used its own, which led it to conclude that the effect of the controversy lasted three months and ceased to be a cause of reduced raw milk demand by January 1996.[248]

4.547 Korea also considered whether the increase in imports of SMPP during the period under investigation had led to a decrease in the overall imports of milk powder.[249] Imports of milk powder were within the import framework for milk powders negotiated by Korea as part of the Uruguay Round. Under this framework, milk powder (as opposed to SMPP) was subject to an agreed tariff rate of 220 per cent which permitted its import to be controlled in an agreed and transparent manner.

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245 *See,* Exhibit Korea-1.
246 *See,* Notification at Paragraph V.2.
247 *See,* Notification at Paragraph V.2.1.a.
248 *See,* Notification at Paragraph V.2.1.
249 *See,* Notification at Paragraph V.2.2.

However, imports of SMPP circumvented this structure and were able to be imported at a much lower tariff rate than milk powder. The increased imports of SMPP far outweighed the drop in imports of milk powder paying the agreed tariff rate, and so there was no reason to conclude that the effect of the increase in imports of SMPP was offset by the decrease in milk powder.

4.548 In relation to demand, Korea considered whether the serious injury was caused by changes in domestic demand, and concluded that such changes did not cause serious injury. The European Communities dispute Korea's conclusion that "no connection could be established between the effect on these dairy products and injury to the domestic industry[250]." However, it is clear that there is no necessary connection between an increase in production and consumption of products using SMPP on the one hand, and injury to the domestic industry on the other. As noted above, no individual criteria of serious injury can be determinative on its own, and must be considered in conjunction with all other relevant criteria.

(c) Additional Arguments by the European Communities Made at the First Meeting of the Panel with the Parties

4.549 At the first meeting of the panel with the parties, the **European Communities** further advanced their arguments under Article 4.2(a) as follows:

(i) Invocation of New Arguments

4.550 The **European Communities** based their analysis of the lack of causal link first on the reasons given by Korea in its Notification of 1 April 1997 and second on a consideration of factors which Korea had failed to consider or make allowance for.

4.551 In the EC view Korea in its First Written Submission seeks to rely on a completely different reasoning in order to try to establish causation. There is little similarity between Korea's First Written Submission on this point and Section V.1 of the Notification and Korea is clearly trying to justify its measure *ex post*. Most notable are arguments for the first time about the increasing membership of the NLCF, the unavailability of any export market, "price suppression", the "displacement" of domestic milk and milk powder by imported SMPP, the doubling of dairy farm debt and finally disinvestment and limited investment in Research and Development. The European Communities submit that the safeguard measure must be judged in the basis of the reasons given in the Notification and that *ex post* rationalizations are not admissible.

4.552 In particular the European Communities take issue with Korea's contention that it determined that increased imports were significantly undercutting domestic production. There was no investigation of this matter and no consideration of the proper relationship between the prices of imported SMPP and domestic milk powder.

4.553 In any event, The European Communities believe that the new reasoning also does not establish any causal link. However, regarding the notion that imports forced an increase in the membership of the NLCF and therefore injury, the European Communities note with interest the affirmation by Korea that the membership of the

[250] *See,* Notification at V.2.3.6.

NLCF now accounts for 99 per cent of dairy farmers and that the NLCF has committed itself to pay the Korean Government recommended prices. Assuming this to be true, the European Communities do not see how it helps to establish causality. This high membership demonstrates that the dairy farmers are shielded from any possible adverse effects. The cause of the increased stock levels of NLCF members would seem to be sales to it by dairy farmers. This would therefore represent one part of the Korean industry (dairy farmers) causing injury to another part (co-operatives) and establishes no direct link with imports.

(ii) The Consequences of the "Pus Milk" Scandal

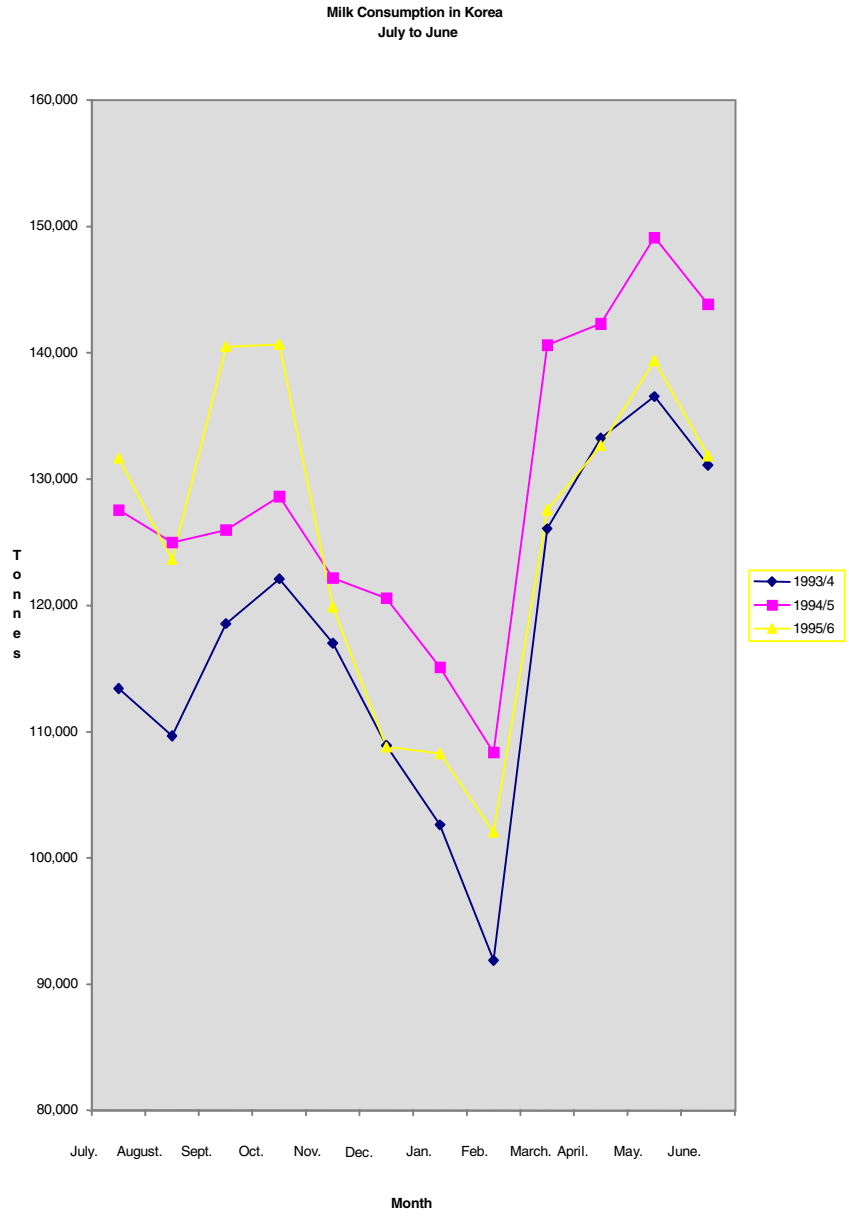
4.554 In the EC view the real cause of the increase in stocks in late 1995-1996 was, the "pus milk" scandal. At the end of 1995, the Korean public reduced its milk consumption when certain dairies started to accuse others of supplying "pus milk" from cows with mastitis. There was no doubt no truth in these allegations but they were made and did have an effect. The European Communities submitted a press Article describing the background to this issue.

4.555 Korea is fairly brief on this matter in its First Written Submission. Its explanation is worth quoting:

> "Korea undertook an extensive analysis of the effect of the "milk quality" controversy on inventory. It rejected the analyses suggested by both the KFIA and the exporters, and used its own, which led it to conclude that the effect of the controversy lasted three months and ceased to be a cause of reduced raw milk demand by January 1996" (footnotes omitted).

No detail is given of the analyses which led to this conclusion.

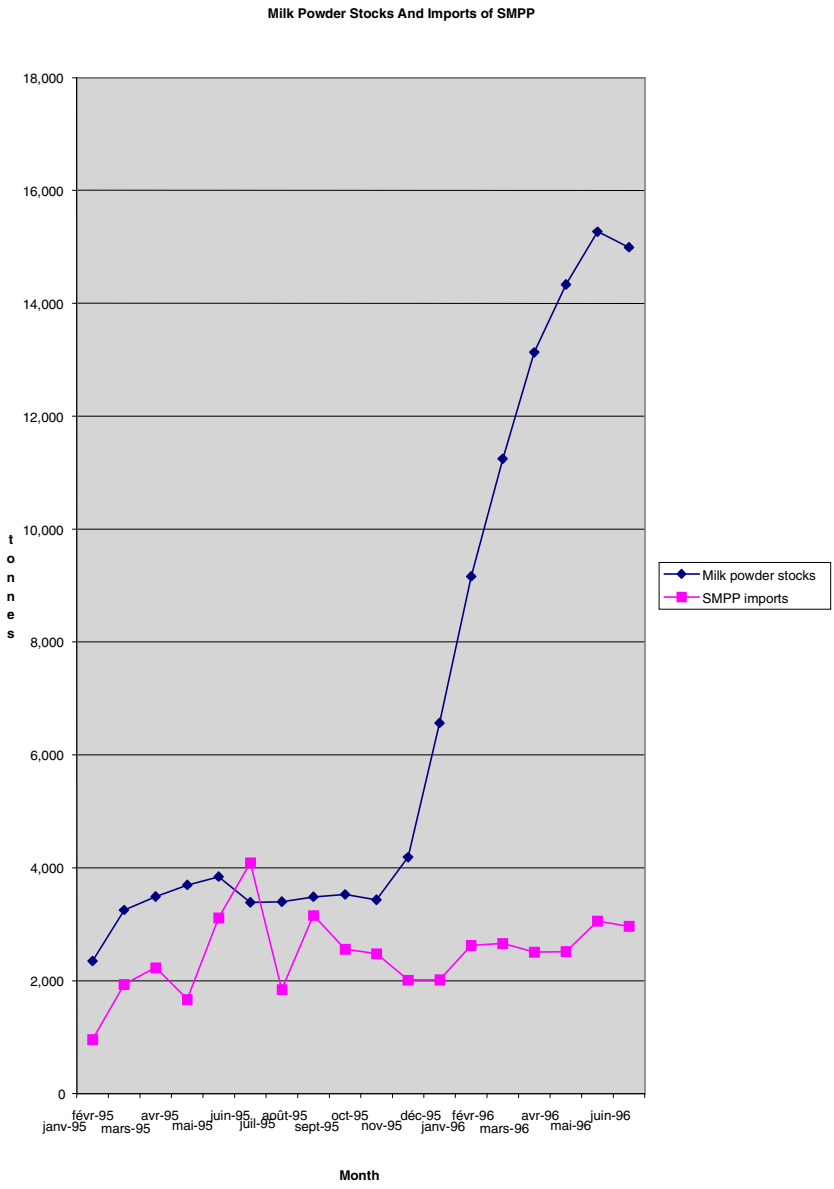
4.556 The Notification of 1 April 1997 had stated that the KFIA had failed to take account of the seasonal variations. The graph below, submitted by the European Communities, show a clear seasonal variation in milk consumption in Korea with a substantial decrease in winter. It also shows that milk consumption was increasing in each period. In 1995-96 there is a sudden dramatic drop which exceeds the previous seasonal variations and brings consumption back to levels of three years earlier. It is easy to understand why this, against a background of increasing dairy production and inflexible supply due to *de facto* assured prices would have led to the increase of stocks.



4.557 The European Communities therefore maintain that the situation of the Korean industry could not be considered to be one of "significant impairment" necessary to establish "serious injury" and in any event had nothing to do with rising

imports of SMPP but was instead the result of the "pus milk scandal" in conjunction with rising and inflexible production caused by high quasi-guaranteed prices.

4.558 The European Communities submitted a graph (reproduced below) illustrating their conclusion on this matter. It shows the development of imports of SMPP and the evolution of stocks. Increased stock levels is a problem which arose from November 1995. It shows no correlation at all with imports of SMPP but very much so with the "pus milk scandal".



(d) Rebuttal Arguments Made by the European Communities

4.559 The **European Communities** made the following arguments in rebuttal:

4.560 Korea's measure cannot be justified on the basis of reasons which were not considered by the investigating authorities and are not reflected in Korea's 24 March

Notification. In any event those put forward by Korea in its First Written Submission do not establish a causal link between imports of SMPP and the injury allegedly suffered by the Korean domestic industry. In particular, the European Communities recall that Korea did not demonstrate any causal effect between *prices* of imported SMPP and those of domestic milk powder or raw milk.

4.561 Furthermore, as regards the effects of the milk quality scandal, the European Communities note that Korea alleges to have relied on three econometric models to dismiss the importance of the quality scandal in explaining the situation of its domestic industry. Having examined the information included in the "OAI Report" which Korea has referred to, the European Communities consider that such information does not provide the explanation that Korea claims and that it has therefore not established that the "Pus Milk" Scandal did not cause or contribute to the injury.

4.562 First of all, the calculations of those models are based on *production* of milk, not on consumption.[251] The European Communities assume that production refers to *white* milk since only this, and not production of raw milk would approximate to consumption of white milk, because of the short shelf life of white milk. It is also remarkable that Korea considers that "there are various factors that can influence milk consumption, such as, among others, the change of consumption patterns, weather, etc." This statement is used to explain away the relevance of the milk quality scandal, but these factors are nowhere considered when examining the impact of imports of SMPP.

4.563 But the most important point is that Korea's deductions from its own figures and models [252] involve completely circular reasoning. Each of the three graphs deriving from the econometric models shows a decrease in milk production lasting through June 1996 (and possibly beyond, as no figures are given beyond that date)*:* in June 1996 a decrease of between 13,000 and 17,000 tonnes of milk production is still evident (depending on which model is considered). These results are dismissed by the statement, "The gap shown from February 1996 is attributable to factors other than quality dispute."[253] Which other factors? Were these investigated? And where are the results of such investigation given?

4.564 The OAI Report also notes that "The investigation authority drew this conclusion on the basis of the nature and short duration of the quality dispute."[254] The issue at stake is not the duration of the dispute, but the duration of its remaining in the public consciousness so as to affect consumption of milk - this is likely to be considerably longer than the dispute itself, but Korea failed to conduct any research to establish the length of this latter period of time. Thus Korea's conclusion that the "Pus Milk" Scandal did not have a lasting effect on stocks is not supported by its own models and is derived from and peremptory statement that it was of short duration. As stated above the reasoning is circular.

4.565 The European Communities affirm that Korea's attempted *ex post* justifications are not based on the investigation and therefore not admissible. In

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[251] *See,* the OAI Report, Exhibit Korea-14, p. 68-70.
[252] *See,* the OAI Report, graph on p. 70.
[253] *See,* the OAI Report, p. 69.
[254] *Ibid.*

addition the further information Korea has supplied to attempt to dismiss the "Pus Milk" Scandal as a factor shows circular reasoning and simply confirms that this factor was not properly considered.

(e) Rebuttal Arguments Made by Korea

4.566 **Korea** makes the following rebuttal arguments:

4.567 Based on its examination of the dairy industry, the Korean authorities concluded that the ease with which imported SMPP could replace domestic raw milk and milk powder meant that SMPP was an effective substitute for domestic raw milk and milk powder in most industrial uses. This was evidenced by the increased amount of SMPP used by the major food processing companies. Given this fundamental fact, the Korean authorities then examined the price at which the SMPP was imported into Korea and found that it considerably undercut the domestic price of both raw milk and milk powder. This price undercutting not only caused a drop in the consumption of domestic milk powder but also reduced raw milk consumption. Conversely, the market share of SMPP in uses such as flavoured and fermented milks increased dramatically at the expense of domestic milk powder and raw milk. Also, the absolute increase in imports of SMPP far outweighed any drop in the imports of milk powder.

4.568 The price undercutting caused an increase in inventory of milk powder. A further consequence of the imports of cheap SMPP was that the percentage of raw milk collected from dairy farms by livestock cooperatives for conversion into milk powder increased as processing companies which traditionally purchased raw milk from dairy households opted to buy the cheaper imported SMPP. The increase in inventory, combined with the relatively limited shelf-life of milk powder, caused the market price of milk powder to become depressed still further.

4.569 Strong competition from cheap imported SMPP also caused a drop in the revenue and profitability of the dairy households, the cooperatives, and the processing companies. The dairy households now had more limited sales opportunities for their raw milk, which out of necessity had to be turned into milk powder, thus increasing the supply of milk powder and inventory, and depressing its price. The losses on sales of milk powder affected the revenue and profitability of the processing companies and the cooperatives, and as the cooperatives are owned by the Korean dairy farmers, these farmers bore part of their losses.

4.570 Decline in profitability of the entire domestic industry also caused an increase in unemployment and a drop in the level of investment in dairy farming, including, *inter alia,* research and development.

4.571 In particular, Korea considers that the investigation demonstrated the existence of a causal link[255] based on the Korean authorities' examination of the following:

[255] Korea again reminds the Panel that the EC has accepted that the competent authorities published (a) "a report setting forth their findings and reasoned conclusions reached on all pertinent issues of fact and law" and (b) "promptly, in accordance with the provisions of Article 3, a detailed analysis of the case under investigation as well as a demonstration of the relevance of the factors examined."

(i) Substitution of Domestic Product by SMPP

4.572 The authorities examined the extent to which cheap SMPP imports replaced domestic products and stated that:

> "[a]n analysis of the written answers submitted by Lotte Confectionery and four other manufacturers shows SMPP replaced domestic product as the share of SMPP used by these companies grew from 3.0 per cent in 1993 to 53.3 per cent in the January-April period of 1996. The decrease in the purchase of domestic product by users affected the level of inventory of domestic milk powder.[256]"

SUBSTITUTION OF SMPP[257]

(UNIT*:* TONNES)

			93	**94**	**95**	**Jan.-Apr 1996**
Lotte	SMPP		-	x,xxx	x,xxx	Xxx
	Domestic	Raw milk	xxx	xxx	xxx	Xxx
		Milk powder	x,xxx	x,xxx	xxx	Xxx
Lotte Samgang	SMPP		-	xxx	-	-
	Domestic	Raw milk	xx	-	-	Xxx
		Milk powder	xxx	xxx	xxx	Xxx
Crown	SMPP		xxx	xxx	xxx	Xxx
	Domestic	Raw milk	-	-	-	-
		Milk powder	-	-	-	-
Haitai	SMPP		xx	xxx	x,xxx	Xxx
	Domestic	Raw milk	xxx	xxx	-	-
		Milk powder	xxx	xxx	x	x
Korean Yakult	SMPP		-	-	xxx	x,xxx
	Domestic	Raw milk	xx,xxx	xx,xxx	Xx,xxx	xx,xxx
		Milk powder	x,xxx	x,xxx	x,xxx	xxx
	SMPP (calculated in terms of raw milk, A)		341 (3,410)	3,298 (32,980)	3,777 (37,770)	2,382 (23,820)

[256] OAI Report at 66.
[257] OAI Report at 28.

			93	94	95	Jan.-Apr 1996
	Domestic	Raw milk	46,305	50,036	47,310	12,635
		Milk powder	6,351	5,551	4,523	821
		Total (calculated in terms of raw milk, B)	**109,815**	**105,546**	**92,540**	**20,845**
	Share(A/<A+B>, %)		3.0	23.8	29.0	53.3

Source: Written answers of users provided to the KTC
Note: 1. The total amount of raw milk, milk and skimmed milk
2. The share is computerized by using the figures calculated in terms of domestic raw milk.

(ii) Effect of the Increased Import of SMPP on Domestic Prices

4.573 The Korean authorities next determined the effect of the increased imports of SMPP on domestic prices. The authorities examined the following:

> "Import price (Won/kg) of SMPP was 1,750 Won in 1993, 1,689 Won in 1994, 1,709 Won in 1995, and 2,008 Won in the January-April period of 1996. Its sales price (Won/kg) was 2,590 Won in 1993, 2,500 Won in 1994, 2,530 Won in 1995, and 2,971 Won in the January-April period of 1996[258]."

As for the domestic milk powder, the sales price (Won/kg) was 5,354 Won in 1993, 5,294 Won in 1994, 5,388 Won in 1995, and 4,994 Won in the January-to-April period of 1996.[259]

[258] OAI Report at 62. *See,* also Notification at IV.3.7.
[259] OAI Report at 63. *See,* also Notification at V.1.2.

PRICE COMPARISON BETWEEN IMPORTS AND DOMESTIC PRODUCTS[260]

(unit: Won/kg, Won, %)

		93	94	95	96.1-4
SMPP	Import Price (CIF)	1,750	1,689	1,709	2,008
	Domestic Sales Price (A)	2,590	2,500	2,530	2,971
Domestic Products	Sales Price (B)	5,354	5,294	5,388	4,994
	Manufacturing Cost (C)	5,158	5,426	5,860	6,178
	Difference (B-C)	196	- 132	- 472	- 1,184
Price Gap	B-A	2,764	2,794	2,858	2,023
SMPP's Domestic Market Share(%)		1.6	7.0	12.2	14.0

Notes: 1) US$=800 Won
2) Domestic Sales Price = Import Price + (Import Price x Customs Duty (40 per cent)) + (Import Price x Expenses and Profit (8 per cent))
3) Domestic Products are based on milk powder.
4) SMPP Market Share = Amount Imported/Amount Consumed
5) Sales Price is average sales price of milk powder produced by the livestock cooperatives.
6) Manufacturing cost is the average manufacturing cost of milk powder produced by the livestock cooperatives.
7) As of August 1996, domestic skimmed milk powder sells at 3,800 Won/kg and the imported SMPP sells at 2,956 Won/kg, the margin being 844 Won/kg.

4.574 The Korean authorities then explained:

(a) "The sales price of SMPP undercut the sales price of the domestic milk powder by 2,764 Won in 1993, 2,796 Won in 1994, 2,858 Won in 1995, and 2,023 Won in the January-April period of 1996. Because the sales price of SMPP was approximately half the price of domestic milk powder, the volume of import of SMPP increased rapidly during the period of investigation.

(b) Because SMPP penetrated the domestic market by taking an increasingly large market share and significantly undercutting the price of domestic milk powder, the price of domestic milk was depressed from 5,354 Won in 1993 to 4,994 Won in the January-April period of 1996.

(c) As the increased import of SMPP depressed domestic price of milk powder, domestic producers' losses grew larger as the domestic sales price could not be increased to keep pace with the rate of production cost increase. These losses were 196 Won in 1993, turning to a loss of 132 Won in 1994, a larger loss of 472 Won in 1995 and a further loss of 1,184 Won in the January-April period of 1996.

(d) In sum, it is apparent that the increase of SMPP and its rapid rise in the market share caused a depression of the domestic sales price which fell below the production cost as of 1994. The large losses have

[260] OAI Report at 63. *See,* also Notification at V.1.2.

been increasing and this combined with domestic sales price below production cost are causing injury to the domestic industry.[261]"

4.575 Therefore, the Korean authorities found that the sales prices for imports of SMPP were significantly undercutting the sales prices of domestic milk powder. As a result, the price of domestic milk powder was severely depressed causing serious injury to the domestic industry.

(iii) Livestock Cooperatives' Volume of Raw Milk Collected

4.576 The Korean authorities also examined the effect of the low price of SMPP imports on the amount of raw milk collected by the livestock cooperatives. The authorities stated:

"The livestock cooperatives' volume of raw milk collected from dairy households was 40.56 per cent in 1990. The rate grew to 41.36 per cent in 1993, to 42.80 per cent in 1994, to 44.30 per cent in 1995, and to 45.30 per cent in January-June period of 1996."[262]

"The increased import of SMPP caused the livestock cooperatives to increase their purchase of raw milk from dairy households, because processing companies that traditionally purchased raw milk from dairy households opted to purchase the much cheaper SMPP. The increased collection of raw milk by the livestock cooperatives caused the deterioration of their business operation, because the displaced raw milk had to be converted into milk powder inventory (see VI.2.A. first paragraph).[263]"

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[261] OAI Report at 63. *See,* also Notification at V.1.2. Korea submits the following regarding the EC's arguments:

In its First Submission, the EC contends that the competent authorities limited their analysis to whether increased market share caused a decrease in domestic milk powder price. *Korea, however, directs the Panel to the price information for SMPP on page 63 of the OAI Report and in section V.1.2 of the Notification.*

In its First Submission, the EC argues that the competent authorities focused solely on the decline in domestic milk powder prices at the end of the investigation. To the contrary, *the competent authorities examined the decline in price at the end of the period, the declining price in real terms (i.e., price adjusted by the overall inflation rate) compared to increases in production costs, and the significant difference in price levels between imports of SMPP and domestic milk powder.*

In its First Submission and in its Oral Statement, the EC makes several statements that demonstrate it has, intentionally or unintentionally, ignored the OAI Report and the Notification. *Korea refers the EC to the OAI Report at 63 and the Notification at IV.3.7 and V.1.2.*

[262] OAI Report at 64.

[263] OAI Report at 64. *See,* also Notification at V.1.3.

LIVESTOCK COOPERATIVES' VOLUME OF RAW MILK COLLECTED[264]

(unit:%)

	1990	1991	1992	1993	1994	1995	1996.1-6
Cooperatives' Portion	40.56	41.14	40.19	41.36	42.8	44.3	45.3
Compared Against Basis Year	100	101.4	99	101.9	105.5	109.2	112

Data*:* Provided by the MAF and NLCF to the KTC
Note: Basis year 1990

4.577 In Korea's view, the above table refutes the EC argument that raw milk collection by the cooperatives was "slowly but steadily rising" and the increases in SMPP imports "did not affect a trend." As the table shows, the cooperatives' portion actually declined to below its 1990 level in 1992 and the portion increased substantially during the investigation period by approximately 12 per cent from 1990 to June 1996 and by 10 per cent from 1993 to June 1996.

(iv) Production of White Milk and Flavoured Milk

4.578 The Korean authorities also examined the extent to which the cheaper SMPP caused the shift from the production of white milk (which can only use domestic raw milk as an input) to the production of flavoured milk. The authorities stated:

> "Of the total amount of milk produced, white milk accounted for 92.9 per cent in 1990, 92.4 per cent in 1991 and 92.4 per cent in 1992, maintaining almost the same level. However, the share of white milk decreased with the rapid increase in import of SMPP. The share of white milk fell to 91.3 per cent in 1993, to 88.6 per cent in 1994, to 83.8 per cent in 1995, and to 82.1 per cent in the January-June period of 1996.
>
> The decline in the production of white milk occurred because the domestic producer chose to use the cheaper SMPP to produce flavoured milk which was favoured by the wholesalers and retailers for the product's higher profit margin.
>
> The decline in the share of white milk which can only be produced from domestic raw milk depressed the demand for domestic raw milk.[265]"

PORTION OF WHITE MILK IN RELATION TO FLAVOURED MILK PRODUCED

(UNIT : %)

	1990	**1991**	**1992**	**1993**	**1994**	**1995**	**1996.1-6**
White Milk	92.9	92.4	92.4	91.3	88.6	83.8	82.1
Flavoured Milk	7.1	7.6	7.6	8.7	11.4	16.2	17.9

Data*:* Provided by the MAF to the KTC

[264] OAI Report at 64.
[265] OAI Report at 64. *See,* also Notification at V.1.4.

4.579 Thus, the cheap SMPP caused a shift of production from white milk to flavoured milk. This shift led to a decline in the use of raw milk by the milk processing companies which in turn led to the increased collection of raw milk by the livestock cooperatives for conversion into milk powder. Contrary to the EC contention, the Korean authorities considered that the shift to flavoured milk production was not the result of consumer preferences but because the cheaper SMPP allowed for the realization of higher profit margins. The European Communities are simply expressing their disagreement with the judgement of the Korean authorities without any evidence. However, the Korean authorities must be accorded due deference in interpreting the data collected rather than being second guessed by a third party.

(v) Impact of SMPP on the Sale of Domestic Products

4.580 The Korean authorities examined the impact of cheap SMPP imports on the sale of domestic products. First, with respect to the decline in price, the authorities stated that "[t]he comparatively cheaper priced SMPP and the increased volume of SMPP caused the sales price of domestic milk powder to fall [in real and nominal terms], resulting in the loss of sales revenue in the [specified amounts from 1993 to] the first four months of 1996." Second, with respect to the loss of sales revenue due to loss of customers, "[b]ecause the imported SMPP is cheaper than the domestic raw milk and milk powder, [two entities] incurred a loss in sales revenue amounting to a total of x,xxx million Won in the period of 1995 to April 1996 as a consequence of their erosion of the customer base[266]."

(vi) Market Share of SMPP Against Total Demand

4.581 With regard to the market share taken by the increased imports of SMPP, the Korean authorities found that:

> "Import of SMPP amounted to 3,217 tons in 1993, 15,561 tons in 1994, 28,007 tons in 1995, and 16,320 tons in the January-to-June [period] of 1996. In terms of the increase rate, it was 384.0 per cent in 1994, 80.0 per cent in 1995, and 16.9 per cent in the January-June period of 1996.
>
> The market share of SMPP against total demand was 1.6 per cent in 1993, 7.0 per cent in 1994, 12.2 per cent in 1995, and 14.1 per cent in the January-June period of 1996, the rate growing larger every year.[267]"

[266] OAI Report at 66.
[267] OAI Report at 58 and 59. *See,* also Notification at V.1.1.

CHANGES IN MARKET SHARE OF SMPP

(UNIT: ton)

	1993		1994		1995		1996.1-6
			Increase rate(%)		Increase rate(%)		Increase rate(%)
Total Demand (A)	2,205,063	2,218,548	9.6	2,303,795	3.8	1,153,964	-2.3
Production (B)	1,857,873	1,917,398	3.2	1,998,445	4.2	1,069,224	4.4
Import of SMPP (C)	3,217	15,561	384.0	28,007	80.0	16,320	16.9
Market Share of SMPP (C/A, %)	1.6	7.0	-	12.2	-	14.1	-

Data: provided by MAF and KITA to the KTC

4.582 Therefore, the Korean authorities found that SMPP's share of total demand (which includes domestic raw milk, domestic milk powder, imported milk powder and imported SMPP) increased during the investigation period from 1.6 per cent in 1993 to 14.1 per cent in the first half of 1996, representing a net increase in market share of 12.5 per cent.

4.583 The Korean authorities determined the extent to which increased imports of SMPP replaced decreased imports of milk powder. The Korean authorities noted:

> "As the import of SMPP increased, its market share in the milk powder sector rose from 10.7 per cent in 1993 to 38.4 per cent in 1994, further to 60.6 per cent in 1995 and to 69.4 per cent in the January-June period of 1996."[268]

As the import of SMPP increased, however, the amount of milk powder imported decreased from 14,843 tons in 1993 to 11,581 tons in 1994, to 7,576 tons in 1995, and further down to 583 tons in the January-June period of 1996.[269]

[268] OAI Report at 60.

[269] OAI Report at 61. *See,* also Notification at V.1.1.

CHANGES IN MILK POWDER PRODUCTS DOMESTICALLY CONSUMED[270]

(UNIT: tonnes)

		1993	1994		1995		1996-1-6	
				Increase (%)		Increase (%)		Increase (%)
Milk powder Consumed (A)		30,181	40,532	34.3	46,254	14.1	23,532	14.5
-Domestic Milk Powder Consumed		12,191	12,468	2.3	10,690	- 14.3	6,629	11.6
Supply	Production (B)	13,512	9,495	- 29.7	15,719	65.6	15,058	93.3
		18,060	27,142	50.3	35,583	30.9	16,903	5.0
	Amount Imported							
	- Milk Powder	14,843	11,581	-22.0	7,576	- 35.0	583	- 84.0
	- SMPP (C)	3,217	15,561	384.0	28,007	80.0	16,320	16.9
	Total	31,572	36,637	16.0	51,302	40.0	31,961	25.9
Inventory		4,509	1,517	- 66.4	6,565	332.8	14,994	342.7
SMPP's Market Share (C/A)		10.7	38.4	-	60.6	-	69.4	-

Data: provided by MAF, KITA to the KTC

4.584 The imports of milk powder essentially entered at a tariff rate exceeding 200 per cent, while imports of SMPP entered at a rate of only 40 per cent.[271] Given the tariff differential, imports of SMPP replaced the entire volume of imported milk powder during the investigation period and also captured all of the 90 per cent increased volume of total milk powder and SMPP imports.[272] Thus, the European Communities claim argument that "much of the increase" of SMPP was at the expense of imported milk powder ignores the fact that the Korean authorities determined that the imports of SMPP far outweighed the decline in milk powder imports.[273]

(vii) The Korean Authorities Considered the Extent to which Other Factors Were Causing Injury to the Domestic Industry

4.585 The Korean authorities evaluated the following other factors:

(a) The milk quality dispute

4.586 The Korean authorities evaluated the arguments presented by interested parties, including the Korea Food Industry Association ("KFIA") and the Korea Dairy

[270] OAI Report at 61.
[271] *Ibid.*
[272] *Ibid. See,* OAI Report at 61; Notification at V.2.2 ("the imports of products under investigation grew by 24,790 tons, while those of milk powder fell by 7,267 ton.
[273] OAI Report at 61; Notification at V.2.2.

Cow Breeding Association ("Breeding Association").[274] The KFIA contended that the milk quality dispute contributed 87.17 per cent to the rise in the milk powder inventory and the increase in SMPP contributed 4.80 per cent.[275] The Breeding Association contended that increased imports of SMPP contributed 61.9 per cent to the increased milk powder inventory and the milk quality dispute contributed 17.0 per cent.[276]

4.587 The Korean authorities rejected the analysis of the KFIA based on flaws in its data and analysis.[277] The authorities also rejected the Breeding Association's analysis because it failed to submit basic materials to support its claims.[278] Instead, the authorities developed three statistical and econometric models for estimating the volume of milk production for the period covering November 1995 to June 1996, assuming the quality dispute had not occurred.[279] The authorities concluded that "[b]ased on the results of three models, the figures reflecting the difference between estimated and actual volume of milk production indicate that the quality dispute no longer had effect as of January 1996.[280]" As part of the OAI's investigation to determine causality, the OAI also employed a commonly-used econometric technique called the "Granger causality test". The test results, checking up to six lags in variables to maximize accuracy, indicated that the increased imports of SMPP caused serious injury to the domestic industry.[281] Taken together, the Korean authorities determined that while the milk quality dispute had an effect for a few months, the imports of SMPP had a negative effect on the domestic industry throughout the entire investigation period.

(b) Influence of reduced imports of milk powder

4.588 The Korean authorities evaluated the influence of reduced imports of milk powder in its causation analysis. The Korean authorities essentially determined that:

> "[d]uring the period of 1993-1995 the imports of products under investigation grew by 24,790 tons, while those of milk powder fell by 7,267 tons. Therefore, the decreased imports of milk powder had a very slight, albeit positive, impact on the injury to the domestic

274 OAI Report at 67-68. *See,* also Notification at V.2.1.
275 OAI Report at 67. *See,* also Notification at V.2.1.a.
276 OAI Report at 67.
277 *See,* OAI Report at 68; Notification at V.2.1.a.
278 *See,* OAI Report at 68.
279 *Ibid.* In its First Submission, the EC contends that the competent authorities "fail[ed] to make any analysis" of the effects of the milk quality dispute. In its Oral Statement, the EC states that "[n]o detail is given of the analyses which led to this remarkable conclusion" and that the milk quality dispute was "lightly dismissed." Korea again suggests that the EC review the OAI Report of which it has had a copy in English at least since early 1997.
280 OAI Report at 69.
281 The Granger causality test indicated for example, that the increased imports of SMPP caused an increase in milk powder inventory at 5 per cent level of significance. In hypothesis testing 5 per cent level of significance means that the level of confidence of the test result is 95 per cent (*See*, for example, Damodar N. Gujarati, *Basic Econometrics*, 2nd. Edition, McGraw Hill*:* NY, 1988, p. 99).

industry compared with the increased imports of the products under investigation.[282]"

(c) Review of demand

4.589 The Korean authorities also examined other factors potentially causing serious injury to the domestic industry relating to demand for domestic raw milk and milk powder. With respect to consumption, they stated that "given the overall increase in consumption, the injury to the domestic industry is not attributable to a decrease in consumption." [283] With respect to whether the shift to flavoured milk from white milk was based on changing consumer preferences, the authorities found that the shift was "attributable to milk processors seeking to change the production structure in order to maximize their profits through the use of cheaper imported products, as opposed to changes in consumer preference." [284] With respect to consumption of final dairy products, they determined that dairy products consumption increased during the period from 1993 to June 1996, and "[t]herefore, it was not regarded as a cause of injury to the domestic industry."[285]

4.590 With respect to the effect of the situation in other dairy products sectors, the Korean authorities examined the white milk, milk powder preparation, evaporated milk, butter, and cheese sectors. Because the production and consumption of these dairy products increased during the period of the survey and because their use of domestic raw milk and domestic milk powder also increased, the authorities found that "no connection could be established between the effect on these dairy products and injury to [the] domestic industry." [286]

(d) Review of price decision by the government

4.591 Finally, the Korean authorities evaluated any potential injury caused by the suggested government price for raw milk. The authorities found that the suggestion of such a price did not adversely affect the domestic industry because it was not obligatory and was intended as a suggested reference price for contracts between dairy households and milk processing firms.[287]

(f) Additional Arguments by the European Communities Made at the Second Meeting of the Panel with the Parties

4.592 At the second meeting of the panel with the parties, the **European Communities** further advanced their arguments under Article 4.2(b) as follows:

4.593 The European Communities point to the flaws in the conclusions drawn from by Korea from its econometric models. The models do show a shortfall in

[282] Notification at V.2.2.
[283] Notification at V.2.3.1.
[284] Notification at V.2.3.2. In its Oral Statement, the EC disagrees with the competent authorities' judgement on this issue. Korea considers that the EC should not be allowed to assume the role of the investigating authority.
[285] Notification at V.2.3.3.
[286] Notification at V.2.3.6.
[287] *See,* Notification at V.2.4.

consumption continuing until June 1996 but it is then stated at pages 68 to 70 of the OAI Report that this cannot be due to the milk quality dispute as this ended in February. No other explanation is advanced for the shortfall. This is perfectly circular reasoning.

4.594 Korea alleges it performed a "Granger causality test", without in any way explaining where it is to be found in the OAI Report, how this test works, precisely what its results demonstrated, what variables were used in relation to "checking lags", what level of statistical accuracy was demonstrated in the test results, etc. This test has never been mentioned before by Korea and cannot be taken seriously without considerably more information being given as to its nature and its application to this situation. Indeed, the European Communities asked, what happens when it is applied to the milk quality scandal?

(g) Additional Arguments by Korea Made at the Second Meeting of the Panel with the Parties

4.595 At the second meeting of the panel with the parties, **Korea** further advanced its arguments under Article 4.2(b) as follows:

4.596 The European Communities argue that the econometric models used by the OAI were flawed in that they examined production, instead of consumption. Korea notes that:

(a) The OAI assumed that production is equal to the consumption of milk, which is a realistic assumption, and the difference between production and consumption data was so small as to be statistically insignificant;

(b) The statistical and econometric models actually focussed on the difference between actual and forecasted production, and not production itself; and

(c) Finally, and most importantly, the Granger Causality test, which checked the causality from increase of imports of SMPP to increase in inventory did not use data such as production or consumption.

4.597 In response to a question by the Panel[288], **Korea** explained that in order to establish any causal relationship between the imports of SMPP and the increase in inventory, the OAI used the econometric technique referred to as "Grainger Causality" test. The following parameters or techniques were applied:

- The period of the data covered January 1993 to June 1996;
- The statistical software "Eviews" was used
- X-11 Arima multiplicative method was used to remove seasonality;
- Since the level terms of most variables are non-stationary, a unit root test was applied, this being an augmented Dickey-Fuller test, with constant and no-trend term;
- Akaike information criterion was adopted to get optimal lags in the right-hand variable; and

[288] The Panel recalls that the question was: "How was the 'Granger' test applied in this case?"

- Lags up to six were checked on the right-hand side of the equation used in the Augmented Dickey-Fuller test.

The calculated ADF statistics were the following:

- level of import of SMPP was -1.163, which is not significant at any reasonable level of significance;
- level of inventory of milk powder was 0.284 , which is not significant at any reasonable level of significance;
- first differentiated value of import of SMPP was -8.159 , which is significant at 1 per cent level of significance; and
- first differentiated value of inventory was -2.976, which is significant at 5 per cent level of significance.

4.598 Therefore the calculated ADF statistics showed that the import of SMPP and inventory of milk powder are integrated of order one, like most other macroeconomic time series. As the first differenced variables were revealed to be stationary, they were used to obtain the result of causality tests. The most commonly used causality test is the Granger test, and this was used to obtain the result. Pairwise Granger causality tests, checking lags up to 6, revealed that imports of SMPP caused an increased in inventory of milk powder at 5 per cent in four out of six cases and at 10 per cent in one case. The causation was negated at 10 per cent only in one out of six cases. The calculated F statistics were the following:

one lag case:	F(1,36) =	1.850;
two lag case:	F(2,34) =	2.733;
three lag case:	F(3,32) =	3.583;
four lag case:	F(4,30) =	5.681;
five lag case:	F(5,28) =	4.314;
six lag case:	F(6,26) =	5.394.

4.599 Therefore, on the basis of the above, the OAI concluded that the econometric causality tests revealed a causal relationship running from the import of SMPP to the increase in inventory of milk powder.

4.600 In response to a question by the Panel[289], **Korea** clarified the substitutability of raw milk, milk powder and SMPP. As stated in Section II.2 of the OAI Report, SMPP can substitute domestically produced raw milk and milk powder to produce flavoured milk, fermented milk, ice cream and cookies. Based on the import clearance document submitted by foreign exporters, the Korean authorities verified

[289] The Panel recalls that the question was: "In Korea's first submission, it is stated that SMPP products are competing directly with domestically-produced raw milk and pure milk powders. Could Korea elaborate? Does this mean that 1 unit (say 1 Kg) of SMPP can substitute 1 unit of milk powder and/or 1 unit of raw milk for the production of downstream products? Please provide the Panel with exact figures for each of the downstream product (*e.g.,* yoghurt, flavoured milk, ice-cream, cheese etc…). Was the Korean Trade Commission aware of these facts at the time of its investigation? Did it take them into account in its report and if so how, and where is it indicated in the OAI Report?

that SMPP can be used to produce milk based beverages, ice cream and cookies. That the imported SMPP and domestic milk powder are in directly competitive relationship is evidenced by the fact that the primary difference between the two products is that the former contains 75 per cent to 85 per cent milk powder and 15 per cent to 25 per cent whey or malt concentrate.[290] Moreover, for commercial purposes, the imported SMPP and domestic products share common end uses. Imported SMPP and domestic products can be used to produce flavoured milk, fermented milk, ice cream and cookies.[291] As a further indication that the imported SMPP and domestic products are directly competitive products, the Korean authorities found that, of the total purchase of basic materials, five dairy processing companies increased their purchases of SMPP from 3 per cent in 1993 to 23.8 per cent in 1994, 29 per cent in 1995 and 53.3 per cent in January-April 1996.[292]

4.601 In producing flavoured milk and cookies, one unit (1 kilogram) of SMPP can substitute one unit(1 kilogram) of milk powder or ten units of raw milk. In producing ice cream and fermented milk, one unit of domestic milk powder can be replaced by anywhere between 0.8 to 1.2 units of SMPP, depending on the dairy processing company. The Korean authorities decided that the use of one to one substitution rate between imported SMPP and domestic milk powder to produce ice cream and fermented milk was appropriate because, based on the data collected, the usage rate would average out to one unit to one unit rate.

4.602 The Korean authorities were aware that (1) the domestic products and the imported SMPP had physical differences but shared common end uses and (2) substitutability between the imported SMPP and domestic milk powder was on a one unit to one unit basis and that ten units of raw milk are needed to produce one unit of milk powder. The conversion rate of ten raw milk units to one milk powder unit is reflected in various places of the OAI Report. For instance, charts in Sections III.5.A and VI.2.A reflect this conversion rate. The substitution rate of one unit to one unit between SMPP and milk powder is reflected in the Note at the bottom of the chart in Section III.5.A which states "for computation of demand and self sufficiency rates, the amounts of SMPP and imported milk powder calculated in terms of domestically produced raw milk were used." Although this is not the most eloquent translation, it indicates that the Korean authorities were familiar with the fact that ten units of domestic raw milk were equivalent to one unit of SMPP or one unit of imported milk powder.

H. Claims under Article 5.1 of the Agreement on Safeguards

(a) Claim by the European Communities

4.603 The **European Communities** claim that Korea violated Article 5.1 of the Agreement on Safeguards by failing to show that the measure was necessary to prevent or remedy serious injury and to facilitate adjustment; by failing to demonstrate that a quota was the most suitable to prevent or remedy serious injury

[290] *See,* OAI Report at Section II.4
[291] *See,* OAI Report at Section IV.1.B.(4).(a)
[292] *See,* OAI Report at Section IV.1.B.(4).(B).(i)

and to facilitate adjustment; and by imposing a quota lower than the average of imports in the last representative three-year period preceding the application of the measure for which statistics were available. The following are the EC arguments in support of these claims:

4.604 Article 5.1 of the Agreement on Safeguards provides that

> "A Member shall apply safeguard measures only to the extent necessary to prevent or remedy serious injury and to facilitate adjustment. If a quantitative restriction is used, such a measure shall not reduce the quantity of imports below the level of a recent period which shall be the average of imports in the last three representative years for which statistics are available, unless clear justification is given that a different level is necessary to prevent or remedy serious injury. Members should choose measures most suitable for the achievement of these objectives".

Even if Korea's analysis of serious injury and causation were correct, the European Communities submit that Korea violated Article 5.1 of the Agreement on Safeguards by failing to show that the quota which it applied was necessary and the most suitable to remedy the injury and facilitate adjustment.

4.605 The fact that safeguard measures are "limitative and deprivational in character or tenor and impact upon Member Countries and their rights and privileges and upon private persons and their acts" was clearly recognized by the Appellate Body in its report in *US - Underwear*.[293] In the light of that characterization, the Appellate Body drew the conclusion that an importing Member should not be allowed "an enhanced ability to restrict the entry into its territory of goods in the exportation of which no unfair trade such as dumping or fraud or deception of origin is alleged to be proven" by taking safeguard action beyond the strict limits laid down in the relevant WTO provisions, which would result in "excluding more goods from the territory of the importing Member".[294]

4.606 Some of the limits built in the WTO safeguard measures regime relate to the measures themselves, notably to their scope, level and type. Those limits are laid down in Article 5.1. Besides recalling that safeguard measures must be necessary to remedy serious injury, as provided for in Article XIX:1(a),[295] Article 5.1 of the Agreement on Safeguards further requires that the temporary protection from foreign competition must be *necessary* to *facilitate adjustment.*[296] The rationale for this provision is clearly that protection of an inefficient industry sector with no recovery prospects by means of safeguard measures should be excluded.

4.607 It follows from the foregoing that a Member of the WTO seeking to take a measure under the Agreement on Safeguards must show that such a measure is, in its

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[293] *See,* Appellate Body report in *US - Underwear*, WT/DS24/AB/R, adopted 25 February 1997, DSR 1997:I, 11, at 23.

[294] *Ibid.*

[295] Article XIX:1(a) refers, in virtually identical terms, to the "extent and time necessary to remedy the injury".

[296] *See,* also the Preamble of the Agreement on Safeguards, second to last paragraph, "[r]ecognizing the importance of structural adjustment and the need to enhance rather than limit competition in international markets".

scope and level, necessary to remedy the injury suffered by the domestic industry and necessary to facilitate its adjustment. In this respect the European Communities note that Korea failed to provide any justification as to the reasons why the quantitative restrictions applied were necessary to remedy the alleged serious injury and to facilitate adjustment. In particular, Korea did not submit any information as to adjustment plans to restore the domestic industry's competitiveness while temporarily shielding it from foreign competition. On the contrary, Korea took safeguard action in the context of a protected market. It is clear to the European Communities by omitting to give any consideration to adjustment plans, *a fortiori* Korea has failed to examine how that measure could be necessary, or even helpful, to their implementation.

4.608 For these reasons, the European Communities submit that Korea violated its obligations under Article 5.1, first sentence of the Agreement on Safeguards.

(i) The Most Suitable Measures to Remedy Serious Injury and Facilitate Adjustment

4.609 Article 5.1, last sentence, of the Agreement on Safeguards, further building upon the remedial character and the adjustment objective of safeguard measures, also requires Members to "choose measures most suitable for the achievement of these objectives." The ordinary meaning of this clause already suggests that both the objective to remedy the injury and the objective to facilitate adjustment also limit the *type* of measure which a Member may adopt, in addition to its level or scope. This construction is further reinforced in the light of the principle of effective interpretation of treaties, based on which where a treaty provision can be subject to several possible interpretations, preference should be accorded to the one giving that provision its effect.[297] In fact, if the second sentence of Article 5.1 were also to be interpreted as a limit to the level or scope of a measure, rather than as including some additional element, it would be redundant in the light of the first sentence.

4.610 The conclusion that the choice of the type of safeguard measure is limited under Article 5.1 of the Agreement on Safeguards is confirmed if that provision is interpreted in its context. In fact the Agreement on Safeguards includes a partially different regime for quotas and tariff measures. In the first place, a maximum limit to the level of protection, additional to the injury level and the adjustment required, is imposed by Article 5.1, second sentence, providing that "if a quantitative restriction is used, such a measure shall not reduce the quantity of imports below the level of a recent period which shall be the average of imports in the last three representative years for which statistics are available." Second, in case of provisional measures Article 6 of the Agreement on Safeguards limits the possibility of action to tariff measures only. Also, the different nature and impact of the various protection measures has been expressly recognized in the regulatory framework established by the WTO Agreement and its annexes. Specifically, Members recognized that

[297] The principle of effectiveness in treaty interpretation was recognized as an appropriate interpreting principle by the Appellate Body in *US - Underwear*, *supra*, footnote 293, at 14.

"price-based measures", that is, "measures with an impact on the price of imported goods" "have the least disruptive effect on trade".[298]

4.611 It follows from the foregoing that if a WTO Member seeks to take a safeguard measure, the choice of the type of measure also needs to be justified in terms of its adequacy to remedy injury and facilitate adjustment. The European Communities therefore conclude that, by failing to consider whether other types of measure than a quota would be the most suitable to remedy serious injury and to facilitate adjustment, Korea further violated its obligations under Article 5.1 of the Agreement on Safeguards.

(ii) Quota Lower than Average of Imports in the Last Representative Three-Year Period Preceding the Application of the Measures for Which Statistics Were Available

4.612 Article 5.1, second sentence, of the Agreement on Safeguards provides that "if a quantitative restriction is *used*, such a measure *shall not* reduce the quantity of imports below the level of a recent period which *shall* be the average of imports in the *last* three *representative* years for which statistics are *available*, unless *clear justification* is given that a different level is *necessary* to prevent or remedy serious injury." (emphasis added).

4.613 The average of imports into Korea for July 1993-June 1996 was lower than the average for the period January 1994-December 1996. The European Communities submit that, by calculating the quota level on the basis of import data relating to the period July 1993-June 1996, rather than to the period January 1994-December 1996, the Korean authorities violated Article 5.1 of the Agreement on Safeguards, second sentence, since July 1993 - June 1996 data did not relate to the "last three representative years for which statistics are available" and the resulting quota was lower than allowed by that provision, without justification being provided.

4.614 In order to demonstrate this claim the European Communities first examine the meaning of Article 5.1, second sentence of the Agreement on Safeguards, and then turns to the three years which are relevant under that provision.

(a) Article 5.1 of the Agreement on Safeguards

4.615 Article 5.1 of the Agreement on Safeguards is clearly intended to avoid the quota being set at a level unrelated to historical import flows prior to its imposition, which would prove particularly disruptive for exporters. By limiting in principle the minimum quota level to the average of the last three representative years the

[298] *See,* the *Understanding on the Balance-of-Payments Provisions of the General Agreement on Tariffs and Trade 1994*, para. 2. Para. 3 is even more explicit in providing that "Members shall seek to avoid the imposition of new quantitative restrictions for balance-of-payments purposes unless, because of a critical balance of payments situation, price-based measures cannot arrest a sharp deterioration (…). In those cases in which a Member applies quantitative restrictions, it shall provide justifications as to the reasons why price-based measures are not an adequate instrument to deal with the balance-of-payments situation."

Agreement on Safeguards establishes a presumption that for quotas such level is the maximum restriction which would be justifiable as "necessary" within the meaning of Article 5.1 Agreement on Safeguards. It is only if the Member seeking to apply a safeguard measure in the form of a quota is able to show that a quota level based on those data is not sufficient to remedy the serious injury in a specific case that a lower quota may be imposed. Since Korea has not considered the issue of necessity at all, it has taken no steps to rebut this presumption.

(b) The last three representative years for which statistics are available

4.616 In order to determine the "last three representative years" which Korea should have used in setting the quota level, the following issues must be addressed: (i) the starting time from which to calculate the three years, (ii) the availability of statistics for those three years and (iii) the representativity of those data.

(1) Starting time

4.617 As regards the relevant time to decide which are the last three years' available import statistics pursuant to Article 5.1 Agreement on Safeguards, the ordinary meaning of the provision already makes clear that it is the moment when a decision to take a measure in the form of a quota has been taken and the quota level is to be decided. The context of the second sentence of Article 5.1 further reinforces that interpretation. In fact the first sentence of Article 5.1 makes clear that the provision relates to the time when a Member "applies" safeguard measures. The Appellate Body Report *US - Underwear* removed any doubt as to the meaning of the term, by pointing out that the word "apply", when used as here in respect of a governmental measure - whether a statute or an administrative regulation - means, in ordinary acceptation, putting such measure into operation."[299] Thus, the European Communities submit that the starting time for the assessment of the "last three years" is the moment when action in the form of a quota was taken and the quota was calculated. Therefore, it is from that moment that a country should look retrospectively at imports trends until it finds three representative years of data. A final decision on a definitive safeguard measure in the form of a quota was taken by Korea on 7 March 1997.[300]

(2) Availability of the data relating to the relevant period

4.618 The import statistics considered by the KTC in determining the appropriate level of the quantitative restriction relate to the period July 1993 through June 1996.[301] While data relating to that period were certainly "available" within the meaning of Article 5.1 when the quantitative restriction level was set, it remains to be clarified whether more recent information was also available. In this respect the European Communities submit that, as made clear from Korea's Statistical Yearbook

[299] *Understanding on the Balance-of-Payments Provisions of the General Agreement on Tariffs and Trade 1994*, p. 8.
[300] *See,* WTO Doc. G/SG/N//10/KOR/1/Suppl/1, 1 April 1997, p.1 (Exhibit EC-10).
[301] *See,* Exhibit EC-8.

of Foreign Trade for 1996[302], import data relating to the whole 1996 were available to the Korean authorities before the amount of quota was finally calculated and that these data should therefore have formed the basis for calculation of the quota level.

(3) Representativity

4.619 The European Communities submit that Korea completely failed to address, either expressly or impliedly, the issue of whether the statistics on which it relied to set the quota level were indeed "representative". The ordinary meaning of the term and its context make clear that "representative" refers to import trends. The aim is to avoid the inclusion of periods where trade flows were abnormal. However, no such evaluation of the quality of the data relied upon is included in any of Korea's notifications to the WTO.

4.620 Moreover, the European Communities further contend that, if such evaluation had been carried out, it would have led to exclude data relating to the second semester of 1993 as not "representative" within the meaning of Article 5.1 of the Agreement on Safeguards. As indicated in Korea's Schedule of concessions, imports of item 1901.90.2000 ("food preparations") into Korea were still subject to Balance-of-Payment restrictions during that period.[303] Therefore, although the relevant tariff rates had been lowered to 40 per cent as of the beginning of 1993, their imports did not take place under conditions which would have made them "representative". This is an additional reason to conclude that Korea should have based its quota on the period January 1994-December 1996. In the light of the foregoing the European Communities consider that Korea based its calculation of the quota level on data that did not relate to the last three representative years available within the meaning of Article 5.1 of the Agreement on Safeguards.

4.621 In response to a question of the Panel[304] the **European Communities** further clarified their arguments under Article 5:

4.622 The first and second sentences of Article 5.1 contain complementary obligations which all have to be respected. The first and third sentences of Article 5.1 apply on their face to all safeguard measures. The second sentence contains an additional obligation which only applies to quantitative restrictions.

4.623 Also in response to a question of the Panel[305] the **European Communities** further argued:

4.624 The second sentence of Article 5.1 contains an additional obligation for quantitative restrictions. If there is no representative three year period the Member

[302] *See,* Exhibit EC-20.

[303] *See,* Exhibit EC-17.

[304] The Panel recalls that the question was*:* " If a quota is established based on the level of imports for the three representative years, does the importing country still have an obligation to prove that such level was necessary? In other words does the level established pursuant to the three representative years constitute a minimum quota, the level of which must still be proven to be "necessary"? Please comment and discuss the relationship between the first and second sentence of Article 5.1 of the Agreement on Safeguards.

[305] The panel recalls that the question was: "If there is no such period of three representative years because good under investigation have been the object of restrictions (GATT/WTO compatible or not) how should the importing country proceed to assess such necessary level of quota?"

must then base its measure on "the level necessary to prevent or remedy serious injury", according to the second part of that sentence. The rule in the first part may still be relevant as a guide.

(b) Response by Korea

4.625 **Korea** responds to the EC arguments as follows:

4.626 Korea based its quota level on the average of imports for the three years from July 1993-June 1996. Korea initiated its safeguards investigation in May 1996. After that date, imports of SMPP would be expected to increase abnormally, as foreign exporters and their Korean customers increase their volume of imports in anticipation of a safeguards measure. In fact, the use of three "representative" years was intended to prevent foreign exporters from manipulating quota levels by flooding the market with imports just prior to the decision to impose a safeguard measure. Therefore, Korea considered that the second half of 1996 was not "representative," and it excluded imports from this period in calculating the quota level. Korea considered that the quota levels chosen were the most suitable for achieving the "objectives" identified in Article 5.1, *i.e.*, preventing or remedying the serious injury and facilitating adjustment to the domestic industry in Korea.[306]

4.627 Pursuant to a question by the Panel[307] **Korea** further clarified its arguments under Article 5 as follows:

4.628 In the view of Korea, the first two sentences of Article 5.1 of the Agreement on Safeguards do not impose a general obligation on Members to demonstrate that the specific level of quota that they decided to impose as a safeguard measure is necessary to prevent or remedy serious injury and to facilitate adjustment. Such an obligation only arises if the level of such quota is lower than the average imports during the three most recent representative years for which statistics are available. As the wording of the second sentence of Article 5.1 makes clear, Members must only justify the level of quotas if it is different (*i.e.*, lower) than the average imports during the three most recent representative years.

4.629 The first clause of Article 5.1 does not impose any obligation but merely states a basic principle regarding the application of safeguard measures. This basic principle is that Members should apply safeguard measures only to the extent necessary to achieve the objectives of safeguard measures (*i.e.,* to prevent or remedy serious injury and to facilitate adjustment). This basic principle is generally applicable whether the safeguard measure imposed is a tariff, a tariff-quota, or a quota. The first clause of Article 5.1 cannot be read as imposing an obligation on Members to demonstrate that a particular *level* of tariff or quota is necessary to

[306] *See,* Exhibit Korea-8 in which only one of the seven KTC commissioners considered that a tariff rate quota was the more appropriate measures for dealing with the serious injury caused by the increased imports.

[307] The Panel recalls that the question was*:* "If a quota is established based on the level of imports for the three representative years, does the importing country still have an obligation to prove that such level was necessary? In other words, does the level established pursuant to the three representative years constitute a minimum quota, the level of which must still be proven to be 'necessary'? Please comment and discuss the relationship between the first and second sentence of Article 5.1 of the Agreement on Safeguards."

prevent or remedy serious injury and to facilitate adjustment. Article 5.1 does not identify objective criteria that may be used to calculate the level of tariff, tariff-quota, or quota that would "remedy" serious injury or "facilitate adjustment" under the unique circumstances facing particular industries.

4.630 The second sentence of Article 5.1 only applies when a Member imposes a safeguard measure in the form of a quota. To give Members useful guidance, the drafters of this sentence established a minimum quota level that would be deemed necessary to achieve the objectives of imposing a safeguard measure. This level is set at the average of imports during the three most recent representative years for which statistics are available. To the extent that the quota is set at that level or at a higher level, Members are not required to prove that this quota level is necessary. This is not a strict minimum quota, however because the second sentence of Article 5.1 permits a Member to set a quota at a lower level than the average imports during the three most recent representative years, provided it presents clear justification that such lower level is necessary. If a Member decides to impose a quota that is not lower than the average imports during the three most recent representative years, it is not required to provide any explanation or justification as to the necessity of this quota level.

4.631 With regard to tariff-based safeguard measures, Article 5.1 does not obligate Members to provide any explanation or justification of the level of such measures. It is not for Korea to speculate why the drafters felt that a benchmark was necessary for quotas but not for tariff-based measures. The fact that the second sentence of Article 5.1 only refers to quotas, however, can only mean that there is no requirement to demonstrate that the level of a tariff-based measure is necessary to achieve the objectives pursued. In Korea's view, the obligation to justify the level of the safeguard measure only exists if the measure is a quota and if such quota is set at a level lower than the average imports during the three most recent representative years for which statistics are available.

4.632 In this case, Korea determined that application of a safeguard measure was necessary to remedy serious injury and facilitate adjustment because "[w]hile it was determined that the domestic industry has been suffering from serious injury caused by increased imports, the injury has not been relieved even by the continuing efforts of the relevant authorities and the petitioner. In this regard, it is agreed that the appropriate relief measures should be taken to resolve the problem." [308] Based on the guidance provided in the second sentence of Article 5.1, Korea rejected the alternatives suggested by the petitioner and recommended a quota at a level based on the three most recent representative years for which statistics were available.[309]

4.633 In response to another question by the Panel[310] **Korea** also argued that:

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[308] *See,* Exhibit Korea-8, at 3.

[309] *Ibid.*

[310] The Panel recalls that the question was*:* "Do you consider that under Article 5.1 of the Agreement on Safeguards the importing country needs to show that a safeguard measure, in the form of a tariff (or tariff-quota), is necessary and the most suitable means to remedy the injury and facilitate the adjustment? Do you need to show that the level of the tariff (or tariff-quota) was appropriate?"

4.634 In the view of Korea, Article 5.1 does not impose an obligation on Members to demonstrate that a particular level of a tariff (or tariff-quota) is necessary or that it is the most suitable means to remedy injury and facilitate the adjustment. In this respect, it is important to distinguish between two issues*:* (i) whether the particular type of safeguard measure (*i.e.,* tariff, quota, tariff-quota) is the most suitable means for achieving the objectives sought, and (ii) whether the level of the tariff, quota, or tariff-quota imposed (as the most suitable measure) is necessary to achieve such objectives. In this regard it is necessary to consider the first and third sentences of Article 5.1. The first sentence states the basic principle that a safeguard measure should be applied only to the extent necessary to prevent or remedy serious injury and to facilitate adjustment. The third sentence of Article 5.1 provides there is no obligation to demonstrate that a tariff (or tariff-quota) is the most suitable measure to achieve these objectives, nor to demonstrate that the level of such tariff (or tariff-quota) is necessary or appropriate to achieve these objectives.

4.635 In this case, it is noteworthy that the KTC Commissioners examined the relief measures requested by the petitioner, including:

- reclassify the tariff treatment of SMPP into the same category of dutiable items as skimmed or whole milk powder;
- increase the customs duties on SMPP to the level of milk powder for four years; and
- restrict the import volume to 10,000 tons per year for four years.[311]

4.636 The KTC stated that:

> [b]efore recommending the relief measures, the KTC commissioners agreed that close considerations should be made beforehand for each relief measure on its impacts on the domestic dairy industry, national economy, and bilateral/multilateral trade. In this regard, the KTC examined the information investigated by the OAI, the relevant articles of the multilateral regulations, the opinions of authorities concerned, and the relief measures stipulated in the Foreign Trade Act and the Enforcement Decree of the Act. Based on all these examinations, the KTC reviewed the petitioner's request for relief measures.[312]

Korea also examined whether a tariff-quota would be more appropriate and what the appropriate duration for the application of the measure should be.[313] Based on its examination, the KTC recommended that the appropriate duration of the measure was four years and that the measure should be in the form of a quantitative restriction in the amount not exceeding the average of the import levels for the three most recent representative years for which statistics were available.[314]

4.637 In another response to a Panel question, **Korea** further clarified its arguments on the "representative" three-year period for purposes of Article 5.1:

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311 *See,* Exhibit Korea-8, at 3.
312 *Ibid.* at 3-4.
313 *Ibid.* at 4-5 (*See* minority opinion of Jeong Mun-Su).
314 *Ibid.* at 4.

4.638 Korea considers that each of the three years prior to the filing of a safeguards petition is normally representative of the import levels on which a quota restriction may be based, absent clear justification otherwise and notwithstanding the existence of import restrictions during any particular year. The "representative" nature of imports under Article 5.1 of the Agreement on Safeguards must be determined with reference to the normal level of imports for the particular Member concerned, regardless of any import "restrictions" then in force. Notably, "representative" under Article 5.1 cannot reasonably be interpreted to mean "fully liberalized" or absent any tariff or non-tariff restriction potentially affecting imports.

(c) Additional Arguments by the European Communities Made at the First Meeting of the Panel with the Parties

4.639 At the first meeting of the panel with the parties, the **European Communities** further advanced their arguments under Article 5.1 as follows:

4.640 The **European Communities** noted that in their endeavours to justify the exclusion of the second semester of 1996 by saying that in that period imports would have "increased abnormally" in anticipation of the measure. The **European Communities** would like to recall that in 1996 imports recorded an increase of approximately 15 per cent as compared to 1995, which increase appears much less "abnormal" *i.e.,* more "representative", than the increases of approximately 384 per cent from 1993 to 1994 and 80 per cent from 1994 to 1995. The **European Communities** would also recall that, as demonstrated by its Exhibit EC-20 and not contested by Korea, full 1996 data were available when the quota was finally decided.

(d) Additional Arguments by Korea Made at the First Meeting of the Panel with the Parties

4.641 At the first meeting of the panel with the parties, **Korea** further advanced its arguments under Article 5.1 as follows:

4.642 Korea not only fully complied with its obligations under Article 5 of the Agreement on Safeguards, but also exercised its good faith in expanding the amount of the quota based on requests during consultations from the **European Communities** and other WTO Members. In its decision of 2 December 1996, the KTC Commissioner evaluated the appropriate relief measures, stating that "[b]efore recommending the relief measures, the KTC commissioners agreed that close considerations should be made beforehand for each relief measure on its impacts on the domestic dairy industry, national economy, and bilateral/multilateral trade." [315] The KTC then listed the information examined regarding the range of proposed relief measures. A majority of the KTC Commissioners then determined that a quota was the most suitable relief measure, with one commissioner offering a minority opinion that a tariff-rate quota would be preferable.

[315] *See,* Exhibit Korea-8.

4.643 Korea does not understand the EC argument that Korea failed to consider whether other types of measures would have been more suitable.[316] In Korea's view, the European Communities are simply wrong.
4.644 The volume of the quota was based on the average level of imports of the three most recent representative years for which statistics were then available, from June 1993 to June 1996. Korea refused to increase the quota further by including the remainder of 1996 in the historical bases for calculating the quota. This period was not representative because exporters can be expected to increase artificially the volume of their exports in anticipation of the safeguard measure.
4.645 During consultations under Article 12.3 of the Agreement on Safeguards, the European Communities objected to the calculation of the quota level. After considering the European Communities concerns, Korea decided, in good faith, and without being obligated to do so, to raise the quota level by almost 5,000 tons.

(e) Rebuttal Arguments Made by the European Communities

4.646 The **European Communities** made the following arguments in rebuttal:
4.647 In the EC view a "necessity" requirement is embodied in Article 5.1 of the Agreement on Safeguards, which requirement must be met in order for a measure to be authorized under that provision. A general "necessity" requirement is laid down in the first sentence. Furthermore, there is a specification of that requirement for safeguard measures in the form of quantitative restrictions to the effect that, in principle, quota level lower than the average of imports in the three representative years is not (never) necessary, unless clear justification is given in this respect. Of course, this principle cannot entail at all that whichever is in compliance with that threshold is automatically necessary.
4.648 The European Communities further maintain that the years used by Korea to calculate its quota level were not the "last three representative available". In the case at issue in this dispute, Korea has neither calculated the quota consistently with this required threshold nor, *a fortiori*, has been able to show that it did.
4.649 The interpretation of Article 5.1 of the Agreement on Safeguards, in the light of its wording, context and purpose and in accordance with the principle of effective treaty interpretation, mandates this conclusion*:* each provision was drafted with its own meaning and must be given its autonomous meaning when being interpreted. On the contrary, by denying the binding character of the necessity requirement except within very strict limits, Korea is trying to unduly reduce the scope of its obligations under the WTO Agreements, and thus the rights arising thereunder to the European Communities. Reduction or modification of rights and obligations is emphatically not allowed under the WTO.[317]

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316 *See,* Exhibit Korea-8.
317 *See,* Article 3.2 and 3.9 of the DSU, respectively providing*:* "Recommendations and rulings of the DSB *cannot add or diminish the rights and obligations* provided in the covered agreements" and "The provisions of this Understanding are without prejudice to the rights of Members to seek authoritative interpretation of provisions of a covered agreement through *decision-making under the WTO Agreement*" (emphasis added).

(i) Necessity is a Requirement Laid Down in Article 5.1, First Sentence in Respect of all Safeguard Measures

(a) Wording

4.650 The European Communities reiterate that the term "necessity" is binding language, both in the first and in the second sentence of Article 5.1 of the Agreement on Safeguards. Both sentences impose obligations upon WTO Members wishing to adopt safeguard measures to do so only to the extent they are necessary to prevent or remedy serious injury and to facilitate adjustment, although the second is a specification of the first one, applicable in respect of one type of measure only. As the Appellate Body pointed out in *US - Underwear*, far from suggesting non-binding character,

> "a contention of necessity may be seen to assume that no other recourse is available to the importing country." [318]

4.651 The European Communities find it curious that, in trying to unduly restrict its obligations and EC rights under the Agreement on Safeguards, just as it does for its obligations arising under Article XIX of GATT, Korea is using the opposite tactics. In the case of Article XIX, lack of repetition of the "unforeseen developments" requirement in the Agreement on Safeguards is deemed to show its abrogation by the latter. In the case of Article 5.1 of the Agreement on Safeguards, in spite of repetition of the word "necessary" in two consecutive sentences of the same Article, Korea is able to deny the binding character of the word in the first sentence but finds unexpectedly that it is binding in the second sentence- be it by further limiting the scope of that more specific obligation.

(b) Context

4.652 The same conclusion is compelled by the interpretation of the provision in its context. First, the term "necessary" is reiterated in the second sentence of Article 5.1, which constitutes the most immediate "context" of the first sentence. Repetition of a term which is binding by its ordinary meaning confirms that use of that term is not accidental or inaccurate, and instead represents a deliberate choice of the drafters. Second, the same term is used elsewhere in the WTO system - notably in provisions derogating from the liberalization principle embodied therein - with the same binding meaning. Article XIX itself embodies virtually identical language and authorizes safeguard measures "to the extent and for such time as may be necessary to prevent or remedy serious injury". Furthermore, Article XX of GATT allows measures to be taken if *e.g.,* "(a) necessary to protect public morals", "(b) necessary to protect human health".

4.653 Comparison with other WTO Agreements regulating trade defence measures also shows that when the drafters have wanted to be permissive as to the maximum level allowed for one of such measures they have used much less strong language. Article 9 of the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 ("the Anti-Dumping Agreement"), provides on

[318] *See,* Appellate Body Report in *US - Underwear*, 10 February 1997, supra, footnote 293, at 27.

the one hand, that anti-dumping duties can never exceed the dumping margin. By contrast, it further stipulates that:

> "It is desirable that the imposition [of an anti-dumping duty in cases where all requirements for the imposition have been fulfilled] be permissive and that the duty be less than the margin if such lesser duty would be adequate to remedy the injury to the domestic industry."

This provision shows that the drafters of the WTO Agreement have chosen a much softer language when intending to express an absence of obligation. It also shows that there is a difference in the regime adopted for dumping measures and for safeguard measures, which is otherwise logical having regard to the different situation - unfair trade practices, fair trade - which dumping and safeguard measures are respectively aimed to remedy.

(c) Purpose

4.654 The purpose of the "necessity" requirement is to avoid that measures, which are recognized as "limitative and deprivational in character or tenor and impact upon Member Countries and their rights and privileges and upon private persons and their acts", [319] not be abused. In the light of that characterization, in *US - Underwear*, the Appellate Body drew the conclusion that an importing Member should not be allowed "an enhanced ability to restrict the entry into its territory of goods in the exportation of which no unfair trade such as dumping or fraud or deception of origin is alleged or proven"[320] by taking safeguard action beyond the strict limits laid down in the relevant WTO provisions, if that action would result in "excluding more goods from the territory of the importing Member." [321] As already noted, the aim of the Agreement on Safeguards is to "clarify and *strengthen*" and to "*re-establish multilateral control*" over safeguards [322] rather than to broaden the authorization to apply them.

4.655 That the safeguard measure at issue in this dispute was not "necessary" to remedy serious injury flows from the fact that there was no such injury, and certainly not serious injury resulting from the imports of SMPP. Furthermore, irrespective of whether a country is always obliged to introduce a structural adjustment plan together with a safeguard measure, in this particular case Korea did, by its own admission, introduce the Dairy Industry Plan "to facilitate adequate adjustment in the Korean dairy sector", but did not show the necessity of the measure to attain the adjustment objective. There was no mention of the link between the measure and the adjustment objective within the broader framework of actions taken in this connection. Accordingly, the European Communities reiterate their conclusion that Korea did not show that the measure it adopted was "necessary", thereby violating Article 5.1 of the Agreement on Safeguards.

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[319] *See,* Appellate Body Report in *US - Underwear*, supra, footnote 293, at 23 (emphasis added).
[320] *Ibid.*
[321] *Ibid.* (emphasis added).
[322] *See,* Preamble of the Agreement on Safeguards, second last para., whereby Members "[recognize] the importance of structural adjustment and the need to enhance rather than limit competition in international markets".

(ii) The Necessity Requirement is Strengthened in Article 5.1, Second Sentence in Respect of Safeguard Measures Taking the Form of Quantitative Restrictions

4.656 As Korea itself admits, by virtue of the second sentence of Article 5.1 a necessity requirement is imposed in respect of safeguard measures taking the form of quantitative restrictions. Article 5.1 of the Agreement on Safeguards is clearly intended to avoid a quota being set at a level unrelated to historical import flows prior to its imposition, which would prove particularly disruptive for exporters*:* in other words, a quota which would afford an importing country

> "an enhanced ability to restrict the entry into its territory of goods in the exportation of which no unfair trade such as dumping or fraud or deception of origin is alleged to be proven"[323]

4.657 The prohibitive, rather than permissive, language of the provision limits in principle the minimum quota level to the average of the last three representative years the Agreement on Safeguards and establishes a presumption that for quotas such level is the maximum restriction which would be justifiable as "necessary" within the meaning of its Article 5.1*:* "such a measure shall not reduce the quantity of imports below the level of a recent period". It is only if the Member seeking to apply a safeguard measure in the form of a quota is able to show that a quota level based on those data is not sufficient to remedy the serious injury in a specific case that a lower quota may be imposed, and then only if "clear justification" is provided. Therefore, the second sentence of Article 5.1 embodies an "enhanced requirement" of necessity when Members want to impose a safeguard measure in the form of a quantitative restriction.

4.658 That in principle a quota level below the three representative years is not (never) "necessary" does *not entail* at all, and indeed is quite the opposite of, saying that whichever quota is in compliance with that threshold is automatically "necessary" and authorized. First, because the first sentence of Article 5.1, which is binding, has general scope (that is, applies to all measures). Second, because if it could be admitted that a quota in accordance with the three-year threshold is "automatically" necessary without demonstration (as suggested by Korea), one would arrive at the unreasonable and absurd result that "necessity" must be shown in respect of a tariff measure, or any measure other than quota, and not for a quota. Of course, Korea can arrive at this unreasonable and false conclusion because it starts from a wrong premise (*i.e.,* that the first sentence does not impose any obligation on WTO Members).

[323] *See,* Appellate Body Report in *US - Underwear*, supra, footnote 293, at 23.

(iii) Korea has Imposed a Quantitative Restriction at a Level which is Below the Average Laid Down in Article 5.1, Second Sentence, without "Clear Justification"

4.659 The European Communities maintain that the "three most recent years for which statistics are available" are to be assessed relative to the moment when the quantitative measure is imposed. Because Article 5.1 of the Agreement on Safeguards regulates the "application" of safeguard measures, *i.e.,* the moment when measures are taken, it is appropriate to consider that moment to assess the relevant three years retrospectively. Furthermore, that sentence uses the term "recent period" in connection with the reference to imposition of the measure. It is otherwise logical that calculation of the level of a measure follows the decision to adopt a measure.

4.660 On the contrary, there is no reference, in the second sentence of Article 5.1, to the initiation of the proceeding. It is clear that referring to that moment could allow the importing country to purposefully choose the initiation time of an investigation. As to availability of data, February 1997 data for all 1996 were available - a fact that is evidenced by Exhibit EC-20 and that Korea has not challenged.

4.661 As to representativity of the data, imports of the second semester of 1996 could not be excluded on grounds of non-representativity, certainly not on the criterion invoked by Korea because there is no "manipulation" by exporters in the sense (massive, or "abnormal" raise in imports) given by Korea to the term. The increase in imports from 1995 to 1996 is lower than the increase from 1994 to 1995, yet Korea had no difficulty in considering "representative" both 1994 and 1995.

4.662 In any event, Korea took into account data relating to a period (June 1996) subsequent to the initiation of the investigation[324], and itself contradicts the criterion which it now proposes. The possible attempts of the exporters to increase exports ahead of the adoption of safeguard measures either are presumed to materialize with opening, or are not. Moreover, in *US - Underwear* the Appellate Body, after having referred to the binding character inherent in the word "necessity", as lack of alternatives available to the importing country, concluded that the need to prevent or deal with a "flood of imports", invoked by the United States to justify retroactive application of its measure, could have been dealt with by measures alternative to such a supplementary restriction - for example with the adoption of urgency measures. The European Communities note that analogous measures are equally available under the Agreement on Safeguards. [325]

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[324] *See,* WTO Doc. G/SG/N/6/KOR/2, 1 July 1996 (Exhibit EC-1).

[325] *See,* Article 6 of the Agreement, reading*:* "*In critical circumstances where delay would cause damage which would be difficult to repair*, a Member may take a provisional safeguard measure pursuant to a preliminary determination that there is clear evidence that increased imports have caused or threaten to cause serious injury." To be noted that Article 6.11 of the Agreement on Textiles and Clothing is drafted in extremely similar conditions*:* "11. *In highly unusual circumstances, where delay would cause damage which would be difficult to repair*, [safeguard] action under paragraph 10 may be taken provisionally on the conditions that the request for consultations and notification to the TMB shall be effected within no more than five working days after taking the action"

4.663 The European Communities maintain that full 1996 data were more "representative" [326] than the second semester of 1993, relied upon by Korea, and notes that there is no trace of explanation about representativity in the Notice of 7 March 1997, by which Korea finally imposed the safeguard measure at issue in this dispute.[327] Therefore, even as regards the representativity of the data used to calculate the quota, Korea's measure did not meet Article 5.1 requirements and should be found to be in violation thereof.

(iv) Korea has not Shown that the Measures were the "Most Suitable" for the Achievement of their Objectives

4.664 Regarding the "suitability" of the measure chosen, in the EC view Korea arrives at the final reduction of its Article 5.1 obligations, by denying the binding character of this requirement without any reasoning. At the same time, Korea again refers to the OAI Report in support of its position. The European Communities assert that the OAI Report is not an appropriate source of information to evaluate Korea's compliance with its obligations arising under Article XIX of GATT and the Agreement on Safeguards. In connection with this specific requirement it would add that, just as for the other requirements imposed by Article 5.1 of the Agreement on Safeguards, there is no explanation of Korea's choice to impose a quantitative measure in the only document which followed the 1 April Notification to the Committee on Safeguards, and by which Korea definitively imposed the measure. As Korea changed the reference period for calculating the quota as compared to what it had announced in January 1997, and did not refer to any other documents as possible sources of explanation in its Notice, it did not come to a definitive reasoning in this respect. This further confirms that its measure is inconsistent with the requirements of Article 5.1. The EC considers that it is not sufficient for the investigation authorities to note the arguments and conclude. They must state its reasons. In particular, it is not sufficient and legitimate to examine only the measures requested by a petitioner in order to comply with the requirement to choose the "most suitable measure" pursuant to Article 5.1, third sentence of the Agreement on Safeguards. This represents an undue weakening of that requirement and would leave the decision within the hands of the very industry seeking safeguard protection.

(f) Rebuttal Arguments Made by Korea

4.665 **Korea** makes the following rebuttal arguments:

[326] The EC agrees with Korea's reply to a question of the Panel, that "representative" does not necessarily means "fully liberalized", it rather means "not abnormal". For example, customs tariffs resulting from bindings are not "extraordinary" restrictions in the WTO system, therefore it seems clear that their presence would not deny representativity of a given period. On the contrary, measures taken for Balance-of-Payment reasons are clearly exceptional measures and may possibly have a more uncertain impact.

[327] *See,* Exhibit EC-9, corresponding to Exhibit-Korea-9.

4.666 In its Report, the OAI concluded with a section on remedies. This section, after setting out in full the provisions of Articles 8 and 12 of the *Agreement on Safeguards* stated:

> "In light of trade relations, if import is restricted by means of tariff rate increase or quantitative restriction, EU member states, Australia and New Zealand, which are leading exporters, may protest. Therefore, it is advised that, before a safeguard measure is taken, bilateral consultations should be held with the major exporting countries.
>
> After rendering a determination on injury to the domestic industry, the KTC must notify the WTO Committee on Safeguards of such determination.
>
> Meanwhile, the WTO Agreement on Safeguards stipulates that if a safeguard measure is taken due to the absolute increase of import volume, as is the case in this investigation, interested Members cannot take retaliatory measures within three years after the effective date of the measure."[328]

4.667 The KTC Commissioners then examined and rejected the relief measures requested by the petitioner. In rejecting the alternatives suggested by the petitioner, and instead recommending to the Minister of Agriculture and Forestry a quota at a level based on the three most recent representative years for which statistics were available[329], the KTC stated that:

> "[b]efore recommending the relief measures, the KTC commissioners agreed that close considerations should be made beforehand for each relief measure on its impacts on the domestic dairy industry, national economy, and bilateral/multilateral trade. In this regard, the KTC examined the information investigated by the OAI, the relevant articles of the multilateral regulations, the opinions of authorities concerned, and the relief measures stipulated in the Foreign Trade Act and the Enforcement Decree of the Act. Based on all these examinations, the KTC reviewed the petitioner's request for relief measures.[330] "

4.668 The Korean authorities also examined whether a tariff-quota would be more appropriate and what the appropriate duration for the application of the measure should be.[331] Based on its examination, the KTC recommended that the appropriate duration of the measure was four years and that the measure should be in the form of a quantitative restriction in the amount not exceeding the average of the import levels for the three most recent representative years for which statistics were available.[332]

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328 OAI Report at 74.
329 *Ibid.*
330 *Ibid.* at 3-4.
331 *Ibid.* at 4-5.
332 *Ibid.* at 4.

4.669 The first notification by Korea, which referred to the nature of the safeguard measure, set out the following amounts[333]:

Year 1	Year 2	Year 3	Year 4
15,595 tonnes	16,483.9 tonnes	17,372.8 tonnes	18,261.7 tonnes

Following prior consultations in Geneva on 4 and 5 February 1997, between Korea on the one hand, and the European Communities, Australia and New Zealand on the other, Korea decided to increase the level of its quota as an act of good faith intended to provide some level of concessions to its trading partners. In its final Notification under Article 12.1(c) of the Agreement on Safeguards[334], Korea set out the following quota amounts:

March 7 1997 - February 1998	March 1998- February 1999	March 1999- February 2000	March 2000- February 2001
20,521 tonnes	21,691 tonnes	22,927 tonnes	24,234 tonnes

This represents an average increase of over 5,000 tonnes in the level of the quota in each of the four years of the safeguard measure, and a total of 21,659 tonnes more imports than originally proposed in accordance with the provisions of Article 5.

4.670 Korea recalled its answers to the Panel's questions regarding the nature of the safeguard measure and the level of quota if a quota is chosen, which can be found at paragraphs 4.634 and 4.628.

4.671 In Korea's view, provided the level of quota was equivalent to or not less than the average of the import levels for the three most recent representative years for which statistics were available, the Korean authorities were not required to show that the nature of the measure, or its level, were "necessary".

(g) Additional Arguments by the European Communities Made at the Second Meeting of the Panel with the Parties

4.672 At the second meeting of the panel with the parties, the **European Communities** further advanced their arguments under Article 5.1 as follows:

(i) Both the First and the Second Sentence of Article 5.1 Impose Obligations on Members, Having Regard to their Wording, Context and Object and Purpose

4.673 The European Communities assert that Korea has provided no explanation for its interpretation that the first sentence of Article 5.1. is non-binding, except to say that the first sentence does not include "objective criteria that may be used to calculate the level of tariff, tariff quota, or quota that would 'remedy' serious injury or 'facilitate adjustment." It is hard to see from where Korea has drawn this criterion to

[333] G/SG/N/10/KOR/1 (27 January 1997).
[334] G/SG/N/10/KOR/1/Suppl. 1 (1 April 1997), section 2.

decide whether the language of the first sentence is binding or not. In any event, in the first sentence of Article 5.1, too reference to injury and adjustment is made, and therefore a threshold is set to determine the level of protection allowed. Also, several other "'necessity' clauses" exist both in GATT and in the other WTO Agreements. The binding character of those clauses is not questioned even in the absence of precise or objective or objective criteria which might be used to calculate the level of tariffs as Korea maintains.

4.674 The European Communities recalled their arguments set out in paragraphs 4.650-4.655 above.

4.675 In the EC view what Korea should have assessed, and did not, is whether the measure chosen was really necessary. The only reference to this issue is in the passage of Exhibit Korea-8 ("Determination of a Relief Measure by the Korean Trade Commission", which is the KTC's Recommendation of relief measures to the Ministry of Agriculture) quoted by Korea in reply to a question of the Panel*:* [w]hile it was determined that the domestic industry has been suffering from serious injury caused by increased imports, the injury has not been relieved even by the continuing efforts of the relevant authorities and the petitioner. In this regard, it is agreed that the appropriate relief measures should be taken to resolve the problem".

4.676 As regards Exhibit Korea-8 in particular, the European Communities would observe the following. First, it is, by its nature, an interim, preparatory document, not a final one. It is not final, as shown by the fact that the measures were eventually changed after the consultations with other WTO Members. Second, it is not a decision, but merely a recommendation to the final decision-making authority, notably the MAF, to take a given safeguard measure. Looking at the content of Exhibit Korea-8, it simply states a conclusion as to the necessity of a measure, certainly does not show the necessity. For instance, which efforts were ever undertaken to solve the difficulties in an alternative way remains unclear.

(ii) The Second Sentence of Article 5.1 Imposes a Specific Obligation in Respect of Quantitative Measures

4.677 The three-year period used by Korea was not the most recent available: as of February 1997, all import data for 1996 were published in Korea's Statistical Yearbook of Foreign Trade (Exhibit EC-20). Presumably, those data were available to the Korean authorities as internal information even in advance of publication. In any event, the European Communities recall that it was precisely in February 1997 that a new calculation of the quota level was performed, following the bilateral consultations under Article 12.3 of the Agreement on Safeguards.

4.678 The data used by Korea were less representative because they included a period where the product at issue was under import restrictions for Balance-of-Payment reasons, which is a temporary and exceptional measure and is not a normal tariff restriction. On the other hand, the import data for the second semester of 1996 were not, as Korea argues, affected by exporters' attempt to export massively in advance of the imposition of the measure. Indeed the import increase from 1995 to 1996 was lower than, for instance, between 1994 and 1995, the data of which Korea had no difficulty to retain as representative.

(iii) The Third Sentence of Article 5.1 Requires that The "Most Suitable Measure" be Selected

4.679 The European Communities note that Korea, while referring extensively to the OAI Report, which in the EC view does not represent Korea's final position on the measures, reports that its Korean authorities considered a certain amount of information and certain sources of information (notably information investigated by the OAI, multilateral regulations, opinions of authorities concerned, measures mentioned in its domestic legislation) when deciding the measure, and that they concluded in a certain way. The European Communities consider that it is not sufficient for the authorities to note the arguments and conclude. They must state reasons. In particular, it is not sufficient and legitimate to examine only the measures requested by a petitioner in order to comply with the requirement to choose the "most suitable measure" pursuant to Article 5.1, third sentence of the Agreement on Safeguards. This represents an undue weakening of that requirement and would leave the decision within the hands of the very industry seeking safeguard protection.

(h) Additional Arguments by Korea Made at the Second Meeting of the Panel with the Parties

4.680 At the second meeting of the panel with the parties, **Korea** further advanced its arguments under Article 5.1 as follows:

4.681 Korea is of the view that there is a requirement on the investigating authority under Article 5.1 to investigate whether a quota or some other safeguard measure is the most appropriate method of offsetting the serious injury caused by the increased imports. In this case, this obligation was discharged by the KTC Commissioners.[335] As to the level of any quota decided upon, Korea reiterates that under Article 5.1 where a Member intends to impose a quota at a level equivalent to or higher than the level of imports during the three most recent representative years for which statistics are available, then it is not required to justify that level of quota. However, should a Member seek to impose a lower level, then, but only then is a justification required as to why that lower level was necessary.

4.682 The European Communities suggest that Korea is trying: "to unduly reduce the scope of its obligations under the WTO Agreements, and thus the rights arising thereunder to the European Communities." In order to defend its position, Korea has to rebut the EC incorrect assertions. It is inherent in the nature of disputes that the assertion of rights by one party affects the obligations of the other party or parties. It is simply not helpful for the European Communities to argue that by raising a defence, Korea is seeking to deny the EC rights.

4.683 Finally, Korea notes the rather curious reasoning used by the European Communities where they state that:

> "That the safeguard measure at issue in this dispute was not "necessary" to remedy serious injury is flowing from the fact that there was no such injury, and certainly not serious injury resulting from the imports of SMPP."

[335] *See,* Exhibit Korea-8.

The European Communities appear to be saying no more than that if serious injury is found, then the safeguard measure was necessary. As the Korean authorities established serious injury, and set the level of quota at or above the level of imports in relation to the three most recent representative years for which statistics were available, this rather curious statement is redundant.

I. Claims under Article 12 of the Agreement on Safeguard

(a) Claim by the European Communities

4.684 The **European Communities** claim that Korea violated its obligations under Article 12 of the Agreement on Safeguards by failing to comply with the notification requirements and by failing to provide adequate opportunity for prior consultations. The following are the EC arguments in support of that claim:

(i) Violation of Article 12.1-2 of the Agreement on Safeguards- Failure to Comply with Notification Requirements

4.685 Article 12.1 of the Agreement on Safeguards provides that*:*

"A Member shall *immediately* notify the Committee on Safeguards *upon*:

(a) initiating an investigatory process relating to serious injury or threat thereof and the reasons for it;

(b) making a finding of serious injury or threat thereof caused by increased imports; and

(c) taking a decision to apply or extend a safeguard measure." (emphasis added)

Article 12.2 further provides:

> "In making the notifications referred to in paragraphs 1(b) and 1(c), the Member proposing to apply or extend a safeguard measure shall provide the Committee on Safeguards with *all* pertinent information, which shall *include evidence* of serious injury or threat thereof caused by the increased imports, precise *description* of the product involved and the proposed measure, proposed date of introduction, expected duration and timetable for progressive liberalization. In the case of an extension of a measure, evidence that the industry concerned is adjusting shall also be provided. The Council for Trade in Goods or the Committee on Safeguards may request such additional information as they may consider necessary from the Member proposing to apply … the measure." (emphasis added)

4.686 The European Communities submit that, in failing to provide immediately the Safeguards Committee with the information required under Article 12.1-2 of the Agreement on Safeguards, Korea violated its obligations arising thereunder. It further submits that Korea failed to comply with its obligation laid down in Article 12.3 of the Agreement on Safeguards in respect of consultations. Furthermore, it considers that the insufficient amount of the information provided in the notifications was not justified on grounds of confidentiality pursuant to Article 12.11 of the Agreement on Safeguards.

4.687 In order to demonstrate this claim the European Communities first reviewed the general meaning and objective of procedural obligations in the Agreement on Safeguards, and then discussed the specific aspects relating to the violations of notification and consultation requirements.

(a) Objective and meaning of procedural obligations in respect of safeguard measures

4.688 In view of the limitative character of safeguard measures their inclusion in the WTO system is accompanied by limits to their use, so that the interests of all the parties are protected. This is particularly important as regards procedural requirements, like the notification obligations. As observed in the Panel report in *Guatemala - Anti-Dumping Investigation Regarding Portland Cement from Mexico* in respect of the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 (AD Agreement) "[a] key function of the notification requirements in the AD Agreement is to ensure that interested parties, including Members, are able to take whatever steps they deem appropriate to defend their interests. Where a required notification is not made in a timely fashion, the ability of the interested party to take such steps is vitiated".[336] Thus, the Panel made clear that failure to comply with such requirements amounts, in itself, to a violation of a WTO Member's obligations under the AD Agreement. The Panel went on to add that "merely that the AD Agreement does not require some action following notification does not mean that nothing useful can take place following a timely notification, and that the exporting Member has therefore no interest in timely notification."[337] *A fortiori* this applies to a case like the one at stake, where, as will be shown below, consultations are mandated by the Agreement following notification and must take place on the basis of the information notified.

4.689 The European Communities also asserted that the notification requirements under Article 12.1-2 of the Agreement on Safeguards are clearly autonomous and additional to the transparency requirements imposed by Articles 3 and 4 of the agreement in respect of the domestic investigatory procedures. This is explained by a variety of considerations, including the possibility for the Members concerned to request consultations on the basis of that information and the general interest of all WTO Members, and not only those more directly concerned by the procedure, in monitoring compliance with the Agreement on Safeguards. Specifically as regards notifications under Article 12.1(b) and (c), as made clear from Article 12.3 one specific purpose is to offer the Members concerned an opportunity for adequate consultations. Effective exercise of these rights by WTO Members calls for a minimum guaranteed level of information officially transmitted in one of the working languages of the WTO.[338] Therefore, compliance with Article 12

[336] *See,* Panel Report in *Guatemala - Anti-Dumping Investigation Regarding Portland Cement from Mexico*, 19 June 1998, WT/DS60/R, DSR 1998:IX, 3797, para. 7.42.

[337] *Ibid.*, at footnote 228.

[338] It is clear in fact that the notifications serve, *inter alia*, the purpose of allowing review within the Safeguards Committee as expressly provided by Articles 13.1(f) and 13.2 of the Agreement on Safeguards. In this respect it should be recalled that Rule 35 of the Rules of Procedure for the

requirements must be reviewed regardless of the conclusions which may be drawn in respect of the domestic procedure documents and measures.

(b) Notifications under Article 12.1(a) and Article 12.1.(b) of the Agreement on Safeguards

4.690 The European Communities consider that Korea failed to fulfil the obligations assumed under Article 12.1(a) and (b) of the Agreement on Safeguards, both in terms of timeliness and of sufficiency of its notifications.

4.691 Insofar as timeliness is concerned, the European Communities recall that the need for timely notifications is particularly stressed by the language of the opening clause of Article 12.1. In this respect, the European Communities note that a delay of 14 days (28 May 1996-11 June 1996) between the publication of the initiation decision and the date appearing on the relevant notification document cannot in principle be said to comply with the requirement of "immediate" notification "upon" initiation.[339] The same conclusion applies in respect of a delay of 40 days (23 October 1996-2 December 1996) between the publication of the injury finding and the date of the document which was notified to the Safeguards Committee.[340]

4.692 The European Communities concede that the expression "immediately upon" may need to be interpreted also in the light of the type and amount of information to be provided and to the purposes for which the information may be used. Nevertheless, it submits that Korea's notifications fell short of the standard laid down in Article 12.1(a) and (b) even making allowance for those considerations. The amount of information required for those notifications, which relate to interim stages of the investigatory process, is limited and, in any event, Korea did not even provide that information in full. The European Communities therefore conclude that Korea failed to notify "immediately" information concerning the initiation of the safeguard procedure and the finding of serious injury.

4.693 As regards the content of Korea's notifications, the European Communities observe, in respect of the initiation notification[341], that no mention was made either of the conditions under which imports occurred, or of whether and on which basis serious injury or threat thereof was alleged by complainants in the domestic investigatory procedure, although, Article 12.1(a) includes an express reference to injury and the reasons therefor. The conditions under which the products investigated were imported should have likewise been mentioned, for their review equally constitutes a requirement for the adoption of a safeguard measure pursuant to Article 2 of the Agreement on Safeguards. Yet no mention in this respect is included in the initiation notification.

4.694 The inadequacy of the information provided by Korea is even more compelling relative to the injury notification.[342] The standard of notification in

Committee on Safeguards provides that "English, French and Spanish shall be the working languages" of that Committee.

339 *See,* WTO Doc. G/SG/N/6/KOR/2, 1 July 1996 (Exhibit EC-1).

340 *See,* WTO Doc. G/SG/N/8/KOR/1, 6 December 1996 (Exhibit EC-2).

341 *See,* WTO Doc. G/SG/N/6/KOR/2, 1 July 1996 (Exhibit EC-1).

342 *See,* WTO Doc. G/SG/N/8/KOR/1, 6 December 1996 (Exhibit EC-2).

respect of injury findings is laid down in Article 12.2, which requires that "all pertinent information" must be supplied. Furthermore, in respect of the matters which are specifically mentioned as "pertinent information", Article 12.2 determines the particular type of information that is required. Thus, as regards "serious injury or threat thereof caused by increased imports", not any information, but evidence, must be provided in order to meet that standard. In the light of the context of Article 12.2, the "evidence" referred to cannot be but that mentioned in Article 4.2 of the Agreement on Safeguards, that is, in the first place, the "factors of an objective and quantifiable nature having a bearing on the situation of" the industry which are listed therein.

4.695 The European Communities note that no information of any kind, or evidence, was provided on the causal link between the increased imports and the serious injury. As to serious injury or threat thereof, the European Communities observe that most of the "factors" listed in Article 4.2 were neither mentioned, nor disregarded as not "pertinent". As to the import trends and conditions, no addition to the information already provided in the initiation notification was made. Thus, the issue of the "conditions" under which the foreign products were imported was still not addressed.

4.696 No justification for the incompleteness of the information submitted was provided in either notification. In particular even assuming, *arguendo*, that the confidential nature of the information received relative to serious injury or threat thereof and on the conditions under which the investigated products were imported could have justified a complete withholding of information, *quod non*, no such explanation was made in either notification.

4.697 In the light of the foregoing the European Communities consider that Korea violated its obligations under Article 12.1(a) and (b) of the Agreement on Safeguards.

(c) Notification under Article 12.1(c) of the Agreement on Safeguards

4.698 The European Communities consider that, as in the case of the notifications under Article 12.(a) and (b) of the Agreement on Safeguards, that made pursuant to Article 12.1(c) was neither timely nor complete. However, in order to discuss compliance with Article 12.1(c) the document constituting the notification must first be identified. There appear to be at least three acts self-qualifying as notification or that could in any event be relevant in order to assess whether Article 12.1(c) was complied with.

- On 21 January 1997 Korea forwarded a document termed as "notification pursuant to Article 12.1(c)" that it "proposes to apply a safeguard measure".[343]
- On 31 January Korea notified a "decision to apply a safeguard measure" pursuant to Article 9.1, footnote 2 of the Agreement on Safeguards. It is, however, explained in the same document that Korea is simply "considering

[343] *See,* WTO Doc. G/SG/N/10/KOR/1, 27 January 1997, p. 1 (Exhibit EC-5).

relief to a domestic industry … in the form of the imposition of quantitative restrictions".[344]

- On 24 March 1997 Korea notified a "supplement" to its 21 January notification.[345] In the meantime, as indicated in this document, a definitive safeguard measure had been published on 7 March, with immediate effect.

4.699 The European Communities note that, irrespective of the title given to the various documents mentioned above, the level of quantitative restrictions reported in the 24 March 1997 notification is different from the one reported in the documents previously notified, and is presumably based on different import statistics.[346] Furthermore, according to the 24 March document the measure described therein had already entered into force on 7 March 1997. Therefore, that document is likely to constitute an autonomous and final notification distinguished from the one reported in the previous documents and is based on partially different import statistics.

4.700 The European Communities consider that inasmuch as the information included in the document of 24 March 1997 regarding the date of entry into force of a safeguard measure in the form of a quantitative restriction is correct, Korea failed to notify it "immediately … upon taking a decision to apply … a safeguard measure" in accordance with Article 12.1(c) of the Agreement on Safeguards.

4.701 Besides the lapse of time (17 days) between the entry into force of the safeguard measure (7 March) and the date of the notification to the Safeguards Committee, the required content and the purpose of this notification warrant the same conclusion. In fact this constitutes the final document on the basis of which consultations can take place under Article 12.3 of the Agreement on Safeguards, and therefore offers the last opportunity for informed bilateral consultations before possibly starting dispute settlement consultations. Seen from this perspective, failure to meet the notification standards has the specific consequence of impairing a Member's provision of "adequate opportunity for prior consultations" within the meaning of Article 12.3 of the Agreement on Safeguards. As regards the required contents of the notification, the European Communities observe that in view of the length of the investigatory process and the previous notification requirements, much of the information should have been available even in English for long time, all the more so if already on 21 January Korea was able to announce "a decision to apply" a safeguard measure. This consideration further reinforces the conclusion that Korea failed to notify in time and thus violated Article 12.1(c) of the Agreement on Safeguards.

4.702 In the unlikely case that the 24 March document was considered to have been notified in time, the European Communities consider that the Panel should also find that it did not include "all pertinent information" and the notification was therefore not complete for purposes of Article 12.1(c). There is no explanation as to the basis

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344 *See,* WTO Doc. G/SG/N/11/KOR/1, 21 February 1997, p.1 (Exhibit EC-6).

345 *See,* WTO Doc. G/SG/N/10/KOR/1/Suppl.1, 1 April 1997 (Exhibit EC-10).

346 Both the 21 January and 31 January documents refer to import statistics for 1993-1995 as the basis for calculating the quota level indicated therein. As the quota level included in the 24 March notification corresponds to that mentioned in the Notification of the Ministry of Trade, Industry and Energy of 7 March 1997 (Exhibit EC-9), the import data relied upon are presumably those mentioned in the 7 March Notification.

for the calculation of the quota, and in particular, no reference to the last three representative years or to the necessity to depart from data relating to those years; that data on employment in a part of the domestic industry (raw milk production) is not provided;[347] that for profits and losses, information for the same part of the domestic industry is also not provided.[348] As with the notifications under Article 12.1(a) and (b), no justification was provided for withholding the missing information, either on grounds of confidentiality or on other grounds. In any event, confidentiality could obviously not have been invoked in respect of such information as the import data forming the basis for the calculation of the quantitative restrictions.

4.703 If the notification dated 24 March 1997 was not to be considered the relevant notification under Article 12.1(c), the European Communities submit, in the alternative, that neither the document dated 21 January 1997 nor that dated 31 January 1997 were complete.[349] Without the need to discuss them in any greater detail, this is made clear by the fact that Korea was indeed able to provide a significantly more detailed notification on 24 March 1997.

(ii) Violation of Article 12.3 of the Agreement on Safeguards- Failure to Provide Adequate Opportunity for Prior Consultations

4.704 Article 12.3. of the Agreement on Safeguards provides that*:*

> "A Member *proposing* to apply … a safeguard measure shall provide *adequate* opportunity for *prior* consultations with those Members having a substantial interest as exporters of the product concerned, with a view to, *inter alia*, *reviewing the information provided under paragraph 2*, exchanging views on the *measure* and reaching an understanding on ways to achieve the *objective set out in paragraph 1 of Article 8*." (emphasis added)

Resulting from Korea's notification dated 24 March 1997, "in order to make its final decision on safeguard measures, Korea circulated a notification (G/SG/N/10/KOR/1 of 27 January 1997) to provide an opportunity for consultations with Member countries concerned in accordance with the Agreement on Safeguards. Korea then held bilateral consultations with the European Communities, Australia and New Zealand on 4 and 5 February 1997 in Geneva and also attended a special meeting of the Safeguards Committee on 21 February 1997".[350] The European Communities submit that consultations eventually afforded by Korea after their reiterated

[347] *See,* WTO Doc. G/SG/N/10/KOR/1/Suppl.1, 1 April 1997, p. 10, para. 3.6 (Exhibit EC-10).
[348] *Ibid*., para. 3.10.a.
[349] *See,* WTO Doc. G/SG/N/10/KOR/1, 27 January 1997 (Exhibit EC-5) and WTO Doc. G/SG/N/11/KOR/1, 21 February 1997 (Exhibit EC-6).
[350] *See,* WTO Doc. G/SG/N/10/KOR/1/Suppl.1, p. 6, para. 7 (Exhibit EC-10). *See,* also WTO Doc. G/SG/11 of 18 March 1997, p. 1 (Communication from Korea on the results of consultations under Article 12.3 of the Agreement on Safeguards, Exhibit EC-7) and WTO Doc. G/SG/M/8, 10 June 1997, p. 2, para. 10 (Minutes of the special meeting of the Safeguards Committee held on 21 February 1997, Exhibit EC-8).

requests[351] failed to meet the standards laid down in Article 12.3 of the Agreement on Safeguards, and therefore Korea breached its obligations under that provision.

4.705 The European Communities first note that Article 12.3 expressly refers to a general standard of "adequacy" of the opportunity to consult, which is then clarified by reference to the subject matter of the consultations and their aim. The text of Article 12.3 makes clear that the purpose of the consultations is to foster an agreement between the WTO Members concerned or to ensure the maintenance of the balance of concessions pursuant to Article 8.1 of the Agreement on Safeguards. In particular Article 12.3, when specifying that it is for the Member "proposing to apply" to offer to consult, *inter alia*, on the "proposed measure",[352] implies that consultations must take place before the measure is taken (*i.e.,* when it is still a "proposal"). This conclusion is reinforced if one has regard to the subject matter on which consultations must be afforded. In order for the opportunity to consult to be adequate pursuant to Article 12.3, consultations must take place on *all the information* provided under Article 12.2 of the Agreement on Safeguards. As already illustrated above, Article 12.2 in turn mentions "all pertinent information", including the evidence specified therein, as the one to be supplied in the notifications of injury findings and of the results of the procedure. Therefore, any consultations falling short of a review of all pertinent information would obviously not meet the Article 12.3 standard. The purpose of Article 12.3 logically requires that such consultations must be held on the basis of all the information required at a date *prior* to the application of the measure, so as to have a possibility to avoid it or ensure that the balance of concessions is preserved.

4.706 The European Communities believe they have already shown above that the documents notified by Korea, either before or after the date of the consultations, including the one dated 24 March 1997, were far from complete. Even assuming that the latter document were sufficiently detailed, the procedural history reported by Korea in its 24 March document omits to underline a crucial element, namely that consultations took place *well before* that document was supplied and when only the extremely limited information included in WTO Documents G/SG/N//6/KOR/2 (initiation notification), G/SG/N/8/KOR/1 (serious injury finding), G/SG/N/10/KOR/1 (Article 12.1(c) notification), and G/SG/N/11/KOR/1 (Article 9, footnote 2 notification) was available. It follows that by failing to provide all pertinent information in its notifications, and specifically in the ones made under Article 12.1(b) and (c) of the Agreement on Safeguards, in advance of consultations, Korea prevented WTO Members having a substantial interest as exporters from engaging in meaningful consultations, thus failing to provide them with an adequate opportunity in this respect. As a consequence, it also frustrated the further objective of those consultations, namely to reach an agreement or to ensure the maintenance of the balance of concessions as foreseen in Article 8.1 of the Agreement on Safeguards.

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[351] *See,* WTO Doc. G/SG/7, 12 December 1996 and WTO Doc. G/SG/8, 17 December 1996 (Exhibits EC-3 and EC-4).

[352] It is only in the case of provisional safeguard measures that the Agreement on Safeguards (Article 12.4) makes an exception by allowing consultations to take pace after adoption of the measure.

4.707 The European Communities further submit that if the document dated 21 January 1997 is found to be a notification of a "decision to apply a safeguard measure" within the meaning of Article 12.1(c) of the Agreement on Safeguards, by affording consultations on 4 February 1997 Korea frustrated the very purpose of the consultations under Article 12.3, which aim at finding a solution alternative to the imposition of a safeguard measure or at the least at enabling the Members concerned to influence the final decision. Thus, *a fortiori* in this case Korea should be found to have failed to comply with its obligation arising under Article 12.3 of the Agreement on Safeguards.

(b) Response by Korea

4.708 **Korea** responds to the EC arguments as follows:

4.709 On 28 May 1996, Korea initiated the safeguards investigation at issue. On 11 June 1996, Korea forwarded its notification of the initiation to the Committee on Safeguards under Article 12.1(a) of the Agreement on Safeguards.[353] Consistent with the guidance issued by the Committee on Safeguards[354], Korea identified the following in its notice*:* (1) the date of initiation of the investigation (28 May 1996); (2) the dairy products subject to the investigation, as identified by their HS numbers, and (3) the reasons for initiating the investigation, including that the investigation was initiated on the basis of a petition filed under Article 33(1) of the Foreign Trade Act and that the non-confidential evidence indicated the specified increase in imports. Notably, the Agreement on Safeguards does not impose obligations regarding the scope of the reasons that are necessary to justify the initiation of a safeguards investigation.

4.710 Article 12.2 of the Agreement on Safeguards provides that notifications under Article 12.1(b) and (c) of the Agreement on Safeguards must include all pertinent information, including "evidence of serious injury or threat thereof caused by increased imports, precise description of the product involved and the proposed measure, proposed date of introduction, expected duration and timetable for progressive liberalization." In the Technical Cooperation Handbook on Notification Requirements (the "Handbook"), the Committee on Safeguards adopted guidance for Members on how to comply with these notification requirements, although it did not define, for example, the amount of evidence that should be provided to comply with Article 12.2.[355] According to the Handbook, a Member should provide:

(a) evidence of serious injury or threat thereof caused by increased imports;

(b) information on whether there is an absolute increase in imports or an increase in imports relative to domestic production;

(c) precise description of the product involved;

(d) precise description of the proposed measure;

[353] G/SG/N/6/KOR/2 (1 July 1996).

[354] Committee on Safeguards, *Notification Under Article 12.1(a) of the Agreement on Safeguards on Initiation of an Investigation and the Reasons for It*, G/SG/N/6 (7 February 1995).

[355] WT/TC/NOTIF/SG/1 (15 October 1996).

(e) proposed date of introduction of the measure;
(f) expected duration of the measure;
(g) proposed date for review if applicable;
(h) expected timetable for progressive liberalization, if applicable; and
(i) other information if the measure is being extended.[356]

4.711 On 2 December 1996, Korea transmitted to the Committee on Safeguards its notification of a finding of serious injury caused by imports under Article 12.1(b) of the Agreement on Safeguards.[357] The notification referred Members to the 23 October 1996 KTC finding, the report of which was publicly available. Consistent with the guidance in the Handbook, the notification also (1) summarized the evidence of serious injury caused by increased imports (2) provided information on whether there is an absolute increase in imports or an increase in imports relative to domestic production, (3) described the products involved, and (4) informed the Committee that no final decision had been made to impose a safeguard measure and, thus, no information was available on the measure.

4.712 After receiving two requests for consultations under Article 12.3 of the Agreement on Safeguards, Korea provided a preliminary notification under Article 12.1(c) on 21 January 1997.[358] Although such preliminary notification was not required under Article 12, Korea considered that for prior consultations to be meaningful under Article 12.3, Members should have more information on the proposed measure.[359] Thus, Korea's preliminary notification under Article 12.1(c) included the information from the 2 December 1996 notification as well as information on the proposed measure. Given its preliminary nature, Korea expressly reserved the right to provide further relevant information after the final decision was made. In addition, the notification provided dates that the Korean delegation was available for consultations and stated that the final decision was expected the week of 24 February 1997, after consultations had been held.

4.713 On 4 and 5 February 1997, Korea held consultations with the European Communities, Australia, and New Zealand under Article 12.3 of the Agreement on Safeguards. These consultations facilitated an exchange of views regarding the measure based on Korea's earlier notifications and on the publicly-available OAI Report.

4.714 On 24 March 1997, Korea provided the Committee on Safeguards with its final notification under Article 12.1(c) of the Agreement on Safeguards.[360] Given the concerns raised by the European Communities and other Members regarding the

[356] WT/TC/NOTIF/SG/1 (15 October 1996).
[357] G/SG/N/8/KOR/1 (6 December 1996). This notification was provided to the Committee on Safeguards on the same day as the KTC issued its recommendations. *See,* Exhibit Korea-11.
[358] G/SG/N/10/KOR/1 (27 January 1997).
[359] Korea notes that it could have held consultations based solely on the notification under Article 12.1(b), given that consultations under Article 12.3 must necessarily be held prior to the final decision to impose a safeguard measure notified under Article 12.1(c). After the decision to impose the measure is made and final notification is provided under Article 12.1(c), consultations would not be meaningful because the consultations could not result in any consideration of Member's concerns prior to the final decision.
[360] *See,* G/SG/N/10/KOR/1/Suppl.1 (1 April 1997).

scope of its earlier notifications, Korea, while not regarding itself as obliged to do so, expanded its discussion in its final notification on virtually every aspect of its 21 January 1997 notification.

4.715 Korea is of the view that it fully complied with its obligations under Article 12 of the Agreement on Safeguards. In fact, Korea took additional steps to ensure that Members were provided additional information to facilitate meaningful consultations.

(c) Rebuttal Arguments Made by the European Communities

4.716 The **European Communities** made the following arguments in rebuttal:

(i) Violation of Article 12.1-3 of the Agreement on Safeguards - Failure to Comply with Notification and Consultation Requirements

(a) Notification requirements

(1) Contents of the notifications

4.717 In this regard Korea alleges the consistency of its action with the "guidance issued by the "Committee on Safeguards" on the matter of notifications, notably the "Technical Cooperation Handbook on Notification Requirements" ("the Handbook").[361] However, by Korea's own admission, this Handbook does not define "the amount of evidence that should be provided to comply with Article 12.2 of the Agreement".

4.718 The European Communities do not accept that Korea's notification is consistent with the Handbook. In particular, the European Communities note that in Document. G/SG/1 quoted by Korea, it is mentioned, *inter alia*, that parties should "1. Provide evidence of serious injury or threat thereof caused by increased imports."[362] As just noted, nowhere in the Handbook are the notions of "evidence", "serious injury", "causation" defined. It is therefore only by referring to Article 12 of the Agreement on Safeguards, as well as at the other provisions referred to therein, that these notions can be interpreted. In perfect consistence with this conclusion is the express disclaimer note at the opening of Document G/SG/1, reading as follows: "These formats are without prejudice to the interpretation of the relevant provisions in the Agreement on Safeguards by the competent bodies."[363] Interpretation obviously concerns the Agreement on Safeguards and will be conducted in line with

[361] *See,* WTO Docs. WT/TC/NOTIF/SG/1, 15 October 1996 and G/SG/1, 1 July 1996; Korea's First Submission, para 142.

[362] *See,* WTO Doc. G/SG/1, Section II, item1.

[363] *See,* WTO Doc. G/SG/1, p. 1. The EC would further recall that in *EC - Bananas* the Appellate Body made clear that a document not "endorsed by a formal decision of the CONTRACTING PARTIES" "cannot be considered as an authoritative interpretation" (*See EC - Bananas*, *supra*, footnote 12, para. 200). The EC considers that the Appellate Body's ruling in respect of GATT 1947 would apply in the present case *mutatis mutandis*, that is, consistently with Article IX:2 of the Agreement establishing the World Trade Organization, pursuant to which: "The Ministerial Conference and the General Council shall have the exclusive authority to adopt interpretations of this Agreement and of a Multilateral Trade Agreement in Annex 1."

the provisions thereof. The Handbook can therefore be of no guidance in deciding whether the information submitted to the Committee on Safeguards constituted "all pertinent information" within the meaning of the Article 12.2 of the Agreement on Safeguards.

(2) Timing of the notifications

4.719 The European Communities disagree with Korea's statement that Korea's Notification of 27 January 1997[364] was not required under Article 12 of the Agreement on Safeguards if this is meant to imply that there is no obligation under Article 12.1(c) to notify "all pertinent information" prior to the application of a safeguard measure, with a view to, *inter alia,* holding consultations. This seems otherwise to contradict what Korea's statement in its First Written Submission:

> "Korea notes that it could have held *consultations* based solely on the notification under Article 12.1(b), given that consultations under Article 12.3 must necessarily be held prior to the final decision to impose a safeguard measure notified under Article 12.1(c). After the decision to impose the measure is made and final notification is provided under Article 12.1(c), consultations would not be meaningful because the consultations could not result in any consideration of Member's concerns prior to the final decision." (emphasis added)

4.720 What Korea has overlooked in this striking admission is that meaningful consultations can only take place if Members are provided all the necessary information, notably that required by Article 12.2 of the Agreement on Safeguards.[365] Therefore, the consultation objective contributes to define the timing of the notification and its content. Since consultations under Article 12.3 must cover "the information provided for under paragraph 2", including on "the proposed measure", Korea's notification under Article 12.1(b) could not have been the exclusive basis for consultations.[366] The European Communities would remind the Panel that Korea's 1 April Notification, which was the most comprehensive document ever provided by Korea to the Committee on Safeguards under Article 12.1(c), was forwarded 17 days after the entry into force of the safeguard measure.

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[364] *See,* WTO Doc. G/SG/N/10/KOR/1, 27 January 1997 (Exhibit EC-5).

[365] The EC also points out in this connection that the Notification Handbook does not address the issue of the timing of notifications, except by repeating that they should be made "immediately" and by regulating the relationship between the one under Article 12.1(b) and the one under Article 12.1(c) of the Agreement on Safeguards. Therefore, in this respect too Korea, by referring to the Handbook, has certainly not rebutted the EC's claim of violation of the requirement to "immediately notify", which is laid down in Article 12.1 in respect of all three notifications mentioned.

[366] *See,* WTO Doc. G/SG/N/8/KOR/1, 6 December 1996 (Exhibit EC-2), para 4, which reads*:* "*Information on measure*. The Korean Trade commission has not made a decision to apply a safeguard measure yet. Therefore, there is no information on such a measure at this time. The KTC will recommend to the relevant Minister an appropriate remedial measure within 45 days of the injury determination."

(b) Consultations

4.721 The foregoing observations on the content and timing of notifications also confirm the EC claim that Korea failed to provide "adequate opportunity for prior consultations" within the meaning of Article 12.3 of the Agreement on Safeguards. In fact, in view of the insufficient content and late submission of Korea's notifications, consultations, which, by Korea's own admission, can only be meaningful if preceding the adoption of the measure, could certainly not be based on "all pertinent information" in terms of Article 12.2, and could not therefore be "meaningful" in terms of Article 12.3. The European Communities therefore conclude that their claim of a violation of Article 12.3 of the Agreement on Safeguards has not been rebutted by Korea and should be upheld by the Panel.

4.722 At the second meeting of the panel with the parties, the **European Communities** further advanced their arguments under Article 12, by presenting its own version of the sequence of events leading up to dispute settlement consultations.

23 October 1996:	Finding of serious injury by KTC
2 December 1996:	First notification of serious injury under Article 12.1(c) of the Agreement on Safeguards.
11 December 1996:	First request for consultations under Article 12.3 by the **European Communities**.
16 December 1996:	Reiteration of the first request for consultations, since the **European Communities** received information about a 30-day deadline running from the date of the recommendation of the imposition of safeguard measures by the KTC to the competent authorities within the Korean Government. Hence, the suggested date for the consultations of 20 December. It should be noted that Korea finally agreed to hold consultations 73 days after the finding of serious injury was made.
28 January 1997:	A set of written questions was sent by the **EC** Delegation in Geneva to the Korean Delegation with a view to preparing consultations under Article 12.3 of the Agreement on Safeguards.[367] The European Communities never received a written reply to those questions. Furthermore during the consultations, Korea equally failed to reply satisfactorily and simply promised to provide further information on specific issues as requested by the European Communities which, with one exception, it never did.[368]
4 February 1997:	Article 12.3 consultations. During the consultations, the Korean Delegation read out prepared answers to the questions sent by the European Communities on 28 January. Korea refused to hand over the written answers to the EC Delegation.

[367] *See,* Exhibit EC-27.
[368] *See,* Exhibit Annex EC 28.

21 February 1997: Special meeting of the Committee on Safeguards. This meeting was requested by the European Communities based on Article 13 of the Agreement on Safeguards which relates to certain particular functions of that Committee, including general vigilance with respect to Members' actions related to safeguards.[369] As can be clearly seen from the record of that meeting, Korea did not provide any further pertinent information on that occasion.

24 March 1997: Korea submitted the amended and extended version of the notification under Article 12.1(c). In the cover letter[370] sent by the Korean Delegation in Geneva to the EC Delegation, the notification was described as being "also intended to serve as an overall response to the questions raised by the European delegation during the bilateral consultations on this matter." Again, the European Communities note that all pertinent information must be notified prior to the adoption of a measure (*i.e.,* in the present case, prior to 7 March 1997) with a view to allowing meaningful consultations, as set forth in Article 12.1-3.

3 September 1997: The European Communities sent a second set of questions[371] to Korea ahead of the first round of dispute settlement consultations under Article XXII:1 of GATT on 10 September. The European Communities never received a written reply.

19 September 1997: The European Communities sent a letter[372] restating questions asked during the first round of dispute settlement consultations under Article XXII:1 of GATT and one question posed during the consultations under Article 12.3 of the Agreement on Safeguards.

16 October 1997: Second round of dispute settlement consultations. Korea gave its sole written response to any of the EC questions. It handed over one page showing a table contained in the OAI Report concerning the development of production of other dairy products in response to the question asked on 4 February 1997 and restated on 19 September 1997, *i.e.,* eight months after the information was requested for the first time.

4.723 The conduct of the consultations as set out above shows that Korea can not rebut the EC claim that Korea violated its obligations under Article 12.1-3 of the Agreement on Safeguards in particular because it did not provide all pertinent information before or during the consultations under Article 12.3 of the Agreement on Safeguards, which could therefore not be "meaningful" in terms of Article 12.3.

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[369] *See,* WTO Doc. G/SG/M/8 10 June 1997, Minutes of the Special Meeting held on 21 February 1997, para 2.
[370] *See,* Exhibit EC-29.
[371] *See,* Exhibit EC-30.
[372] *See,* Exhibit EC-31.

4.724 In response to a question by the Panel[373] the **European Communities** further clarified their position on Article 12 notifications:

4.725 Although the absence of a notification is a clearer violation than a deficient notification, the European Communities consider that the adequacy of a notification must be verified by the Panel in the same way as any other alleged violation of the WTO Agreements. A violation of a procedural obligation can in principle give rise to the same kind of finding as a substantive violation, and that is what the European Communities are requesting in this case.

4.726 There are however important distinctions to be made between some procedural and substantive violations when it comes to implementing a Panel report. The violation of a procedural obligation which only serves an objective of transparency, will not have the same consequences as the violation of a procedural obligation which is an indispensable precondition for a measure (*e.g.,* the obligation to conduct an investigation or to give adequate opportunity for prior consultations in order to review all pertinent information in the meaning of Article 12).

4.727 Also in response to a question of the Panel[374] the **European Communities** clarified their position on the issue of the content of the notification:

4.728 The European Communities are of the view that "all pertinent information" is an objective standard because it is defined in Article 12.3 of the Agreement on Safeguards as including "evidence of serious injury or threat thereof caused by increased imports, precise description of the products involved and the proposed measure, proposed date of introduction, expected duration and timetable for progressive liberalization." The Member proposing to apply safeguard measures may be obliged to provide further information since this list is not exclusive, but at least the items which are listed are objective standards and subject to review by the panel. Further guidance for the interpretation of the first item of this list, "evidence of serious injury or threat thereof caused by increased imports", can be found in Article 4.2(a) and (b) of the Agreement on Safeguards.

4.729 The consequence of a finding of violation is not a matter for the Panel, as the panel in the Guatemala case correctly concluded.[375]

4.730 The Panel also requested[376] the **European Communities** to clarify their position on the documents that Korea provided the Panel at the second meeting of the Panel with the parties regarding the consultations held with Korea.[377] The EC answer was as follows:

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[373] The Panel recalls that the question was: "With regard to Article 12.1 and 12.2, do the parties believe that a distinction should be drawn between a complete or a deficient notification, or between the existence or the absence of such notification? What should the consequences be of the absence or the incompleteness of the notification with regard to the safeguard measure itself?"

[374] The Panel recalls that the question was: "Is the concept of 'all pertinent information' an objective or subjective standard? Please comment on how your answer should affect the Panel's conclusion with regard to the consequences of such a standard not being met?"

[375] *See,* Panel Report in *Guatemala - Anti-Dumping Investigation Regarding Portland Cement from Mexico*, *supra*, footnote 336, WT/DS60/R, para 8.3.

[376] The panel recalls that the question was: "What judicial notice should the Panel now take of the consultations?"

[377] *See* paragraph 4.751.

4.731 The European Communities consider that the fact that the parties have provided details of the consultations under Article 12.3 to the panel means that the panel should take them into account in adjudicating this dispute and in its report in particular in reviewing whether Korea complied with Article 12.3.

(d) Rebuttal Arguments Made by Korea

4.732 **Korea** makes the following rebuttal arguments:

4.733 Korea reiterated its view that Korea's notifications were:

(a) timely;

(b) adequate, in that they contained "all pertinent information"; and

(c) permitted the parties to reach an agreement.

(i) The Timeliness of Notifications and Consultations

4.734 The notifications were timely in that they: Were provided to the Committee on Safeguards as soon as practically possible after the conclusion of the procedural step that triggered such notification; and permitted third parties sufficient time to prepare for and engage in meaningful prior consultations.

4.735 Korea notes that as to timeliness:

(a) On 11 June 1996, Korea notified the WTO Committee on Safeguards under Article 12.1(a) of the Agreement on Safeguards regarding the KTC's initiation of a safeguards investigation and the reasons supporting initiation;

(b) The notification identified the date that the investigation was initiated (28 May 1996), the products subject to investigation (dairy products under the specified HS headings), and the reasons for the initiation (a petition filed under Article 33(1) of the Foreign Trade Act providing evidence of increased imports);

(c) Following 26 days' public notice of the KTC hearing, and after having had the OAI's Interim Report for 8 days, representatives of EC Member States attended the KTC's Public Hearing held on 20 August 1996 and made substantive comments;

(d) Representatives of the European Communities then had almost 2 months to make comments to the OAI concerning the material contained in the OAI's Interim Report and matters raised at the public hearing;

(e) Dr. Beseler of DG1 of the European Commission then had an exchange of letters with the KTC, in which Director-General Kim again summarized the reason for the initiation of the KTC investigation and noted the steps taken by certain EC Member States to protect their commercial interests, *inter alia,* by attending the KTC hearing and obtaining copies of the OAI's Interim Report;[378]

[378] *See,* Exhibits Korea-15 and 16.

(f) The KTC, after a full deliberation of the final OAI Report, made a determination of serious injury on 23 October 1996, a summary of which was published in *Kwanbo* on 11 November 1996. It should be noted, *inter alia*, that the final three paragraphs of the OAI Report note Korea's international obligations and the necessity of both notification and prior consultation under the Agreement on Safeguards;

(g) The European Communities raised the issue of the OAI's investigation at a regular meeting of the Committee on Safeguards on 25 October 1996. The comments made by the European Communities indicated that they were very well informed about the nature of the investigation underway, and they asked for further particulars regarding the conclusion of the OAI's investigation 2 days earlier. The Korean delegate:

> "indicated that his delegation was not in a position to furnish additional information at the meeting. He asked any interested Members to address their questions to the Korean delegation in writing, and indicated that his delegation would do its best to provide the additional information requested, so long as such information was not confidential."[379]

(h) On 2 December 1996, Korea transmitted to the Committee on Safeguards its notification of a finding of serious injury caused by imports under Article 12.1(b) of the Agreement on Safeguards.[380] The notification referred Members to the 23 October 1996 OAI Report which was publicly available. The notification under Article 12.1(b):

(i) summarized the evidence of serious injury caused by increased imports;[381]

(ii) provided information on whether there is an absolute increase in imports or an increase in imports relative to domestic production;

(iii) described the products involved; and

(iv) stated that no final decision had been made to impose a safeguard measure and, thus, no information was available on the measure.

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[379] *See,* G/SG/M/7 (19 March 1997) at paragraph 24.

[380] G/SG/N/8/KOR/1 (6 December 1996). This notification was provided to the Committee on Safeguards on the same day as the KTC issued its recommendations. *See,* Exhibit Korea-11.

[381] The non-confidential evidence that Korea deemed pertinent for purposes of the notification included evidence on (1) the increase of imports, share of domestic industry in consumption, and stock, (2) the sale price of imported goods and domestic goods, and manufacturing costs of domestic goods, and (3) the reduction of the number of dairy farming households and loss incurred by Livestock Cooperatives. Given that the KTC's Report was publicly available, Korea did not deem it necessary to delay its notification in order to translate the report.

(i) Korea's first notification under Article 12.1(c)[382] was made in a preliminary form to provide interested third parties with information about Korea's proposal to apply a safeguard measure; It should be noted that the obligation to file a notification under Article 12.1(c) arises upon "taking a decision to apply or extend a safeguard measure" which, as noted at paragraph 7 of that notification, was due to be taken not earlier than "the week beginning 24 February 1997." However, as noted above, Korea took the view that in order to provide for meaningful prior consultations under Article 12.3, it should circulate information "before it makes a final decision on the measure by the week beginning 24 February 1997";[383] This preliminary notification was made 17 days prior to the actual consultations and 47 days prior to the actual imposition of what is intended to be an emergency measure.

(j) It is noteworthy that the European Communities in their second request for consultations[384] wished to provide only 4 days notice, which would not, in Korea's view, have provided sufficient opportunity to prepare for meaningful consultations. Further, the European Communities were able to provide Korea with 11 pages of detailed questions within 7 days of Korea's preliminary Article 12.1(c) notification. These are remarkably detailed questions and are obviously based on a close reading of the OAI Report. Korea answered within 6 days and before the consultations; during the course of the consultations on 4 and 5 February, the European Communities produced an English translation of the OAI Report, which it provided to the Korean delegation;

(k) The European Communities had the opportunity to request, attend and address a Special Meeting of the Committee on Safeguards after its consultations but still prior to the imposition of the measure. It is clear from that meeting that all parties concerned had full access to all relevant information and that the matter was fully aired.

(l) It is worthy of note that the Committee has the power to "request such additional information as they may consider necessary from the Member proposing to apply or extend the measure" (Article 12.2) and "to find, upon request of an affected Member, whether or not the procedural requirements of this Agreement have been complied with in connection with a safeguard measure, and report its findings to the Council for Trade in Goods" (Article 13.1(b)). The Committee did neither; and

382 *See,* G/SG/N/10/KOR/1 (27 January 1997).
383 *See,* G/SG/N/10/KOR/1 (27 January 1997).
384 *See,* G/SG/8 (17 December 1996).

(m) Korea provided the Committee on Safeguards with an amended and extended version of the notification under Article 12.1(c)[385] that fully set out all aspects of the safeguard measure imposed.

(n) The earlier 21 January notification was amended *inter alia* to take into account the fact that, following on from consultations and as a demonstration of good faith, Korea reconsidered the base years for the establishment of the quota, thus increasing its amount by approximately 5,000 tonnes.

(ii) The Adequacy of Notification and Consultations

4.736 Korea's notifications were *adequate* in that they:

(a) provided "all pertinent information" required by Article 12.2, *i.e*:

- evidence of serious injury or threat thereof caused by increased imports;
- a precise description of the product involved;
- the proposed measure;
- the proposed date of introduction;
- the expected duration;
- a timetable for progressive liberalization; and

(b) adhered to the format approved by the Committee on Safeguards[386]; and

(c) permitted the European Commission to reach a settlement of the dispute, albeit one that was not accepted by the EC Member States.

4.737 Regarding the adequacy of information provided, Korea suggests that notifications under Article 12 serve a different function from the publication of information relating to the investigation by the Korean authority under Articles 3.1 and 4.2(c) of the Agreement on Safeguards, which state respectively:

> "The competent authorities shall publish a report setting forth their findings and reasoned conclusions reached on all pertinent issues of fact and law."
>
> "The competent authorities shall publish promptly, in accordance with the provisions of Article 3, a detailed analysis of the case under investigation as well as a demonstration of the relevance of the factors examined."

Notification is intended to provide the Committee on Safeguards with information which is to be disseminated to Members to facilitate meaningful prior consultations under Article 12.3 and, where appropriate, consultations under Article XXII GATT. This function is implied both by the structure of Article 12, which includes both

[385] *See,* G/SG/N/10/KOR/1/Suppl.1 (1April 1997).

[386] *See,* G/SG/M/1, 24 May 1995 paragraphs 35 and 36, which endorsed the suggested formats set out in the Note from the Chairman contained in G/SG/W/1 (23 February 1995). On 15 October 1996, the WTO Secretariat provided Members with the Technical Cooperation Handbook on Notification Requirements, WT/TC/NOTIF/SG1.

notification *and* consultation, and by the final sentence of Article 12.2 which provides that "The Council for Trade in Goods or the Committee on Safeguards may request such additional information as they may consider necessary from the Member proposing to apply or extend the measure." Clearly, if the purpose of Article 12 were to replicate the exacting standards of Article 3 and 4.2(c), the final sentence of Article 12.2 would be redundant;

4.738 However, Korea does not view the notification procedure as a replacement for a third party Member's responsibility to be vigilant in international trade matters. Once a third party Member has been notified of the simple fact of the initiation of an investigation (and, where applicable, each of the subsequent stages), it must bear some responsibility for monitoring developments and for protecting its international law rights.

4.739 Indeed, Korea notes that the European Communities were extremely vigilant in this respect in that:

(a) they attended the OAI public hearing on 20 August 1996;

(b) they wrote to Dr. Kim of the KTC on 23 September 1996[387] and received a reply from Director-General Kim on 11 October 1996.[388] D-G Kim summarized the reason for the initiation of the KTC investigation and noted the steps taken by certain EC Member States to protect their commercial interests by, *inter alia,* attending the KTC hearing and obtaining copies of the OAI's Interim Report;

(c) it raised issues concerning the nature of the KTC investigation at the regular meeting of the Committee on Safeguards on 25 October 1996;

(d) it requested prior consultations with Korea on 11 and 16 December 1996;

(e) on 28 January 1997, it provided Korea with 11 pages of questions concerning various aspects of Korea's investigation and the proposed safeguard measure;

(f) on 3 February 1997, it received full responses to all questions posed to Korea;

(g) it undertook prior consultations with Korea on 4 and 5 February 1997 in Geneva where it provided Korea with an English translation of the final OAI Report; and

(h) it addressed a Special Meeting of the Committee on Safeguards on 21 February 1997 at which no further action was taken;

4.740 Korea is of the view that "all pertinent information" can only reasonably be interpreted as meaning all information required by Article 12.2 available at the time of the specific notification, that is, "evidence of serious injury or threat thereof caused by increased imports, precise description of the product involved and the proposed measure, proposed date of introduction, expected duration and timetable for progressive liberalization". "All pertinent information" does not and cannot, as the European Communities imply, mean all information and analysis produced

[387] *See,* Exhibit Korea-15.
[388] *See,* Exhibit Korea-16

during the investigation by the Korean authorities. In any thorough investigation, this information and analysis will run to thousands of pages and will be summarized and reported during the course of the national proceedings, as required by Article 3.1 of the Agreement on Safeguards, which again Korea notes the European Communities have conspicuously failed to use as a basis for any claims.

4.741 The requirement to provide "evidence of serious injury or threat thereof caused by increased imports" does not imply that the notifying party has to: provide further analysis, whether detailed or otherwise, of any evidence provided; or provide any separate analysis of causation[389];

4.742 In Korea's view, the Committee on Safeguards and the WTO Secretariat acknowledge that certain legal systems may draw a distinction between "making a finding" (triggering a notification under Article 12.1(b)) and "taking a decision" (triggering a notification under Article 12.1(c)).[390] Thus, in making a notification under both of these provisions, some information may not be available. In the case of Korea, it made a good faith attempt to provide relevant information that would assist prior consultations.

4.743 Finally, Korea notes that the notifications and prior consultations permitted the parties to reach a settlement[391]. The European Communities in their Oral Statement argue that no *binding* settlement was reached between the parties. However, the European Communities cannot deny that an exchange of proposals leading to a settlement was made. If the notifications and prior consultations were inadequate as the European Communities suggest, no such proposal could have been made at all.

(iii) Conclusion

4.744 Korea takes its obligations under Articles 3.3 and 3.7 of the Understanding on Dispute Settlement to reach a "mutually acceptable" solution very seriously. It reiterates that it acted in good faith during all consultations and is pleased that the European Communities acknowledged this in their comments at the Oral Hearing. Korea also reiterates that it unilaterally increased the amount of its quota as part of its attempt to settle this dispute. However, Korea objects to the EC argument that Korea's notification and consultations were inadequate when the real blame lies in the sectional interests of its Member States.

4.745 At the second meeting of the panel with the parties, **Korea** further advanced its defence on the EC claims under Article 12 as follows:

4.746 Notification and consultations are intended to provide the Committee on Safeguards with information that is to be disseminated to Members to facilitate meaningful prior consultations under Article 12.3, and where appropriate, consultations under Article XXII GATT 1994. Korea does not view its obligations

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[389] *See,* G/SG/W/1 (23 February 1995) where, at Section VI, the obligation to "provide evidence of serious injury or threat thereof caused by increased imports" is distinguished from the obligation to "provide information on whether there is an absolute increase in imports relative to domestic production." If evidence of causation is a separate requirement, it would have been separated out as are serious injury and increase in imports.

[390] *Ibid.*

[391] *See* Korea's arguments in paragraph 4.6 above.

under Article 12 as a complete replacement for the duty of its trading partners, including the European Communities, to be vigilant in international commercial matters, and to monitor the activities of its trading partners. Korea notes that the European Communities and certain other WTO Members were involved in every stage of the Korean investigation leading to the imposition of the safeguard measure. This involvement demonstrates both adequacy of published and publicly available information, and openness of the investigation procedure.

4.747 The European Communities addressed a regular[392] and special meeting[393] of the Committee on Safeguards. While such meetings are not a replacement for the dispute settlement procedure, it is clear that although the European Communities had a full and fair opportunity to air their grievances, the Chairman of the Committee took note of the statements made, but made no recommendations and requested no further action.

4.748 Korea undertook extensive consultations with the European Communities, New Zealand and Australia prior to imposition of the safeguard measure. This process included answering very detailed questions on Korea's investigation and on the process which would eventually lead to the imposition of the safeguard measure.

4.749 Each notification provided all the information available at the time of submission, and is consistent with the *pro forma* drafted by a Working Group of the Committee, agreed by the Committee on Safeguards in May 1995, and provided to all Members in a Handbook prepared by the Secretariat. Korea cannot accept the EC argument that "the Handbook can therefore be of no guidance in deciding whether the information submitted to the Committee on Safeguards constituted 'all pertinent information.'" If the European Communities felt that the formats were inadequate, and could not provide guidance to Members, it should have made these points at the time of their adoption by the Committee on Safeguards rather than seeking to raise such objections when it suits its arguments.

4.750 Korea cannot accept as the European Communities appear to imply that "all pertinent information" means all information and analysis produced during the investigation by competent authorities. This information and analysis is to be found within the documents produced in accordance with Articles 3 and 4.2(c), which the European Communities have chosen not to challenge.

4.751 The EC argument that no binding settlement of this case was reached wholly misses the point of Korea's comments: clearly, the notification and prior consultations were sufficiently adequate to permit settlement. The fact that this could not be finalized by the European Communities, as a result of their internal procedures, is irrelevant. If the notifications and prior consultations were inadequate, as the European Communities suggest, no proposal to its Member States would or could have been made at all; Korea, mindful of the confidential nature of these consultations, had not provided the Panel with *proces verbal* containing the terms of settlement and all correspondence between the European Communities and Korea on

[392] *See* meeting of 25 October 1996, G/SG/M/7 (19 March 1997).
[393] *See* meeting of 21 February 1997, G/S/M/8 (19 June 1997).

this matter. Given the EC challenge to Korea to prove that a settlement was almost concluded, Korea provided the Panel with the following documents:[394]

- the various versions of the exchanged proces verbal including the final settlement; and
- the relevant correspondence accompanying these documents.

4.752 As the third sentence of Article 3.7 of the DSU unequivocally states "a solution mutually acceptable to the parties to the dispute and consistent with the covered agreements is clearly to be preferred." It was pursuant to this Article of the DSU that Korea entered into settlement negotiations with the European Communities with a view to working out a mutually satisfactory solution. It was the European Communities, and not Korea, that breached the outcome of these good faith negotiations by failing to confirm this settlement with its Member States.

4.753 In response to a question of the Panel[395] **Korea** further clarified its position on Article 12 notifications:

4.754 Korea is very clear that the complete absence of a notification must be distinguished from a notification. Further, there is a distinction between a complete and incomplete notification. In Korea's view, the incompleteness of the notification cannot affect the validity of the underlying safeguard measure.

4.755 The European Communities suggested that a procedural violation, however insignificant or immaterial, *could* call in question the very existence of the safeguard measure. Further, Korea also understood the European Communities to be implying that a procedural violation of Article 12 could in some way also amount to a substantive violation.

4.756 Korea's view is that a procedural violation of Article 12 cannot be a substantive violation.

4.757 Korea further notes that whether or not the safeguard had been implemented did not appear to alter the issue of whether or how a deficient notification could be remedied. Korea stated that should a Member be held by a panel to violate Article 12, then as is set out in Article 19.1 of the DSU, and as is normally the case, the Member in breach should be requested to bring its measures into conformity with the agreement under consideration. In a case such as this, the question has to be asked as to exactly how a Member *could* bring its notification into conformity. If the Member has imposed its safeguard measure, then entry into further (meaningful) consultations would not be pointless, but could facilitate a revision in that safeguard measure (for example an increase in quota, or decrease in a tariff). If the safeguard measure was otherwise wholly in conformity with the Agreement on Safeguards, it would then be inappropriate for a Panel to suggest that a Member should be required to withdraw that safeguard.

4.758 Also in response to a question by the Panel[396] **Korea** clarified its position on the issue of the content of the notification:

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[394] *See,* Korea Exhibit 18.

[395] The Panel recalls that the question was: "With regard to Article 12.1 and 12.2, do the parties believe that a distinction should be drawn between a complete or a deficient notification, or between the existence or the absence of such notification? What should the consequences be of the absence or the incompleteness of the notification with regard to the safeguard measure itself?"

4.759 Korea is of the view that "all pertinent information" should be and is based on an objective standard, that of the format. These replicate the structure and content of Article 12.2.

4.760 However, the European Communities appear to want a decision regarding the issue of what is the *precise content* of the term "all pertinent information". Korea suggests that the precise nature of "all pertinent information" will vary from case to case.

4.761 The Panel also requested[397] **Korea** to clarify its position on the documents that it had provided the Panel regarding the consultations held with the European Communities. Korea's answer was as follows:

4.762 Korea is of the view that the evidential value of any fact supplied by the parties ultimately has to be assessed by the Panel, and possibly the Appellate Body. This is *a fortiori* the case where the parties appear to dispute those facts. Korea only notes that the documentation it has supplied concerning the consultations was merely provided to establish that these consultations were adequate enough to permit the European Communities and Korea to agree on the terms of settlement, albeit not legally binding.

V. THIRD PARTY ARGUMENTS

A. United States

5.1 The **United States** made the following arguments as third party:

(a) Standard of Review

5.2 The United States agrees with Korea's assertions concerning the standard of review applicable in safeguard cases. The United States recalls the panel's determination in *US - Underwear,* as cited by Korea, wherein the panel concluded that its function was not to engage in a *de novo* review, but rather to examine the consistency of a Member's actions with its international obligations.[398] The *US - Underwear* panel decided to make an objective assessment of the written decision of the US authorities embodying their determination and findings; this objective assessment entailed an examination of whether those authorities had examined all relevant facts before them, whether adequate explanation had been provided of how the facts as a whole supported the determination made, and, ***consequently***, whether the determination made was consistent with the international obligations of the United States.[399] Similarly, the panel on *US - Shirts and Blouses* followed this standard of review in its assessment of another textile safeguard action by the United States. The panel made a close examination of the written decision of the US

[396] The Panel recalls that the question was: " Is the concept of "all pertinent information" an objective or subjective standard? Please comment on how your answer should affect the Panel's conclusion with regard to the consequences of such a standard not being met?"

[397] The panel recalls that the question was: "What judicial notice should the Panel now take of the consultations?"

[398] *Supra*, footnote 33, paras. 7.12-7.13.

[399] *See, US - Underwear, supra,* footnote 33, para. 7.13.

authorities; it commented on factors addressed in the written decision, and dealt as well with the decision's failure to address certain factors, and with the issue of causation. Finally, the panel made an overall assessment of the US determination. However, at no time did the *US - Shirts and Blouses* panel engage in a *de novo* review. The findings of these two panels concerning the issue of standard of review were adopted by the DSB without any modification by the Appellate Body.

5.3 The standard articulated above is also the appropriate standard of review for disputes involving the application of the Agreement on Safeguards in the context of safeguard determinations made by national authorities. National authorities are in the best position to evaluate the facts and determine the applicable weight to be accorded to various factors. As the Appellate Body properly noted in *European Communities - Measures Concerning Meat and Meat Products ("Hormones")*, panels "are poorly suited to engage in such review."[400] The appellate body further noted in *Hormones* that the role of a panel is to make an objective assessment of the matter in dispute, both as to the facts and the law, as mandated by Article 11 of the DSU.[401] The United States submits that a panel would be assured of arriving at an "objective assessment" of the matter in dispute if it applied a standard of review, consistent with *US - Underwear* and *US - Shirts and Blouses*, that considers whether (a) the domestic authority has examined all relevant facts before it; (b) adequate explanation has been provided of how the facts as a whole supported the determination made; and (c) consequently, whether the determination made is consistent with the international obligations of the Member.

(b) The Agreement on Safeguards has Subsumed the Applicable Provisions of Article XIX of GATT

5.4 The United States disagrees with the EC assertion that a Member may only impose a safeguard measure if, *inter alia*, the increase in imports results "from both unforeseen developments and compliance with GATT obligations, including tariff liberalization according to a party's schedules of concessions." Article XIX:1(a) of the GATT must now be read in accordance with the rights and obligations set out in the Agreement on Safeguards, as required by Article 11.1(a) of that Agreement. The Agreement on Safeguards has defined, clarified, and in some cases modified, the package of rights and obligations of a potential user of safeguard measures, and Article 2 of the Agreement on Safeguards makes clear that a demonstration of "unforeseen developments" and a causal nexus to GATT obligations are no longer prerequisites to the application of a safeguard measure.

5.5 The Agreement on Safeguards clarifies and expands on the provisions of Article XIX, and establishes procedures for the application of safeguards measures. Thus, the preamble to the Agreement on Safeguards "recogniz[es] the need to *clarify* and reinforce the disciplines of GATT, and specifically those of its Article XIX", while Article 1 "establishes the rules for the application of the safeguard measures ... provided for in Article XIX of GATT." The two agreements must be read *in tandem* and, together, they create a ***new*** package of rights and obligations which are distinct

[400] WT/DS26/AB/R (16 January 1998), DSR 1998:I, 135, para.117.
[401] *EC - Hormones, supra,* footnote 400, para. 118.

from the rights and obligations contained in the original GATT provision. The United States recalls that the Appellate Body arrived at a similar determination in *Desiccated Coconut,* wherein the Appellate Body, quoting the panel, asserted:

> Article VI of GATT and the SCM Agreement represent a new and different package of rights and obligations, as among WTO Members, regarding the use of countervailing duties... . The SCM Agreements do not merely impose *additional* substantive and procedural *obligations* on a potential user of countervailing measures. Rather, the SCM Agreements and Article VI together define, clarify and in some cases modify the whole package of *rights* and obligations of a potential user of countervailing measures.[402]

5.6 In addition, the negotiators of the Agreement on Safeguards were specific in their intent to subsume Article XIX under the new regime established by the Agreement on Safeguards. Thus, Article 11.1(a) of the Agreement on Safeguards establishes the relationship between GATT Article XIX and the Agreement as follows:

> A Member shall not take or seek any emergency action on imports of particular products as set forth in Article XIX of GATT unless such action conforms with the provisions of that Article applied in accordance with this Agreement.

The phrase "applied in accordance with this Agreement" is significant in that it demonstrates the intent of the negotiators to subsume Article XIX under the new rights and obligations created by the Agreement on Safeguards. This intention is made even more apparent when the language in Article 11.1(a) is contrasted, for example, with language in the *Agreement on Subsidies and Countervailing Measures* ("SCM Agreement") where there is ***not*** a similar intent to subsume Article VI of GATT under the SCM Agreement. Thus, Article 10 of the SCM Agreement provides:

> Members shall take all necessary steps to ensure that the imposition of a countervailing duty on any product of the territory of any Member imported into the territory of another Member is *in accordance with the provisions of Article VI of GATT and the terms of this Agreement.* (Emphasis added).

5.7 The explicit terms of the Agreement on Safeguards make clear that Article XIX does not maintain an existence separate and apart from the Agreement; rather, those provisions of Article XIX *that remain in force* are incorporated into the Agreement on Safeguards. Moreover, the Agreement on Safeguards does not merely establish a procedural framework for the application of GATT Article XIX. Instead, the Agreement subsumes Article XIX under its umbrella and thereby creates a new package of rights and obligations that defines, clarifies and, in some cases, modifies the rights and obligations articulated in Article XIX. In this instance, the Agreement on Safeguards modifies the package of rights to ensure that a Member may impose a safeguard action without regard to the question of whether the increase in imports (or threat thereof) was "as a result of unforeseen developments and of the effect of the

[402] *Supra*, footnote 16, at 181 (emphasis in original).

obligations incurred by a contracting party under this Agreement, including tariff concessions ..." as originally articulated in Article XIX.[403] Under this new regime, Article 2 establishes the threshold conditions a Member must satisfy before a safeguard measure properly can be imposed. This interpretation is further borne out by the fact that the negotiators of the Agreement on Safeguards conspicuously reiterated in Article 2 every sentence of Article XIX:1(a) ***except*** the language regarding "unforeseen developments" and GATT obligations.

5.8 Accordingly, the United States respectfully submits the EC assertion that the safeguard measure imposed by Korea violates the "unforeseen developments" provision of Article XIX:1(a) of GATT is erroneous because Article 2 of the Agreement on Safeguards contains no such requirement.

(c) Safeguard Measures Must Be Imposed in Accordance with the Requirements of Article 4 of the Agreement on Safeguards

5.9 The United States agrees with the European Communities that a Member, in making its injury determination, must examine all of the relevant factors bearing on the condition of the industry as a whole, as required by Article 4 of the Agreement on Safeguards. To the extent that Korea examined relevant factors only with respect to the condition of a portion of an industry without relating that examination to the condition of the industry as a whole, Korea's determination is deficient. Article 4.2(a) states that the Korean authorities in the Member "shall evaluate all relevant factors of an objective and quantifiable nature having a bearing on the situation of that industry, in particular ... " (a list of factors follows). This requirement, read in conjunction with the definition of domestic industry in Article 4.1(c) - "the producers as a whole ... or those whose collective output ... constitutes a major proportion of the total domestic production" - indicates that the evaluation should be in terms of the whole industry, and not just one or another part of it. While injury to an industry can be analyzed in terms of a portion of an industry, the implication is that information relating to a portion of the industry must be shown as relating to the condition of the industry as a whole. Thus, to the extent that Korea failed to examine all the relevant factors set out in Article 4.2(a), its investigation is deficient.

5.10 Similarly, the European Communities enumerate a number of factors that Korea allegedly failed to evaluate in arriving at its affirmative injury determination. In response to this claim, Korea furnished a number of tables and other information. It is unclear from Korea's submission, however, whether this information was before the KTC and considered by the KTC when it made its determination, or whether this information was compiled after the fact to support the KTC's determination. There

[403] Indeed, such a modification was necessary in order to reflect actual practice. It is simply not credible to suggest that a trade Minister would negotiate a particular concession if it could be foreseen that such a concession would result in increased imports that, in turn, would seriously injure an industry in the country granting the concession. A Minister who engaged in such conduct would, quite properly, be relieved of his or her post. Thus, the use of the term "unforeseen developments" is surplusage because circumstances where increased imports cause or threaten serious injury are, almost by definition, "unforeseen".

are no citations to the record of the KTC investigation or to the KTC's report demonstrating that such information was evaluated by the KTC. While a decision on the merits of the evidence submitted must be left to the discretion of the domestic competent authority, Article 4.2(a) clearly requires that the *competent authority* evaluate all such relevant evidence. If the KTC did indeed fail to evaluate relevant evidence, such an act would violate the explicit terms of Article 4:2(a).

(d) The Agreement on Safeguards Does Not Establish a Numerical Market Penetration Threshold

5.11 Both Korea and the European Communities erroneously suggest that there is an implicit but undefined numerical threshold in Article 4.2(a) relating to market share for determining whether increased imports are causing or threatening serious injury. The European Communities indicate that the 5.7 per cent decline in domestic market share of Korean raw milk and milk powder producers is too small to be a cause for concern, while Korea counters that the 5.7 per cent decline indicates serious injury to the domestic industry. In support of its position, Korea cites to the March 1998 affirmative injury determination of the US International Trade Commission (USITC) in *Wheat Gluten*, in which the USITC found that imports increased their share of the US market by 8.8 per cent during the period of investigation.

5.12 The United States submits that Article 4.2(a) contains no numerical test or threshold requirement for market penetration, explicit or implied. Instead, Article 4.2(a) requires that the competent authority evaluate "all relevant factors," of which the percentage share of the domestic market is only one. If the percentage share change were taken as the sole benchmark, it would be contrary to the requirement that the competent authorities evaluate all relevant factors. As demonstrated by the USITC determination in *Wheat Gluten*, at the pages in the USITC report cited by Korea, the increase in market share held by imports was only one of several factors that the USITC considered in determining that increased imports were a substantial cause of serious injury in that particular case.

5.13 Furthermore, no single number could logically serve as a benchmark for evaluating the significance of market penetration. The importance of any given change in market share will vary from case to case. Whether a change of 5.7 per cent is significant or insignificant will depend in large part on the nature of the product and the nature of competition in the market.

(e) The Agreement on Safeguards does not Require Adjustment Plans

5.14 The United States disagrees with the EC assertion that Korea violated Article 5.1, *inter alia*, because it "did not submit any information as to adjustment plans to restore the industry's competitiveness..." and that "by omitting to give any consideration to adjustment plans, *a fortiori* Korea has failed to examine how its safeguard measure could be necessary or even helpful to their implementation." The Agreement on Safeguards does ***not*** require that an industry submit an adjustment plan, thus, the Panel cannot read such a requirement into the Agreement. Article 5.1 provides solely that "[a] Member shall apply safeguard measures only to the extent

necessary to prevent or remedy serious injury and to facilitate adjustment... ." Although submission and consideration of an adjustment plan may be desirable as a means of substantiating that a Member has satisfied the objective of Article 5.1, there is no specific *requirement* in the Article that either refers to adjustment plans or requires that a member consider such plans.

VI. INTERIM REVIEW

6.1 On 17 March 1999, The European Communities and Korea requested the Panel to review, in accordance with Article 15.2 of the DSU, certain aspects of the interim report that had been transmitted to the parties on 3 March 1999. The European Communities requested the Panel to hold an additional meeting. This additional meeting of the Panel with the parties took place on 22 March 1999.

6.2 We have reviewed the arguments and suggestions presented by the parties, and finalized our report, taking into account those comments by the parties which we considered justified. In doing so we have ensured that no new arguments were introduced at this stage of the panel process. In this context we have made slight modifications to certain paragraphs, including those made to paragraphs 4.325, 4.416 to 4.419, 4.449 and 4.452 of the descriptive part and paragraphs 7.16, 7.18, 7.23, 7.24, 7.30, 7.31, 7.46, 7.49, 7.55, 7.70, 7.72, 7.73, 7.75, 7.77, 7.78, 7.79, 7.86, 7.87, 7.96 and 7.116 of the findings. In addition, we have made other minor modifications including linguistic and typographical corrections.

VII. FINDINGS

A. Procedural Matters

7.1 In the present section, we address two procedural objections raised by Korea in its first submission. We also recall an oral ruling made at the end of the first substantive meeting of the Panel with the parties regarding Korea's request to file the English version of its OAI Report, at a date following the first substantive meeting of the Panel. Finally, we address Korea's challenge of the scope of this dispute, namely the consequences of the absence of any claim by the European Communities under Article 3 of the Agreement on Safeguards.

1. Insufficiency of the EC Request for Establishment of the Panel

7.2 Korea requests the Panel to reject the European Communities' complaint in its entirety on the basis of the insufficiency of its request for establishment of a panel, in violation of Article 6.2 of the Understanding on the Rules and Procedures Governing the Settlement of Disputes ("DSU"). Korea argues that the EC panel request is in violation of Article 6.2 of the DSU as it simply lists four articles of the Agreement on Safeguards, which, it argues, is insufficient "especially in a request relating to the determination of a domestic authority…". For Korea the panel request must contain a detailed statement of the matter in dispute and the legal basis of the European Communities' claims, in order to permit the defendant to conduct an effective defense and the third parties to assess whether or not to intervene. Korea requests

this Panel to refrain from following the interpretation given by the Appellate Body in the *EC - Bananas*[404]case, where it was stated that it was sufficient under Article 6.2 of the DSU for a panel request to list the articles of the relevant agreements.

7.3 On this issue the European Communities refers the Panel to the conclusions of the Appellate Body in *EC -Bananas*:

> "[we] accept the Panel's view that it was sufficient for the Complaining Parties to *list the provisions of the specific agreements alleged to have been violated* without setting out detailed arguments as to which specific aspects of the measures at issue relate to which specific provisions of those agreements". [405] (emphasis added)

7.4 Article 6.2 of the DSU reads as follows:

> "The request for the establishment of a panel shall be made in writing. It shall indicate whether consultations were held, identify the specific measures at issue and provide a brief summary of the legal basis of the complaint sufficient to present the problem clearly".

7.5 We consider that a request for establishment of a panel is sufficiently detailed if it contains a description of the measures at issue and the claims, i.e. the violations alleged.[406]

7.6 We note that the EC request for establishment of a panel contains the following references:

> "The contested safeguard measure was imposed in the form of an import quota on imports of certain dairy products (Korean CN codes 0404.90.0000, 0404.10.2190, 0404.10.2900 and 1901.90.2000) effective as of 7 March 1997 and made public through notification in the revision of "Separated Notice of Export-Import" and in "Detailed Principle of Import Licence on Imitation Milk Powder". …
>
> "Therefore, the EC requests that the panel consider and find that this measure is in breach of Korea's obligations under the provisions of the Agreement on Safeguards, in particular of Articles 2, 4, 5 and 12 of the said Agreement and in violation of Article XIX of GATT 1994."

7.7 We consider, therefore, that the EC request for establishment of a panel is sufficiently detailed as it contains a description of the measures at issue and the claims, i.e. the violations alleged.

2. Lack of Economic Interest

7.8 Korea also claims that the European Communities admits having little or no commercial interest in bringing this matter before the Panel. For Korea this admission, coupled with the failure to settle the dispute during the consultations, suggests that the current proceeding is merely an attempt by the European

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404 *EC - Bananas, supra,* footnote 12.

405 *EC - Bananas*, *supra*, footnote, 12, para. 141.

406 *See* for instance, the Appellate Body statement in *EC - Bananas*, Appellate Body Report, para. 141. In the recent *Guatemala - Cement* the Appellate Body reiterated that these were the two requirements prescribed by Article 6.2 of the DSU. We see no reason to depart from this position, *supra*, footnote 61.

Communities to use the DSU to establish a precedent on safeguards by way of an advisory opinion from the Panel. Korea argues that this goes against the spirit of the DSU which provides that formal dispute settlement should be reserved for disputes where Members consider, in good faith, that their interests are being impaired, and that Article 3.7 of the DSU specifically instructs Members to exercise restraint in bringing dispute settlement cases and articulates a preference for mutually agreed solutions over resort to formal dispute settlement.

7.9 The European Communities responds that in the *EC - Bananas* case, the Appellate Body, in reply to a similar objection by the European Communities, held that:

> "a Member has broad discretion in deciding whether to bring a case against another Member under the DSU. The language of Article XXIII:1 of the GATT 1994 and of Article 3.7 of the DSU suggests, furthermore, that a Member is expected to be largely self-regulating in deciding whether any such action would be 'fruitful'." [407]

7.10 Korea also alleges that after intensive consultations the parties appeared to have settled their dispute. For Korea, the fact that the European Communities later withdrew its acceptance of the settlement proposed by Korea is evidence of lack of good faith on the part of the European Communities.

7.11 As to the alleged acceptance of a settlement offered by Korea, the European Communities responds that there never was any formal proposal or acceptance of a mutually agreed settlement. For the European Communities, each side negotiated in good faith in an effort to reach a mutually satisfactory solution in this case, but that solution did not materialize. The European Communities concludes by stating that if Korea wants to challenge the European Communities' good faith in negotiations and in bringing this dispute, it must bear the burden of proving its allegations.

7.12 First, we note that Korea is not clear as to what it wants the Panel to do in response to its argument. Korea does not request the rejection of the complaint for lack of economic interest on the part of the European Communities or for lack of good faith on the part of the European Communities during the negotiations. However, assuming that Korea's position is that there is a requirement for the European Communities to have some economic interest and that the European Communities has failed to meet it, the Panel would have to decide what action is appropriate. We consider therefore that we should rule on this issue.

7.13 Regarding Korea's reference to the lack of economic interest of the European Communities, we consider that under the DSU there is no requirement that parties must have an economic interest. In *EC - Bananas*, the Appellate Body stated that the need for a "legal interest" could not be implied in the DSU or in any other provisions of the WTO Agreement and that Members were expected to be largely self-regulating in deciding whether any DSU procedure would be "fruitful". We cannot read in the DSU any requirement for an "economic interest". We also note the provisions of Article 3.8 of the DSU, pursuant to which nullification and impairment is presumed once violation is established.

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[407] *See EC - Bananas*, *supra*, foootnote 12, para. 135.

7.14 Even assuming that there is some requirement for economic interest, we consider that the European Communities, as an exporter of milk products to Korea, had sufficient interest to initiate and proceed with these dispute settlement proceedings.

7.15 Concerning Korea's reference to the unsuccessful settlement negotiations, we can only note that the European Communities considers that the offers by Korea were not acceptable to it, and both parties admit that no formal settlement of the present dispute was ever reached and approved by the relevant national authorities. The DSU favours the conclusion of mutually acceptable solutions. We note that, for the present dispute, no mutually agreed solution was notified to the DSB. We can only recall that when a WTO Member considers that its rights have been nullified by the actions of another Member it is entitled[408] (under Article 14 of the Safeguards Agreement and Articles XXII and XXIII of GATT 1994) to initiate the dispute settlement procedures envisaged in the DSU.

3. Submission of the OAI Report

7.16 In its first submission Korea refers to a report of the Korean Trade Commission (OAI Report)[409] of which it submitted only a version in the Korean language. At the outset of the first substantive meeting of the Panel with the parties, the Panel stated that it was disappointed that Korea had filed only a Korean language version of the OAI Report. Although the Panel understood the difficulties involved with the translation of the investigation report, the Panel suggested to Korea that should it wish to refer to the OAI Report in support of its allegations, Korea should file a version of the report in one of the official languages of the WTO. Korea raised doubts as to whether the OAI report was relevant since in Korea's view the EC limited its complaints to the quality and depth of Korea's notification under Article 12. The Panel was not addressing the issue whether it was for Korea to submit such OAI Report but simply that any submission of evidence had to be done in one of the official languages of the WTO.

7.17 At the end of the first meeting of the Panel, Korea informed the Panel that it would need an additional period beyond what was scheduled for answers and rebuttals to submit an English version of the OAI Report.[410]

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[408] *See* Appellate Body Report on *United States - Measures Affecting Imports of Woven Wool Shirts and Blouses from India*, adopted on 23 May 1997, WT/DS33/AB/R (*"US - Shirts and Blouses"*), DSR 1997:I, 323, at 334.

[409] In its 2 December 1996 notification, G/SG/N/8/KOR/1, circulated on 6 December 1996 Korea stated that the term "OAI Report" is equivalent to the "KTC Report". Therefore, in our findings we shall refer to the report of the KTC's investigation as the "OAI Report".

[410] In response, the European Communities complained that it appeared to it that Korea had had *ex parte* communications with the Panel during which, according to the European Communities, the Panel had authorized Korea to submit an English version of the OAI Report after the rebuttals. The Panel immediately informed the parties that no members of the Panel (nor any one from the Secretariat) had communicated with Korea on this issue. The only reference to the filing of the OAI Report was contained in the transmission letter that Korea sent to the Panel with its first submission and which was copied to the parties. The latter part of this letter reads as follows: "Given the time constraint, Korea was unable to produce an official English version of the investigation report of the Korea Trade Commission. Only the original version (Korean version) is attached herewith. Korea

7.18 The Panel informed Korea that if it intended to submit any piece of evidence, including the OAI Report, it should do so by 20 November 1998, that is, the deadline given to the parties to answer the questions posed to them during the first substantive meeting of the Panel. In this way parties would be able to submit full and useful rebuttals before the second meeting of the Panel. On 20 November 1998, Korea submitted, together with its answers to the questions submitted to it, an English version of the OAI Report, as Exhibit Korea-6.

7.19 We based our ruling on paragraph 5 of the Additional Rules of Procedure, adopted by the Panel pursuant to Article 12.1 of the DSU, which provides that:

> "5. Parties shall submit all factual evidence to the Panel no later than during the first substantive meeting, except with respect to evidence necessary for purposes of rebuttals submissions or answers to questions. … "

7.20 We also consider that this is in line with the two stage approach advocated by the Appellate Body in Ar*gentina - Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items.*[411]

4. The Absence of a Claim by the European Communities under Article 3 of the Agreement on Safeguards

7.21 In its second submission, Korea argues that because the European Communities did not raise any claim under Article 3 or Article 4.2(c), the European Communities must be deemed to accept that the "competent authorities" in Korea have published: "a report setting forth their findings and reasoned conclusions reached on all pertinent issues of fact and law" (Article 3.1, final sentence). For Korea, since the European Communities has failed to invoke Article 3 of the Agreement on Safeguards, and has failed to raise claims under Article 4.2(c) of that Agreement, the European Communities is, therefore, only challenging the quality and depth of Korea's notifications under Article 12 of the Agreement on Safeguards. The European Communities agrees with Korea that it is not bringing a complaint under Article 3 of the Agreement on Safeguards, nor is it relying upon Article 4.2(c) thereof. For the European Communities this does not affect its right to challenge the substance of the OAI Report.

7.22 We agree with the European Communities that the absence of a claim under Article 3 of the Agreement on Safeguards means at most that the European Communities agrees that the report is WTO compatible for the purpose of Article 3.1 of the Agreement on Safeguards. The European Communities has the right to raise more specific claims under Article 4 of the Agreement on Safeguards and has done so. We consider that if a Member wants to challenge the WTO compatibility of the manner in which an "injury" determination was performed, or the choice of an appropriate measure to be imposed, this Member does not have to challenge the publication of the final report as such.

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will submit the English version as expeditiously as possible." Clearly there had been no *ex-parte* communication.

[411] *See* Appellate Body Report in *Argentina - Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items*, *supra*, footnote 24, para. 79 (*"Argentina - Measures Affecting Apparel"*).

B. Burden of Proof

7.23 Korea alleges that the burden of proof is on the European Communities and adds that this burden "does not shift between the parties during the dispute". The European Communities does not submit any argument on the burden of proof.

7.24 In the context of the present dispute, which is concerned with the assessment of the WTO compatibility of a safeguard measure imposed by a national authority, we consider that it is for the European Communities to submit a *prima facie* case of violation of the Agreement on Safeguards, namely, to demonstrate that the Korean safeguard measures are not justified by reference to Articles 2, 4, 5 and 12 of the Agreement on Safeguards.[412] We recall in this regard the statement of the Appellate Body in *EC - Hormones*[413] that "… a *prima facie* case is one which, in the absence of *effective refutation* by the defending party, requires a panel, as a matter of law, to rule in favour of the complaining party presenting the prima facie case". It is therefore for Korea to provide an "effective refutation" of the European Communities' case. In the present case, it is for Korea to effectively refute the European Communities' evidence and arguments, by submitting its own evidence and arguments in support of its assertions that, at the time of its determination, Korea did respect the requirements of the Agreement on Safeguards.[414] As a matter of law the burden of proof rests with the European Communities, as complainant, and does not shift during the panel process. As a matter of process before the Panel, the European Communities will submit its arguments and evidence and Korea will respond to rebut the EC claims. At the end of this process, it is for the Panel to weigh and assess the evidence and arguments submitted by both parties in order to reach conclusions as to whether the EC claims are well-founded.

7.25 In the present case, after considering the extensive submissions of both parties, we must weigh the evidence submitted by each of them and assess the value of their legal arguments in view of the provisions of the Agreement on Safeguards to determine whether the European Communities' claims are well-founded.

C. Standard of Review

7.26 We note there are no specific provisions on standard of review in the Agreement on Safeguards. We consider, therefore, in line with the prescription of the Appellate Body in the *EC - Hormones* dispute, that in the absence of a specific standard of review for the relevant WTO multilateral trade agreement, the provisions of Article 11 of the DSU are applicable[415].

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[412] *See* Appellate Body Report in *Australia - Measures Affecting Importation of Salmon,* adopted on 6 November 1998, WT/DS18/AB/R, (*"Australia - Salmon"*), DSR 1998:VIII, 3327, paras. 257-261.

[413] Appellate Body Report *EC - Hormones*, *supra*, footnote 400, para. 104.

[414] We note that this was the conclusion reached by the Panel in *US - Shirts and Blouses*, *supra* footnote 45, para. 6.8: "… it was for India to submit a prima facie case of violation of the ATC, namely, that the restriction imposed by the United States did not respect the provisions of Articles 2.4 and 6 of the ATC. It was then for the United States to convince the Panel that, at the time of its determination, it had respected the requirements of Article 6 of the ATC." This was confirmed by the Appellate Body.

[415] *EC - Hormones*, Appellate Body Report, *supra*, footnote 400, para. 116.

7.27 Article 11 of the DSU provides that "… a panel should make an objective assessment of the matter before it, including an objective assessment of the facts of the case and the applicability of and conformity with the relevant covered agreements…".
7.28 Korea asks the Panel not to enter into a *de novo* review of its national authorities' determination to impose a safeguard measure. For Korea, the standard of review of Article 11 implies that the function of the Panel is to assess whether Korea (i) examined the relevant facts before it at the time of the investigation; and (ii) provided an adequate explanation of how the facts before it as a whole supported the determination made. Korea adds that a certain deference or latitude should be left to the national authorities.
7.29 The European Communities agrees that the standard is that established in Article 11 of the DSU and that the Panel should not perform a *de novo* assessment. In this context, the European Communities claims that it is not contesting the basic economic data produced by Korea but only their completeness and the conclusions drawn from them. The European Communities submits that the "objective assessment of the facts" referred to in Article 11 DSU cannot be satisfied by verifying what conclusions the investigating authority came to but must also include "how" it came to those conclusions, that is to say the national authority must provide a reasoned opinion explaining how such factors and arguments have led to its findings.
7.30 We consider that for the Panel to adopt a policy of total deference to the findings of the national authorities could not ensure an "objective assessment" as foreseen by Article 11 of the DSU. This conclusion is supported, in our view, by previous panel reports that have dealt with this issue[416]. However, we do not see our review as a substitute for the proceedings conducted by national investigating authorities. Rather, we consider that the Panel's function is to assess objectively the review conducted by the national investigating authority, in this case the KTC. For us, an objective assessment entails an examination of whether the KTC had examined all facts in its possession or which it should have obtained in accordance with Article 4.2 of the Agreement on Safeguards (including facts which might detract from an affirmative determination in accordance with the last sentence of Article 4.2 of the Agreement on Safeguards), whether adequate explanation had been provided of how the facts as a whole supported the determination made, and, consequently, whether the determination made was consistent with the international obligations of Korea. Finally, we consider that the Panel should examine the analysis performed by the national authorities at the time of the investigation on the basis of the various national authorities' determinations and the evidence it had collected. In this case, this evidence is found mainly in the Report by the Office of Administrative Investigation ("OAI Report") and the subsequent determinations by the relevant

[416] We recall that in *US - Underwear*, *supra*, footnote 33, paras. 7.53-54, a case dealing with a safeguard action under the ATC, the panel reached the conclusions that the standard of review was that established in Article 11 of the DSU and commented on the implications of such standard of review for safeguard measures. *See* also the Panel Report in *Brazil - Countervailing Duty Proceeding Concerning Imports of Milk Powder from the European Community*, adopted on 28 April 1994, SCM/179: "It was incumbent upon the investigating authorities to provide a reasoned opinion explaining how such facts and arguments had led to their finding.", para. 286.

Korean authorities[417]. We note that the European Communities has initially relied on the notifications to the Committee on Safeguards to establish its claims. We are of the view that such notifications are not necessarily complete evidence of what the Korean national authorities actually *did*. Rather, the full reflection of the Korean investigation can only be found in the investigation report or the final determination by the Minister[418], and not (as argued by the European Communities at the first meeting of the Panel) in the notifications to the Committee on Safeguards. In its rebuttals and at the second meeting of the Panel with the parties, the European Communities, in support of its allegations, made reference to the OAI Report as well.

7.31 We consider, further, that Members are required, in their recommendations or determinations on the application of a safeguard measure, to explain how they considered the facts in their possession or which they should have obtained in accordance with Article 4.2 of the Agreement on Safeguards and why they concluded, at the time of the decision, that the measure to be applied was necessary to remedy the serious injury and facilitate the adjustment of the industry. This is not to say that the Panel interprets the Agreement on Safeguards as imposing on the importing Member any specific method either for collecting data or for considering and weighing all the relevant economic factors upon which the importing Member will decide whether there is need for a safeguard restraint.[419] Korea remains free to choose an appropriate method of assessing whether the state of its domestic industry was caused by imports of SMPP, or by other factors, but it must be in a position to demonstrate that it did address the relevant issues. We also consider that this standard of review is in line with GATT/WTO practice.

D. General Principles of Interpretation

7.32 In its examination of the Agreement on Safeguards, the Panel is bound by the principles of interpretation of public international law (Article 3.2 of the DSU) which include Articles 31 and 32 of the Vienna Convention on the Law of Treaties. As provided in these articles and as applied by panels and the Appellate Body, we shall interpret the provisions of the Agreement on Safeguards on the basis of the ordinary meaning of the terms of its provisions in their context, in the light of the object and purpose of the Agreement on Safeguards, the GATT 1994 and the WTO Agreement. We note also Article XVI:1 of the WTO Agreement which provides that "… the WTO shall be guided by the decisions, procedures and customary practices followed by CONTRACTING PARTIES to GATT 1947 and the bodies established in the framework of GATT 1947".

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[417] Evidence of what the Korean authorities did can also be found in the present case in: The Determination to Initiate an Investigation (17 May 1996, Exhibit Korea-3 and Exhibit Korea-4), Public Notice of Decision on Injury by the KTC (11 November 1996, Exhibit Korea-7), Public Notice of Implementation of Relief Measure by the Ministry of Commerce, Industry and Energy (7 March 1997, Exhibit Korea-9).

[418] *See* Section IV.B.2(b), *supra*.

[419] We note that a similar conclusion was reached by the Panel in *US - Shirts and Blouses*, *supra*, footnote 45, para. 7.52.

E. Claims under Article XIX of GATT

7.33 The European Communities initially makes two claims under Article XIX of GATT 1994. In its first submission it claims that Korea failed to examine whether the import trends of the products under investigation were the result of "unforeseen developments" as provided for in Article XIX:1(a). Korea responds that the text of the Agreement on Safeguards supports the interpretation that the provisions therein established are now the sole articulation of the rules that must be followed in the application of a safeguard measure. In its first submission the European Communities also argues that Korea failed to comply with its obligations under Article XIX:1(a) of GATT and Article 2 of the Agreement on Safeguards, to address whether the "conditions" under which importation of the products being investigated were of such a nature as to cause serious injury to the domestic industry producing like or directly competitive products. In its second submission, the European Communities argues that failing to examine under which conditions these increased imports occurred and in particular the prices at which the products were imported is a violation of the provisions of Article 2.1 of the Agreement on Safeguards (and the European Communities made no further reference to Article XIX:1(a) of GATT). Therefore, we shall examine the European Communities' claim that Korea failed to examine under which conditions these importations occurred only in relation to its claims under Article 2 of the Agreement on Safeguards.

7.34 The claim of the European Communities regarding "unforeseen developments" under Article XIX of GATT, the wording of which is not repeated in the Agreement on Safeguards, necessitates that we examine the relationship between the provisions of Article XIX of GATT and those of the Agreement on Safeguards.

7.35 The parties debated at length whether there is a conflict between the provisions of Article XIX of GATT and those of the Agreement on Safeguards and how the Panel should interpret the relationship between the terms of Article XIX:1 of GATT and the different terms used in Article 2.1 of the Agreement on Safeguards.[420]

7.36 Essentially, Korea argues that there is such a conflict, which should be resolved in favour of the exclusive application of the Agreement on Safeguards. The European Communities submits that all WTO obligations are generally cumulative. For the European Communities, the provisions of Article XIX of GATT, which are still fully applicable because there is no conflict between the provisions of the first paragraph of Article XIX and Article 2.1 of the Agreement on Safeguards, impose in addition to those of the Agreement on Safeguards, a condition that the increase of imports must be "the result of unforeseen developments".

7.37 We recall that the terms of a treaty must be interpreted with reference to their ordinary meaning taken in their context and in light of the object and purpose of the agreements examined. We also recall the principle of "effective interpretation" whereby all terms must be given their full meaning and must be interpreted with each other to avoid inconsistencies or "inutility"[421].

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[420] We refer to the European Communities' arguments and Korea's arguments in Section IV.C of this Panel Report.

[421] The principle of effective interpretation or "l'effet utile" or in latin *ut res magis valeat quam pereat* reflects the general rule of interpretation which requires that a treaty be interpreted to give meaning and effect to all the terms of the treaty. For instance one provision should not be given an

7.38 It is now well established that the WTO Agreement is a "Single Undertaking" and therefore all WTO obligations are generally cumulative and Members must comply with all of them simultaneously unless there is a formal "conflict" between them.[422] In the absence of conflict, there remain, however, difficult issues of interpretation for the reader to reconcile various provisions of a treaty as extensive as the WTO Agreement.[423]

7.39 We consider that the terms and prescriptions of Article XIX:1 of GATT are still generally applicable, as we are of the view that there is no conflict between the provisions of the Article XIX:1 of GATT and those of Article 2.1 of the Agreement on Safeguards. Our conclusion is based on our interpretation of the ordinary meaning of the terms of Article XIX:1 of GATT.

7.40 The first paragraph of Article XIX of GATT reads as follows:

Emergency Action on Imports of Particular Products

> "1. *(a)* If, as a result of unforeseen developments and of the effect of the obligations incurred by a contracting party under this Agreement, including tariff concessions, any product is being imported into the territory of that Member in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers in that territory of like or directly competitive products, the Member shall be free, in respect of such product, and to the extent and for such time as may be necessary to prevent or remedy such injury, to suspend the obligation in whole or in part or to withdraw or modify the concession."

Article 2.1 of the Agreement on Safeguards provides that

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interpretation that will result in nullifying the effect of another provision of the same treaty. For a discussion of this principle, *see Yearbook of the International Law Commission*, 1966, Vol II A/CN.4/SER.A/1966/Add.1 page 219 and following. *See* also *E.g., Corfu Channel* Case (1949) *I.C.J. Reports*, p.24 (International Court of Justice); Territorial Dispute Case (Libyan Arab Jamahiriya v. Chad) (1994) *I.C.J. Reports*, p. 23 (International Court of Justice); *Oppenheim's International Law* (9th ed., Jennings and Watts eds., 1992), Volume 1, 1280-1281; P. Dallier and A. Pellet, *Droit International Public*, 5è ed. (1994) para. 17.2); D. Carreau, *Droit International*, (1994) para. 369. *See* for instance the statement of the Appellate Body in *United States - Gasoline*, *supra*, footnote 69: WT/DS2/AB/R :"An interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility"; also the Appellate Body Report on *Japan - Taxes, supra,* footnote 69 at 105-106; Appellate Body Report on *US - Underwear*, *supra*, footnote 293, at 24.

[422] The principle of interpretation against conflict has been confirmed by the Appellate Body in *Canada - Certain Measures Concerning Periodicals*, adopted on 30 July 1997, WT/DS31/AB/R, ("*Canada Periodicals*"), DSR 1997:I, 449, at 465; in *EC -Bananas*, *supra*, footnote 12, paras. 219-222; in *Guatemala - Cement*, supra, para.65; and by the panel in *Indonesia - Certain Measures Affecting the Automobile Industry*, adopted 23 July 1998, WT/DS54, 55, 59 and 64/R (not appealed) ("*Indonesia - Autos*"), DSR 198:VI, 2201, para. 14.28. For a definition of conflict, *see* for instance the Appellate Body statement in *Guatemala - Cement*, *supra*, footnote 61, para. 65 or the Panel Report on *Indonesia - Autos*, para. 14.28.

[423] *See* for instance the Panel and Appellate Body Reports *in Brazil - Measures Affecting Desiccated Coconut,* supra footnote 60, and footnote 16 where it was concluded that although there is no strict conflict between them the provisions of Article VI of GATT must be reconciled with those of Article 32.3 and 32.4 of the SCM Agreement.

> "A Member may apply a safeguard measure to a product only if that Member has determined, pursuant to the provisions set out below, that such product is being imported into its territory in such increased quantities, absolute or relative to domestic production, and under such conditions as to cause or threaten to cause serious injury to the domestic industry that produces like or directly competitive products."

7.41 We recall that the purpose of Article XIX was (and still is) to allow an importing Member to deviate temporarily from its obligations under Articles II and XI of GATT (i.e. to suspend its concessions or other obligations) in situations of increased imports causing serious injury to the relevant domestic industry. We consider that the first paragraph of Article XIX provides only for that: an importing Member is "free", in situations where "any product is being imported into the territory of that Member in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers in that territory of like or directly competitive products" to deviate temporarily from Articles II and XI of GATT.

7.42 We consider that the prior section of the sentence, "If, as a result of unforeseen developments and of the effect of the obligations incurred by a contracting party under this Agreement, including tariff concessions…" does not add conditions for any measure to be applied pursuant to Article XIX but rather serves as an explanation of why an Article XIX measure may be needed, taking into account the fact that at the time (1947) the CONTRACTING PARTIES had just agreed (for the first time) on multilateral tariff bindings and on a general prohibition against quotas.

7.43 For us, the ordinary meaning of the terms "as a result of unforeseen developments and of the effect of the obligations incurred by a contracting party under this Agreement" leads us to conclude that this proposition only describes generally the situations where the binding nature of the obligations contained in Articles II and XI of GATT may need to be set aside (for a certain period). In other words, this sentence could read

> "If, *notwithstanding this new set of rules that we have just agreed upon… which imply that a contracting party cannot use quotas (XI) or breach its bindings (II),* one contracting party is faced with increased imports that are causing serious injury, that contracting party shall be free to suspend the obligation in whole or in part (XI) or to withdraw or modify the concession (II)."

7.44 The reference to "unforeseen developments" was probably considered necessary as negotiators had just ended a negotiating exercise which was based on expectations of trade increases (therefore foreseen developments) and where some quantitative restrictions were grand-fathered. We think that this reference to "unforeseen circumstances " must be interpreted within its context, namely in view of the rest of this proposition which provides that "… the effect of the obligations incurred by a contracting party under this Agreement ". These latter terms can only refer to the binding nature of the GATT prohibitions against breach of tariff concessions and the prohibition against quotas, as it would not be logical to conclude that a Trade Minister would have negotiated a particular concession if it could have been foreseen that such a concession would result in increased imports, that, in turn, would seriously injure an industry in the country granting the concession.

7.45 In other words, the proposition "as a result of unforeseen developments and of the effect of the obligations incurred by a contracting party under this Agreement" does not address the conditions for Article XIX measures to be applied but rather explains why a provision such as Article XIX may be needed. For us, the object of this section of the first sentence of paragraph 1 of Article XIX cannot be anything else but a statement (of what we would now consider to be obvious) that because of the binding nature of the GATT obligations and concessions, tariffs and other obligations negotiated on the basis of trade expectations may need to be changed temporarily in light of actual unforeseen developments. Thus, the phrase "unforeseen circumstances" does not specify anything additional as to the conditions under which measures pursuant to Article XIX may be applied.

7.46 This interpretation is compatible with the object and purpose of GATT which was to ensure some certainty and predictability in tariff bindings and other GATT obligations. Our interpretation of these provisions of Article XIX:1 of GATT is confirmed by the practice of the contracting parties[424] over some 48 years and the adoption of the new Agreement on Safeguards.[425]

7.47 The adoption of the Agreement on Safeguards without this phrase "as a result of unforeseen developments and of the effect of the obligations incurred by a contracting party under this Agreement " is logical. It was not necessary to refer to this context which had by then evolved. Members had since understood the GATT system of binding obligations. In support of this interpretation, we recall that in *Brazil - Dessicated Coconut* the Appellate Body made clear that some of the Annex 1A agreements represent an elaboration or evolution of the provisions of GATT 1994. Because Members had understood that this reference to "unforeseen developments" did not add to the rest of the paragraph (but rather described its context), there was no need to insert it explicitly in the Agreement on Safeguards.

7.48 Consequently, we reject the specific claim of the European Communities that Korea was wrong in failing to examine whether the import trends of the products under investigation were the result of "unforeseen developments" contrary to Article XIX:1(a), as we consider that Article XIX of GATT does not contain such a requirement.

F. Violation of Article 2.1 of the Agreement on Safeguards - Failure to Analyze "under Such Conditions"

7.49 In its first submission, the European Communities argues that Korea violated Article 2.1 of the Agreement on Safeguards and Article XIX:1 of GATT because Korea failed to examine under which conditions the imports occurred and in

[424] Article XVI:1 of the Marrakesh Agreement Establishing the WTO.

[425] In 1951, the Working Party *on "Withdrawal by the United States of a Tariff Concession under Article XIX*", (except for the United States), agreed that unforeseen developments referred to events occurring after the negotiation of the relevant tariffs and, although the Working Party considered that this phrase contained a criterion to be respected, it rendered satisfaction of this criterion automatic, since it would not be reasonable to expect a contracting party to foresee that imports would cause serious injury to its domestic industry. Working Party on *Withdrawal by the United States of a Tariff Concession under Article XIX of the General Agreement* ("*Fur Felt Hat*"), GATT/CP.6/SR 19 (adopted 22.10.51).

particular Korea failed to consider the prices at which the product was imported. In its second submission, the European Communities limits that specific argument (failure to examine under which conditions the imports occurred) to its claim of violation of Article 2.1 of the Agreement on Safeguards only. Korea responds that there is no requirement to examine the prices of the imports with reference to those of the like or directly competitive products as such. Korea adds that it did consider, in its overall determination under Article 2 of the Agreement on Safeguards, whether the SMPP were imported into Korea in such increased quantities and under such conditions as to cause serious injury to the domestic industry that produces like or directly competitive products to SMPP. We shall examine this EC argument only with reference to its claim under Article 2 of the Agreement on Safeguards.

7.50 Article 2 of the Agreement on Safeguards reads:

> "A Member may apply a safeguard measure to a product only if that Member has determined, pursuant to the provisions set out below, that such product is being imported into its territory in such increased quantities, absolute or relative to domestic production, *and under such conditions* as to cause or threaten to cause serious injury to the domestic industry that produces like or directly competitive products." (emphasis added).

7.51 Although the prices of the imported products will most often be a relevant factor indicating how the imports do, in fact, cause serious injury to the domestic industry, we note that there is no explicit requirement in Article 2[426], that the importing Member perform a price analysis of the imported products and the prices of the like or directly competitive products in the market of the importing country.

7.52 We consider that the phrase "and under such conditions" does not provide for an additional criterion or analytical requirement to be performed before an importing Member may impose a safeguard measure. We are of the view that the phrase "and under such conditions" qualifies and relates both to the circumstances under which the products under investigation are imported and to the circumstances of the market into which products are imported, both of which must be addressed by the importing country when performing its assessment as to whether the increased imports are causing serious injury to the domestic industry producing the like or directly competitive products. In this sense, we consider that the phrase "under such conditions" refers more generally to the obligation imposed on the importing country to perform an adequate assessment of the impact of the increased imports at issue and the specific market under investigation.

7.53 The European Communities raised various other arguments in support of its claims that Korea violated Article 4, and consequently Article 2, of the Agreement on Safeguards, namely that Korea did not adequately demonstrate the existence of serious injury and a causal link with the increased imports.[427] We shall address the EC argument that Korea did not perform an adequate assessment of whether the

[426] Contrary to the explicit references to prices in Article 3 of the Agreement on Implementation of Article VI of GATT 1994 ("AD Agreement") and Article 15 of the Agreement on Subsidies and Countervailing Measures ("SCM Agreement").

[427] In its request for a panel the European Communities claimed that the Korean determinations violated Articles 2, 4, 5 and 12 of the Agreement on Safeguards.

products under investigation were being imported into its territory in such increased quantities and under such conditions as to cause serious injury to the domestic industry when we examine the European Communities' more specific claims of inadequate serious injury and causation assessments made pursuant to Article 4.2 of the Agreement on Safeguards. We note that a violation of Article 4.2 would constitute a violation of Article 2 of the Agreement on Safeguards.

G. Claims under Article 4.2 of the Agreement on Safeguards

1. Korea's Examination of Serious Injury to the Domestic Industry

7.54 The European Communities claims that in its evaluation of serious injury to the domestic industry Korea failed to examine correctly all relevant factors of an objective and quantifiable nature having a bearing on the situation of the domestic industry. We note that the parties are in agreement that the appropriate definition of the domestic industry in this case comprises the producers of both raw milk and milk powder, as these two products are directly competitive with SMPP when used as input for the manufacturing of downstream dairy products such as flavoured milk, fermented milk and ice cream. Thus, the parties' disagreement regards the correct examination of the relevant factors of an objective and quantifiable nature having a bearing on the situation of this industry. We also note that the complex definition of the domestic industry as including producers of both a raw material and one of its downstream products has repercussions for how the serious injury assessment on the whole domestic industry as defined has to be performed.

7.55 In conducting our review of Korea's serious injury determination we are mindful of the obligations contained in Article 4.2 of the Agreement on Safeguards. This provision mandates that competent authorities when performing a serious injury investigation:

> "…shall evaluate all relevant factors of an objective and quantifiable nature having a bearing on the situation of that industry, in particular, the rate and amount of the increase in imports of the product concerned in absolute and relative terms, the share of the domestic market taken by increased imports, changes in the level of sales, production, productivity, capacity utilization, profits and losses, and employment."

This provision sets out the general principle regarding the economic factors which need to be considered in a serious injury investigation, and provides a list of factors that are *a priori* considered to be especially relevant and informative of the situation of the domestic industry. The use of the wording "in particular" makes it clear to us that, among "all relevant factors" that the investigating authorities "shall evaluate", the consideration of the factors listed is always relevant and therefore required, even though the authority may later dismiss some of them as not having a bearing on the situation of that industry. Under the applicable standard of review, our function is to assess whether Korea (i) examined all relevant facts in its possession or which it should have obtained in accordance with Article 4.2 of the Agreement on Safeguards at the time of the investigation; and (ii) provided an adequate explanation of how those facts as a whole supported the determination made. Thus, we shall examine

whether at the time of the determination all factors listed in Article 4.2 were appropriately considered; whether the Korean authorities explained how each factor considered supports (or detracts from) a finding of serious injury; and whether valid reasons have been put forward for dismissing a considered factor as not being relevant to the serious injury determination in this case.

7.56 We note that previous panel decisions have applied similar tests in reviewing determinations by investigating authorities on the existence of serious damage in the context of a transitional safeguard under the Agreement on Textiles and Clothing, and of material injury under the Tokyo Round Agreement on the Implementation of Article VI (the Anti-Dumping Code). In *United States - Shirts and Blouses,* the panel stated that:

> "The wording of the first sentence of Article 6.3 of the ATC imposes on the importing Member the obligation to examine, at the time of its determination, at least all of the factors listed in that paragraph. The importing Member may decide - in its assessment of whether or not serious damage or actual threat thereof has been caused to the domestic industry - that some of these factors carry more or less weight. At a minimum, the importing Member must be able to demonstrate that it has considered the relevance or otherwise of each of the factors listed in Article 6.3 of the ATC.[428]"

7.57 Even more to the point the panel in *United States - Salmon*, set out the following test when reviewing a material injury determination:

> "[A] review of whether a determination of material injury was in conformity with this requirement necessitated an examination of whether the investigating authorities had examined all relevant facts before them (including facts which might detract from an affirmative determination) and whether a reasonable explanation had been provided of how the facts as a whole supported the determination made by the investigating authorities."[429]

While the concepts of serious damage and material injury are not entirely analogous to the requirement of serious injury in the Agreement on Safeguards, we believe that the general considerations expressed by both panels on issues similar to those before us offer useful guidance as to how a panel should evaluate fulfilment of the serious injury requirement.

7.58 In our evaluation of Korea's serious injury determination there are three issues that we find particularly troublesome. First, we find that there is a lack of consideration in the OAI Report of some of the factors listed in Article 4.2. This is the case for instance for capacity utilization and productivity. In both cases Korea offers explanations in its submissions to the Panel of why it considered these factors not to bear on the situation of the domestic industry. While these explanations seem plausible, there is nothing in the OAI Report which would indicate to the Panel that these factors were taken into consideration in the serious injury finding of the Korean

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[428] *US - Shirts and Blouses, supra,* footnote 45, para. 7.26.

[429] *United States - Imposition of Anti-Dumping Duties on Imports of Fresh and Chilled Atlantic Salmon from Norway,* adopted 27 April 1994, ADP/87, para. 492 *("US - Salmon")*.

authorities. Second, as we noted above, the definition of the domestic industry in this case as comprising two different segments of the dairy products market has consequences for the evaluation of the situation of the industry. In assessing the serious injury to the whole domestic industry, we find that it is acceptable to analyze distinct market segments but, as stated above, all factors listed in Article 4.2 must be addressed. In considering each of the factors listed in Article 4.2, and any others found to be relevant by the authority, the investigating authority has two options: for each factor, the investigating authority can consider it either for all segments, or if it decides to examine it for only one or some segment(s), it must provide an explanation of how the segment(s) chosen is (are) objectively representative of the whole industry. A lack of consideration of all segments, without any explanation, is a flaw that we find present in Korea's analysis of the domestic industries' profits and losses, prices, debt to equity ratio, capital depletion and production cost. How Korea relates developments in one segment to its determination regarding the industry as a whole is for Korea to decide in the first instance. Our point here is that an analysis of only a segment of the domestic industry, without any explanation of its significance for the whole industry, will not satisfy the requirements of the Agreement on Safeguards. Third, we find that for certain factors considered by Korea it has failed to provide sufficient reasoning on some of the choices made in the analysis of such factors which may have affected the result of the consideration. Also, there is a lack of reasoning in some cases on how the factor considered supports (or detracts from) a finding of serious injury. This lack of explanation or reasoning is perceived in Korea's consideration of market share, production, profits and losses, employment and inventory.

7.59 Having laid out our overall concerns with Korea's compliance with its obligations under Article 4.2, we turn to the specifics of Korea's consideration of each of the factors listed in Article 4.2, as well as additional factors Korea considered in determining the existence of injury to the domestic industry. Since our task is to make an objective assessment of the factual considerations and reasoning of the Korean authorities in arriving at a finding of serious injury at the time of the determination, our analysis of Korea's compliance with the provisions in Article 4.2 will be on the basis of the OAI Report. We would also like to make it clear that even if we examine each one of the factors listed in Article 4.2 and others used by Korea, it is not our task to question the weight accorded to each factor for purposes of the final determination of serious injury. In this regard we concur with what the panel in *US - Shirts and Blouses* stated in examining the imposition of a safeguard measure under the ATC:

> "This is not to say that the Panel interprets the ATC as imposing on the importing Member any specific method either for collecting data or for considering and weighing all the relevant economic factors upon which the importing Member will decide whether there is need for a safeguard restraint. The relative importance of particular factors including those listed in Article 6.3 of the ATC is for each Member to assess in the light of the circumstances of each case."[430]

[430] *US - Shirts and Blouses , supra,* footnote 45, para. 7.52.

(a) Increased Imports

7.60 The European Communities argues that Korea excluded certain products (mixed products)[431] from the scope of application of the measure which were nevertheless included in the calculation of the increase in imports. Korea pointed out that the import volume of these products, found on page 7 of the OAI Report,[432] shows that the excluded mixed products accounted for just 0.7, 0.8, 1,5 and 1,3 per cent of SMPP imports for the years 1993, 1994, 1995, and the first semester of 1996 respectively. After examining the figures pointed out by Korea, we consider that the excluded mixed product imports are a very minor portion of the SMPP imports. Thus, there is no basis for finding that Korea's decision not to exclude those products from the import increase calculation is inadequate for the purpose of Article 4.2 of the Agreement on Safeguards.

7.61 Based on the relevant sections in the OAI Report, we find that the Korean authorities' consideration of increased imports was adequate for the purposes of Article 4.2. Korea's assessment of the increased imports can be found from pages 32 through 35 of the OAI Report, where the progression of SMPP imports for the period under investigation both in absolute terms and relative to domestic production is detailed.

(b) Market Share Captured by Imports

7.62 Korea's consideration of this factor can be found on page 35 of the OAI Report, where it states: "The market share of SMPP against the total demand was 1.6 per cent in 1993, 7.0 per cent in 1994, 12.2 per cent in 1995, and 14.1 per cent in Jan.-June in 1996, showing an upward trend." On its face this consideration of the total dairy market share captured by the increased imports of SMPP would seem to be correct and in compliance with the provisions of Article 4.2. However, we note that on page 16 of the OAI Report Korea defines the total market of basic materials for the production of dairy products in Korea as being composed of: raw milk produced by domestic dairy farms; milk powder produced from raw milk by processing companies, imported milk powder, imported basic materials for cheese, and other imports including SMPP. In a footnote on page 16 of the OAI Report the investigating authorities state:

> "Considering the characteristics of the analysis, data on cheese import was excluded but import of cheese, which has direct influence on consumption of domestic raw milk, also has largely been increasing since import liberalization in 1995. Including the cheese import volume, the total demand comes to 2,027,713 tons in 1993, 2,249,958 tons in 1994, 2,414,525 tons in 1995, and 1,222,804 tons in Jan.-June 1996, showing the increase rates of 11.0 per cent in 1994, 7.3 per cent in 1995 and -1.4 per cent in Jan.-June 1996."

7.63 The Panel can only assume that this footnote actually refers to an exclusion of data on imported basic materials for cheese, since it would be these kinds of imports

[431] The excluded products are: milk mineral (calcium), concentrated product, Chilean special products and raw material for the production of Nestlé's Cerelac.

[432] *See* para. 4.370, *supra*.

which would have a direct influence on consumption of raw milk. Also, the text that is being expanded upon in the footnote does not mention cheese as a finished product but imported basic materials for cheese. We find that this exclusion has not been sufficiently explained by Korea, even though it admits in the footnote quoted above, that these imports are part of the total market of basic materials for dairy products, that they affect consumption of raw milk and that they have increased significantly during the period of investigation. Such exclusion is not inconsequential as it may result in a decrease of the relevant market size, and a corresponding overestimation of the share of the market being captured by SMPP imports. We would like to make it clear that our view is not that this exclusion of imported basic materials for cheese from the total volume of the dairy market was necessarily incorrect. Rather, since Korea did not provide any reasoning as to why it chose to exclude this portion of the relevant market, we find that Korea's analysis of the market share captured by imports of SMPP was not adequately performed for the purpose of Article 4.2.

(c) Sales

7.64 The Korean authorities' consideration of changes in the level of sales for the domestic industry was performed separately for raw milk and milk powder and can be found respectively at pages 38 and 45 of the OAI Report. Regarding raw milk consumption for the period of investigation the report states:

> "The amount of domestic raw milk consumed was 1,844,463 tons in 1993, 1,947,128 tons in 1994, 1,947,965 tons in 1995, and 984,934 tons in the January-June period of 1996. The consumption increase rate was 5.6 per cent for 1994, 0.0 per cent for 1995, and -2.0 per cent for the January-June period of 1996."[433]

7.65 Regarding milk powder consumption the Korean authorities found:

> "The amount of domestic milk powder consumed was 12,191 tons for 1993, 12,468 tons for 1994, 10,690 tons for 1995 and 2,741 tons for the January-April period of 1996. In terms of increase rate, it was 2.3 per cent in 1994, -14.3 per cent in 1995 and -40.9 per cent in the January-April period of 1996."[434]

7.66 We note that in the case of domestic raw milk and milk powder sales in Korea there is a decline in consumption. This decline could support the Korean authorities' finding of serious injury to the domestic industry. Thus, we find that this factor was adequately considered for the purpose of Article 4.2.

(d) Production

7.67 This factor was considered in the OAI Report for both the raw milk and the milk powder segments of the industry respectively at pages 38 and 45 of the OAI Report, where it is stated:

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[433] OAI Report, page 38.
[434] *Ibid*. at 45.

> "The production amount of domestic raw milk was 1,857,873 tons in 1993, 1,917,398 tons in 1994, 1,998,445 tons in 1995, and 1,069,224 tons in the January-to-June period of 1996. The increase rate was 3.2 per cent for 1994, 4.2 per cent for 1995, and 4.4 per cent for the January-June period of 1996."[435]
>
> "The amount of domestic milk powder produced was 13,512 tons for 1993, 9,495 tons for 1994, 15,719 tons for 1995, and 10,401 tons for the January-April period of 1996. In terms of the production increase rate, it was -29.7 per cent in 1994, 65.6 per cent in 1995 and 52.6 per cent in the January- to-April period of 1996."[436]

Korea later explains that it does not consider this factor to be relevant as "it was not an appropriate measure for determining the state of the domestic industry".[437] However, this explanatory statement is made in the first submission of Korea to the Panel. We fail to find any analysis by the Korean authorities at the time of the investigation, as to how these figures on production are relevant (or not) to a finding of serious injury to the domestic production. Lacking this explanation it is not possible for us to discern whether the Korean authorities' dismissal of this factor as an indicator of serious injury to the domestic industry was appropriate. Thus, we find that this factor was not adequately considered for the purpose of Article 4.2.

(e) Productivity

7.68 As described above the first task of the Panel is to examine whether all factors listed in Article 4.2 have been appropriately considered. We find that there is no mention of this factor in the OAI Report. While Korea in its submissions argues that "changes in productivity were not appropriate indicators of serious injury" and gives reasoning for this conclusion, this reasoning is not found in the OAI Report. There is no indication that Korea considered the productivity of the domestic industry when making a finding of serious injury. Thus, we find that this factor was not adequately considered for the purpose of Article 4.2.

(f) Capacity Utilization

7.69 Just as in the case of productivity we fail to find any discussion in the OAI Report of the changes in capacity utilization of the domestic industry. Although this factor is mentioned in the Interim Draft Investigation Report[438] it is not brought forward in the final OAI Report on which Korea based the adoption of its safeguard measure. Thus, we find this factor was not adequately considered for the purpose of Article 4.2.

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435 OAI Report, page 38.
436 *Ibid*. at 45.
437 *See* para. 4.364, *supra*.
438 An extract of this draft report was submitted as Exhibit Korea-5.

(g) Profits and Losses

7.70 The Korean authorities' consideration of this factor appears at page 41 of the OAI Report for the raw milk segment of the industry and page 49 for the milk powder segment of the industry. Regarding the raw milk segment the Korean authorities found that various livestock cooperatives had declining profits during the period, to the point where by the first semester of 1996 they were reporting losses of 17,546 million Won. Korea explained in the OAI Report that this analysis was carried out on the livestock cooperatives with the following reasoning: "since the livestock cooperatives, which are comprised of dairy households producing raw milk, distribute their profits to their members, the livestock cooperatives' profits and losses are directly linked to the raw milk producers' income."[439]

7.71 First, we note that the livestock cooperatives' business is not only the collection, distribution and sale of raw milk but also the processing of this raw milk into downstream dairy products for subsequent sale. Thus, the profits or losses of the livestock cooperatives do not reflect exclusively their activities in the raw milk sector but also other activities.

7.72 Second, the raw milk producers' profits or losses do not derive only from their investment in the livestock cooperatives, but also from the sale of raw milk to the livestock cooperatives. In its first submission[440] Korea presents data on the profit margins for raw milk producers based on the difference between the reference sale prices and the production cost of raw milk. However, as admitted by Korea, [441] this analysis was not performed at the time of the investigation.

7.73 Third, we also gather from Korea's description of its analysis that it examined only some of the livestock cooperatives. However, there is no explanation of why this was done. Lacking any such explanation it is not possible for us to assess whether the selection of the livestock cooperatives rendered an objective picture of the situation of the whole domestic industry.

7.74 Taken together the flaws in Korea's consideration of profits and losses in the raw milk segment of the industry outlined above lead us to find that this factor was not adequately considered for the purpose of Article 4.2.

7.75 Regarding the milk powder sector of the industry, we again find flaws in Korea's consideration of profits and losses. In examining the profits and losses of the milk powder sector the Korean authorities examined only two livestock cooperatives and four milk processing companies. Again, there is no explanation of why the an examination of only these companies would constitute an objective and representative picture of the situation of the whole domestic industry. Footnote 15 of the OAI Report contains a reference to the proportion of annual production by the chosen cooperatives and companies where the data have been deleted. Without any such explanation Korea has not demonstrated that it had considered the objectivity and representativeness of the sample. Thus, we find that for the purpose of Article

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439 OAI Report, page 41.

440 *See* para. 4.343, *supra*.

441 In its request for interim review, Korea submits that it "has never made any attempt to argue that [an analysis of the profits and losses of the raw milk producers] was conducted during the investigation".

4.2 Korea has not adequately considered the profits and losses of the whole domestic industry.

(h) Employment

7.76 The analysis of changes in the levels of employment for the domestic industry was also performed by the Korean authorities first for the raw milk producers and then for the milk powder producers. Regarding the analysis of the employment in the raw milk sector, the Korean authorities chose to analyze whether there was a decrease in the number of dairy households. The reasons for this choice were explained to the Panel as follows:

> "Korean dairy farms are on the whole small scale family businesses, and represent one part of the economic activity of some members of that family. It is not possible to determine how much time each person spends working on that business, and what proportion of that time is devoted to dairy production … and so the Korean authorities used changes in the number of dairy households as a surrogate"[442]

This explanation was made in the oral statement at the second meeting of the Panel with the parties, and not in the OAI Report. We commend Korea for devising a surrogate methodology to measure the employment in the raw milk industry and not simply dismissing this factor as irrelevant or not quantifiable. Nevertheless, this deviation from normal practice should have been explained at the time of the decision in the OAI Report. Lacking this explanation in the OAI Report we find that this factor was not adequately considered for the purpose of Article 4.2.

7.77 Regarding the analysis of employment for the milk powder producers, the Korean authorities, explained in the OAI Report, that:

> "As the milk powder production became automated, the number of workers employed in milk powder production decreased over the years. Currently, very few people are fully employed for the exclusive purpose of engaging in milk powder production. Workers producing other dairy products are used temporarily, when needs arise, to engage in milk powder production. Accordingly, employment and wage are insignificant factors in operating milk powder business"[443]

In the light of this explanation in the OAI Report, we find that, for the purpose of Article 4.2, Korea has adequately considered this factor for milk powder production.

(i) Inventory

7.78 Regarding this factor, Korea considered inventories of domestic milk powder only, since raw milk is not susceptible of stockage.[444] There are two references to the inventory levels throughout the OAI Report (pages 38-39, and 46). We note that the figures at pages 38-39 are slightly different from those at page 46. Nevertheless, they

[442] *See* para.4.513, *supra*.
[443] OAI Report, page 48.
[444] OAI Report, page 38.

both show an accumulation of stock for the period under investigation.[445] We find, however, that there is no reasoning as to why such levels of inventory are indicative of serious injury or why they are negative for the domestic dairy industry. Again this explanation is made in the second submission of Korea, where it is stated:

> "Increase of milk powder inventory is clear evidence of serious injury in this case not only to the milk powder industry, but also to the entire domestic industry. As explained above, raw milk that is not consumed has to be converted into, *inter alia,* milk powder. Conversion only increases supply and inventory of milk powder. Therefore, increased milk powder inventory not only indicates oversupply of milk powder but also demonstrates displacement of domestic raw milk by cheap imported SMPP, thus signifying serious injury to the entire domestic industry.[446]
>
> The increased inventory incurred a significant amount of costs. Even if depreciation is disregarded, the cost of inventory amounted to 17.3 billion Won (approximately US $21.6 million) during the investigation period. The inventory costs during the first six months of 1996 alone were 5.8 billion Won (approximately US $7.3 million), and the domestic producers were compelled to incur the full inventory cost[447]"

Thus, it is clear from the statement made in Korea's second submission that the level of inventories of milk powder found by the Korean authorities has negative consequences for the milk powder sector of the industry and could indicate that the domestic industry is injured. However, this reasoning provided in Korea's second submission is not discernible in the OAI Report, and it is only after it has been explained in the second submission that the precariousness of the situation of the domestic industry regarding this factor becomes evident. Thus, we find that this factor was not adequately considered for the purpose of Article 4.2.

(j) Price

7.79 This factor is not explicitly mentioned in the list of factors included in Article 4.2, however, Korea considered it in its investigation. The Korean authorities examined prices for milk powder and found that they were lower in the first half of 1996 than they were in 1993 at the beginning of the period of investigation.[448] We note that milk powder prices had risen to a high level as recently as 1995. Taking into account the entire OAI Report, we consider that Korea has established that lower prices for milk powder are indicative of serious injury for the milk powder industry[449]. However, while there is an analysis of prices for the milk powder industry, we note that there is no explanation of the relationship between the price

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445 *See* para. 4.323, *supra*.
446 *See* para.4.460, *supra*.
447 *See* para.4.462, *supra*.
448 OAI Report, page 47.
449 This reasoning can be found in the causation section of the OAI Report at page 62.

levels for milk powder and the serious injury alleged to be suffered by the whole domestic industry.

7.80 Indeed, Korea did not examine prices of raw milk in its investigation. In this regard Korea stated in its submissions that "there is no reliable way of arriving at an accurate or appropriate transaction price for raw milk in Korea"[450] and "that any impact of declining domestic milk powder prices adversely affected the entire domestic industry, since raw milk producers own the livestock cooperatives."[451]

7.81 We are of the view that conclusions about the prices of milk powder only, do not constitute a consideration of prices to the whole domestic industry which was defined as producers of raw milk and milk powder. The fact that it is the producers of raw milk who own the cooperatives does not exempt the Korean authorities from examining the particular conditions of the raw milk producers as this is a different segment of the industry from milk powder production. For this reason we find that Korea's consideration of the prices was incomplete as it only took into account one segment of the domestic industry. Thus, we find that this factor was not adequately considered for the purpose of Article 4.2.

7.82 Moreover, we note that even if actual transaction prices for raw milk in Korea were unavailable or it was not feasible to collect them given the large number of producers, there were several other avenues available to the Korean authorities that would have allowed them to calculate or construct an approximation of raw milk prices.[452] Such indicators, even if not one hundred per cent accurate could have enabled the Korean authorities to identify the existence of trends, either positive or negative, in the prices for raw milk. The choice of methodology to determine prices rests with the investigating authorities, but given that there were various options available in this case we find that the Korean authorities should have made an effort to determine the prices for raw milk, instead of dismissing this factor as not being quantifiable.

(k) Debt to Equity Ratio and Capital Depletion

7.83 These are two additional economic indicators that do not appear in the illustrative list of Article 4.2, which were considered by the Korean authorities. These factors were evaluated exclusively with regard to the livestock cooperatives. The results, presented at pages 43 and 44 of the OAI Report, only give information on a portion of the livestock cooperatives. It is impossible for us to assess if the data presented reflect the position of the whole domestic industry. Thus, we fail to see in the OAI Report any explanation as to why these two factors reflect serious injury, especially serious injury to the whole Korean domestic industry producing raw milk and milk powder. Thus, we find that this factor was not adequately considered for the purpose of Article 4.2.

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[450] *See* para.4.504, *supra*.

[451] *See* para.4.449, *supra*.

[452] For example, Korea could have performed: (1) an analysis based on sampling of the raw milk producers, a methodology which was used by Korea elsewhere in its analysis; (2) a construction of the prices for raw milk based on the cost of production of raw milk producers, for which data appear to be on the record; on (3) a construction of the prices by making adjustments to the cost of raw materials reported by the milk powder producers.

(l) Production Cost

7.84 The Korean authorities only examined the production cost of livestock cooperatives in the production of milk powder. In this examination the Korean authorities found:

> "The manufacturing cost increased from 5,158 won/kg in 1993 to 5,426 won/kg in 1994, 5,860 won/kg in 1995 and 6,178 won/kg in the January-April period of 1996.
>
> The difference between the sales price and the manufacturing cost was 196 won in 1993. However, it recorded -132 won in 1994 and the negative margin grew larger to -472 won in 1995 and further to -1,184 won in the January-to-April period of 1996."[453]

The Korean authorities concluded that there was a widening negative gap between the cost of manufacturing milk powder and its sale price. These sales below cost would indicate that livestock cooperatives were going through a difficult period. However, as this factor was only evaluated for a portion of the domestic industry (livestock cooperatives producing milk powder) it is not possible for us to assess the situation with regard to the whole domestic industry. We do not consider this factor to provide adequate support for the conclusion that there is serious injury to the domestic industry as defined by the Korean authorities. Thus, we find that this factor was not adequately considered for the purpose of Article 4.2.

(m) Conclusion

7.85 For the reasons described above, we find that Korea's determination of serious injury to the domestic production of raw milk and milk powder does not meet the requirements of Article 4.2 of the Agreement on Safeguards.

7.86 Article 2.1 permits the application of a safeguard measure only if, *inter alia*, there has been a determination of serious injury pursuant to Article 4.2. Since we find that Korea's determination of serious injury does not meet the requirements of Article 4.2, the application of the safeguard measure at issue would necessarily also violate Article 2.1of the Agreement on Safeguards. We note that in its request for establishment of a panel, the European Communities claims generally that Korea violated Articles 2.1, 4.2(a), 4.2(b), 5.1 and 12.1 to 12.3 of the Agreement on Safeguards. However, in its submissions, the European Communities did not argue specifically, nor did it submit any evidence, in support of its claim under Article 2.1, other than those relating to "under such conditions" (as discussed in Section F *supra*.[454] Therefore, we do not reach any conclusion on the issue of whether Korea's determination of serious injury violates the provisions of Article 2.1 of the Agreement on Safeguards.

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[453] OAI Report, page 53.

[454] *See* the Appellate Body report on *Japan - Measures Affecting Agricultural Products* (WT/DS76/AB/R), DSR 1999:I, 277, paras. 118 to 131.

2. *Korea's Examination of the Causal Link between Increased Imports and Serious Injury*

7.87 We have already determined above that Korea's injury determination did not meet the requirements of Article 4.2 of the Agreement on Safeguards. We concluded that Korea did not address all injury factors listed in Article 4.2 of the Agreement on Safeguards. In addition, we concluded that when addressing factors listed in Article 4.2 of the Agreement on Safeguards, the OAI Report did not contain any reasoning, analysis or evidence in support of its findings and sometimes it limited its analysis to only one segment of the relevant domestic industry. Having reached these conclusions with regard to Korea's assessment of the injury factors, it is not necessary for us to reach any findings on whether Korea demonstrated that increased imports "caused" serious injury to the domestic industry producing like or directly competitive products. However, keeping in mind the conclusions of the Appellate Body in *Australia - Salmon*[455], we would like to offer some general comments relevant to an analysis of a causal link between increased imports and injury, in the context of the Korean investigation.

7.88 We recall the provisions of Articles 2 and 4.2 of the Agreement on Safeguards:

> "2.1 A Member may apply a safeguard measure to a product *only* if that Member has determined, pursuant to the provisions set out below, that such product is being imported into its territory in *such increased quantities*, absolute or relative to domestic production, *and under such conditions as to cause or threaten to cause* serious injury to the domestic industry that produces like or directly competitive products…
>
> 4.2. (a) In the investigation to determine *whether increased imports have caused or are threatening to cause serious injury* to a domestic industry under the terms of this Agreement, the competent authorities *shall evaluate all relevant factors of an objective and quantifiable nature having a bearing on the situation of that industry*, in particular, the rate and amount of the increase in imports of the product concerned in absolute and relative terms, the share of the domestic market taken by increased imports, changes in the level of sales, production, productivity, capacity utilization, profits and losses, and employment.
>
> (b) The determination referred to in subparagraph (a) shall not be made *unless* this investigation demonstrates, on the *basis of objective evidence*, the existence of the *causal link between increased imports of the product concerned and serious injury or threat thereof*. When *factors other than increased imports are causing injury* to the domestic industry at the same time, *such injury shall not be attributed to increased imports*." (emphasis added)

[455] *Australia - Salmon*, *supra*, footnote 412, para. 223.

7.89 In performing its causal link assessment, it is our view that the national authority needs to analyze and determine whether developments in the industry, considered by the national authority to demonstrate serious injury, have been caused by the increased imports. In its causation assessment, the national authority is obliged to evaluate all relevant factors of an objective and quantifiable nature having a bearing on the situation of that industry. In addition, if the national authority has identified factors other than increased imports which have caused injury to the domestic industry, it shall ensure that any injury caused by such factors is not considered to have been caused by the increased imports.

7.90 To establish a causal link, Korea has to demonstrate that the injury to its domestic industry results from increased imports. In other words, Korea has to demonstrate that the imports of SMPP cause injury to the domestic industry producing milk powder and raw milk. In addition, having analyzed the situation of the domestic industry, the Korean authority has the obligation not to attribute to the increased imports any injury caused by other factors.

7.91 For instance, the KTC needs to explain how the developments with respect to factors considered by the KTC to demonstrate serious injury, were caused by the imports of SMPP. This is to say that the KTC, in its analysis of the increased market share of SMPP for example, should have tried to explain how the imports of SMPP effectively displaced the domestic production of like or directly competitive products.

7.92 To take one example using only one factor for only one year we note that the OAI Report[456] states that the most important increase of import of SMPP occurred from 1993 to 1994 (384 per cent). However, we know that during the first year under investigation (1994), domestic demand for raw milk and milk powder increased significantly. The OAI Report[457] indicates: "… the large increase of dairy production in 1994 resulted from the drastically increased demand for market milk and fermented milk due to the quite warm winter". The Korean authorities found[458] that from 1993 to 1994, total demand of raw milk increased by 9.6 per cent while domestic production only increased by 3.2 per cent. We consider, therefore, that in 1994, to meet the increased demand in raw milk it was necessary to increase imports of raw milk substitutes. The reasons for this are: first, raw milk supply (in the short term) is very rigid, as it depends upon the number of milk cows (head) which cannot be increased rapidly and; second, the import tariff on milk powder had been increased to a very high level (220 per cent) which constrained imports of milk powder. This situation therefore implied that the only way for Korea to respond to the increased demand was to import more of the low-tariff SMPP (39 to 40 per cent). In other words, in 1994 domestic demand for raw milk in Korea was larger than domestic production of raw milk. This had the effect of decreasing the production of milk powder (which is made from raw milk)[459] and decreasing milk powder inventories[460]. It seems clear to us, that at least for 1994, the imports of SMPP cannot

[456] OAI Report, page 32.
[457] OAI Report, page 14.
[458] OAI Report, page 39.
[459] OAI Report, pages 58-60.
[460] OAI Report, page 17.

have caused injury to the domestic industry producing like or directly competitive products in Korea. On the contrary the increasing imports of SMPP were the result of the increasing needs for raw milk and milk powder substitutes by the Korean industry faced with the incapacity of the domestic production to fulfill the increasing demand for such products. In the OAI Report there is no analysis of the interaction of these various elements. However, any adequate causation assessment had to be performed for the overall injury determination.

7.93 As to other factors that may have caused injury to the domestic industry producing like or directly competitive products, we know, from the OAI Report, that domestic demand for raw milk was affected by other factors. For example, it is said in the footnote to page 16 of the OAI Report: "Considering …, data on cheese import was excluded *but imports of cheese, which has direct influence on consumption of domestic raw milk,* also has largely been increasing since import liberalization in 1995…". As we mentioned before (see paragraphs 7.62 and 7.63 *supra*), this footnote must refer to an exclusion of data on imported basic material for cheese, as the text that is expanded upon does not mention cheese as a finished product but rather imported basic materials for cheese. In other words, it would be these imports of basic materials for cheese that would have a direct influence on consumption (demand) for raw milk.

7.94 Korea recognizes that the domestic production of cheese has decreased.[461] This decrease of cheese production directly affected the consumption of and demand for raw milk. However, the OAI Report does not contain any evaluation or analysis of the impact of this factor (i.e. increased imports of cheese or increased imports of basic material for cheese, and their impact on the reduced demand for cheese and consequently the reduced demand for domestic raw milk in making cheese).

7.95 The same line of reasoning holds for the other dairy products that use raw milk or milk powder as inputs which, according to Korea, also decreased. Therefore, the demand for raw milk and milk powder should have decreased as well. On page 14 of the OAI Report, the KTC notes that the domestic production of white milk, condensed milk, cheese and lactic-acid-producing beverages went down during the period of investigation. We know from Korea's domestic regulation[462] that SMPP cannot substitute for raw milk in the production of white milk, condensed milk, cheese, and lactic-acid-producing beverages. If the domestic production of these products went down as well, factors other than imports of SMPP must have caused the reduction of domestic production of these products which, in turn also must have had an impact on the reduced consumption of raw milk and milk powder. In compliance with the provisions of Article 4.2 of the Agreement on Safeguards, the causal link between increased imports of SMPP and the factors it found to demonstrate injury must also be assessed by the national authority.

7.96 This should not be construed to mean that the Panel interprets the Agreement on Safeguards as imposing on the importing Member any appropriate method either for collecting data or for considering and weighing all the relevant economic factors upon which the importing Member will decide whether there is need for a safeguard restraint.

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[461] *See* the negative data in the OAI Report, page 14.

[462] *See* Food Industry Handbook, referred to in the OAI Report, page 26.

The relative importance of particular factors including those listed in Article 4 of the Agreement on Safeguards is for each Member to assess in the light of the circumstances of each case. Korea remains free to determine an appropriate method of assessing whether the state of its domestic industry was caused by imports of SMPP and how this analysis was performed. Korea also remains free to choose the method of assessing whether any serious injury to its domestic industry was caused by such other factors.

H. Claims under Article 5.1 of the Agreement on Safeguards

7.97 The European Communities argues that when a WTO Member takes a safeguard measure, it needs to prove that such measure was necessary and therefore should justify its "adequacy" in remedying injury and facilitating adjustment. The European Communities claims that (i) by omitting to give any consideration to adjustment plans, Korea violated Article 5.1, first sentence; (ii) by failing to consider whether types of measure other than a quota would be the most suitable to remedy serious injury or facilitate adjustment, Korea violated Article 5.1, first sentence; and (iii) by failing to show that the level of the quota itself was necessary to remedy serious injury or facilitate adjustment remedy, Korea violated its obligations under Article 5.1, first and second sentences. The European Communities also claims that by not choosing the appropriate three representative years (which should start as of the date of the imposition of the measure), without submitting a "clear justification that a different level was necessary to prevent or remedy the serious injury", Korea violated the provision of Article 5.1, second sentence.

7.98 Korea responds that since Article 5.1 states that "Members should choose measures most suitable for the achievement of these objectives," it complied with this provision, as it considered that the quotas at these levels for that period of 4 years, were the most suitable for remedying the serious injury and facilitating adjustment to the domestic industry in Korea. For Korea, there is no obligation to demonstrate that the type of measure is the most suitable measure to achieve these objectives. Korea adds that the Korean competent authorities did examine whether other types of measures, including tariff-quota, would be more appropriate. For Korea, there is no obligation to demonstrate that the level of such tariff is necessary or appropriate to achieve these objectives. In its view, the wording of the second sentence of Article 5.1 makes it clear that Members must only justify the level of quotas if it is different (*i.e.*, lower) than the average imports during the three most recent representative years. It based its quota level on the average of imports for the three years from July 1993 to June 1996, as it initiated its safeguards investigation in May 1996. The requirement for consideration of three "representative" years was intended to prevent foreign exporters from manipulating quota levels by flooding the market with imports just prior to the decision to impose a safeguard measure. Therefore, Korea considered that the second half of 1996 was not "representative", and it excluded imports from this period in calculating the quota level. Since it chose the appropriate three representative years, Korea argues that it did not have to provide any justification.

7.99 We are of the view that Article 5 of the Agreement on Safeguards establishes certain rules on the application of safeguard measures. In the view of the Panel these rules on the application of a measure come into play only after a decision has been

taken to adopt a safeguard measure. The first sentence of Article 5.1 reads: "A Member shall apply safeguard measures only to the extent necessary to prevent or remedy serious injury and to facilitate adjustment." We believe that this provision is not concerned with the decision or even the right of a Member to adopt a safeguard measure. The general authorization for a Member to apply a safeguard measure is found in Article 2.1 of the Agreement on Safeguards, which provides that "[a] Member *may* apply a safeguard measure" (emphasis added) after that Member has made the injury and causation determination refered to in that article. The use of the verb "may" indicates that the decision whether to apply a measure or not, after the above-mentioned conditions have been evidenced, rests with the Member conducting the investigation. We find that in the context of the discretion authorized by Article 2.1 we cannot conclude that Article 5.1 requires a Member to further justify the necessity of applying a safeguard measure. In consequence the decision by a Member to adopt a safeguard measure once all the required conditions have been determined to exist can not be challenged by another Member under Article 5.1.

7.100 The fact that the Panel finds that, after full compliance with the provisions of Articles 2 and 4 of the Agreement on Safeguards, there is no obligation under Article 5.1 to justify the decision to adopt a safeguard measure does not mean, however, that the first sentence of Article 5.1 only "states a basic principle"[463] or "does not impose a general obligation".[464] The first sentence of Article 5.1 does contain a very specific obligation. This obligation is to apply a measure that is commensurate with the goals of preventing or remedying the serious injury suffered by the domestic industry and of facilitating the adjustment of the domestic industry. Our interpretation of this obligation is bolstered by the last sentence of Article 5.1, which provides that Members "should choose measures most suitable for the achievement" of the objectives of preventing or remedying the serious injury and facilitating adjustment.

7.101 In our view a measure is defined by the following elements: product coverage, form, duration and level. Thus, in order to comply with Article 5.1 a Member must apply a measure which in its totality is no more restrictive than is necessary to prevent or remedy the serious injury and facilitate adjustment. In addition, it must be possible for a Panel to evaluate, in accordance with the applicable standard of review, whether a Member has acted in compliance with Article 5.1. Therefore, the Member applying the measure must provide a reasoned explanation as to how the authorities reached the conclusion that the particular measure in question satisfies all the requirements of Article 5.1. We consider that the obligations of the first sentence of Article 5.1 apply to all safeguard measures in their entirety.

7.102 In the present case the European Communities argues that Korea has not fulfilled its obligations under Article 5.1 with respect to the justification of type and level of the measure at issue. In considering whether Korea has complied with its obligations under Article 5.1, we apply the standard of review set out in paragraphs 1.25 to 1.30. Thus, we need to consider whether the Korean authorities examined all relevant facts before them, whether adequate explanation was provided of how the facts

[463] *See* para. 4.629, *supra*.
[464] *See* para. 4.628, *supra*.

as a whole supported the determination made, and, consequently, whether the determination made was consistent with the international obligations of Korea. In other words, Members are required, in their recommendations or determinations on the application of a safeguard measure, to explain how they considered the facts before them and why they concluded, at the time of the decision, that the measure to be applied was necessary to remedy the serious injury and facilitate the adjustment of the industry. Our task is not to determine for ourselves whether the measure applied by Korea is at a level that is no more restrictive than necessary to remedy the serious injury and facilitate adjustment. Rather, we must evaluate whether in deciding on the type and level of the measure to be applied, the Korean authorities considered relevant information and explained their decision that the measure chosen was no more restrictive than necessary to prevent or remedy serious injury to the Korean dairy industry and to facilitate the industry's adjustment.

7.103 In examining Korea's compliance with Article 5.1 we consider the Determination of Relief Measure, by the Korean Trade Commission dated 2 December 1996[465] to be most relevant, as this document describes the measure adopted by the Korean authorities.[466] It is this document which should, in our view, reflect the Korean authorities' considerations underlying the measure adopted.

7.104 Looking at the Determination of Relief Measure, we find a bare description of the elements of the measure. We note the absence of any discussion or analysis indicating the considerations underlying the choice of the measure adopted and any explanation as to why the Korean authorities concluded that the measure adopted was necessary to remedy the serious injury and facilitate adjustment. There is no reference to the measure, in any of the other determinations before or after the Determination of Relief Measure.

7.105 It appears from the evidence presented by Korea that the Korean authorities were aware of, and may even have considered, measures other than the quantitative restriction adopted.[467] However, these potential measures are merely described in the determination. In our view mere description of the alternative measures considered is insufficient. There must be some discernible reasoning as to why the measure recommended or adopted is preferable to the others, specifically with respect to achieving the objectives of remedying the serious injury and facilitating adjustment.

7.106 Korea's Determination of Relief Measure lists different factors that appear to have been considered in deciding on the adoption of the measure to be applied. However, this is again merely descriptive, as is evident from the following paragraph:

> "[b]efore recommending the relief measures, the KTC commissioners agreed that close considerations should be made beforehand for each relief measure on its impacts on the domestic dairy industry, national

[465] Exhibit Korea-8.

[466] We recognize that there was a later decision to adjust the level of the measure. However, as this affected only one of the defining elements of the measure, we nonetheless focus on the 2 December 1996 Determination.

[467] Other measures that may have been considered include those measures which were proposed by the petitioner (*see*, Exhibit Korea-8 at pg. 3) and the application of a tariff quota as recommended by Commissioner Jeong Mun-Su in his minority opinion (*Ibid*. at pg. 4).

> economy, and bilateral/multilateral trade. In this regard, the KTC examined the information investigated by the OAI, the relevant articles of the multilateral regulations, the opinions of authorities concerned, and the relief measures stipulated in the Foreign Trade Act and the Enforcement Decree of the Act. Based on all these examinations, the KTC reviewed the petitioner's request for relief measures."[468]

We do not see any explanation as to whether or how each of these factors shaped the Korean authorities' recommendation on the type, level and duration of the applied measure.

7.107 Indeed the Determination of Relief Measure simply continues:

> "The KTC decided to recommend to the Minister of Agriculture and Forestry (MAF) that he permit the following in connection with the import restrictions on the products under investigation[:]
>
> The import restriction on the products under investigation should be implemented for 4 years.
>
> The restricted volume should amount to 15,595 tons (average import volume during the year of 1993 - 1995) in the first year of the total 4 years of relief measures period. From the second year, the yearly 5.7 per cent increase rate (average increase rate of total domestic demand during 1993 - 1995) over the preceeding year's restricted volume should be applied."

This recommendation does not contain any consideration or explanation of why the Korean authorities concluded that the recommended measure was necessary to prevent or remedy serious injury and facilitate the adjustment of the domestic industry.

7.108 We wish to make it clear that we do not interpret Article 5.1 as requiring the consideration of an adjustment plan by the authorities, as the European Communities asserts.[469] The Panel finds no specific requirement that an adjustment plan as such must be requested and considered in the text of the Agreement on Safeguards. Although there are references to industry adjustment in two of its provisions,[470] nothing in the text of the Agreement on Safeguards suggests that consideration of a specific adjustment plan is required before a measure can be adopted. Rather, we believe that the question of adjustment, along with the question of preventing or remedying serious injury, must be a part of the authorities' reasoned explanation of the measure it has chosen to apply. Nonetheless, we note that examination of an adjustment plan, within the context of the application of a safeguard measure, would be strong evidence that the authorities considered whether the measure was commensurate with the objective of preventing or remedying serious injury and facilitating adjustment.

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468 Exhibit Korea-8 at pg. 3

469 *See* para. 4.611, *supra*.

470 Articles 5 and 7 of the Agreement on Safeguards.

7.109 In response to a question by the Panel,[471] Korea states that Article 5 "does not impose a general obligation on Members to demonstrate that the specific level of quota that they decided to impose as a safeguard measure is necessary to prevent or remedy serious injury and to facilitate adjustment". In our interpretation, Article 5.1 does not require a Member to demonstrate *ex posteriori* to the Panel that the measure adopted is effectively the most appropriate one. We consider rather, as we mentioned before, that Members are required, in their recommendations or determinations on the application of a safeguard measure, to explain how they considered the facts before them and why they concluded, at the time of the decision, that the measure to be applied was necessary to remedy the serious injury and facilitate the adjustment of the industry. It is such reasoning and explanation concerning the measure adopted, essential to evaluate Korea's compliance with Article 5.1, which we cannot discern in Korea's determination to apply a safeguard measure in the present case.

7.110 Korea argues that "provided the level of quota was equivalent to or not less than the average of the import levels for the three most recent representative years for which statistics were available, the Korean authorities were not required to show that the nature of the measure, or its level, were [*sic*] 'necessary'".[472] However, as explained above, we consider that the first sentence of Article 5.1 applies to all elements of a safeguard measure, including the level of any quota. In consequence, even assuming Korea based its quota level on the average imports levels for the last three representative years, this would not suffice to meet the requirements of Article 5.1, as the scope of that Article is greater than just the level of the applied quota. We conclude therefore that Korea's determination of the measure did not meet the requirements of Article 5 of the Agreement on Safeguards.

7.111 The European Communities also claims that Korea violates Article 5.1 because it applied a quota whose level was lower than the average of imports in the last representative three-year period preceeding the application of the measure for which statistics were available. Since we have already found that Korea's application of a measure was not consistent with the provisions of the first sentence of Article 5.1 which we consider to be generally applicable, also when a quantitative restriction based on the average import levels for the last three representative years is used, we do not address the question of whether the quota level was calculated consistently with the second sentence of Article 5.1.

I. Claims under Article 12

1. Incomplete and Untimely Notifications

(a) Arguments of the Parties

7.112 The European Communities claims that Korea failed to notify its measure in a timely fashion and with sufficient detail contrary to Article 12.1 and 12.2 of the Safeguards Agreement. The European Communities argues that in view of the limitative character of safeguard measures, their inclusion in the WTO system is accompanied by limits to their use, so that the interests of all the parties may be

[471] *See* para. 4.628, *supra*.
[472] *See* para. 4.671, *supra*.

protected. As regards notifications under Article 12.1(b) and (c), one specific purpose is to offer the Members concerned an opportunity for adequate consultations. Effective exercise of these rights by WTO Members calls for a minimum guaranteed level of information officially transmitted in one of the working languages of the WTO.

7.113 Korea responds that its notifications are consistent with the guidance issued by the Committee on Safeguards and with the Technical Cooperation Handbook on Notification Requirements. For Korea, its notifications provided the European Communities with all pertinent information. In its view, the purpose of the notification pursuant to Article 12 is to provide the Committee on Safeguards with information which is to be disseminated to Members to facilitate meaningful prior consultations under Article 12.3 and, where appropriate, consultations under Article XXII of GATT 1994. This function is implied both by the structure of Article 12, which includes both notification and consultation, and by the final sentence of Article 12.2 which provides that "The Council for Trade in Goods or the Committee on Safeguards may request such additional information as they may consider necessary from the Member proposing to apply or extend the measure." For Korea, if the purpose of Article 12 were to replicate the exacting standards of Article 3 and 4.2(c), the final sentence of Article 12.2 would be redundant.

(b) The Notifications under Examination

7.114 We asked Korea to clarify for us the sequence of its WTO notifications. In light of its response, we understand that the following notifications were made:

(a) 11 June 1996, G/SG/N/6/KOR/2, circulated on 1 July 1996. Notification of the KTC's decision to initiate an investigation on 17 May 1996. (Circulated as an Article 12.1(a) notification, of the initiation of an investigatory process relating to serious injury or threat thereof and the reasons for it). (See Exhibit EC-1).

(b) 2 December 1996, G/SG/N/8/KOR/1, circulated on 6 December 1996. Notification of the completion of the report by the Office of Administration and Investigation (OAI) that provided the basis for the KTC's determination of injury (on 23 October 1996). This notification stated: "The Korean Trade Commission has not made a decision to apply a safeguard measure yet. Therefore, there is no information on such a measure at this time. The KTC will recommend to the relevant Minister an appropriate remedial measure within 45 days of the injury determination." This document was circulated as an Article 12.1(b) notification of a finding of serious injury or threat thereof caused by increased imports. (See Exhibit EC-2)

In this case, the KTC decided on the relief measure, namely the quota, on 2 December 1996, and recommended it on 6 December 1996 to the Minister for Agriculture and Forestry for his consideration.[473] Korea stated that the KTC's recommendation on relief measures is not made

[473] *See* para. 4.113, *supra*.

public because it is only a recommendation that has no legal effect and that is subject to change by the relevant Minister.

(c) 21 January 1997, G/SG/N/10/KOR/1, circulated on 27 January 1997, as an Article 12.1(c) notification of a decision to apply or extend a safeguard measure. In the notification Korea invited interested Members for consultations during the week of 3 February 1997, "before it makes a final decision on the measure by the week beginning 24 February 1997." (See Exhibit EC-5)

(d) 31 January 1997, G/SG/N/11/KOR/1 circulated on 21 February 1997. Notification of non-application of the proposed safeguard measure to developing countries. (Footnote 2 of Article 9 of the Agreement on Safeguards). (See Exhibit EC-6)

(e) 24 March 1997, G/SG/N/10/KOR/1/Suppl.1, circulated on 1 April 1997 as a supplemental notification under Article 12.1(c). Notification of the Minister of Agriculture and Forestry's decision of 1 March 1997 to impose a measure. This notification contained an attachment with further detailed information following the 6 February 1997 consultations and the special Committee on Safeguards meeting. (See Exhibit EC-10)

(c) Analysis of Article 12 of the Agreement on Safeguards

7.115 We shall proceed in the following way: First, we will examine the provisions of Article 12 generally in order to determine which WTO Members' actions or measures ought to be notified, the content of these notifications and their timing; Second, we shall examine each of Korea's notifications and assess their compatibility with the requirements of Article 12 of the Agreement on Safeguards.

(i) What Actions Must be Notified

7.116 It is clear that the provisions of Article 12 of the Agreement on Safeguards prevail over the Guidance issued by the Committee on Safeguards[474] (which contains a disclaimer to that effect) and the Technical Cooperation Handbook on Notification Requirements (prepared by the Secretariat but which explicitly states that it "does not constitute a legal interpretation of the notification obligations under the respective agreement(s)"). At issue in this case are the notifications required under Articles 12.1(a), (b) and (c).

7.117 The wording of Article 12 provides that a number of types of actions must be notified to the WTO Committee on Safeguards by Members proposing to use the provisions of the Agreement on Safeguards. Article 12.1 refers to three such actions, by inference Article 12.2-3 refers to a fourth item and Article 12.6 to a fifth item.

7.118 Article 12.1 requires notification to the Committee on Safeguards of (a) the initiation of an "investigatory process relating to serious injury or threat thereof and

[474] *See* document G/SG/1.

the reasons for it"; (b) any "findings of serious injury or threat thereof caused by increased imports"; and (c) any "decision to apply or extend a safeguard measure".

7.119 Articles 12.2 and 12.3 set forth the required content of such notifications, and provide as well certain guidance as to the sequence of events to be followed in the notifications and related consultations. These Articles read as follows:

> "2. In making the notifications referred to in paragraphs 1(b) and 1(c), the Member proposing to apply or extend a safeguard measure shall provide the Committee on Safeguards with all pertinent information, which shall include evidence of serious injury or threat thereof caused by increased imports, precise description of the product involved and the proposed measure, proposed date of introduction, expected duration and timetable for progressive liberalization…."
>
> "3. A Member proposing to apply or extend a safeguard measure shall provide adequate opportunity for prior consultations with those Members having a substantial interest as exporters of the product concerned, with a view to, *inter alia*, reviewing the information provided under paragraph 2, exchanging views on the measure and reaching an understanding on ways to achieve the objective set out in paragraph 1 of Article 8."

7.120 Although not explicitly listed in Article 12.1, the wording of Article 12.2 and 12.3 make it clear that any proposed measure must also be notified to the Committee on Safeguards. Article 12.2 provides that the notifications under Article 12.1(b) and 12.1(c) must contain information as to the basis for the serious injury finding, as well as information as to the "proposed" measure to be applied. Article 12.3 requires that the notifying Member provide an adequate opportunity for "prior consultations" with interested Members, that is, consultations prior to the actual application of the measure. Article 12.3 further requires that among the information to be discussed in the consultations is the information already notified under Article 12.1(b) and 12.1(c), i.e., the basis for the serious injury finding, and the details of the measure that the notifying Member proposes to apply. Thus, Article 12.1, 12.2 and 12.3 taken together makes it clear that before a definitive safeguard measure may be applied, the Member proposing to apply it must notify all the pertinent information regarding the proposed measure and the factual basis (the injury finding) for applying it, and must provide an opportunity for consultations with Members whose trade will be affected by the proposed measure. In other words, details of the measure proposed must be notified before it is applied, so that affected Members may consult about it before it takes effect. Therefore, we reject Korea's argument that it was not obliged to notify its proposed measure, but we note that Korea did do so.

7.121 Finally, pursuant to Article 12.6, a provisional measure shall also be notified to the Committee on Safeguards.

(ii) The Content of such Notifications

(1) 12.1(a)

7.122 Regarding the "content" of notifications under Article 12.1, we note that with regard to the notification of the initiation of an investigation, the terms of Article

12.1(a) only refer to the obligation to notify "initiating an investigatory process relating to serious injury or threat thereof and the reasons for it".

7.123 We also note that the notification under Article 12.1(a) does not have to take place before the investigation is initiated, but rather immediately upon its initiation. In this context, we recall that there is no individual country notification (as there exists for instance for antidumping actions) under the Agreement on Safeguards, presumably because in principle the safeguard measure is to be applied on an MFN basis. The purpose of the notification under paragraph 1(a) of Article 12 is to inform all WTO Members of the initiation of an investigation so that Members having a substantial interest may exercise their rights to participate in the investigation (provided for under Article 3.1) in the first instance and possibly to request consultations under Article 12.3.

(2) 12.1(b) and (c)

7.124 For the notifications envisaged under paragraphs 1(b) and (c) of Article 12, i.e. the finding of serious injury caused by imports, the proposed measure and the decision to apply a measure, we note that the terms of Article 12.2 provide for a standard expressed in terms of an overall and a specific requirement as to the content of these notifications. First, there is a reference to "all pertinent information" (the overall criterion) and then there is a list of factors (the specific criteria) presumed to be pertinent information for which information must be provided.

> "12.2 In making the notifications referred to in paragraphs 1(b) and 1(c), the Member proposing to apply or extend a safeguard measure shall provide the Committee on Safeguards with *all pertinent information*, which shall *include* evidence of serious injury or threat thereof caused by increased imports, precise description of the product involved and the proposed measure, proposed date of introduction, expected duration and timetable for progressive liberalization." (emphasis added)

Article 12.2 refers thereby to six more specific items which must be covered by such notifications. Thus it is necessary to notify: (1) evidence of serious injury or threat thereof that was caused by increased imports, (2) the precise description of the product involved, (3) the proposed measure, (4) the proposed date of introduction, (5) the expected duration and (6) the timetable for progressive liberalization.

7.125 In our examination of the context of the expression "all pertinent information" in Article 12.2, we note that the same word "pertinent" is also used in Article 3, with reference to the domestic publication of the overall report. But Article 12 refers to "all pertinent information", while Article 3 refers to "all pertinent issues of fact and law". The term "information" differs from "issues of fact and law", the former being more general. Based on the ordinary meaning of the terms and their context, a distinction may be made between the less stringent requirement of "all pertinent information" for the purpose of the WTO notification (Article 12), and "all pertinent issues of fact and law" for the purpose of the final report (Article 3) which must be published domestically. "Information" (Article 12) on a matter is certainly less comprehensive than a "report setting forth … reasoned conclusions" (Article 3) on the same matter.

7.126 The term "pertinent information" ought to be interpreted taking into account the context of Article 12 and the object and purpose of the Agreement on Safeguards and its notification requirements. We think that the notification serves essentially a transparency and information purpose. In ensuring transparency[475], Article 12 allows Members through the Committee on Safeguards to review the measures. Another purpose of the notification of the finding of serious injury and of the proposed measure is to inform Members of the circumstances of the case and the conclusions of the investigation together with the importing country's particular intentions. This allows any interested Member to decide whether to request consultations with the importing country which may lead to modification of the proposed measure(s) and/or compensation.[476]

7.127 We understand the European Communities to argue that, although in a summary form, Members should notify to the WTO (pursuant to Article 12 of the Agreement on Safeguards) everything they are required to publish domestically pursuant to Articles 3 and 4 of the Agreement on Safeguards. We consider that the standards of what must be published domestically and what ought to be notified to the WTO are different. If Members, when they negotiated the Agreement on Safeguards, intended that what was to be published domestically also had to be notified to the WTO, they could have made such a requirement clear by simply referring in Article 12 to the publication requirements mentioned in Articles 3 and 4. However, the ordinary meaning of the word "information" implies that the other Members must gain knowledge of the actions undertaken by the notifying Member. In this sense, the amount of information notified must be sufficient to be useful to Members with a substantial interest in the proposed safeguard measure. We note that while not required by the Agreement on Safeguards, and not included as an element of information in the agreed notification formats adopted by the Committee, it may be desirable for the notification to include a reference to the published report on the case referred to in Articles 3.1 and 4.2. Such reference would, however, not replace the requirements of Article 12. We note finally that the Committee has the power to

> "request such additional information as they may consider necessary from the Member proposing to apply or extend the measure".[477]

(iii) The Timing of such Notifications

7.128 Article 12.1 provides that "A Member shall *immediately* notify the Committee on Safeguard upon …" (emphasis added). The ordinary meaning of the term "immediately"[478] introduces a certain notion of urgency. As discussed above, we believe that the text of Article 12.1, 12.2 and 12.3 makes clear that the notifications on the finding of serious injury and on the proposed measure shall in all cases

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[475] We recall the need for transparency of Members' actions as emphasized in the Marrakesh Decision on Notification Procedures.

[476] Article 12.3 explicitly provides that among the topics to be discussed are the objective of Article 8.1, i.e. endeavouring to maintain a substantially equivalent level of concession and other obligations to that existing under GATT.

[477] Article 12.2 of the Agreement on Safeguards.

[478] The New Webster Encyclopedic Dictionary defines immediately as "without delay, straightaway"; the New Shorter Oxford Dictionary defines it as "without delay, at once, instantly".

precede the consultations referred to in Article 12.3. We note finally that no specific number of days is mentioned in Article 12. For us this implies that there is a need under the agreement to balance the requirement for some minimum level of information in a notification against the requirement for "immediate" notification. The more detail that is required, the less "instantly" Members will be able to notify. In this context we are also aware that Members whose official language is not a WTO working language, may encounter further delay in preparing their notifications.

7.129 We shall now proceed to examine the European Communities' claims with regard to the notifications made by Korea, and determine whether such notifications respect the requirements of Article 12 as to their content and timing.

(d) Examination of the Specific Notifications by Korea

(i) Notification Pursuant to Article 12.1(a): the Initiation of the Investigation - 1 July 1996, G/SG/N/6/KOR/2

7.130 Korea's notification states the date of the initiation of the investigation, the products covered and then refers to two reasons for the initiation of the investigation: a petition was filed and the level of imports had increased. There is no explicit reference to any serious injury to the domestic industry, but Korea does refer to an initiation pursuant to Article 12.1(a) of the Agreement on Safeguards.

7.131 We disagree with the European Communities that such notification should necessarily include a discussion of all of the legal requirements for a safeguard action to be taken such as a discussion of the conditions of the markets, etc. We note that initiation is the beginning of the process, and the Agreement on Safeguards does not establish specific standards for the decision to initiate, as do Article 5 of the Agreement on the Implementation of Article VI of GATT 1994 and Article 11 of the Agreement on Subsidies and Countervailing Measures. Thus, to require a discussion in the notification of initiation of evidence regarding the elements that must be found to exist to impose a measure at the end of the investigation would impose a requirement at the initiation stage that is not required by the Agreement on Safeguards itself. We note in the first instance that whatever the relationship between the requirements of Article 12.2 regarding the contents of notifications and the contents of the investigation reports published pursuant to Articles 3.1 and 4.2, this question is not relevant to Article 12.1(a) notifications, as Article 12.2 specifically and exclusively addresses "notifications referred to in paragraphs [12.]1(b) and [12.]1(c)".

7.132 The format agreed by the Committee for notifications under Article 12.1(a) is not legally binding, although helpful. The guidance in the format is general as to the kind of information to be provided, referring simply to examples of information on the reasons for initiation, and saying nothing about the level of detail of that information.

7.133 Although Korea's notification could usefully have included a reference to allegations of serious injury and a cross-reference to any domestic publication(s) in Korea, we think that this notification was sufficient to inform WTO Members adequately of Korea's initiation of an investigation concerning a particular product, so that Members having an interest in the product could avail themselves of their right to participate in the domestic investigation process.

7.134 As to the timing of this notification, we note a delay of 14 days (28 May 1996 to 11 June 1996) between the publication of the initiation decision and its notification to the WTO.[479] We recall that Members are required to notify the initiation of any investigation "immediately", although no specific time-period is identified. We note, moreover, that the content of the Article 12.1(a) notification is minimal. Recalling again the reasons for the requirement of a notification without delay, we believe that any delay in Article 12.1(a) notifications can be problematic. We therefore disagree with Korea that it satisfied the requirement for an immediate notification because it did so "as soon as practically possible". There is no basis in the wording of Article 12.1 to interpret the term "immediately" to mean "as soon as practically possible". In light of all of the foregoing considerations, we find that the 14-day period between Korea's initiation of the investigation and its presentation of the notification related thereto, does not respect the requirements for "immediate" notification and is in violation of Article 12.1 of the Agreement on Safeguards.

(ii) Notification Pursuant to Article 12.1(b) and 12.2: Determination of Serious Injury Caused by Increased Imports - 2 December 1996, G/SG/N/8/KOR/1

7.135 Korea's notification of the finding of serious injury caused by increased imports stated that imports had grown, that the domestic industry's share of domestic consumption had decreased and domestic stocks had increased. There is no explicit reference to any analysis of the level of sales, production, productivity, and employment as such, nor is there any reference to any causation element. We note that there is no cross-reference to the domestic publication of this finding of serious injury where the reader would find further information.

7.136 We consider, however, that this notification contains sufficient information on what Korea considered to be evidence of injury caused by increased imports as well as on the other listed items in Article 12.2. We note that there is no explicit requirement to explain how such injury has been caused by increased imports. Rather the requirement is to notify "evidence of injury caused". We note that the last sentence of Article 12.2 allows for the possibility to request additional information. We find that Korea's notification would permit the effective exercise of the right of other Members to request consultations. Consequently, we consider that the content of that Korean notification made pursuant to Article 12.1(b) meets the requirements of Article 12.2 of the Agreement on Safeguards.

7.137 As to the timing of such notification, we note that, although it was made two months prior to the consultations, a delay of 40 days (23 October 1996 to 2 December 1996) between the domestic publication of the injury finding and the date of that notification to the Committee on Safeguards took place. We find that this delay does not satisfy the requirements for an immediate notification and therefore is in violation of Article 12.1 of the Agreement on Safeguards.

[479] We note, however, a period of 34 days between the domestic publication of the initiation decision, 28 May 1996, and the date of the circulation of the said notification to all WTO Members, i.e. 1 July 1996.

(iii) Notification Pursuant to Article 12.1(c) and 12.2: Proposed Measure - 21 January 1977, G/SG/N/10/KOR/1

7.138 As we mentioned before, we are of the view that Members are obliged under Article 12.1(c) to notify any decision with regard to the proposed imposition of a safeguard measure. Korea did so on 21 January 1997.

7.139 Considering that an important purpose of the notifications of the serious injury determination and the proposed measure is to provide other Members with an effective possibility to request consultations, we examine only the notifications of 2 December 1996 and 21 January 1997 which are the only notifications which were circulated before the consultations of 6 February 1997. The notification of 2 December 1996 is discussed above. We consider that this notification contains sufficient information on what Korea considered to be evidence of injury caused by increased imports as well as on the other listed items in Article 12.2. We note that there is no explicit requirement to explain how such injury had been caused. Rather one of the listed factors is "evidence of injury caused by increased imports". We note again that the last sentence of Article 12.2 allows for the possibility to request additional information. Consequently, we consider that the content of that Korean notification of its proposed measure, made pursuant to Article 12.1(c), meets the requirements of Article 12.2 of the Agreement on Safeguards as it contains sufficient information on the proposed measure, e.g. its nature, scope and duration, to provide Members with a substantial interests with adequate information to request consultations.

7.140 As to its timing, we note that this notification took place more than 6 weeks after the decision on the proposed measure was taken (6 December 1996 to 21 January 1997). For us, this is not an "immediate" notification. We consider that this delay does not meet the requirements for an "immediate" notification and therefore is in violation of Article 12.1 of the Agreement on Safeguards.

(iv) Notification Pursuant to Article 12.1(c) : the Taking of the Safeguard Measure - 24 March 1997, G/SG/N/10/KOR/1. Suppl.

7.141 Following the consultations with interested Members and the special meeting of the Committee on Safeguards, Korea notified a revised description of its investigation process and the measure it had by then imposed. This notification is, in the present case, the more complete one.

7.142 We consider that provision of additional notifications following consultations may be helpful in furthering multilateral transparency, that it may be evidence of adequate consultations and may also constitute a rectification of prior, incomplete notifications.[480] In this context, we recall that one of the purposes of consultations is to review the Article 12.1(b) and (c) notifications, logically implying that such

[480] In our view, in the event that a Member considers that it has to revise or to correct its notification, that Member may, but is not obligated to, offer further consultations on this revised notification before any definitive measure is imposed, in an attempt to prevent any eventual dispute settlement proceedings based on an alleged violation of Article 12.

consultations may lead to revision and rectification of those notifications. The wording of Article 12.2 and 12.3 seems to confirm this possibility.

7.143 In our view notifications can always be revised. However, we cannot accept Korea's argument that the fact that the European Communities and Korea almost "settled" this case is evidence that the notification was sufficient. Parties may settle a case on the basis of additional information provided during the consultation and not contained in the prior notification.

7.144 As far as it covers Korea's final decision to take a safeguard measure[481], we find that the content of the Korean notification of 24 March 1997 meets the requirements of Article 12.1(c) and 12.2 of the Agreement on Safeguards.

7.145 As to the timing of this notification (as far as it covers Korea's final decision to take a safeguard measure), we note that Korea notified on 24 March 1997 that on 1 March 1997 a final decision had been taken to impose a quota as a safeguard measure. We fail to see how this can be viewed as an immediate notification. As far as it covers Korea's final decision to take a safeguard measure, we find that the timing of the Korean notification of 24 March 1997 does not meet the requirements of Article 12.1 of the Agreement on Safeguards.

2. Claim of Inadequate Consultations

7.146 The European Communities first claim that since Korea's notifications, which serve as the basis for the consultations, were incomplete and untimely, the consultations were therefore inadequate. For the European Communities, in order for the opportunity to consult to be adequate pursuant to Article 12.3, consultations must take place on *all the pertinent information* to be provided under Article 12.2 in advance of the consultations, including the evidence to be supplied in the notifications of injury findings and of the results of the investigation.

7.147 The European Communities further argue that Article 12.3, when specifying that it is for the Member "proposing to apply a safeguard measure " to offer to consult, *inter alia*, on the "proposed measure", implies that consultations must take place *before* the measure is applied (i.e. when it is still a "proposal"). We agree with the European Communities on this issue. Notification of the proposed measure must take place before the consultations.

7.148 In the present case, a special meeting of the Committee on Safeguards took place on 21 February 1997 and Korea held bilateral consultations with the European Communities, Australia and New Zealand on 4 and 5 February 1997 in Geneva. By failing to provide all pertinent information in its notifications in advance of consultations (and specifically those notifications made pursuant to Article 12.1(b) and (c)), the European Communities argues that Korea prevented WTO Members having a substantial interest as exporters from engaging in meaningful consultations, thus failing to provide them with an adequate opportunity in this respect. As a

[481] This notification can only be viewed as a notification of the final decision taken since it was notified and circulated only after the final decision was put into force; this notification cannot be taken into account for the purpose of assessing whether Korea complied with its obligation to notify its proposed measure since this notification took place after the consultations, and therefore cannot remedy the flaws in the previous notification.

consequence, it also frustrated the further objective of those consultations, namely to reach an agreement or to ensure the maintenance of the balance of concessions as foreseen in Article 8.1 of the Agreement on Safeguards.

7.149 Korea responds that after receiving two requests for consultations under Article 12.3 of the Agreement on Safeguards, it provided (although, according to Korea, this was not required) a preliminary notification of the proposed measure, under Article 12.1(c) on 21 January 1997. We have already mentioned that we consider that Members are under an obligation to notify any proposed measures and must also invite any interested party to consult on this issue. Korea adds that consultations were certainly fruitful as they almost resulted in a mutually agreed solution. The European Communities responds that the case was never settled but that in any case the information and responses submitted by Korea never provided it with all pertinent information.

7.150 We have found above that the content of Korea's notifications was in conformity with the provisions of Article 12. Moreover, we consider that consultations may be adequate even in circumstances where prior notifications of a finding of serious injury or of any proposed measure are incomplete. In fact one of the purposes of the consultations is to review the content of such notifications (and thereby augment it if necessary). During consultations parties usually exchange further information, exchange questions and answers and proceed to a thorough discussion of the national authority's determinations.

7.151 The parties have explicitly requested us to assess the compatibility of their consultations with the requirements of the Agreement on Safeguards, based on the chronology of events that they submitted to us.[482] We note that no formal mutually agreed solution was reached by the parties in this dispute, but we do not consider that the only criterion for assessing the adequacy of consultations is whether parties through such consultations settle their dispute. Many formal dispute settlement proceeding take place following consultations which are WTO compatible and which do not lead to a mutually agreed settlement of the dispute.

7.152 In the present case we note that parties exchanged questions and answers. The European Communities claims that it has always been unsatisfied with the Korean's answers and notifications (together with Korea's determination). This may be the case and would explain why it decided to pursue dispute settlement proceedings, but it does not prove that Korea did not consult in good faith for the purpose of informing interested Members of its investigation, its conclusion and its proposed actions. We note also that Korea did impose a measure at a level and for a duration different, and less restrictive, than initially proposed. Consultations were certainly fruitful in this respect, albeit not sufficient to satisfy the European Communities.

7.153 We reject therefore the EC claim that Korea failed to provide adequate opportunity to consult. Moreover, it seems to us that such consultations have led to an important revision of the initial notification and that parties, at some point, entered into very serious negotiations and considered serious elements of a mutually agreed solution. The fact that this proposed settlement was not formalized through the acceptance by the relevant internal authorities of the European Communities is

[482] *See* paras.4.730 and 4.762 *supra*.

immaterial. What is relevant for the purpose of this EC claim, is the fact that the parties to these consultations were able to negotiate quite effectively, which, in our view, demonstrates that the consultations were adequate. For us, this is the purpose of any consultation process and the scope of the obligation contained in Article 12.3 of the Agreement on Safeguards, i.e. to favour efforts by the parties to reach a mutually agreed solution of their disagreement. In our view Korea has very well respected its obligation during the consultation process in this case. We therefore reject this EC claim made pursuant to Article 12.3 of the Agreement on Safeguards.

VIII. CONCLUSIONS AND RECOMMENDATIONS

8.1 In the light of the findings above, we conclude that the definitive safeguard measure was imposed inconsistently with the provisions of the Agreement on Safeguards in that

(a) Korea's serious injury determination is not consistent with the provisions of Articles 4.2(a) of the Agreement on Safeguards;

(b) Korea's determination of the appropriate safeguard measure is not consistent with the provisions of Article 5 of the Agreement on Safeguards;

(c) Korea's notifications to the Committee on Safeguards (G/SG/N/6/KOR/2, G/SG/N/8/KOR/1, G/SG/N/10/KOR/1, G/SG/N/10/KOR/1. Suppl) were not timely and therefore are not consistent with the provisions of Article 12.1 of the Agreement on Safeguards.

8.2 In the light of the findings above, we reject

(a) the European Communities' claim that Korea violated the provisions of Article XIX:1 of GATT by failing to examine the "unforeseen developments";

(b) the European Communities' claim that Korea violated the provisions of Article 2.1 of the Agreement on Safeguards by failing to examine, as a separate and additional requirement, the "conditions" under which increased imports caused serious injury to the relevant domestic industry;

(c) the European Communities' claims that the content of Korea's notifications to the Committee on Safeguards (G/SG/N/6/KOR/2, G/SG/N/8/KOR/1, G/SG/N/10/KOR/1, G/SG/N/10/KOR/1. Suppl) did not meet the requirements of Article 12.1, 12.2 and 12.3 of the Agreement on Safeguards;

(d) the European Communities' claim that Korea violated the provisions of Article 12.3 of the Agreement on Safeguards in refusing to offer appropriate consultations to the European Communities.

8.3 Under Article 3.8 of the DSU, in cases where there is infringement of the obligations assumed under a covered agreement, the action is considered *prima facie* to constitute a case of nullification or impairment of benefits under that agreement. Accordingly, we conclude that to the extent that Korea has acted inconsistently with the provisions of the Agreement on Safeguards, as described in paragraph 8.1 *supra*,

it has nullified or impaired the benefits accruing to the European Communities under that agreement.

8.4 The Panel *recommends* that the Dispute Settlement Body request Korea to bring its measures into conformity with its obligations under the WTO Agreement.

CHILE - TAXES ON ALCOHOLIC BEVERAGES

Report of the Appellate Body
WT/DS87/AB/R, WT/DS110/AB/R

Adopted by the Dispute Settlement Body
on 12 January 2000

Chile, *Appellant*
European Communities, *Appellee*
Mexico, *Third Participant*
United States, *Third Participant*

Present:
Feliciano, Presiding Member
Ehlermann, Member
Lacarte-Muró, Member

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I. INTRODUCTION

1. Chile appeals certain issues of law and legal interpretation developed in the Panel Report, *Chile - Taxes on Alcoholic Beverages*.[1] Following a request for consultations[2], a Panel was established on 25 March 1998 by the Dispute Settlement Body (the "DSB") to consider a complaint by the European Communities against Chile regarding its Special Sales Tax on Spirits, as modified by the Additional Tax on Alcoholic Beverages ("Impuesto Adicional a las Bebidas Alcohólicas" or "ILA").[3]

2. The ILA provides a transitional tax system (the "Transitional System") for distilled spirits ("spirits") which is applicable until 1 December 2000, and a revised tax system (the "New Chilean System") which will be applied from 1 December 2000.[4] The New Chilean System taxes all spirits on the basis of their alcohol content and price. Spirits with an alcohol content of 35° or less are taxed at a rate of 27 per cent *ad valorem*. From a rate of 27 per cent *ad valorem*, the tax rate increases in increments of 4 percentage points per additional degree of alcohol, until a maximum rate of 47 per cent *ad valorem* is reached for all spirits over 39°.[5] The Panel found that roughly 75 per cent of the total volume of domestically produced spirits will be taxed at 27 per cent *ad valorem*, while over 95 per cent of the total volume of imported spirits will be taxed at 47 per cent *ad valorem*.[6] A detailed description of the factual aspects of the dispute is provided at paragraphs 2.1 to 2.29 of the Panel Report.

3. The Panel considered claims made by the European Communities that the measure at issue is inconsistent with Article III:2, second sentence, of the General Agreement on Tariffs and Trade 1994 (the "GATT 1994") because it accords preferential tax treatment to pisco, a distilled alcoholic beverage produced in Chile, thereby affording "protection" to domestic production in relation to certain imported alcoholic beverages. The Panel Report was circulated to the Members of the World Trade Organization (the "WTO") on 15 June 1999. The Panel reached the conclusion that "the domestic distilled alcoholic beverages produced in Chile, including pisco, and the imported products presently identified by HS classification 2208, are directly competitive or substitutable products." [7] The Panel also concluded that both the "Transitional System and [the] New Chilean System provide for dissimilar taxation

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1 WT/DS87/R, WT/DS110/R, 15 June 1999.

2 On 4 June 1997, the European Communities requested consultations with Chile with regard to the Special Sales Tax on Spirits (WT/DS87/1). On 15 December 1997, the European Communities further requested consultations with Chile with regard to the modifications to the Special Sales Tax on Spirits introduced by the enactment of the Additional Tax on Alcoholic Beverages, contained in Law No. 19,534 of 13 November 1997 (WT/DS110/1).

3 Pursuant to Article 9.1 of the DSU, the DSB, at its meeting of 25 March 1998, agreed that the Panel established on 18 November 1997 to examine the complaint contained in document WT/DS87/5 should also examine the complaint contained in document WT/DS110/4.

4 Panel Report, para. 2.3.

5 *Ibid*., paras. 2.5 and 2.6, and Table 2.

6 Panel Report, para. 7.158.

7 *Ibid*., para. 8.1. The imported products identified in HS classification 2208 include the following: whisky, brandy, rum, gin, vodka, liqueurs, aquavit, korn, fruit brandies, ouzo and tequila (*Ibid*., para. 2.7).

of the imports in an amount that is greater than *de minimis* levels."[8] Furthermore, the dissimilar taxation in both systems was found to be "applied in a manner so as to afford protection to Chile's domestic production."[9] As a result, the Panel concluded that "there is nullification or impairment of the benefits accruing to the complainant under GATT 1994 within the meaning of Article 3.8 of the Dispute Settlement Understanding"[10], and recommended that the DSB request Chile to bring its taxes on distilled alcoholic beverages into conformity with its obligations under the GATT 1994.[11]

4. On 13 September 1999, Chile notified the DSB of its intention to appeal certain issues of law and legal interpretation developed by the Panel, pursuant to paragraph 4 of Article 16 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "DSU"), and filed a Notice of Appeal with the Appellate Body, pursuant to Rule 20 of the *Working Procedures for Appellate Review* (the "*Working Procedures*"). In its Notice of Appeal, Chile appealed certain of the Panel's findings with respect to the New Chilean System. [12] On 23 September 1999, Chile filed its appellant's submission.[13] On 8 October 1999, the European Communities filed its appellee's submission[14] and Mexico and the United States filed their respective third participant's submissions.[15] The oral hearing in the appeal was held on 20 October 1999.[16] At the oral hearing, the participants and the third participants presented oral arguments and answered questions from the Division of the Appellate Body hearing the appeal.

II. ARGUMENTS OF THE PARTICIPANTS AND THIRD PARTICIPANTS

A. *Claims of Error by Chile - Appellant*

1. "Not Similarly Taxed"

5. Chile argues that the Panel erred in finding that the New Chilean System results in dissimilar taxation of directly competitive or substitutable imported and domestic products under Article III:2, second sentence, of the GATT 1994. Chile asserts that it is important to adopt the "proper perspective"[17] when determining whether dissimilar taxation exists: margins of difference in the taxation of imported and domestic products will vary depending on the perspective chosen.

6. The New Chilean System taxes all distilled alcoholic beverages, irrespective of their origin or type, according to the same criteria: alcohol content and price.

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8 Panel Report, para. 8.1
9 *Ibid.*
10 *Ibid.*
11 *Ibid.*, para. 8.2.
12 Chile does not appeal the Panel's findings on the Transitional System.
13 Pursuant to Rule 21(1) of the *Working Procedures.*
14 Pursuant to Rule 22(1) of the *Working Procedures.*
15 Pursuant to Rule 24 of the *Working Procedures.*
16 Pursuant to Rule 27 of the *Working Procedures.*
17 Chile's appellant's submission, page 13, heading 4.

These are standard, non-"arbitrary"[18] criteria widely used in the taxation of alcoholic beverages.

7. According to Chile, the Panel chose an incorrect perspective from which to examine the New Chilean System. The Panel looked at the system in two alternative ways: as if it were an *ad valorem* tax and as if it were a specific tax. It was the decision to use this erroneous perspective that led to the Panel's conclusion that dissimilar taxation existed. Chile objects to the fact that the Panel viewed its system with "skepticism" simply because it was a "hybrid", or mixed, system applying two criteria, instead of one. [19]

8. Since the Panel looked at the tax from the wrong perspective, it considered the *effect* of the tax rather than the tax *as such*. The consequence is that dissimilarities appear. However, these perceived dissimilarities in taxation result simply from dissimilarities in the alcohol content and price of different types of alcoholic beverage.

9. The Panel should have looked at the tax as a percentage of the price of a distilled alcoholic beverage of a particular alcohol content. If looked at in this way, the system applies an identical *ad valorem* tax rate to *all* products of a particular alcohol content, regardless of origin.

10. Chile believes that the Panel Report, if upheld, would require WTO Members to adopt tax systems based on either an *ad valorem* or a specific tax. In practice, only these two types of tax system would be permitted under WTO rules. This would seriously limit the freedom of WTO Members in establishing tax policies, since the practical effect of the Panel's finding would be that "hybrid" systems are not permitted.

2. "So as to Afford Protection"

11. Chile argues that this case is very different from *Japan - Taxes on Alcoholic Beverages* ("*Japan - Alcoholic Beverages*")[20] and *Korea - Taxes on Alcoholic Beverages* ("*Korea - Alcoholic Beverages*")[21] in that the New Chilean System is not discriminatory. Chile's tax law does not identify products by name or refer to their characteristics. The New Chilean System distinguishes between products on the basis of two widely accepted criteria: alcohol content and price. For this reason, imports are able to compete with domestic products in each and every tax category. The European Communities and other exporters produce numerous alcoholic beverages that will fall into the lowest tax bracket. The fact that more domestic products than imported products fall into the lowest tax bracket cannot be attributed to the New Chilean System. This product distribution is based on market factors, and the market is subject to change and evolution in the future.

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[18] Chile's appellant's submission, para. 39.

[19] *Ibid*., paras. 40 and 41.

[20] Appellate Body Report, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, adopted 1 November 1996, DSR 1996:I, 97.

[21] Appellate Body Report, WT/DS75/AB/R, WT/DS84/AB/R, adopted 17 February 1999, DSR 1999:I, 3.

12. Chile stresses that many domestic products, such as Chilean whisky, brandy, rum, gin, vodka, gran pisco, and pisco reservado, will fall into the highest tax bracket. Applying the New Chilean System to current trade, in volume terms, the burden of the highest tax bracket would fall mainly on domestic products: 70 per cent of the products in the tax brackets applying to products of an alcoholic strength of more than 35° are Chilean, and 63 per cent of the products in the tax bracket applying to products of an alcoholic strength of more than 39° are also Chilean. The Panel erred by disregarding the existence of many domestic products subject to the higher tax brackets.

13. Chile contends that there is nothing inherently "domestic" or "imported" about the production of a beverage of a particular alcoholic strength. Both domestic and foreign producers can and do produce spirits of different strengths. Therefore, the Panel's conclusion that the tax is applied "so as to afford protection" was erroneous.

14. Chile asserts that the Panel erred in finding that the stated objectives of the measure were "inconsistent"[22] with the measure. While perhaps not fully successful in achieving the objectives, the measure is not inconsistent with its goals. Such a finding constitutes an indirect evaluation by the Panel of the "efficiency"[23] of the policies of WTO Members. This is inappropriate. A WTO Member has the right to choose between different tax systems and the mere fact that one system may "inconvenience"[24] imports more than another system does not render it inconsistent with WTO law. The Panel was wrong even to consider Chile's legislative objectives, since the Appellate Body has established that the "so as to afford protection" requirement is not a matter of intent.

15. Finally, Chile insists that the Panel's assertion that there is a "logical connection" between the New Chilean System and the previous tax systems is inappropriate and irrelevant. This statement "seems to be mainly motivated by the old cliché 'once a thief always a thief'." [25]

3. Article 12.7 of the DSU

16. Chile submits that the Panel failed to provide the "basic rationale" for its findings on the "not similarly taxed" issue, as required by Article 12.7 of the DSU. The Panel based its findings on the Appellate Body's findings in *Japan - Alcoholic Beverages*, but the findings in that case do not resolve the question for the more complicated facts of the dispute at hand.

17. In Chile's view, the Panel's findings do not explain how it interpreted the term "not similarly taxed". Furthermore, the Panel did not explain how the New Chilean System could, in the future, satisfy the "similarity" criteria. Finally, in its reasoning, the Panel, in essence, listed and discarded a number of arguments, but did not elaborate on how it reached its own conclusions. Thus, the Panel did not provide a "basic rationale" for its findings as required by Article 12.7 of the DSU.

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22 Chile's appellant's submission, para. 97, and Panel Report, para. 7.154.
23 Chile's appellant's submission, para. 98.
24 *Ibid*., para. 99.
25 *Ibid*., para. 101.

4. Articles 3.2 and 19.2 of the DSU

18. Chile contends that the Panel compromised the "security and predictability" of the multilateral trading system, and added to the obligations provided in the covered agreements, in contravention of Articles 3.2 and 19.2 of the DSU. The violation of Article 3.2 of the DSU arises in part from the absence of a "basic rationale" for the "not similarly taxed" finding in the Panel Report. As a result, the Report leaves Members without clear guidelines as to how to design their systems of taxation. Furthermore, by preferring certain systems of taxation over others, the Panel has unlawfully added to the obligations of WTO Members, in violation of Articles 3.2 and 19.2 of the DSU.

19. Moreover, Chile argues that the Panel's evaluation of the "efficiency" or "rationality" of the measure in light of its stated objectives also adds to the obligations of WTO Members in contravention of Articles 3.2 and 19.2 of the DSU.

B. Arguments by the European Communities - Appellee

1. "Not Similarly Taxed"

20. The European Communities argues that, contrary to Chile's claims, the New Chilean System is like any other *ad valorem* tax system in which different tax rates are applied to different categories of product. All tax systems impose a tax burden based on a percentage of the price (an *ad valorem* tax) or an absolute amount per unit (a specific tax). The New Chilean System is no exception. The fact that *ad valorem* rates vary with alcohol content does not set this system apart from other *ad valorem* systems.

21. According to the European Communities, the "not similarly taxed" issue requires a comparison of the relative tax burdens on imported and domestic products, rather than an examination of the method of taxation, as proposed by Chile. Under the New Chilean System, tax burdens are expressed in *ad valorem* terms, and, therefore, must be compared on that basis. Thus, the Panel's method of analysis, comparing the *ad valorem* rates applied to pisco with the *ad valorem* rates applied to imported spirits, was appropriate.

22. The European Communities argues that panels must compare the tax burden on each individual imported product with the tax burden on each individual directly competitive or substitutable domestic product. This principle requires a comparison between the tax burden on imported spirits and the tax burden on low alcohol content pisco. This comparison leads to a finding of dissimilar taxation of pisco and imported products under the New Chilean System. Chilean law prescribes a minimum alcohol strength for each type of spirit. The principal types of imported spirits are products required to have a minimum alcohol content of 40°, placing them in the highest tax bracket. By contrast, the minimum alcohol content of pisco is 30°, with 35° alcohol content being the most widely consumed pisco, placing these pisco products in the lowest tax bracket. As a result, the tax distinctions between spirits with a different alcohol content under the New Chilean System necessarily lead to

low alcohol content pisco always being taxed "at a lower rate than imported spirits."[26]

23. In addition, the European Communities suggests that if Chile's arguments were adopted it would be extremely easy to circumvent the prohibitions of Article III:2, second sentence, of the GATT 1994. WTO Members would be able to draw many types of distinction between spirits as long as they avoided making formal distinctions based on the name of the product. The result would be that, based on these distinctions, domestic products and imports could in reality be "not similarly taxed". Chile attempts to deal with this problem by distinguishing between the use of tax criteria that are "arbitrary" as against criteria that are "non-arbitrary". However, this distinction has no support in Article III:2, second sentence, of the GATT 1994 and, moreover, Chile offers no guidance as to how "arbitrary" and "non-arbitrary" criteria are to be distinguished from each other.

24. Finally, the New Chilean System is based on an unusual method of taxation that combines two criteria that may conflict. Since higher priced products may, in some cases, have a low alcohol content, the use of *ad valorem* rates will, in those cases, lead to higher tax on high-priced products with low alcohol content than the tax imposed on low-priced products with high alcohol content.

2. "So as to Afford Protection"

25. The core of the Chilean argument is that the structure of the New Chilean System does not support a finding that the law is applied "so as to afford protection" because it does not distinguish between products by name. The European Communities insists that this is irrelevant. The issue is whether the New Chilean System, although "facially neutral"[27], is *de facto* discriminatory under Article III:2, second sentence, of the GATT 1994.

26. The European Communities notes that, contrary to Chile's claim, the Panel did not reject the relevance of the fact that some domestic products were in the highest tax category. The more important fact is that the percentage of domestic products in the highest tax bracket, as compared to the percentage of domestic products in other tax brackets, is "relatively small".[28] The percentage of domestic products in the highest tax bracket is comparable to the equivalent figures in *Japan - Alcoholic Beverages*.

27. Moreover, the fact that there are some imports in the lowest tax bracket does not undermine the Panel's finding that the New Chilean System was applied "so as to afford protection". The amount of imports in this bracket, approximately five percent of total imports, is very small. In both *Japan - Alcoholic Beverages* and *Korea - Alcoholic Beverages*, the existence of a small amount of imports in the lowest tax bracket did not preclude a finding that the measures were applied "so as to afford protection". Furthermore, according to the European Communities, Chile's argument that foreign producers have the opportunity to export low alcohol content products in the future is irrelevant.

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[26] European Communities' appellee's submission, para. 33.
[27] *Ibid*., para. 58.
[28] *Ibid*., para. 63.

28. The European Communities contends that the Panel was right to review the rational connection between the New Chilean System and its stated objectives. The Panel did not evaluate the objectives themselves; it simply examined whether there was a rational connection between the measure and the objectives. This was one piece of evidence supporting the finding of protective application. Furthermore, the Panel did not, as Chile claims, apply a "necessity" test to assess the relationship of the measures with their stated objectives. Certain of the Panel's factual findings establish that the New Chilean System is, in fact, "inconsistent" with its stated policy objectives. Finally, if the Panel's review of the rational connection between Chile's stated objectives and the measure was in error, the other factors cited by the Panel nevertheless constitute sufficient evidence that the measure was applied "so as to afford protection".

3. Article 12.7 of the DSU

29. The European Communities states that Chile's argument that the Panel failed to provide a "basic rationale" for its findings, in contravention of Article 12.7 of the DSU, is, in fact, the same as its argument that the Panel erred in interpreting Article III:2, second sentence, of the GATT 1994. Chile's disagreement with the logic behind the Panel's reasoning is not sufficient to conclude that the Panel failed to provide a "basic rationale" for its findings.

4. Articles 3.2 and 19.2 of the DSU

30. The Panel could only have added to the rights and obligations of WTO Members in contravention of Articles 3.2 and 19.2 of the DSU if it had made a legal error in its interpretation of Article III:2, second sentence, of the GATT 1994. Similarly, Chile's claim that the Panel's findings undermine the "security and predictability" of the multilateral trading system contrary to Article 3.2 of the DSU is premised on an assumption that the Panel erred in its interpretation of Article III:2, second sentence, of the GATT 1994. The European Communities believes that the Panel's findings on Article III:2, second sentence, of the GATT 1994 should be upheld. Therefore, the Panel could not have acted in contravention of Articles 3.2 and 19.2 of the DSU. Finally, it is doubtful whether the first sentence of Article 19.2 of the DSU creates a legal obligation, violation of which would provide the basis for a claim.

C. *Arguments by the Third Participants*

1. Mexico

(a) "Not Similarly Taxed"

31. Mexico notes that, in previous WTO disputes involving Article III:2, second sentence, of the GATT 1994, a simple and direct analysis has been carried out to determine whether imports and domestic products are "not similarly taxed". In this case, the Panel did not deviate from this method. The fact that the Panel recognized the existence of difficulties in the analysis, or omitted to make suggestions on how the New Chilean System could comply with the "not similarly taxed" requirement, is not a legal error.

(b) "So as to Afford Protection"

32. According to Mexico, the Panel was correct to observe that, even though the New Chilean System is based on alcohol content, that System mainly benefits domestic producers. For example, the tax differential between pisco corriente and tequila is very high. This differential is compounded by the fact that the difference in alcohol content between these products is low.

33. Mexico contests Chile's assertion that the Panel erred by examining the consistency of the New Chilean System with its stated objectives. The Panel examined only whether the stated objectives had a logical connection with the measure itself. In any case, this was just one of several elements that the Panel took into account in examining the design, architecture and structure of the New Chilean System.

(c) Article 12.7 of the DSU

34. According to Mexico, the Panel was not obliged to determine how Chile's taxation of distilled alcoholic beverages might comply with Article III:2, second sentence, of the GATT 1994. The Panel's failure to do this does not violate Article 12.7 of the DSU.

(d) Articles 3.2 and 19.2 of the DSU

35. In Mexico's view, the Panel's finding does not prejudice the "security and predictability" of the multilateral trading system under Article 3.2 of the DSU, nor does it "add to or diminish" the rights and obligations of WTO Members under the *WTO Agreement* in terms of Articles 3.2 and 19.2 of the DSU.

2. United States

(a) "Not Similarly Taxed"

36. The United States notes that the tax brackets set forth in the New Chilean System for products with an alcohol content of over 35° affect the vast majority of imports and are subject to steeply increasing *ad valorem* rates. The increased rates do not apply to spirits at or below 35°, which, in fact, are "almost all" pisco, a product that is "by law" Chilean. [29] The result is a difference in tax treatment between those products above and those at or below the 35° threshold. According to the United States, this difference in tax treatment is more than *de minimis*.

37. The United States emphasizes that the existence of dissimilar taxation does not render a tax measure inconsistent with Article III:2, second sentence, of the GATT 1994 because the third issue of "so as to afford protection" must be examined.

(b) "So as to Afford Protection"

38. According to the United States, it is the particular design of the alcohol content threshold established by New Chilean System that raises questions about protective application. The New Chilean System has been designed to provide the

[29] United States' third participant's submission, para. 14.

same, or even more, protection to pisco as did previous tax systems. The fact that some imported liqueurs will have access to the lower *ad valorem* rates does not alter the protective treatment applied against the *great majority* of imports.

39. The second critical factor revealing a protective structure is the extent of the difference in treatment for imported and domestic products. In this respect, there are large increases in the tax rate in relation to proportionally small differences in alcohol content. This disproportionate increase implies that Chile rejected a single specific tax or a straight *ad valorem* tax because neither would provide sufficient protection for pisco.

40. In the view of the United States, the issue of whether a measure is applied "so as to afford protection" is clearly a question of the "intent of the law in its classic sense." [30] However, the way in which the Panel examined Chile's alleged policy objectives appears to create new kinds of *ad hoc* legal criteria. Nevertheless, since the Panel's finding on this issue has a sufficient basis in the other factors examined, the United States concludes that the New Chilean System is applied "so as to afford protection".

(c) Article 12.7 of the DSU

41. According to the United States, the Panel cited the correct authority for its findings, set out all of Chile's claims, and then rejected them with detailed findings of fact and arguments. The fact that Chile does not agree with the Panel's logic, or that the Panel did not develop a definitive theory for other disputes, does not mean that a "basic rationale" was not provided. The Panel's reasoning is, therefore, consistent with the requirements of Article 12.7 of the DSU.

(d) Articles 3.2 and 19.2 of the DSU

42. The United States believes that the provisions of Article 3.2 do not give rise to an obligation on which a claim can be made. The first sentence of Article 3.2 describes a very important objective, which sheds light on the meaning of all legal obligations in the *WTO Agreement.* This objective, however, is not an obligation in and of itself and should not be raised as the basis for an independent violation.

III. ISSUES RAISED IN THIS APPEAL

43. The following issues are raised in this appeal:

(a) whether the Panel erred in its interpretation and application of the term "not similarly taxed", which appears in the *Ad* Article to Article III:2, second sentence, of the GATT 1994;

(b) whether the Panel erred in its interpretation and application of the term "so as to afford protection", which is incorporated into Article III:2, second sentence, of the GATT 1994, by specific reference to the "principles set forth in paragraph 1" of Article III of that Agreement;

[30] United States' third participant's submission, para. 31.

(c) whether the Panel failed to set out the basic rationale for its findings and recommendations regarding the interpretation and application of the term "not similarly taxed", as required by Article 12.7 of the DSU; and

(d) whether the Panel acted inconsistently with Articles 3.2 and 19.2 of the DSU by adding to the rights and obligations of WTO Members in its interpretation and application of the terms "not similarly taxed" and "so as to afford protection", under Article III:2, second sentence, of the GATT 1994.

IV. "NOT SIMILARLY TAXED"

44. On the issue of "not similarly taxed", the Panel observed:

> The difference in taxation between the top (47%) and bottom (27%) levels of *ad valorem* rates of taxation of distilled alcoholic beverages is clearly more than *de minimis* and is so by a very large margin. Indeed, it is obvious that the difference of four percentage points between the various levels of alcohol content also constitutes a greater than *de minimis* level of dissimilar taxation.[31]

45. The Panel found that, from the aggregate group of directly competitive or substitutable products, "*some* of the imports are being taxed dissimilarly from *some* of the domestic production and the difference is more than *de minimis*."[32] (emphasis added) The Panel concluded that there was, therefore, "dissimilar taxation of the imports in an amount that is greater than *de minimis*".[33]

46. Chile argues on appeal that, if the New Chilean System is examined from the "proper perspective"[34], it is clear that all of the beverages at issue, regardless of their origin, are taxed according to the same objective criteria: alcohol content and price. When evaluated from this "perspective", Chile maintains, the New Chilean System does not apply dissimilar taxation because all distilled alcoholic beverages, whether domestic or imported, with the same alcohol content are taxed at an identical *ad valorem* rate. Chile contends that, because there is no dissimilar taxation, there is no need or justification to proceed to the third issue under Article III:2, second sentence, of the GATT 1994 and examine whether the New Chilean System is applied "so as to afford protection to domestic production."

47. We begin by recalling that, in *Japan - Alcoholic Beverages*, we stated that three separate issues must be addressed when assessing the consistency of an internal tax measure with Article III:2, second sentence, of the GATT 1994. These three issues are whether:

> (1) the imported products and the domestic products *are "directly competitive or substitutable products" which are in competition with each other*;

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31 Panel Report, para. 7.110.
32 *Ibid*., para. 7.113.
33 *Ibid*., para. 8.1.
34 Chile's appellant's submission, page 13, heading 4.

(2) the directly competitive or substitutable imported and domestic products *are* "*not similarly taxed*"; and

(3) the dissimilar taxation of the directly competitive or substitutable imported and domestic products *is* "*applied ... so as to afford protection to domestic production*".[35]

48. The Panel's conclusion on the first issue, that "domestic distilled alcoholic beverages produced in Chile, including pisco, and the imported products presently identified by HS classification 2208, are directly competitive or substitutable products", has not been appealed.[36] Therefore, we have to base our reasoning, for the purposes of this appeal, on the finding that all the domestic and imported products at issue are directly competitive or substitutable with each other, within the meaning of *Ad* Article III:2 of the GATT 1994.

49. In *Japan - Alcoholic Beverages*, we stated that "to be 'not similarly taxed', the tax burden on imported products must be heavier than on 'directly competitive or substitutable' domestic products, and that burden must be more than *de minimis* in any given case."[37] Like the Panel[38], we consider that this is the appropriate legal standard to apply under the second issue of "not similarly taxed". We must, therefore, assess the relative tax burden imposed on directly competitive or substitutable domestic and imported products.

50. The New Chilean System applies a minimum tax rate of 27 per cent *ad valorem* to all distilled alcoholic beverages with an alcoholic content of 35° or less and a maximum rate of 47 per cent *ad valorem* to all such beverages with an alcohol content of more than 39°. The Panel found, as a factual matter, that "roughly 75% of domestic production will enjoy the lowest rate and … over 95% of all current (and potential) imports will be taxed at the highest rate …".[39]

51. Chile has argued that there is "similar taxation" of domestic and imported production under the New Chilean System because all beverages with a specific alcohol content are subject to identical *ad valorem* tax rates, irrespective of their origin. In making this argument, Chile invites us to focus exclusively on a comparison of the relative tax burden on domestic and imported products *within each fiscal category* and to disregard the differences of tax burden on distilled alcoholic beverages which have different alcohol contents and which are, therefore, in *different fiscal categories*. In other words, Chile asks us to disregard the comparison which the Panel undertook of the relative tax burden on domestic and imported products located in *different fiscal categories*.

52. It is certainly true that, as Chile claims, if we were to focus the inquiry under the second issue solely on a comparison of the taxation of beverages of a specific alcohol content, we would have to conclude that all distilled alcoholic beverages of a specific alcohol content are taxed similarly. However, as we stated at the outset, in

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35 *Supra*, footnote 20, at 116.

36 Panel Report, para. 8.1. The imported products at issue include whisky, brandy, rum, gin, vodka, liqueurs, aquavit, korn, fruit brandies, ouzo and tequila.

37 *Supra*, footnote 20, at 119.

38 Panel Report, para. 7.89.

39 *Ibid*., para. 7.158. Chile has not contested this factual finding.

our analysis we must assume that the group of directly competitive or substitutable products in this case is broader than simply the products *within each fiscal category*.[40] Chile's argument fails to recognize that the Panel has found, and Chile has not appealed, that imported beverages of a specific alcohol content are directly competitive or substitutable with other domestic distilled alcoholic beverages of a different alcohol content. To accept Chile's argument on appeal would, we believe, disregard the objective of Article III, which is to "provide equality of competitive conditions" for *all* directly competitive or substitutable imported products in relation to domestic products, and not simply for *some* of these imported products.[41] The examination under the second issue must, therefore, take into account the fact that the group of directly competitive or substitutable domestic and imported products at issue in this case is not limited solely to beverages of a specific alcohol content, falling within a *particular* fiscal category, but covers *all* the distilled alcoholic beverages in *each and every* fiscal category under the New Chilean System.

53. A comprehensive examination of this nature, which looks at *all* of the directly competitive or substitutable domestic and imported products, shows that the tax burden on imported products, most of which will be subject to a tax rate of 47 per cent, will be heavier than the tax burden on domestic products, most of which will be subject to a tax rate of 27 per cent. We agree with the Panel that the difference in the level of the tax burden is clearly more than *de minimis* and, in any event, Chile has not appealed the Panel's finding that the difference between these tax rates is more than *de minimis*.

54. In these circumstances, we uphold the Panel's finding, in paragraph 8.1 of the Panel Report, that directly competitive or substitutable imported and domestic products are "not similarly taxed", within the meaning of *Ad* Article III:2 of the GATT 1994.

55. We stress, finally, that a tax measure is inconsistent with Article III:2, second sentence, of the GATT 1994 *only* if dissimilar taxation of directly competitive or substitutable imported products is applied "so as to afford protection to domestic production". As we stated in *Japan - Alcoholic Beverages*, the issues of "not similarly taxed" and "so as to afford protection" are entirely separate, and both issues must be resolved before a finding of consistency or inconsistency can be reached under Article III:2, second sentence.[42] A finding of dissimilar taxation *by itself* is not sufficient to sustain a conclusion that the New Chilean System is inconsistent with Article III:2, second sentence. Rather, a finding of dissimilarity of taxation merely calls for an inquiry under the third issue, to which we now turn.

V. "SO AS TO AFFORD PROTECTION"

56. The Panel began its analysis of whether the New Chilean System will be applied "so as to afford protection" by recalling certain of the Appellate Body's statements in *Japan - Alcoholic Beverages*.[43] The Panel stated that the "real issue" is

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40 *Supra*, para. 48.
41 Appellate Body Report, *Japan - Alcoholic Beverages, supra*, footnote 20, at 109.
42 *Supra*, footnote 20, at 116 and 118-119.
43 Panel Report, paras. 7.114 and 7.115.

"how the measure in question is *applied*."[44] The Panel noted that this can often be discerned from an examination of the "design, architecture and revealing structure" of the measure, as well as from the magnitude of the dissimilar taxation.[45] The Panel also took the view that "an important question is who receives the benefit of the dissimilar taxation."[46]

57. The Panel expressed its conclusion on this issue in the following terms:

> In sum, considering: (1) the structure of the New Chilean System (with its lowest rate at the level of alcohol content of the large majority of domestic production and its highest rate at the level of the overwhelming majority of imports); (2) the large magnitude of the differentials over a short range of physical difference (35° versus 39° of alcohol content); (3) the interaction of the New Chilean System with the Chilean regulation which requires most of the imports to remain at the highest tax level without losing their generic name and changing their physical characteristics; (4) the lack of any connection between the stated objectives and the results of such measures (recognizing that "good" objectives cannot rescue an otherwise inconsistent measure); and, (5) the way this new measure fits in a logical connection with existing and previous systems of *de jure* discrimination against imports, we find that the dissimilar taxation assessed on directly competitive or substitutable imports and domestic products is applied in a way that affords protection to domestic production.[47]

58. Chile argues, first, that since its law is based on two widely accepted, non-arbitrary criteria - alcohol content and price - the structure of the system does not support a finding of protection.[48] In fact, imports are able to compete equally with domestic products in each and every fiscal category. Second, Chile submits that the New Chilean System is not applied "so as to afford protection" because a majority of the products in the highest tax brackets are domestic, not imported. Third, Chile contends that the Panel erred in taking into account the objectives of the New Chilean System. Finally, Chile rejects as non-relevant the Panel's assertion of a "logical relationship" between existing and previous systems of *de jure* discrimination against imports.

59. At the outset, it is useful to recall that in *Japan - Alcoholic Beverages*, we observed:

> Members of the WTO are free to pursue their own domestic goals through internal taxation or regulation so long as they do

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[44] Panel Report, para. 7.115, citing the Appellate Body Report in *Japan - Alcoholic Beverages*, *supra*, footnote 20, at 119.

[45] *Ibid*., para. 7.115, citing the Appellate Body Report in *Japan - Alcoholic Beverages*, *supra*, footnote 20, at 120.

[46] *Ibid*., para. 7.123.

[47] Panel Report, para. 7.159.

[48] Chile's appellant's submission, para. 39.

> not do so in a way that violates Article III or any of the other commitments they have made in the *WTO Agreement.*[49]

60. Members of the WTO have sovereign authority to determine the basis or bases on which they will tax goods, such as, for example, distilled alcoholic beverages, and to classify such goods accordingly, provided of course that the Members respect their WTO commitments. The reference in *Ad* Article III:2, second sentence, of the GATT 1994 to "not similarly taxed" is not in itself a prohibition against classifying goods for revenue and regulatory purposes that Members set for themselves as legitimate and desirable. Members of the WTO are free to tax distilled alcoholic beverages on the basis of their alcohol content and price, as long as the tax classification is not applied so as to protect domestic production over imports. Alcohol content, like any other basis or criterion of taxation, is subject to the legal standard embodied in Article III:2 of the GATT 1994.

61. We turn now to consider the Panel's interpretation and application of the expression "so as to afford protection to domestic production", an expression which we have already had occasion to consider in other appeals. In our Report in *Japan - Alcoholic Beverages*, we said that examination of whether a tax regime affords protection to domestic production "is an issue of how the measure in question is *applied*"[50], and that such an examination "requires a comprehensive and objective analysis"[51]:

> … it is possible to examine objectively the underlying criteria used in a particular tax measure, its structure, and its overall application to ascertain whether it is applied in a way that affords protection to domestic products.[52]

62. We emphasized in that Report that, in examining the issue of "so as to afford protection", "it is not necessary for a panel to sort through the many reasons legislators and regulators often have for what they do and weigh the relative significance of those reasons to establish legislative or regulatory intent."[53] The *subjective* intentions inhabiting the minds of individual legislators or regulators do not bear upon the inquiry, if only because they are not accessible to treaty interpreters. It does not follow, however, that the statutory purposes or objectives - that is, the purpose or objectives of a Member's legislature and government as a whole - to the extent that they are given *objective* expression in the statute itself, are not pertinent. To the contrary, as we also stated in *Japan - Alcoholic Beverages*:

> Although it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the *design*, the *architecture*, and the revealing *structure* of a measure.[54] (emphasis added)

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49 *Supra*, footnote 20, at 110.
50 *Supra*, footnote 20, at 119.
51 *Ibid.*, at 20.
52 *Ibid.*
53 *Ibid.*, at 119.
54 *Ibid.*, at 120.

63. We turn, therefore, to the design, the architecture and the structure of the New Chilean System itself. That system taxes *all* alcoholic beverages with an alcohol content of 35° or below on a linear basis, at a fixed rate of 27 per cent *ad valorem*. Thereafter, the rate of taxation increases steeply, by 4 percentage points for every additional degree of alcohol content, until a maximum rate of 47 per cent *ad valorem* is reached. This fixed tax rate of 47 per cent applies, once more on a linear basis, to *all* beverages with an alcohol content in excess of 39°, irrespective of how much in excess of 39° the alcohol content of the beverage is.

64. We note, furthermore, that, according to the Panel, approximately 75 per cent of all domestic production has an alcohol content of 35° or less and is, therefore, taxed at the lowest rate of 27 per cent *ad valorem*.[55] Moreover, according to figures supplied to the Panel by Chile, approximately *half* of all domestic production has an alcohol content of 35° and is, therefore, located on the line of the progression of the tax at the point *immediately before* the steep increase in tax rates from 27 per cent *ad valorem*.[56] The start of the highest tax bracket, with a rate of 47 per cent *ad valorem*, coincides with the point at which most imported beverages are found. Indeed, according to the Panel, that tax bracket contains approximately 95 per cent of all directly competitive or substitutable imports.[57]

65. Although the tax rates increase steeply for beverages with an alcohol content of more than 35° and up to 39°, there are, in fact, very few beverages on the Chilean market, either domestic or imported, with an alcohol content of between 35° and 39°.[58] The graduation of the rates for beverages with an alcohol content of between 35° and 39° does not, therefore, serve to tax distilled alcoholic beverages on a progressive basis. Indeed, the steeply graduated progression of the tax rates between 35° and 39° alcohol content seems anomalous and at odds with the otherwise linear nature of the tax system. With the exception of the progression of rates between 35° and 39° alcohol content, this system simply applies one of two fixed rates of taxation, either 27 per cent *ad valorem* or 47 per cent *ad valorem*, each of which applies to distilled alcoholic beverages with a broad range of alcohol content, that is, 27 per cent for beverages with an alcoholic content of *up to 35°* and 47 per cent for beverages with an alcohol content of *more than 39°*.

66. In practice, therefore, the New Chilean System will operate largely as if there were only two tax brackets: the first applying a rate of 27 per cent *ad valorem* which ends at the point at which most domestic beverages, by volume, are found, and the second applying a rate of 47 per cent *ad valorem* which begins at the point at which most imports, by volume, are found. The magnitude of the difference between these two rates is also considerable. The absolute difference of 20 percentage points between the two rates represents a 74 per cent increase in the lowest rate of 27 per

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55 Panel Report, para. 7.158. *See* also Panel Report, para. 7.155.

56 Chile's response to Question 1 of the Panel, 26 November 1998. At the oral hearing, Chile confirmed the accuracy of the figures contained in this response.

57 Panel Report, para. 7.158.

58 Chile's response to Question 1 of the Panel, 26 November 1998. These figures indicate that approximately 5 per cent of *all* distilled alcoholic beverages have an alcohol content in this range. At the oral hearing, Chile confirmed that very few beverages have an alcohol content of between 35° and 39°.

cent *ad valorem*. Accordingly, examination of the design, architecture and structure of the New Chilean System tends to reveal that the application of dissimilar taxation of directly competitive or substitutable products will "afford protection to domestic production."

67. It is true, as Chile points out, that domestic products are not only subject to the highest tax rate but also comprise the major part of the volume of sales in that bracket. This fact does not, however, by itself outweigh the other relevant factors, which tend to reveal the protective application of the New Chilean System. The relative proportion of domestic versus imported products within a particular fiscal category is not, in and of itself, decisive of the appropriate characterization of the total impact of the New Chilean System under Article III:2, second sentence, of the GATT 1994. This provision, as noted earlier, provides for equality of competitive conditions of *all* directly competitive or substitutable imported products, in relation to domestic products, and not simply, as Chile argues, those imported products within a particular fiscal category.[59] The cumulative consequence of the New Chilean System is, as the Panel found, that approximately 75 per cent of all domestic production of the distilled alcoholic beverages at issue will be located in the fiscal category with the lowest tax rate, whereas approximately 95 per cent of the directly competitive or substitutable imported products will be found in the fiscal category subject to the highest tax rate.

68. The comparatively small volume of imports consumed on the Chilean market may, in part, be due to past protection.[60] We consider that it would defeat the objective of Article III:2, second sentence, of the GATT 1994 if a Member of the WTO were able to avoid a finding that a measure is applied "so as to afford protection" for reasons that could, in part, result from its past protection of domestic production.[61]

69. Before the Panel, Chile stated that the New Chilean System pursued four different objectives: "(1) maintaining revenue collection; (2) eliminating type distinctions [such] as [those which] were found in Japan and Korea; (3) discouraging alcohol consumption; and (4) minimizing the potentially regressive aspects of the reform of the tax system."[62] Chile also stated that the New Chilean System reflected compromises between the four objectives which became necessary in the process of legislative enactment. The Panel did not find any clear relationship between the stated objectives and the tax measure itself and considered the absence of a clear relationship as "evidence *confirming* the discriminatory design, structure and architecture of [the Chilean] measure."[63] (emphasis added)

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59 *Supra*, para. 52.

60 Chile acknowledged to the Panel that it reformed its taxation of distilled alcoholic beverages, in part, in order to eliminate the "type distinctions" between spirits condemned in *Japan - Alcoholic Beverages* and *Korea - Alcoholic Beverages* (*see* Panel Report, paras. 4.450 and 4.504). The "type distinctions" were formal distinctions between "pisco", "whisky" and "other spirits" (*Ibid.*, para. 2.4).

61 *See* Appellate Body Report, *Korea - Alcoholic Beverages*, *supra*, footnote 21, para. 120.

62 Panel Report, para. 7.147. *See* also Panel Report, paras. 4.449, 4.450 and 4.452.

63 Panel Report, para. 7.154.

70. On appeal, Chile argues that the Panel was "wrong to even consider the objectives" underlying the New Chilean System.[64] Chile declines to explain the relationship between the design, architecture and structure of the New Chilean System and the objectives it stated that System sought to realize. At the oral hearing, Chile confirmed that, in its view, the stated objectives of the New Chilean System were not "relevant" in assessing whether that measure would be applied "so as to afford protection".[65]

71. We recall once more that, in *Japan - Alcoholic Beverages*, we declined to adopt an approach to the issue of "so as to afford protection" that attempts to examine "the many reasons legislators and regulators often have for what they do".[66] We called for examination of the design, architecture and structure of a tax measure precisely to permit identification of a measure's objectives or purposes as revealed or objectified in the measure itself. Thus, we consider that a measure's purposes, objectively manifested in the design, architecture and structure of the measure, *are* intensely pertinent to the task of evaluating whether or not that measure is applied so as to afford protection to domestic production. In the present appeal, Chile's explanations concerning the structure of the New Chilean System - including, in particular, the truncated nature of the line of progression of tax rates, which effectively consists of two levels (27 per cent *ad valorem* and 47 per cent *ad valorem*) separated by only 4 degrees of alcohol content - might have been helpful in understanding what *prima facie* appear to be anomalies in the progression of tax rates. The conclusion of protective application reached by the Panel becomes very difficult to resist, in the absence of countervailing explanations by Chile. The mere statement of the four objectives pursued by Chile does not constitute effective rebuttal on the part of Chile.

72. At the same time, we agree with Chile that it would be inappropriate, under Article III:2, second sentence, of the GATT 1994, to examine whether the tax measure is *necessary* for achieving its stated objectives or purposes. The Panel did use the word "necessary" in this part of its reasoning.[67] Nevertheless, we do not read the Panel Report as showing that the Panel did, in fact, conduct an examination of whether the measure is necessary to achieve its stated objectives. It appears to us that the Panel did no more than try to relate the observable structural features of the measure with its declared purposes, a task that is unavoidable in appraising the application of the measure as protective or not of domestic production.

73. In reaching its conclusion on the issue of "so as to afford protection", the Panel also relied on the fact that Chilean law imposes minimum alcohol content requirements on a range of distilled alcoholic beverages, including most of the beverages imported into Chile.[68] The Panel invoked the "interaction of the New Chilean System with the Chilean regulation which requires most of the imports to remain at the highest tax level without losing their generic name and changing their

64 Chile's appellant's submission, para. 100.
65 Response by Chile to questioning at the oral hearing.
66 *Supra*, footnote 20, at 119.
67 Panel Report, para. 7.149.
68 Panel Report, para. 7.155.

physical characteristics".[69] We believe this reliance by the Panel to be unjustified. Chilean law does not prohibit the importation of any distilled alcoholic beverages, whatever their alcohol content. Under Chilean law, a regulation imposes minimum quality standards, in respect of various kinds of distilled alcoholic beverages, relating to, *inter alia*, alcohol content, maximum sugar content and maximum volatile (e.g., aldehydes, furfural) impurities content.[70] This regulation appears to be broadly reflective of similar standards enforced in many markets. The "interaction" the Panel sees between the New Chilean System and the Chilean regulation does not contribute to the cogency of the Panel's conclusion on the "so as to afford protection" issue and, in our view, should not have been taken into account by the Panel.

74. The final factor that the Panel relied upon in reaching the conclusion under the issue of "so as to afford protection" was "the way this new measure fits in a logical connection with existing and previous systems of *de jure* discrimination against imports".[71] In our view, the Panel has relied on the fact that previous Chilean measures, which are no longer applicable, involved some protection of domestic alcoholic beverages to show that the *new* tax system will also be applied "so as to afford protection". The Panel's reliance on this factor is wrong. Members of the WTO should not be assumed, in any way, to have *continued* previous protection or discrimination through the adoption of a new measure.[72] This would come close to a presumption of bad faith. Accordingly, we hold that the Panel committed legal error in taking this factor into account in examining the issue of "so as to afford protection".

75. However, in view of the other factors properly relied upon by the Panel, we believe that the Panel's conclusion that the dissimilar taxation is applied "so as to afford protection" is unaffected by the exclusion of these last two factors.

76. In light of the foregoing, we uphold the Panel's finding, in paragraph 8.1 of the Panel Report, that the dissimilar taxation under the New Chilean System is applied "so as to afford protection to domestic production", and, hence, is inconsistent with the requirements of Article III:2, second sentence, of the GATT 1994.

VI. ARTICLE 12.7 OF THE DSU

77. Chile argues that "the Panel failed to fulfill its obligation under Article 12.7 [of the] DSU to provide the basic rationale behind its findings when analyzing the 'dissimilarity' condition of Article III:2, second sentence."[73] Specifically, Chile states

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[69] Panel Report, para. 7.159.

[70] Articles 9-13, Title II, Decree No. 78 of 31 July 1986, implementing Law No. 18,455 of 31 October 1985 (Exhibit No. 13 submitted by the European Communities to the Panel).

[71] Panel Report, para. 7.159.

[72] As we have said, past protection of domestic production may, however, be a relevant factor in assessing current consumer preferences and the current structure of a market, since these may have been influenced, in part, by that past protection (*see supra*, para. 68, and Appellate Body Report, *Korea - Alcoholic Beverages*, *supra*, footnote 21, para. 120).

[73] Chile's appellant's submission, para. 47.

that "the Panel did not provide a basic rationale for defining 'dissimilarity' as such nor did it explain how the Chilean tax system could satisfy that condition."[74]

78. A similar claim was made by Korea in *Korea - Alcoholic Beverages*. In that case the Appellate Body concluded that the Panel had provided a "detailed and thorough" rationale for its findings.[75] In our view, in this case, the Panel did "set out" a "basic rationale" for its finding and recommendation on the issue of "not similarly taxed", as required by Article 12.7 of the DSU. The Panel identified the legal standard it applied, examined the relevant facts, and provided reasons for its conclusion that dissimilar taxation existed.[76] Therefore, Chile's claim that the Panel failed to "set out" a "basic rationale" for its findings and recommendations in accordance with Article 12.7 of the DSU is denied.

VII. ARTICLES 3.2 AND 19.2 OF THE DSU

79. Chile claims that the Panel's findings on the issues of "not similarly taxed" and "so as to afford protection" compromise the "security and predictability" of the multilateral trading system, provided for in Article 3.2 of the DSU, and "add to … the rights and obligations of Members" under Article III:2, second sentence, of the GATT 1994, in contravention of Articles 3.2 and 19.2 of the DSU. In this dispute, while we have rejected certain of the factors relied upon by the Panel, we have found that the Panel's legal conclusions are not tainted by any reversible error of law. In these circumstances, we do not consider that the Panel has added to the rights or obligations of any Member of the WTO. Moreover, we have difficulty in envisaging circumstances in which a panel could add to the rights and obligations of a Member of the WTO if its conclusions reflected a correct interpretation and application of provisions of the covered agreements. Chile's appeal under Articles 3.2 and 19.2 of the DSU must, therefore, be denied.

VIII. FINDINGS AND CONCLUSIONS

80. For the reasons set out in this Report, the Appellate Body:

(a) upholds the Panel's interpretation and application of the term "not similarly taxed", which appears in the *Ad* Article to Article III:2, second sentence, of the GATT 1994;

(b) upholds the Panel's interpretation and application of the term "so as to afford protection", which is incorporated into Article III:2, second sentence, of the GATT 1994, by specific reference to the "principles set forth in paragraph 1" of Article III of that Agreement, subject, however, to the exclusion of the third and fifth considerations relied upon by the Panel in reaching its conclusion in paragraph 7.159 of its Report;

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74 Chile's appellant's submission, para. 52.

75 *Supra*, footnote 21, para. 168.

76 The Panel's reasoning is set out in paragraphs 7.103 to 7.113 of the Panel Report.

(c) concludes that the Panel did not fail to set out the basic rationale for its findings and recommendations regarding the interpretation and application of the term "not similarly taxed", as required by Article 12.7 of the DSU; and

(d) concludes that the Panel did not act inconsistently with Articles 3.2 and 19.2 of the DSU by adding to the rights and obligations of WTO Members in its interpretation and application of the terms "not similarly taxed" and "so as to afford protection", under Article III:2, second sentence, of the GATT 1994.

81. The Appellate Body *recommends* that the DSB request Chile to bring the New Chilean System, contained in the Additional Tax on Alcoholic Beverages, into conformity with its obligations under Article III:2, second sentence, of the GATT 1994.

CHILE - TAXES ON ALCOHOLIC BEVERAGES

Report of the Panel

WT/DS87/R
WT/DS110R

Adopted by the Dispute Settlement Body
on 12 January 2000
as Modified by the Appellate Body Report

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I. PROCEDURAL BACKGROUND

1.1 This proceeding has been initiated by a complaining party, the European Communities.

1.2 On 4 June 1997, the European Communities requested consultations with Chile under Article XXII:1 of the General Agreement on Tariffs and Trade 1994 ("GATT 1994") and Article 4 of the Understanding on Rules and Procedures Governing the Settlement of Disputes ("DSU") with regard to the Special Sales Tax on Spirits of Chile (WT/DS87/1). Chile agreed to the request. Peru, the United States, and Mexico requested, in communications dated 19 June 1997 (WT/DS87/2), 23 June 1997 (WT/DS87/3) and 20 June 1997 (WT/DS87/4) respectively, to be

joined in those consultations, pursuant to Article 4.11 of the DSU. Consultations between the European Communities and Chile were held on 3 July 1997, in which Peru, the United States and Mexico participated, but the parties were unable to settle the dispute.

1.3 On 3 October 1997, the European Communities requested the establishment of a panel pursuant to Article 6 of the DSU (WT/DS87/5).

1.4 In its panel request, the European Communities claims that:

> Chile, by according a preferential tax treatment, through the Special Sales Tax on Spirits, to pisco *vis-à-vis* certain alcoholic beverages falling within HS heading 2208, has acted inconsistently with Article III:2 of GATT 1994, therefore nullifying or impairing the benefits accruing to the European Communities under GATT 1994.

1.5 The Dispute Settlement Body (DSB) agreed to this request for a panel at its meeting of 18 November 1997, establishing a panel pursuant to Article 6 of the DSU with standard terms of reference.

1.6 Canada, Mexico, Peru and the United States reserved their rights to participate in the Panel proceedings as third-parties.

1.7 On 15 December 1997, the European Communities further requested consultations with Chile under Article XXII:1 of GATT 1994 and Article 4 of the DSU with regard to the Additional Tax on Alcoholic Beverages ("Impuesto Adicional a las Bebidas Alcoholicas"), as modified by Law No. 19,534 (WT/DS110/1). The United States and Mexico requested, in communications dated 23 December 1997 (WT/DS110/2) and 27 December 1997 (WT/DS110/3) respectively, to be joined in those consultations, pursuant to Article 4.11 of the DSU. Also, on 16 December 1997, the United States requested consultations with Chile under Article XXII of GATT 1994 and Article 4 of the DSU (WT/DS109/1). Peru and Mexico requested, in communications dated 17 December 1997 (WT/DS109/2) and 27 January 1998 (WT/DS109/3) respectively, to be joined in those consultations, pursuant to Article 4.11 of the DSU. Joint consultations between the European Communities and the United States, the requesting parties, and Chile, were held on 28 January 1998, in which Peru and Mexico participated, but the parties were unable to settle the dispute.

1.8 On 9 March 1998, the European Communities requested the establishment of a panel pursuant to Article 6 of the DSU (WT/DS110/4).

1.9 In its panel request, the European Communities claims that:

> Like the measures which are subject of the Panel established on 18 November 1997, the modifications introduced by Law No. 19.534, including those to be applied on a transitional basis until 1 December 2000, are inconsistent with Chile's obligations under the GATT. In particular, the modifications introduced by Law No. 19.534 impose a lower tax rate on domestic pisco than on certain other like distilled spirits and liqueurs imported from the European Communities, thus infringing GATT Article III:2, first sentence. Those modifications also impose a lower tax rate on domestic pisco than on certain other directly competitive or substitutable distilled spirits and liqueurs imported from the European Communities so as to afford protection

to Chile's domestic production, thereby violating GATT Article III:2, second sentence.

1.10 The DSB agreed to this request for a panel at its meeting of 25 March 1998, establishing a panel pursuant to Article 6 of the DSU with standard terms of reference. At this meeting, the DSB further agreed, pursuant to Article 9 of DSU, that the Panel established at the DSB meeting of 18 November 1997, should also examine the complaint of the European Communities in WT/DS110/4.

1.11 The Panel has the following standard terms of reference:

To examine, in the light of the relevant provisions of the covered agreements cited by the European Communities in documents WT/DS87/5 and WT/DS110/4, the matter referred to the DSB by the European Communities in those documents and to make such findings as will assist the DSB in making the recommendations or in giving the rulings provided for in those agreements.

1.12 Canada, Mexico, Peru and the United States reserved their rights to participate in the Panel proceedings as third-parties.

1.13 On 10 and 11 June 1998, the European Communities and Chile, respectively, requested the Director-General, pursuant to Article 8.7 of the DSU, to determine the composition of the Panel. On 1 July 1998, the Chairman of the DSB informed the parties that the Director-General composed the Panel as follows:

Chairman:	Mr. Wilhelm Meier
Members:	Mr. Mohan Kumar
	Professor Colin McCarthy

1.14 The Panel had substantive meetings with the parties on 6 and 7 October 1998, and on 11 November 1998.

II. FACTUAL ASPECTS

A. Measures in Issue

1. Transitional System

2.1 The measure at issue is the so-called "Additional Tax on Alcoholic Beverages" ("*Impuesto Adicional a las bebidas Alcohólicas*", hereafter "ILA"), contained in Law No. 19,534.[1]

2.2 The ILA is an excise tax levied on the sale and importation of alcoholic beverages. It is payable by the seller or, in the case of imports, by the importer. The

[1] Law No. 19,534 of 13 November 1997, amending Article 42 of Decree Law 825/74 (hereafter, "Law 19,534/97") (EC Exhibit 3). The European Communities claims that the measure in issue is contained in Decree-Law No. 825, of 27 December 1974, on the Tax on Sales and Services (hereafter, "Decree-Law 825/74" (EC Exhibit 4), amended by Law No. 19,534. The text of this Decree-Law was replaced by Decree-Law No. 1606, of 30 November 1976 ("hereafter", Decree-Law 1606/76) (EC Exhibit 6). In contrast, Chile claims that Law No. 19,534 constitutes an entirely new law, repealing and replacing Decree-Law 825/74. The Panel considers that there is no substantive difference between the two positions.

ILA takes the form of an *ad valorem* tax. The tax basis is the same as for the assessment of the Value Added Tax.

2.3 Law No. 19,534 was signed by the President of the Republic of Chile on 13 November 1997, and promulgated on 18 November 1997, and entered into force as of 1 December 1997, replacing Decree-Law 825/1974, which provided a tax system until 30 November 1997 (hereafter, the "Old Chilean System"). Law No. 19,534 provides a new tax system which will become applicable as of 1 December 2000, and a transitional system which is applicable until 1 December 2000 (hereafter, the "Transitional System").

2.4 The Old Chilean System distinguished three types of distilled spirits ("pisco", "whisky" and "other spirits", a residual category comprising all distilled spirits other than pisco and whisky) and applied to each of them a different *ad valorem* tax rate.[2] The Transitional System also applies different rates of taxes depending on whether the product is considered "pisco", "whisky" or "other spirits," until 1 December 2000. Nevertheless, as a transitional measure, it provides for a progressive reduction of the rate on whisky in accordance with the schedule shown in Table 1 below, while applies the same rate to pisco as the Old Chilean System until the new tax system takes effect on 1 December 2000.[3,4]

Table 1

Applicable tax rates from 1 December 1997 to 1 December 2000

	Whisky	**Pisco**	**Other Spirits**
Until 30.11.1997*	70 %	25 %	30 %
From 1.12.1997	65 %	25 %	30 %
From 1.12.1998	59 %	25 %	30 %
From 1.12.1999/Until 1.12.2000	53 %	25 %	30 %

*Old Chilean System

2. New Chilean System

2.5 The new tax system introduced by Law 19,534 (hereafter referred to as the "New Chilean System") abolishes the distinction between pisco, whisky and "other spirits". Instead, all distilled spirits are taxed according to a scale based on their degree of alcohol content.[5]

2.6 Law 19,534 provides that, as shown in Table 2 below, all spirits with an alcohol content of 35° or less are taxed at the rate of 27 %. From that base, the rate escalates in increments of 4 percentage points per additional degree of alcohol, peaking at a rate of 47 % for all spirits bottled over 39°.

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2 Article 42 of Decree 825/74, as lastly amended by Article 4.III of Law No. 18,413, of 8 May 1985 (hereafter, "Law 18,143/85") (EC Exhibit 11).

3 Transitional Article of Law 19,534/97 (EC Exhibit 3).

4 EC First Submission, Table 4.

5 Single Article of Law 19,534/97 (EC Exhibit 3).

Table 2 [6]

Tax rates applicable from 1 December 2000

Alcohol content	Tax rate *ad valorem*
Less or equal to 35°	27 %
Less or equal to 36°	31 %
Less or equal to 37°	35 %
Less or equal to 38°	39 %
Less or equal to 39°	43 %
Over 39°	47 %

B. Products in Issue

2.7 The products in issue in this dispute are all distilled spirits falling within the heading 22.08 of the Harmonized System ("HS") nomenclature, including, but not limited to the following:

- all kinds of pisco falling within HS 2208;
- all kinds of whisk(e)y falling within HS 2208.30 (hereafter, "whisky");
- all kinds of brandy obtained by distilling grape wine or grape marc and falling within HS 2208.20 (hereafter, "brandy");
- all kinds of rum and taffia falling within HS 2208.40 (hereafter, "rum");
- all kinds of gin and geneva falling within HS 2208.50 (hereafter, "gin");
- all kinds of vodka falling within HS 2208.60 (hereafter, "vodka");
- all kinds of liqueurs falling within HS 2208.70, such as anisettes, curacao, cream liqueurs, emulsions and bitters (hereafter, "liqueurs"); and
- all kinds of aquavit, korn, fruit brandies (such as plum brandy, cherry brandy, pear brandy and cider brandy), ouzo and tequila falling within HS 2208.90 (hereafter, "aquavit", "korn", "fruit brandies", "ouzo" and "tequila", respectively).

1. Pisco

2.8 Under Chilean law, the term "pisco" is a protected geographical indication, the use of which is reserved exclusively for wine distillates produced and bottled in certain regions of Chile from certain varieties of muscat grapes grown in those regions.[7]

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[6] EC First Submission, Table 5.

[7] The European Communities points out that according to the explanations provided by Chile during the consultations, the protected geographical indication for pisco was "made official" in 1931 by means of Decree-Law 181. *See* Chile's answers to questions from the EC dated 22 July 1997 (EC Exhibit 1).

2.9 Article 28 (a) of Law No. 18,455/85[8] provides that the designation "pisco":

> [...] is reserved for *aguardiente* produced and bottled, in units for consumption, in the regions III and IV, made by distillation of genuine potable wine obtained from the varieties of grapevines to be determined by regulation, planted in the said regions.

2.10 The term *aguardiente*, in turn, is defined in Decree 78/1986[9] (which implements Law No. 18,455/85) as follows:

> A distillate of wine, to which no additives have been added except sugar and water. [10]

2.11 Decree 78/1986 also specifies that pisco may be produced only from wine obtained from one or more of the following varieties of grapes of the species *Vitis Vinifera L*: *Chasselas Musque Vrai*, *Moscatel Amarilla*, *Moscatel Blanca Temprana*, *Moscatel de Alejandría* or *Italia*, *Moscatel de Austria*, *Moscatel de Frontignan*, *Moscatel de Hamburgo*, *Moscatel Negra*, *Moscatel Rosada* or *Pastilla*, *Moscato de Canelli*, *Muscat Orange*, *Pedro Jiménez* and *Torontel.*[11] In practice, most pisco is made by blending spirits distilled from two or more of these types of grapes.

2.12 The so-called *zona pisquera* currently comprises Regions III (Atacama) and IV (Coquimbo). These two regions lay between the parallels 27 and 32, some 600 kilometres north of Santiago, and are characterized by a very dry and sunny climate. The grapes for the production of pisco are grown along a series of narrow valleys irrigated by rivers flowing from the Andes into the Pacific, the so-called five *valles pisqueros*: Copiapó, Vallenar, Elqui, Limarí and Choapa.

2.13 The production of pisco is dominated by two large co-operatives, each grouping several hundred associated grape growers: Cooperativa Agrícola Pisquera Elqui Ltda (hereafter "Capel") and Cooperativa Agrícola Control Pisquero de Elqui y Limarí (hereafter "Control"). It is estimated that, together, Control and Capel account for more than 90 % of the sales of pisco.

2.14 The main stages in the production process of pisco may be summarized as follows:

(i) harvesting and grinding of the grapes;

(ii) fermentation of the grape-juice in large earthenware or steel containers in order to produce wine, with an alcohol strength of approximately 14°;

(iii) distillation of the wine in copper pot stills.[12] The raw spirit obtained at the end of this phase has about 55°-60°;

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[8] Law No. 18,455, of 31 October 1985, laying down rules for the production, preparation and marketing of ethyl alcohol, alcoholic beverages and vinegar (hereafter, "Law 18,455/85") (EC Exhibit 12).

[9] Decree No. 78 of 31 July 1986 implementing Law 18,455/85 (hereafter, "Decree 78/1986") (EC Exhibit 13).

[10] *Ibid*., Article 1.2.

[11] *Ibid*., Article 56.

[12] According to the European Communities, the stills are similar to those used by the producers of Cognac. The distillation process may be described as a "batch" process, rather than a continuous process, although rectifiers are sometimes used to boost the strength of the spirit.

(iv) maturation of the raw spirit in wooden containers for a relatively short period of time, usually not exceeding several months. The best quality brands may be stored in American oak casks for a longer period; and

(v) finally, the spirit from the different distilleries is centralized to be blended, diluted with de-mineralized water in order to obtain the desired alcohol strength, filtered and bottled.

2.15 By law, pisco must have an alcohol content of no less than 30°; the four types of pisco are designated as[13]:

- *Pisco corriente* or *tradicional* between 30° and 35°;
- *Pisco especial* between 35° and 40°;
- *Pisco reservado* between 40° and 43°;
- *Gran pisco* 43° or more.

2.16 According to the explanations provided by the Chile during the consultations, Chile's pisco industry is currently producing and selling pisco of the following alcohol contents[14]:

- Pisco corriente or tradicional 30°, 32°, 33°
- Pisco especial 35°[15]
- Pisco reservado 40°
- Gran pisco 43°, 46° and 50°

2.17 According to the regulations in force, the four different types of pisco are distinguished solely in terms of their alcohol strength.[16] As already indicated by its name, *pisco tradicional* or *corriente* used to be the largest selling type of pisco. Over the last few years, however, it has been overtaken by *pisco especial*, which is now the best selling pisco category. *Pisco reservado* and *gran pisco* account for about 9 % of the market.

2.18 Although there are no official statistics on the production or sale of the different types of pisco, the European Communities submitted market data compiled by AC Nielsen, a private market organization employed by the European distilled spirits industry to estimate the market share of each type of pisco, as follows:[17]

[13] Decree 78/1986, Article 56.

[14] Chile's answers to questions from the EC dated 24 February 1998 (EC Exhibit 2).

[15] According to the European Communities, the brand "Control de Guarda" appears to be sold also at 36°. *See* EC Exhibit 51.

[16] Article 13 of Decree 78/1986 (EC Exhibit 13).

[17] The European Communities submits the source of Table 4 as EC Exhibit 24.

Table 3 [18]

Pisco sales by category

	Aug 94/July95	Aug 95/July96	Aug 96/July97
Tradicional	46.2 %	35.8 %	34.5 %
Especial	40.8 %	49.8 %	51.4 %
Reservado	5.5 %	6.4 %	6.3 %
Gran Pisco	4.4 %	4.8 %	4.2 %
Pisco sour[19]	3.0 %	3.2 %	3.7 %

Basis: % of total sales of pisco

2.19 Chile provides information concerning production and sales of various types of distilled spirits in Chile. Table 4 indicates the data for 1997:[20]

Table 4

Volume in Thousands Litres and Value in Thousands of US$

	Production 1997		Imports 1997		Exports 1997		Apparent Consumption 1997	
Type of Spirits	**Volume**	**Value**	**Volume**	**Value**	**Volume**	**Value**	**Volume**	**Value**
Total, Pisco of different alcoholic content*	40,977.9		0.0	0.0	301.6	933.3	40,676.3	
Pisco 30º *	16,276.5							
Pisco 35º *	20,969.0							
Pisco 40º - 46º *	3,732.5							
Aguardiente minimum 30º			9.1	37.9				
Aguardiente minimum 50º								
Other grape spirits			94.4	336.2	106.1	266.0		
Brandy, cognac, armagnac (minimum 38º)								
Grapa (minimum 30º)								
Whisky (minimum 40º)			2,484.7	13,799.7	0.2	3.6		

[18] EC First Submission, Table 1.

[19] The European Communities notes that *pisco sour* is not a variety of pisco but, rather, a cocktail made with pisco. Specifically, Decree 78/1986 (Article 58) defines *pisco sour* as "[…] the cocktail produced and bottled in regions III and IV, prepared with pisco, lemon juice or natural lemon flavouring […]". Table 3 shows the share of pre-mixed *pisco sour*.

[20] Chile First Submission, Annex III, Table 7. Chile additionally provides the following estimates by the domestic industry of pisco production in 1998 (January to September): Pisco 30° - 8,613.0, Pisco 35° - 20,730.0; Pisco 40° to 46° - 2,465.0; Aguardiente min. 30° - 45.0; and Aguardiente min. 50° - 480.0 (million litre).

	Production 1997		Imports 1997		Exports 1997		Apparent Consumption 1997	
Type of Spirits	**Volume**	**Value**	**Volume**	**Value**	**Volume**	**Value**	**Volume**	**Value**
Rum and other spirits of sugar cane (minimum 40º)			642.8	1640.8	0.3	1.6		
Gin and geneva (minimum 40º)			198.9	967.8	0.0	0.0		
Other Spirits			1,679.9	6,412.9	111.3	287.2		
Vodka (minimum 40º)			389.9	1,246.4	0.0	0.1		
Liqueurs			183.1	1,359.6	41.7	71.8		
Other spirits			1,106.9	3,806.9	69.6	215.3		

Sources:

(1) Production:

- Piscos according to alcoholic strength: Control Pisquero Ltd. and Capel Ltd.
- Aguardiente; Brandy, Cognac, Armagnac; grapa; whisky; rum and other spirits of sugar cane; gin and geneva; vodka; other distilled spirits; fruit liqueurs; anisette, anise liqueur; arack, pastis, anesone; bitter liqueurs; cocktails; other spirits: **Asociación de Licoristas de Chile.**

(2) Exports and Imports: Central Bank of Chile.

Notes: (i) Bold type represents the sum, where possible, of the rows below.

(ii) The row vodka (minimum 40°) is underlined for emphasis, since there are import and export statistics for the years 1996 and 1997.

2.20 Finally, the merger of the two largest producers of pisco, Control and Capel, was authorized by Chile's competition authority as of 30 October 1998. Their combined market share is 90%. In giving this authorization, the competition authority indicated that pisco had a high degree of competition with other alcoholic beverages, such as wine, beer and whisky, given the practice of ingesting pisco mixed with a non-alcoholic beverages, and therefore, in the market for alcoholic beverages, and despite the fact that the merger of the applicant co-operative companies would result in a combined share of the pisco market of 98%, there are alternative products which consumers of alcoholic beverages could choose to drink.

2. The Other Spirits in Issue

2.21 The names of the main types of distilled spirits at issue in this dispute, other than pisco, are permitted to be used only for those alcoholic beverages which are defined by Decree 78/1986 in the following terms[21]:

(i) *Whisky*: "The distillate of the alcoholic fermentation of malted or unmalted mashes of grain, which is subjected to ageing processes in wooden vessels, whether or not coloured with natural caramel".[22]

[21] According to the European Communities, Decree 78/1986 contains no definition of rum.

[22] Decree 78/1986, Article 1.42 (EC Exhibit 13).

(ii) *Brandy*: "*Aguardiente* aged in vessels of noble wood, whether or not coloured with natural caramel, and whether or not sweetened with sugar".[23]

(iii) *Gin*: "Beverage obtained by flavouring rectified alcohol from starchy raw materials with distillates, macerations or essential oils from juniper berries".[24]

(iv) *Vodka:* "Beverage obtained from alcohol from starchy raw materials, with or without maceration of grass".[25]

(v) *Liqueurs*: "The product prepared from potable ethyl alcohols, distillates, fermented alcoholic beverages, whether or not mixed with each other, and with or without natural or synthetic aromatic extracts. It may contain sweeteners, water, colorants or any other permitted additive".[26]

2.22 Decree 78/1986 also prescribes the minimum alcohol content requirements for the use of the main type names of distilled spirits in dispute, as follows[27]:

Table 5[28]

Legally required minimum alcohol strength in Chile

Whisky, rum, tequila, gin	40°
Brandy, cognac, armagnac	38°
Aguardiente, fruit aguardiente, grappa	30°
Fruit liqueurs	25-34°
Anisettes	25-40°
Bitters	25-30°
Cocktails	12-16°
Other liqueurs	25-28°

C. History of Taxation of Alcoholic Beverages in Chile

2.23 Between 1916 and 1954, pisco was totally exempted from the excise taxes imposed on the other alcoholic beverages. Between 1954 and 1974, pisco was taxed at a rate that was half of the rate applied to all the other liquors.

2.24 In 1974, Decree-Law No 826/74 introduced a 40 % *ad valorem* tax on all categories of spirits, including pisco.[29] At the same time, however, Decree-Law 826/74 imposed a 50 % surcharge ("*recargo*") on all imported beverages.[30]

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[23] Decree 78/1986, Article 1.5.
[24] *Ibid*., Article 1.11.
[25] *Ibid*., Article 1.41.
[26] *Ibid*., Article 1.17.
[27] *Ibid*., Article 12.
[28] EC First Submission, Table 2, with corrections made by the Panel based upon Decree 78/1986, Article 18 (EC Exhibit 13).
[29] Article 3 of Decree-Law No. 826, of 27 December 1974 (hereafter, "Decree 826/74") (EC Exhibit 5).
[30] *Ibid*.

2.25 In 1977, Decree-Law 826/74 was amended by Decree-Law 2,057/77, which abolished the *recargo*.[31] Simultaneously Decree-Law 2,057/77 lowered the rate of tax on pisco from 40 % to 25 %, while the tax on other spirits was reduced from 40 % to 30 %.

2.26 In June 1979, Decree-Law No 826/74 was repealed and replaced by the ILA, a new tax applied in conjunction with the Value Added Tax system.[32] At first, the ILA was applied at the same rates as the tax which it had replaced, i.e., 25 % on pisco and 30 % on all other distilled spirits.[33] But in December 1983 the rate on distilled spirits other than pisco was increased from 30 % to 50 %, while the rate applied to pisco was unchanged at 25 %.[34]

2.27 On 23 January 1984, the ILA was amended again in order to lower the applicable rate on distilled spirits other than pisco and whisky from 50 % back to its previous level of 30 %.[35] At the same time, the rate on whisky was further increased from 50 % to 55 %.[36] Thus, following these changes, the ILA was applied at three different rates: 25 % on pisco; 55 % on whisky and 30 % on all other distilled spirits.

2.28 In May 1985, the rate on whisky was increased once again from 55 % to 70 %.[37] Following this change, the ILA rates have remained unmodified until the amendment approved in November 1997.

2.29 The table below summarizes the evolution of the applicable rates between 1974 and the entry into force of Law 19,534 on 1 December 1997.

Table 6[38]

Evolution of taxes rates between 1974 and 1997

	Pisco	**Whisky**	**Other Spirits**
With effect from 12/74	40 %	40 %*	40 %*
With effect from 12/77	25 %	30 %	30 %
With effect from 7/79	25 %	30 %	30 %
With effect from 12/83	25 %	50 %	50 %
With effect from 1/84	25 %	55 %	30 %
With effect from 5/85	25 %	70 %	30 %

* imported spirits subject to the 50 % *recargo* until 1977.

[31] Decree-Law No. 2,057 of 30 November 1977 amending Decree-Law 826/74 (hereafter "Decree 2,057/77")(EC Exhibit 7), Article 1.2.

[32] Decree No 2,752, of 21 June 1979, integrating the taxes on alcoholic beverages within the VAT system (hereafter, "Decree 2,752/79") (EC Exhibit 8). According to the European Communities, this Decree-Law brought the taxation of alcoholic beverages within the scope of Decree-Law 825/74.

[33] *Ibid*., Article 1.3.

[34] Article 4.III of Law No. 18,267, of 1 December 1983 amending Article 42 of Decree 825/74 (hereafter, "Law 18,267/83") (EC Exhibit 9).

[35] Article 1 of Law No. 18,289, of 23 January 1984 amending Article 42 of Decree 825/74 (hereafter, "Law 18,289/84") (EC Exhibit 10).

[36] *Ibid*.

[37] Article 4.III of Law 18,413/85 (EC Exhibit 11).

[38] EC First Submission, Table 7.

III. CLAIMS OF THE PARTIES

3.1 **The claim of the European Communities is** that both the Transitional System and the New Chilean System are inconsistent with Chile's obligations under GATT Article III:2, second sentence.

3.2 The European Communities claims that[39]:

(i) the Transitional System, which is applicable through 30 November 2000, is contrary to GATT Article III:2, second sentence, because it provides for the imposition of lower internal taxes on pisco than on other directly competitive or substitutable imported spirits which fall within the tax categories of "whisky" and "other spirits", so as to afford protection to Chile's domestic production;

(ii) the New Chilean System, which will become applicable as of 1 December 2000, is also contrary to Article III:2, second sentence, because it results in the imposition of lower taxes on pisco with an alcohol content of 35° or less than on other directly competitive or substitutable imported spirits which have a higher alcohol content, so as to afford protection to Chile's domestic production.[40]

3.3 **In response, Chile contends** that the New Chilean System is fully consistent with Article III:2 because it taxes all distilled spirits, regardless of type and regardless of whether imported or domestic, according to identical objective criteria of alcoholic strength and value (*ad valorem*).

3.4 Chile then claims that this Panel should reject the unwarranted and intrusive interpretation of the reach of Article III that the European Communities has put forward in this dispute, and that in keeping with the plain language and the history of Article III, the Panel should find that the New Chilean System is fully consistent with Article III:2, second sentence.

3.5 Chile also argues that to the extent that the Panel considers the Transitional System to be at issue notwithstanding the short time in which it will remain in effect, it would be appropriate for the Panel to find that pisco is not directly competitive or substitutable with other distilled spirits in Chile, and hence that the Transitional System also conforms with Article III:2, second sentence.

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[39] The European Communities notes that in its panel request, it also claimed a violation of GATT Article III:2, first sentence. The European Communities states that even though certain spirits exported from the European Communities to Chile (including in particular certain types of brandy) may be considered as being "like" to pisco, it decided not to pursue that claim, given that those spirits are in any event "directly competitive or substitutable" with pisco.

[40] The European Communities argues that the New Chilean System already constitutes mandatory legislation, and as such, it may be the subject of dispute settlement under the WTO Agreement, citing Panel Report on *United States - Taxes on Petroleum and Certain Imported Substances,* BISD 34S/136, paras. 5.2.1-5.2.2.

IV. ARGUMENTS OF THE PARTIES

A. Overview

1. GATT Article III:2, Second Sentence

4.1 **The European Communities puts forth** the relevant GATT provision, GATT Article III:2, second sentence, which reads as follows:

> Moreover, no Member shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.

4.2 Further, the European Communities refers to Article III:1, which provides in relevant part that:

> The Members recognize that internal taxes ... should not be applied to imported or domestic products so as to afford protection to domestic production.

4.3 The European Communities then indicates that the Interpretative Note to Article III:2 states that:

> A tax conforming to the requirements of the first sentence of paragraph 2 would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed.

4.4 The European Communities further points out that in *Japan - Taxes on Alcoholic Beverages II*[41], the Appellate Body clarified that in order to determine whether an internal tax measure is inconsistent with Article III:2, second sentence, it is necessary to address the following three issues:

(i) whether the imported products and the domestic products are "directly competitive or substitutable products" which are in competition with each other;

(ii) whether the directly competitive or substitutable imported and domestic products are "not similarly taxed"; and

(iii) whether the dissimilar taxation of the directly competitive or substitutable imported products is "applied ... so as to afford protection to domestic production".

4.5 In addition, the European Communities points out that as a preliminary matter it must be ascertained whether the measures at issue are "internal taxes". The ILA is levied on all distilled spirits intended for consumption in Chile, whether locally manufactured or imported, and not just "on" or "in connection" with the importation of distilled spirits. Accordingly, the ILA constitutes an "internal tax" in the sense of

[41] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages* (hereafter, "*Japan - Taxes on Alcoholic Beverages II*"), adopted on 1 November 1996, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, DSR 1996:I, 97 at 116. *See also* the Appellate Body Report on *Canada - Certain measures concerning Periodicals* (hereafter "*Canada - Periodicals*"), adopted on 30 June 1997, WT/DS31/AB/R, DSR 1997:I, 449, at 470.

GATT Article III:2, and not an "import charge" within the purview of GATT Articles II and VIII.

4.6 **Chile,** while agreeing that the proper basis for analyzing whether a measure conforms with Article III:2, second sentence, is the test set out in the ruling of the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*, **points out** that concerning these three elements, the Appellate Body in *Japan - Taxes on Alcoholic Beverages II* emphasized that:

> [T]hese are three *separate issues*. Each must be established separately by the complainant for a panel to find that a tax measure imposed by a Member of the WTO is inconsistent with Article III:2, second sentence.[42]

4.7 Chile then argues that the EC complaint does not and could not meet this three-part test. Chile asserts that the European Communities, perhaps out of habit based on arguing about the Japanese and Korean tax systems, devotes the largest part of its argumentation to the first part of the three-part test: the question of whether pisco is directly competitive or substitutable with other spirits in the Chilean market. Chile does not agree that the European Communities has met its burden with respect to the first element. However, the issue of directly competitive or substitutable, which was at the core of the disputes concerning the Japanese and Korean systems of taxation, is essentially irrelevant in the analysis of the New Chilean System, because the new system eliminates all distinctions based on type of distilled spirits. Instead, the New Chilean System applies an identical system of taxation to all types of distilled spirits, regardless of whether they are like, competitive or substitutable and regardless of origin.

4.8 In response, **the European Communities contends** that Chile's strategy in this case is to divert the Panel's attention from the examination of Chile's own tax system. Chile attempts to do so by focusing the discussion on other tax systems (both real and hypothetical), which are fundamentally different from the New Chilean System. With the same purpose, Chile tries to focus the debate on a number of superficial differences between this case and previous cases.

4.9 According to the European Communities, Chile has good reasons to follow this strategy. Indeed, the New Chilean System does not withstand a close examination in light of the three-prong test established by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II.*

2. Transitional System

4.10 With respect to the Transitional System, **the European Communities states** that from 1985 to November 1997 pisco was taxed at the rate of 25 % *ad valorem*, whereas whisky, the main imported distilled spirit, was taxed at the rate of 70 % and "other spirits" (a residual category comprising all distilled spirits other than pisco and whisky) at the rate of 30 %.

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[42] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra,* footnote 41, at 116 (emphasis added by Chile).

4.11 The European Communities argues that in an attempt to address longstanding complaints from the European Communities and other WTO Members, Chile amended its liquor tax system in November 1997, following protracted discussions between its Government and the local pisco industry and a lengthy debate by the Chilean Congress.

4.12 According to the European Communities, the New Chilean System approved in November 1997 will not take effect until 1 December 2000. In the meantime, the previous system will remain in place, with the only difference that the tax rate on whisky will be progressively lowered from 70 % to 53 %.

4.13 The European Communities argues that the Transitional System, which is applicable until 30 November 2000, is contrary to GATT Article III:2, second sentence, because it provides for the imposition of lower internal taxes on pisco than on directly competitive or substitutable imported spirits that fall within the tax categories of "whisky" or "other spirits", so as to afford protection to Chile's domestic production.

4.14 **Chile replies** that the EC complaint about the Transitional System, in effect, seeks to replicate previous EC complaints about Japanese and Korean systems of alcohol taxation. Chile notes that by invoking the analysis of the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*, the European Communities argues, among other things, that in Chile all distilled spirits are directly competitive or substitutable.

4.15 Chile goes on to state that, with respect to the Transitional System, it believes that there are significant differences of fact and law between this case and the cases of the Japanese and Korean systems that were found inconsistent with Article III:2. While all three systems make distinctions based on type of distilled spirit, there is much less difference in taxation under the Transitional System, and there are much stronger bases for considering that pisco is not competitive or substitutable in the Chilean market with any other type of spirit.

3. New Chilean System

4.16 **The European Communities argues** that the New Chilean System that will become applicable as of 1 December 2000 is also contrary to Article III:2, second sentence, because it results in the imposition of lower taxes on pisco with an alcohol content of 35° or less than on directly competitive or substitutable imported spirits which have a higher alcohol content, so as to afford protection to Chile's domestic production.

4.17 The European Communities asserts that the New Chilean System abolishes only as a formal matter the distinction between pisco and the other types of distilled spirits. Instead, the applicable rate varies according to (but not proportionally with) alcohol content. Specifically, all spirits with 35° of alcohol content or less are taxed at the rate of 27 % *ad valorem*. From that base, the rate escalates by 4 percentage points for each additional degree of alcohol content, peaking at 47 % for all distilled spirits above 39°. Thus, for a mere five degrees increase in alcohol content, the applicable rate nearly doubles. In contrast, similar differences in alcohol content, both above and below the 35°-39° bracket, do not entail any difference in taxation at all.

4.18 The European Communities thus concludes that the New Chilean System is designed to continue to afford protection to pisco at the expense of imported distilled

spirits. In fact, approximately 90 % of pisco is bottled at 30° to 35° and, therefore, will be taxed at the lowest rate of 27 %.

4.19 The European Communities further argues that in contrast, all imports of whisky, rum, gin, vodka and tequila (which together account for more than 95 % of all imports of spirits into Chile) will be taxed at the highest rate of 47 %. Furthermore, unlike pisco those spirits do not have the flexibility to move down the scale. Under Chilean law, all of them must be bottled at no less than 40° and, therefore, are automatically locked in the highest rate of 47 %.

4.20 According to the European Communities, the protective effects of the New Chilean System are by no means incidental. The lack of internal coherence of the new system (as revealed in particular by the spasmodic progression of the tax rates) evidences that the tax differentials serve no legitimate purpose. Alcohol content has been chosen as a taxation principle simply because it provides a basis for replicating indirectly the protective effects of the old system, and not because the new system is genuinely aimed at discouraging alcohol consumption.

4.21 **Chile replies** that the New Chilean System, in terms of Article III:2, "similarly taxes" all distilled spirits, regardless of type. All distilled spirits are taxed according to the objective, neutral criteria of alcohol strength and value (*ad valorem*). The European Communities notes that low alcohol pisco will bear less tax than high alcohol scotch whisky, but that effect of the Chilean system is no more inconsistent with Article III:2 than is the higher tax that high horsepower U.S.-built cars may face in Europe relative to small European cars.

4.22 Chile contends that a violation of Article III has not occurred merely because, by some measurements, an imported product bears a higher tax than even a like domestic product, if the difference in the tax is not based on nationality of the product and results from the application of objective criteria. As will be demonstrated below, the European Communities itself has conceded in past WTO cases that neutral, objective criteria such as value (*ad valorem*) and alcohol content are permissible bases for a neutral tax system.

4.23 Chile points out that implicitly, the European Communities also concedes the legitimacy of an alcohol content system in this case as well, but the European Communities still tries to argue that the Panel should require still more: that the differentiation in *ad valorem* tax be directly and evenly proportional to the differences in alcohol content. There is no such requirement in the language or history of Article III:2.

4.24 According to Chile, while the European Communities tries to give the impression that this is just one more complaint about taxation of alcoholic beverages in the mold of recent cases such as those involving Japan (twice) and Korea, that is not the case. The New Chilean System is very different from those alcohol tax systems successfully challenged in the past in that the New Chilean System does not distinguish by type, but rather applies identical objective critieria to all products. Chile argues that the European Communities is asking the Panel to expand the interpretation of Article III in ways that are unprecedented and unwarranted.

4.25 Chile also indicates that the major distilled spirits exporting companies and countries have enjoyed success in past cases in challenging tax laws where there was explicit discrimination based on national origin of the products or where, as in the case of the Japanese and Korean systems, the favored product was of a type that effectively could only be domestic. Now the European Communities asks this Panel

to go further to ban tax distinctions based on the neutral criterion of alcohol content, at least if the distinction is not directly proportional to the difference in alcohol content. For the European Communities, it is apparently not sufficient that taxes not discriminate by national origin or by type, nor is it sufficient that the results of the application of the neutral criterion will favor some imports as well as domestic products and disfavor some domestic products as well as imports. Finally - and perhaps most significantly - the European Communities ignores the fact that the use of this objective criterion of alcohol content will enable foreign and domestic producers alike to adapt their products in a very simple process (dilution with water) if they wish to obtain the most favored tax treatment.

4.26 Further, Chile states that if the Panel accepts the EC reasoning, it would not be a far step from such an interpretation to strike down national standards that, though based on objective criteria and applied without regard to national origin, had the effect of being less convenient or more burdensome for many foreign producers than for many domestic producers.

4.27 Accordingly, Chile concludes that this Panel should reject the unwarranted and intrusive interpretation of the reach of Article III that the European Communities has put forward in this dispute. Instead, in keeping with the plain language and the history of Article III, the Panel should find that the New Chilean System is fully consistent with Article III:2, second sentence.

B. "Directly Competitive or Substitutable"

1. Overview

4.28 **The European Communities argues** that pisco and the other distilled spirits are "directly competitive or substitutable".

4.29 In response, **Chile argues** that the European Communities has not established that other distilled spirits are directly competitive or substitutable with pisco. Chile does not deny that there is **some** degree of substitutability among various distilled spirits, but Chile disagrees that this degree is large enough so as to fall within the **directly** competitive or substitutable products in the Chilean market, within the meaning of Article III:2 second sentence.

4.30 Chile goes on to claim that the EC arguments on this point are at least relevant (though unpersuasive) with regard to the Transitional System, which imposes different rates of taxation based on type of distilled spirit. However, the question of whether the different types of distilled spirits are directly competitive or substitutable does not arise in the New Chilean System. The liquor tax systems of Japan and Korea examined by WTO panels involved tax structures organized around product type. The New Chilean System is an entirely different system where differentiation in taxation is based on alcohol content, not type of distilled spirit.

2. General Consideration

4.31 **The European Communities begins with the argument** that the scope of "directly competitive or substitutable" products is broader than that of "like" products. Products which may be too different in terms of physical characteristics or end uses to qualify as "like" for the purposes of the first sentence of Article III:2 may

still be found to be "competitive or substitutable" for purposes of its second sentence.[43]

4.32 The European Communities points out that in *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body ruled that the terms "like product" must be construed "narrowly" in the first sentence of Article III:2.[44] This interpretation was deemed necessary in view of the fact that, as put by one of the complainants in that dispute, Article III:2, first sentence, operates as "guillotine": once it has been established that two products are "like", any tax differential between them is deemed prohibited, without it being necessary to ascertain whether the tax differential is applied "so as to afford protection".

4.33 Further, the European Communities notes that the Appellate Body arrived at its conclusion that the term "like" should be construed "narrowly" as follows:

> Because the second sentence of Article III:2 provides for a separate and distinctive consideration of the protective aspect of a measure in examining its application to a broader category of products that are not "like products" as contemplated by the first sentence, the European Communities agrees with the Panel that the first sentence of Article III:2 must be construed narrowly so as not to condemn measures that its strict terms were not meant to condemn. Consequently, the European Communities agrees with the Panel also that the definition of 'like products' in Article III:2, first sentence, should be construed narrowly.[45]

4.34 The European Communities also states that, in contrast, there is no suggestion in *Japan - Taxes on Alcoholic Beverages II* that the notion of "directly competitive or substitutable" product must also be construed "narrowly". This reflects the different wording and structure of the second sentence of Article III:2. Unlike the first sentence, the second sentence makes express reference to the first paragraph of Article III. This means that in order to establish a violation of Article III:2, second sentence, it must be determined first, as one of three separate requirements, that the tax differential is "applied ... so as to afford protection to domestic production". Therefore, a "narrow" reading of the terms "directly competitive or substitutable", unlike a "narrow" interpretation of the terms "like product", is not required in order to ensure that only protectionist measures are condemned.

4.35 According to the European Communities, the drafting history of the GATT 1947 also supports a broad interpretation of the scope of "directly competitive or substitutable" products. At the Geneva session of the Preparatory Committee, delegates cited several examples of products that could be considered sufficiently "competitive" to trigger the application of Article III:2, second sentence. These

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[43] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*., footnote 41, at 117.

[44] *Ibid*., at 112-113.

[45] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra.,* footnote 41, at 112.113. The European Communities points out that the Panel Report on *Japan - Taxes on Alcoholic Beverages*, (hereafter, "*Japan - Taxes on Alcoholic Beverages II*"), adopted on 1 November 1996, WT/DS8/R, WT/DS10/R, WT/DS11/R, DSR 1996:I, 125, para. 6.22 states: "Giving a narrow meaning to 'like products' is also justified by the inescapability of violation in case of taxation of foreign products in excess of [*sic*] domestic products".

examples included quite broad categories of products, such as apples and oranges[46]; linseed oil and tung oil[47]; and synthetic rubber and natural rubber.[48] The record discloses that no disagreement was expressed by delegates with respect to the breadth of these examples. At the Havana Conference, some delegates mentioned even larger categories of products, such as tramways and busses or coal and fuel as examples of "directly competitive or substitutable" products.[49]

4.36 The European Communities argues that past panels which have interpreted the notion of "directly competitive or substitutable products" have also taken a broad approach. The Panel Report on *Japan - Taxes on Alcoholic Beverages I*[50] found that shochu and all other distilled spirits were directly competitive and substitutable on the Japanese market. This finding was confirmed in *Japan - Taxes on Alcoholic Beverages II*.

4.37 Also, the European Communities points out that another example is provided by the Panel Report on *EEC - Measures on Animal Feed Proteins*, which concluded that vegetable proteins and skimmed milk powder were "directly competitive or substitutable" products for the purposes of applying the second sentence of Article III:5.[51]

4.38 **Chile contends** that despite the slight and temporary practical effect of the issue whether pisco is directly competitive or substitutable with any other distilled spirits, at least as a matter of precedent, it is important to emphasize that the European Communities has failed to substantiate its claim that pisco is directly competitive or substitutable in the sense of Article III with European spirits.

4.39 Chile goes on to state that the European Communities has been careful to include many paragraphs and even some charts purporting to fulfill each of the elements necessary to demonstrate that other distilled spirits are directly competitive or substitutable with pisco in the Chilean market. The Panel should not simply accept the EC's contentions which, in the view of Chile, do not stand up to close scrutiny as proofs that the products are directly competitive or substitutable. Chile notes that the European Communities has provided what are undoubtedly thick studies and annexes, and the Transitional System has some superficial similarities to the Japanese and Korean cases. Chile urges the Panel to reject the EC's arguments. Accepting the EC's contentions regarding the Transitional System would set an adverse precedent that would constitute yet one further significant step toward requiring harmonization of taxation of increasingly disparate products - even as panels continue to claim that such is not their objective or intent.

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46 E/PC/T/A/PV/9, p. 7.

47 E/CONF.2/C.3/SR.11, p.1 and Corr. 2.

48 E/CONF.2/C.3/SR.11, p. 3.

49 E/Conf.2/C.3/SR.40, p. 2. Nevertheless, the European Communities notes that unlike in the case of the examples mentioned at Geneva, there was some disagreement among delegates with respect to these examples.

50 Panel Report on *Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, BISD 34S/83 (hereafter, "*Japan - Taxes on Alcoholic Beverages I*").

51 Panel Report on *EEC - Measures on Animal Feed Proteins*, BISD 25S/49, para. 4.3.

4.40 Chile then states that the Panel should instead find that the European Communities has failed to meet its burden of demonstrating that pisco is directly competitive or substitutable with other distilled spirits in the Chilean market.

3. Potential Competition

4.41 **The European Communities stresses** that Article III:2, second sentence, is concerned not only with tax differentials between products that are already *actually* competitive or substitutable on a given market, but also with tax differentials between products that are *potentially* competitive or substitutable. Furthermore, the notion of potential competition must be deemed to include not only competition that would exist "but for" the tax measures at issue, but also competition that could be reasonably expected to develop in the future having regard, for example, to existing trends in the market concerned or to the situation prevailing in other markets.

4.42 The European Communities explains that the relevance of potential competition, as defined above, flows from the well-established principle that GATT Article III does not protect export volumes but competitive opportunities. As stated by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*:

> [I]t is irrelevant that the "trade effects" of the tax differential between imported and domestic products, as reflected in the volumes of imports, are insignificant or even non-existent. Article III protects expectations not of any particular trade volume but rather of the equal competitive relationship between imported and domestic products.[52]

4.43 The European Communities states that the recognition of the relevance of potential competition for the purposes of Article III:2, second sentence, is of particular importance in the present dispute. In the first place, pisco has benefited from protective taxation for a long time. As a result, the current level of actual competition between pisco and other spirits is necessarily less than the level that could have developed under equal tax conditions. Secondly, distilled spirits, like many foods and beverages, are so-called "experience goods", i.e., goods which must be purchased and consumed in order to appreciate their aptitude to satisfy the consumers' needs. Furthermore, consumption of spirits is largely based on habits, which only change gradually. For those reasons, market penetration is generally slow and short-term reactions to price changes tend to be relatively low.

4.44 **Chile replies** that the European Communities offers as an excuse that cross-elasticities are often low for products that are new to the market. Such a comment hardly seems appropriate to the case of whisky, which has a very long history in the Chilean market.

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[52] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*.footnote 41 at 110. *See* also Working Party on Brazilian Internal Taxes, adopted 30 June 1949, II/181, 185, para. 16; Panel Report on *United States - Taxes on Petroleum and Certain Imported Substances, supra.,* para. 5.1.9; Panel Report on United States - Measures affecting Alcoholic and Malt Beverages (hereafter, "*United States - Malt Beverages*"), BISD 39S/206, para. 5.6; and Panel Report on *United States - Measures Affecting the Importation, Sale and Use of Tobacco,* BISD 41S/131, paras. 99-100.

4. Relevant Factors and Their Evidentiary Weight

(a) Relevant Factors

4.45 **The European Communities points out** that in *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body noted that "how much broader [the] category of 'directly competitive or substitutable products may be in a given case' is a matter for the panel to determine based on all relevant facts in that case".[53]

4.46 Also, according to the European Communities, in the same report, the Appellate Body referred specifically to the following factors as being relevant for assessing whether two products are "directly competitive or substitutable"[54]:

(i) the physical characteristics of the products;

(ii) their end-uses;

(iii) their tariff classification; and

(iv) the "market place", and in particular the degree of elasticity of substitution between the products concerned.

4.47 **In response, Chile states** that the question whether products are like, directly competitive or substitutable under various GATT rules has provoked many disputes over the years, but has not led to the development of any particularly clear or objective standards to guide WTO member governments or their legislatures. The case by case approach of the panels to date may be thought desirable, insofar as it leaves panels considerable discretion for judgement as to what are permissible and impermissible distinctions, but the cost of that discretion is a loss in predictability and certainty for national governments and legislatures.

4.48 Thus, Chile argues that panels have taken the approach of considering a variety of factors (none of which are considered individually dispositive) rather than applying any readily apparent formula. In reading the various decisions, it is impossible to avoid the sense that there is as much intuition as science lying behind past GATT and WTO decisions. Under such a standard, Chile disagrees with the EC claim that its finest single malt whiskeys and its rarest cognacs must be viewed as directly competitive or substitutable with Pisco corriente.

4.49 Chile states that the EC argument in this case nominally tracks the factors that the Appellate Body endorsed in the *Japan - Taxes on Alcoholic Beverages II* case. Those factors include such matters as physical characteristics, common end-uses, and tariff classifications, but also the "market place".

4.50 Chile argues that in sum, each supposed element of the EC case appears ill-founded. While perhaps every factor need not be present with equal force to find two products to be directly competitive or substitutable, every element should not be so weak as the evidence presented by the European Communities. Accordingly, the Panel should find that the European Communities has not shown that pisco and other distilled spirits are directly competitive or substitutable, and that the Transitional System is consistent with Article III:2, even for the brief period it remains in force.

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[53] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*. footnote 41, at 117.

[54] *Ibid*.

(b) Evidentiary Weight

(i) Physical Characteristics

4.51 **The European Communities points out** that as illustrated by the drafting history of Article III:2 and past panel reports, two products need not have the same physical characteristics in order to be "directly substitutable and competitive". As noted by the Panel Report on *Japan - Taxes on Alcoholic Beverages II*:

> [C]ompetition can and does exist among products that do not necessarily share the same physical characteristics. In the Panel's view, the decisive criterion is whether they have common end uses.[55]

4.52 According to the European Communities, at the same time, however, it is obvious that if two products have sufficiently similar physical characteristics, such similarity may in and of itself be sufficient to conclude that the products in question are apt to serve for the same end-uses and, therefore, that they are "directly competitive or substitutable".

4.53 The European Communities argues that in order to be "directly substitutable and competitive" two products need not have the same physical characteristics. In fact, if there were no differences in physical characteristics between two products, they would be "like" instead of "directly competitive or substitutable". The decisive criterion for determining whether two products are "directly competitive or substitutable" is whether they have common end-uses. At the same time, it seems obvious that if two products have sufficiently similar physical characteristics, such similarity may in and of itself be sufficient evidence to conclude that the products in question are apt for the same end-uses and, therefore, that they are "directly competitive or substitutable".

4.54 According to the European Communities, the existence of differences in physical characteristics between Japanese shochu and the other distilled spirits did not prevent the two panels on *Japan - Taxes on Alcoholic Beverages I* and *II* from concluding that they were directly "competitive and substitutable" in the Japanese market. Likewise, in *Korea - Taxes on Alcoholic Beverages*, the panel concluded that soju was "directly competitive or substitutable" with a number of other distilled spirits, despite the existence of differences with respect to factors such as alcohol content, ageing, colour or flavouring.[56] The differences between pisco and other distilled spirits are similar to those existing between shochu or soju and other distilled spirits. Therefore, those differences cannot exclude of themselves a finding that pisco is "directly competitive or substitutable" with other distilled spirits.

4.55 **In rebuttal, Chile states** that not all physical characteristics of the products involved need to overlap for the products in question to be considered "directly competitive or substitutable". However, Chile does consider that the European Communities needs to demonstrate more than a coincidence of one physical characteristic, in this case the alcohol content of the beverage, before claiming that products are *directly* competitive or substitutable in the sense required by Article III.

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[55] Panel Report on *Japan - Taxes on Alcoholic Beverages II, supra*. footnote 45, para. 6.22.

[56] Panel Report on *Korea - Taxes on Alcoholic Beverages*, 17 September 1998, WT/DS75/R and WT/DS84/R, DSR 1999:I, 44, para. 10.67.

(ii) End-uses

4.56 **The European Communities states** that as observed by the panel on *Japan - Taxes on Alcoholic Beverages II* in the above quoted passage, commonality of end-uses is the "decisive criterion" for establishing whether two products are "directly competitive or substitutable". In fact, the other criteria are relevant only to the extent that they can provide an indication as to the existence of such commonality of end-uses.

4.57 According to the European Communities, in order to be "directly competitive or substitutable" for the purposes of Article III:2, second sentence, two products need not be competitive or substitutable with respect to all their possible end-uses. This was made clear by the Appellate Body in *Canada - Periodicals.*[57] In that case, Canada argued that US magazines were not "directly competitive or substitutable" with Canadian magazines because, while they provided a reasonable substitute as an advertising medium, they were poor substitutes as an entertainment and communication medium. Thus, according to Canada, US and Canadian magazines were only "imperfect substitutes". The Appellate Body dismissed this argument by pointing that a case of "perfect substitutability" would fall within Article III:2, first sentence.

4.58 The European Communities goes on to state that similarly, in *Japan - Taxes on Alcoholic Beverages I*, the panel based its conclusion that Japan's Liquor Tax Law violated Article III:2, second sentence, on the finding that there existed direct competition or substitutability among the liquors concerned, "even if not necessarily in respect of all the economic uses to which the products may be put".[58]

4.59 Further, the European Communities contends that from the principle that Article III is concerned with the protection of competitive opportunities, it follows that the end-uses to be taken into account include all the objective (or functional) end-uses to which the products may be put, irrespective of whether the products are currently being employed for those end-uses in the market concerned. Similarity of actual end-uses may, of course, provide further evidence of substitutability, but is not required for a finding that products are "directly competitive or substitutable".

(iii) Tariff Classification

4.60 **In the view of the European Communities,** tariff nomenclatures classify products in accordance with their physical characteristics and end-uses. For that reason, as noted by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*, "if sufficiently detailed, tariff classification can be a helpful sign of product similarity".[59]

4.61 The European Communities points out that tariff classification has already been relied upon by several previous panel reports in order to make a "like" product determination.[60] *A fortiori*, tariff classification may also be relevant for the purposes

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[57] Appellate Body Report on *Canada - Periodicals, supra,* footnote 41, at 473.

[58] Panel Report on *Japan - Taxes on Alcoholic Beverages I, supra,* footnote 50, para. 5.7.

[59] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra,* footnote 41, at 114.

[60] Panel Report on *Japan - Taxes on Alcoholic Beverages I, supra*., para. 5.6. *See* also the Panel Report on *EEC - Measures on Animal Feed Proteins, supra* footnote 51*;* and Panel Report on

of determining whether two products fall within the broader category of "directly competitive or substitutable" products.

4.62 According to the European Communities, two products falling within the same tariff position may be covered by different bindings and vice-versa. Tariff nomenclatures such as the Harmonized System classify products according to their objective characteristics. For that reason, they may provide useful guidance in order to determine whether products are "like" or "directly competitive or substitutable".

4.63 **Chile concedes** the obvious point that all distilled spirits share a common tariff category; however, according to Chile, the point is of virtually no legal significance, because there are 4-digit HS categories which include products which are obviously not "directly competitive or substitutable"; for example, aviation gas and vaseline white oil (HS 2710), mackerel and caviar (HS 1604), lobster and crabmeat meal (HS 0306), and ivory and nails (HS 0507).

(iv) Market Place

4.64 **The European Communities notes** that in *Japan - Taxes on Alcoholic Beverages II*[61], the Appellate Body approved the Panel's decision to look at the "market place" and in particular to the cross-price elasticity between the products concerned. At the same time, however, the Appellate Body emphasized that cross-price elasticity is "not *the* decisive criterion". According to the Appellate Body, cross-price elasticity is but one of the means of examining the relevant market. In turn, looking at the relevant market is but "one among a number of means" of identifying the products that are directly competitive or substitutable in a particular case.

4.65 According to the European Communities, a high rate of cross-price elasticity may be sufficient to establish that two products are directly competitive or substitutable for the purposes of the second sentence of Article III:2. The opposite, however, is not necessarily true. A relatively low rate of cross-price elasticity does not of itself exclude the possibility that two products may be "directly competitive or substitutable". Such a low rate may simply be the result of the tax measures at issue. Or it may reflect the fact that imports are new entrants in the market concerned, a hypothesis that may be of particular significance in the case of experience goods such as those at issue in this dispute.

4.66 The European Communities further points out that as noted by the Panel Report on *Japan - Taxes on Alcoholic Beverages II*:

> ... a tax system that discriminates against imports has the consequence of creating and even freezing preferences for domestic goods, In the Panel's view, this meant that consumer surveys in a country with such a tax system would likely understate the degree of potential competitiveness between substitutable products.[62]

United States - Standards for Reformulated and Conventional Gasoline, WT/DS2/R, adopted on 20 May 1996, DSR 1996:I, 29.

[61] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*.footnote 41, at 117.

[62] Panel Report on *Japan - Taxes on Alcoholic Beverages II, supra* footnote 45, para. 6.28, citing the Panel Report on *Japan - Taxes on Alcoholic Beverages I, supra* footnote 50, para. 5.7.

4.67 According to the European Communities, when "looking at the market-place," it may also be relevant to consider, in addition to cross-price elasticity, other factors such as the actual end-uses of the products (as opposed to their objective end uses), their availability in different sales channels or the way in which they are advertised. Nevertheless, when assessing the evidence related to these factors, it must always be borne in mind that Article III:2 is concerned with the protection of competitive opportunities and not of actual competition. Evidence that two products are sold in the same channels and used for the same purposes can be taken as evidence that they are "directly competitive or substitutable". The absence of such evidence, however, does not, in and of itself, lead to draw the opposite conclusion.

4.68 **Chile replies** that the European Communities offers as an excuse that cross-price elasticities are often low for products that are new to the market. Such a comment hardly seems appropriate to the case of whisky, which has a very long history in the Chilean market. Further, Chile argues that the regression analysis submitted by the European Communities has serious methodological flaws. Chile further states that the Search Marketing surveys submitted by the European Communities have inconsistent results.

4.69 Chile further argues that common distribution channels are not strong evidence, and multi-purpose channels are weaker still than dedicated channels.

4.70 **The European Communities responds** that the regression analysis it has submitted to the Panel was conducted by a consultation firm at the request of the Chilean pisco industry. Further, it claims that the regression analysis Chile submitted to the Panel has a more serious flaw of multicolinearity.

5. Product Categories

4.71 **The European Communities argues** that all pisco must be considered as a single product for the purposes of Article III:2. Accordingly, the existence of direct competition or substitutability must be assessed with respect to the category of pisco as a whole and not with respect to each of the four types of pisco.

4.72 The European Communities claims that, according to the regulations in force, the four different varieties of pisco are distinguished solely in terms of their alcohol strength.[63] This means that, for example, any pisco with 43° or more is entitled to use the designation *gran pisco*, irrespective of the varieties of muscat grape from which it is made, the length of its ageing period or the type of container in which it has been matured. As acknowledged by Chile during the consultations[64], all that is required in order to produce *pisco especial* or *pisco corriente* instead of *gran pisco* or *pisco reservado* is adding some more water before bottling the product.

4.73 The European Communities then argues that this difference does not warrant treating each of them as a distinct product for the purposes of Article III:2, second

[63] Article 13 of Decree 78/1986 (EC Exhibit 13). In this connection, the European Communities notes that Chile claimed in Chile's answers to questions from the EC, dated 24 February 1998 (EC Exhibit 2) that each of the four types of pisco is made from different varieties of grapes and according to a different manufacturing process, in particular as regards the maturation phase.

[64] Chile's answers to questions from the EC, dated 24 February 1998 (EC Exhibit 2).

sentence, especially since, as will be shown below, most pisco is consumed mixed with other non-alcoholic beverages or "on the rocks". In *Japan - Taxes on Alcoholic Beverages II*, the panel noted that "a difference in the alcoholic strength of two products dos not preclude a finding of likeness, especially since alcoholic beverages are often drunk in diluted form".[65]

4.74 Further, the European Communities points out that as shown in Tables 7 and 8 below, most other distilled spirits are also bottled at different alcohol strengths. Japanese shochu, for instance, is bottled in a range from 20° to 45°. Yet, the two panels on *Japan - Taxes on Alcoholic Beverages I* and *II* have treated all shochu as a single product, irrespective of its alcohol content.

4.75 The European Communities disagrees with Chile's claim that *gran pisco* and *pisco reservado* are products of higher quality and, for that reason, are sold at higher prices than the other types of pisco.[66] There is no clear correlation between quality/prices and alcohol strength. The European Communities submitted a survey of retail prices conducted in May 1998 by Search Marketing S.A. at five big super-markets of Santiago (hereafter, "the 1998 SM price survey").[67] This survey shows that price differentials among brands of the same alcohol strength are often larger than price differentials among strength categories within the same brand. Thus, for example, *pisco especial* of high quality brands such as "Alto del Carmen", "Control de Guarda" or "Mistral" is more expensive than *pisco reservado* or even *gran pisco* of average quality such as the basic "Capel" and "Control" brands.

4.76 The European Communities further argues that, with respect to the samples of pisco provided to the Panel[68], the bottles and labels of all piscos of the same brand tend to be identical, except for the mandatory indication of their respective alcohol strength and denomination. Promotional claims are generally made with respect to all products of the same brand, rather than with respect to specific alcohol strengths.

4.77 Further, according to the European Communities, the pisco industry has pursued a marketing strategy apparently aimed at segmenting the pisco market in order to expand its consumer base and raise unit profitability. This policy has taken two different courses. The first of them was to develop product categories based on alcohol strength, a strategy that was officially sanctioned by Decree-Law 78/1986. The second and more recent trend is to extend the line of brands of each producer. Thus, in addition to its basic brand "Capel", Capel is now selling the "prestige" brands "Artesanos de Cochiguaz" and "Alto del Carmen", as well as less expensive brands such as "Limarí" and "Límite". In turn, Control's brand portfolio includes, besides the brand "Control", the brands "Control de Guarda", "La Serena", "Mistral", "Tres Erres" and "Sotaqui". The identity of these new brands has been built upon

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65 *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 45, para. 6.23.

66 Chile's answers to questions from the European Communities, dated 24 February 1998 (EC Exhibit 2).

67 A copy is attached as EC Exhibit 23. The European Communities notes that additional confirmation is provided by the price data shown in the 1997 report of The International Wine & Spirits Record (hereafter the "IWSR Report"), pp. 80-81, Table G (EC Exhibit 19).

68 EC Exhibits 62-71.

motives such as the place of origin of the grapes, traditional manufacturing methods, product age claims, fancy packaging and differentiated advertising.[69]

4.78 The European Communities further argues that most brands are sold in a wide range of strengths, with the consequence that the number of brands/strengths now available in the market may be close to 100, despite the fact that the two main producers account for more than 90 % of the sales. The proliferation of new brands, each with a different identity, has blurred the segmentation based on alcohol content which the industry had attempted to build on the basis of the legal categorization established in Decree 78/1986. As already mentioned above, inter-brand differences in quality and price may now be greater than intra-brand differences between strength categories.

4.79 The European Communities then concludes that in any event, pisco is by no means unique in being sold in different types/qualities. If anything, pisco is a much more homogeneous product than other spirits. For instance, to mention but the best known types of whisky, one may distinguish between malt Scotch, grain Scotch, blended Scotch, Canadian, Irish, Bourbon and Rye, each with its own specific characteristics. Moreover, within each of those types of whisky, it is still possible to draw further distinctions. Thus, in the case of blended Scotch, the trade makes a distinction between "premium" blended Scotch (12 or more years old) and "standard" blended Scotch (less than 12 years old). The differences in terms of quality and price between the four varieties of pisco alleged by Chile are not greater than those that exist between different types/qualities of whisky.

4.80 In response to a question posed by the Panel about product categories and comparisons, **Chile contends** that there are both similarities and differences between, on the one hand, the cases of Boss Suits/Discount Store Suits, Mont Blanc Pens/Bic Pens and, on the other hand, pisco and whisky or other distilled spirits. In the cases of the suits and the pens, one product is essentially a luxury version of the other, with corresponding differences in price and presumably quality. As a result, in most markets there is probably little substitutability between the products, as poor consumers cannot afford Boss suits or Mont Blanc pens, while rich ones will not buy discount suits or pens where a choice is available (although Chile thinks that even rich consumers may be more likely to use Bic Pens for some purposes than to buy cheap suits). A hypothetical "average" consumer of suites might see some substitutability, but more likely would find neither a satisfactory alternative. Chile believes that the differences in market segment and price are such that a higher tax on the luxury product would not infringe Article III:2, even if all Boss suits were imported and all discount suits were domestically made.

4.81 Chile goes on to argue that the case of pisco and other distilled spirits has some similarities, but also some important differences. The analogy to the pens and suits cases would be more precise if one compared a cheap, 30º *pisco corriente* to a high quality *gran pisco*, since one is a luxury version of the other.

4.82 In Chile's view, the more appropriate analogies when comparing *pisco corriente* and, for example, a good Scotch whisky or French cognac would be the

[69] *See* e.g. the description of Control's different brands contained in Control's Internet home page (EC Exhibit 51).

difference between a cheap apple and a top quality orange; Belgian endives and cabbage, or a cheap soybean oil and a high quality extra virgin olive oil from Umbria. In each of these examples, the two different products are capable of being used for the same purposes and, at some level of price and consumer desperation, might be used interchangeably. However, their markets are in practice very different and they would not be considered directly competitive or substitutable by consumers in most markets. Indeed, except when pursuing the lowest possible taxes for its products, the Scotch Whisky Association itself would doubtless wholeheartedly reject the idea that its products were directly competitive or substitutable with *pisco corriente*.

4.83 **The European Communities notes** that Chile's changes of analogies from vehicles to vegetables does not help its case. *Pisco corriente* and "a good Scotch whisky" are compared by Chile, respectively, to a "cheap apple" and a "top quality orange". However, apples and oranges were precisely one of the examples of "directly competitive and substitutable products" cited by the drafters of GATT. The qualification that the apple must be a "cheap" one and the orange "top quality" is inappropriate. The present case is not just about expensive "good" Scotch and cheap *pisco corriente*. It is about all kinds of whisky and of pisco. The European Communities has shown that the prices of pisco and of other spirits already overlap, despite differences in taxation.

4.84 According to the European Communities, the example of "cheap soybean oil" and "high quality extra virgin olive oil from Umbria" is flawed for similar reasons. The relevant comparison would be with olive oil and soybean oil, without any further qualifications.

4.85 Also, the European Communities states that endives are not a "luxurious" product in Belgium. Over time, they could become less expensive also in Washington DC, provided that they are not subject to a "luxury" tax. In Europe, avocados or kiwis could have been considered as a "luxury" item product 20 years ago. They would have remained so, had they been subjected to protective taxation.

6. Arguments on Each Factor

(a) Physical Characteristics

4.86 **The European Communities argues** that pisco and the other distilled spirits share the same basic physical characteristics. All of them have the essential feature of being beverages containing alcohol obtained from naturally fermented ingredients by using similar distillation processes. The choice of raw materials from which the alcohol is distilled and/or the use of post-distillation processes such as ageing, colouring or flavouring confer to each type of distilled spirits its own distinctive identity. The resulting differences, however, are not so important as to render the various types of distilled spirits non-substitutable with each other.

4.87 In Tables 7 and 8 below, the European Communities compares the physical properties and manufacturing processes of pisco and the main types of imported distilled spirits. The essential differences between them may be summarized as follows:

(i) *Raw materials*: like most types of brandy (*e.g.,* cognac, armagnac, sherry brandy[70]), pisco is distilled from grape wine. Other spirits are made from grains (whisky, korn, gin, vodka, aquavit, soju, shochu), potatoes (vodka, soju, shochu), sugar cane or molasses (rum, ouzo), fruits (fruit brandies) or neutral spirits (gin, vodka, aquavit, soju, shochu).

(ii) *Colour*: the colour of pisco may go from "clear" or "white" to "light amber". Whisky and the majority of other brandy types are "amber".[71] Rum, aquavit and fruit brandies may be both "white" and "amber". Gin, vodka, ouzo and korn are generally "clear" or "white".

(iii) *Ageing*: like whisky and brandy, pisco is matured in wooden casks. This differentiates pisco from spirits such as vodka, aquavit, korn or ouzo, which are not aged. Rum and certain types of fruit brandy may also be aged in wooden casks.

(iv) *Flavouring*: some spirits have specific flavourings added during or after distillation. For instance, gin has the distinctive feature of being flavoured with juniper berries

(v) *Alcohol content*: pisco is bottled at 30° to 50°. Whisky, gin, rum, vodka, ouzo, korn and aquavit, are bottled at 37/37.5° to 50°. Brandy is bottled at 36 ° to 50 °.

Table 7 [72]

Physical characteristics of distilled spirits

	Alcohol Strength (% vol.)	Colour	Added flavourings	Body/flavour (sensory attributes)
Whisky	37-50	Amber	Yes	Medium to high
Brandy	36-50	Amber/Clear*	Yes	Medium
Gin	37-50	Clear	Yes	Light to medium
Rum	37-50	Clear/Amber	Yes	Light to medium
Vodka	37-50	Clear	Yes	Light
Pisco	30-50	Clear/light amber	Yes	Light to medium
Soju	25-45	Clear/light amber	Yes	Light to medium
Shochu	20-45	Clear/ light amber	Yes	Light to medium
Ouzo	37.5-50	Clear	Yes	Medium to high
Korn	32-45	Clear	No	Light to medium
Aquavit	37.5-50	Clear/light amber	Yes	Light to medium
Fruit brandy	37.5-45	Clear***	Yes**	Light to medium

* Grappa is an example of clear brandy

** Certain countries (*e.g.,* EC) do not permit flavourings in whisky, rum and fruit brandies

*** Except plum brandy (light amber/amber)

[70] The European Communities notes that brandy can also be made from grape marc (e.g. grappa).

[71] The European Communities notes that grappa is generally "white".

[72] EC First Submission, Table 10.

Table 8[73]

Manufacturing processes of distilled spirits

	Raw material*	Distillation strength (% vol.)	Method of distillation	Matura-tion in wooden casks	Reduction with water to bottling strength	Bottling strength (% vol.)
Whisky	Grain	Less than 95	Continuous or pot still	Yes	Yes	37-50**
Brandy	Grapes	Less than 95	Continuous or pot still	Yes	Yes	36-50
Gin	Grain Neutral spirits	At or above 95	Continuous	No	Yes	37-50
Rum	Sugar cane / Juices Molasses	Less than 96	Continuous	Varies	Yes	37-55
Vodka	Grain Potatoes Neutral spirit	At or above 95	Continuous	No	Yes	37-50
Pisco	Grapes	Less than 95	Pot still	Yes	Yes	30-50
Soju	Grain Potatoes Neutral spirits	At or above 85	Continuous or pot still	Varies	Yes	25-45
Shochu	Grain potatoes Neutral spirits	At or above 85	Continuous or pot still	Varies	Yes	20-45
Ouzo	Molasses	55-80	Pot still	No	Yes	37.5-50
Korn	Whole grain	At or above 95	Continuous	No	Yes	37.5-50
Aquavit	Grain molasses Neutral spirits	At or above 95	Continuous	No	Yes	37.5-50
Fruit brandy	Fruits Neutral spirits	Less than 86	Continuous or pot still	No***	Yes	37.5-50

* Neutral spirit is an alcohol spirit distilled at no less than 95 % vol. from any material of agricultural origin.

** Many countries set a minimum alcohol strength of 40 % vol. for whisky, *e.g.,* the EC, the USA and Chile. In some countries, higher or lower minimum strength requirements apply, *e.g.,* Australia (37 %), Brazil (38 degrees Gay Lussac) and South Africa (43 %). Canada sets no minimum strength for whisky.

*** Except plum brandy.

4.88 According to the European Communities, the above differences are relatively minor and do not prevent pisco and the other distilled spirits from being "directly

[73] EC First Submission, Table 11.

competitive or substitutable" within the meaning of Article III:2, second sentence. To the contrary, the degree of similarity between pisco and other spirits is such that, even in the absence of any other evidence, it could be sufficient for this Panel to conclude that they are "directly competitive or substitutable" products.

4.89 The European Communities considers that, indeed, some of the differences between pisco and the other distilled spirits would not even be sufficient to exclude a finding of "likeness". In accordance with well-established case law, "minor differences in taste, colour and other properties (including different alcohol contents) do not prevent products from qualifying as like products".[74] In particular, previous panels have determined that differences in alcohol content do not, of themselves, make two liquors "unlike". Thus, the two panels on *Japan - Taxes on Alcoholic Beverages I* and *II* concluded that shochu was "like" vodka, even though shochu has generally a lower alcohol content. *A fortiori*, differences in alcohol content cannot prevent two products from falling within the broader category of "directly competitive or substitutable" products.

4.90 The European Communities points out that Panel Report on *Japan - Taxes on Alcoholic Beverages II* noted in this regard that:

> ... a difference in the physical characteristics of alcohol strength of two products did not preclude a finding of likeness, especially since alcoholic beverages are often drunk in diluted form.[75]

4.91 In the view of the European Communities, as evidenced by Tables 7 and 8, the differences between pisco and other distilled spirits are similar to the differences between Japanese shochu and other distilled spirits. For example, shochu is generally made from unmalted cereals, potatoes or neutral spirits, unlike brandy, rum, whisky or fruit brandies; is not usually aged or coloured, unlike brandy, whisky or rum; and has an alcohol content of 25° to 30°, unlike the main types of western spirits, which have a strength of 37/37.5° to 50°. Yet, despite those differences, shochu was found to be directly competitive and substitutable with the other distilled spirits falling within HS 22.08 by the two successive panels on *Japan - Taxes on Alcoholic Beverages I* and *II*.

4.92 According to the European Communities, the characteristic of being a "distilled alcoholic beverage" is the essential feature of all the products in dispute. Even if there was no other evidence in the record establishing the existence of actual competition on the Chilean market between pisco and other spirits, the fact that all of them share that essential characteristic could, in and of itself, be sufficient to conclude that they are objectively apt to serve the same end-uses and are therefore "directly competitive or substitutable" within the meaning of the second sentence of Article III:2.

4.93 **Chile responds** that as to the much more objective question of common ingredients and physical characteristics, it is apparent that the products share virtually no ingredients or characteristics, other than containing alcohol. One might as readily find trucks and bicycles to be substitutable because both contain wheels.

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[74] Panel Report on *Japan - Taxes on Alcoholic Beverages I, supra,* footnote 50, para. 5.9 d).

[75] Panel Report on *Japan - Taxes on Alcoholic Beverages II, supra,* footnote 35, para. 6.23.

4.94 Chile considers that it is not irrelevant that all the products in question are distilled alcoholic beverages. However, in the evaluation whether the products are directly competitive or substitutable, this single common characteristic is not in itself sufficient.

4.95 In Chile's view, previous panels considered that to evaluate products as being directly competitive and substitutable, the complaining parties need to show evidence that the products in question share not only physical characteristics (such as nature and quality), but also similar end-uses, channels of distribution and points of sale, marketing strategies, elasticity of substitution, and price.[76] The European Communities failed to submit to the Panel evidence that is conclusive or reliable. (Chile notes, for example, that in its evaluation the European Communities does not seem to take into account that pisco is based on perishable grapes produced domestically, whereas whisky and other distilled beverages are produced on the basis of grain, which can be produced, shipped and stored anywhere.)

4.96 Chile does not consider that all physical characteristics of the products involved need to overlap for the products in question to be considered "directly competitive or substitutable". However, Chile does consider that the European Communities needs to demonstrate more than a coincidence of one physical characteristic, in this case the alcohol content of the beverage, before claiming that products are *directly* competitive or substitutable in the sense required by Article III.

4.97 **The European Communities responds** that together, ethyl alcohol and water account for more than 99 % of the volume of all distilled spirits. Thus, even if Chile's assertion that pisco and other spirits share "virtually no ingredients or characteristics, other than containing alcohol", was true in all cases (*quod non*), it would hardly be condemning. According to the European Communities, the analogy drawn by Chile between ethyl alcohol and the wheels contained in bicycles and trucks is manifestly inept. Wheels do not account for 99 % of the components of either bicycles or trucks. Furthermore, the wheels of a truck are different from the wheels of a bicycle, whereas ethyl alcohol is always the same product, irrespective of the spirit in which it is contained. Finally, unlike pisco and the other distilled spirits, bicycles and trucks do not have similar end-uses. Someone invited to a cocktail party in Santiago is likely to be offered the choice between a pisco drink and a whisky drink. If Capel or Control want to ship some pisco from La Serena to Santiago, they are unlikely to do so by bicycle.

4.98 **Chile further states** that it does not deny that all spirits contain alcohol, nor that alcohol and water account for over 99% of volume. However, it cannot be concluded from here that all such spirits are directly competitive without much more proof.

4.99 Chile indicates that to accept that all spirits have the same end uses, because their basic constitution is water and alcohol, is to say that the only consideration for the consumer is the alcohol, no matter in which beverage it is contained. That is equivalent to say that pasta competes with bread, because both of them are basically wheat flour and water.

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[76] Report of the working party on *Border Tax Adjustments*, BISD 18S/97, para. 18; Panel Report on *Japan - Taxes on Alcoholic Beverages II, supra* footnote 45, paras. 6.22 and 6.28.

4.100 Chile notes that distilled spirits are by no means the only products that share that same characteristic. Wine and beer also contain approximately 99% of water and ethyl alcohol, but, according to the European Communities, they are not directly competitive and substitutable. Chile says that according to the European Communities, only some products that have the same intrinsic characteristics are competitors. That is highly questionable reasoning.

4.101 Chile further states that the European Communities having insisted, albeit unpersuasively, that distilled spirits should all be viewed as directly competitive or substitutable, it is impossible to sympathize with claims that each producer must have a right to market its product based on its alleged unique characteristics. The large exporters of distilled spirits cannot condemn systems for making tax distinctions based on arbitrary type distinctions and then turn around and insist that Article III not only tolerate but actively enforce those type distinctions when that suits the interest of the exporters. The creative effort to take the Panel through such mental gymnastics may warrant admiration on one level, but does not warrant support as a matter of interpretation of Article III:2.

(b) End-Uses

4.102 **The European Communities argues** that having the same basic physical characteristics, pisco and the other distilled spirits are intrinsically suitable for the same end-uses. Furthermore, there is evidence that, despite the competitive distortions caused by the current taxation conditions, pisco and the other distilled spirits are already being employed by the Chilean consumers for similar end-uses.

4.103 According to the European Communities, at the request of the EC spirits industry, Search Marketing S.A., a market research consultant based in Santiago, conducted in December 1997 a comprehensive survey of the drinking habits of a representative sample of spirits consumers (hereafter, the "1997 SM survey").[77] The findings of this study show that pisco and the other distilled spirits are drunk in similar styles, in the same occasions and places and by essentially the same categories of consumers.

4.104 **Chile argues** that to accept that all spirits have the same end-uses, because their basic constitution is water and alcohol, is to say that the only consideration for the consumer is the alcohol, no matter in which beverage it is contained.

(i) Drinking Styles

4.105 **The European Communities presents** Table 9 which summarizes the findings of the 1997 SM survey with respect to drinking styles.[78] According to the European Communities, it shows that pisco and the other distilled spirits are consumed in the same styles (straight, diluted with water, ice, soft drinks or fruit juice and in cocktails), even if the order of preferences may vary.

4.106 The European Communities explains that "mixed with a soft drink" is the most usual style for drinking pisco and all the other spirits, with the only exception of whisky. Nevertheless, the survey shows that there is also substantial overlapping

[77] EC Exhibit 21.

[78] 1997 SM survey, at p. i and Section 4.3 (EC Exhibit 21).

of end-uses between whisky and pisco: the leading usage of whisky ("with ice") is also the third preference for pisco, whereas the leading usage of pisco ("mixed with soft drinks") is the third preferred style for drinking whisky. Moreover, both whisky and pisco are drunk "straight" and in "cocktail" by a significant percentage of respondents.

Table 9 [79]

Drinking styles

	Pisco	Whisky	Gin	Vodka	Tequila	Rum	Brandy
With soft drink	83	21	65	51	41	68	64
Lemon ("sour")	31	-	-	3	11	2	2
Water	-	1	8	2	5	3	-
"On the rocks"	22	75	31	36	16	30	28
Cocktail	9	5	12	29	33	7	4
Straight	9	24	16	18	31	15	36
Other	3	1	-	-	-	-	-
Not Applicable/No response	-	1	-	-	-	-	-

Basis: % of consumers of each type of spirit

(ii) Drinking Occasion

4.107 According to the European Communities, Table 10 sets out the findings of the 1997 SM survey with respect to drinking occasions.[80] It shows a marked convergence across all spirits types. Not only are all spirits consumed in the same types of occasions, but the order of preference also tends to be the same. Thus, at "parties" and "with friends" are mentioned as the two top preferences in connection with pisco and all the other types of spirits, with only the exception of liqueurs.

Table 10 [81]

Drinking occasions

	Pisco	Whisky	Gin	Vodka	Tequila	Rum	Brandy	Liqueur
Parties	61	55	54	59	62	54	57	20
With friends	59	64	77	65	72	72	65	42
Family meetings	46	43	23	29	22	33	35	27
Week-ends	34	24	23	35	24	18	27	6
Aperitif	15	14	8	15	8	9	9	8
After work	10	6	8	11	4	3	6	-
During week	8	6	8	7	4	3	6	-
Digestive	7	12	6	9	6	11	9	42

Basis: % of consumers of each spirit

[79] EC First Submission, Table 12.
[80] 1997 SM survey, p. ii and Section 4.3 (EC Exhibit 21).
[81] EC First Submission, Table 13.

(iii) Drinking Place

4.108 According to the European Communities, Table 11 summarizes the results of the 1997 SM survey with respect to the place of consumption.[82] Again, it shows a remarkable convergence across all spirits types. Off-premise consumption "at home" and at "friends' houses" stand out as the two main preferences for drinking both pisco and all the other spirits.

Table 11[83]

Drinking places

	Pisco	**Whisky**	**Gin**	**Vodka**	**Tequila**	**Rum**	**Brandy**
Home	72	65	57	53	51	67	75
Friends' house	60	58	62	55	67	61	56
Restaurant	31	18	13	16	14	9	13
Disco	20	19	26	35	28	23	14
Pub	20	16	30	42	31	18	12
Bar	12	9	1	22	14	21	5

Basis: % of consumers of each type of spirit

(iv) Consumer Profile

4.109 According to the European Communities, Table 12 shows that both pisco and the other distilled spirits are widely consumed across all social and age segments.[84]

Table 12 [85]

Consumer profile

Socio-economic segment				**Age**			**Gender**		
	High	**Middle**	**Low**	**20/34**	**35/44**	**45+**	**Male**	**Female**	**Total**
Pisco	93	88	97	89	96	93	91	93	92
Whisky	66	55	39	51	46	54	56	44	51
Tequila	43	43	27	58	24	17	34	42	37
Chilean Brandy	7	17	30	19	16	25	21	19	20
Liqueur	15	15	20	19	11	18	11	25	17
Vodka	21	16	15	25	7	10	19	13	16
Rum	20	18	10	23	8	12	17	14	16
Gin	13	17	9	20	11	8	17	10	14
Brandy	1	3	2	4	-	3	3	2	3

Basis: % of consumers of each spirit

4.110 **In rebuttal, Chile points out** that with regard to end-uses of different spirits, Table 9 demonstrates significant differences in the way consumers use the products,

82 1997 SM survey, p. iii and Section 4.3 (EC Exhibit 21).
83 EC First Submission, Table 14.
84 1997 SM survey, p. iv (EC Exhibit 21).
85 EC First Submission, Table 15.

most notably the totally different tendency of pisco and whisky drinkers to consume the respective products as mixed drinks.

4.111 Chile indicates that as to places of consumption and occasions for consumption, the survey shows little more than that most Chilean vodka drinkers have a markedly greater tendency to consume that product in discos and that Chileans generally prefer to consume all the different types of products with friends (except liqueurs, which inexplicably attract a less sociable Chilean consumer). Otherwise, this study has approximately the same probative value as if, in trying to decide whether meat and bread were directly competitive or substitutable, a study were produced demonstrating that both tended to be consumed at meal times (and with friends or family, Chile would guess).

4.112 Chile disagrees with the 1997 SM survey conclusion that "... pisco and other distilled spirits are drunk in the same styles, in the same occasions and places and by essentially the same categories of consumers". While it is not Chile's aim to rebut each one of these findings, Chile disagrees that these findings (even if they were true) are conclusive of "direct competition or substitutability" as required by GATT Article III:2, second sentence.

4.113 Chile argues that following the EC's reasoning, it must conclude that all type of food are directly competitive, because they are eaten basically by the same category of consumers (actually everybody has to eat), in the same occasions and places (home, friend's home, restaurants, etc) and is consumed in the same styles (cooked, raw, mixed with other food).

4.114 Chile further casts doubt on the conclusions drawn by the European Communities regarding drinking style. As it can be seen from Table 9, pisco is mostly drunk with a soft drink (83% of consumers) while whisky is mostly drunk "on the rocks" (75%); 31% of consumers drink pisco as a "sour drink", while the closer spirit would be tequila, with a mere 11% of its consumers. Table 9 shows that drinking styles are shared (actually it will be difficult to discover another drinking style), but nobody could draw the conclusion that all distilled spirits are similarly drunk.

4.115 **The European Communities contests** Chile's argument that, in any event, the responses to the EC consumer surveys "do not establish that the products are directly competitive or substitutable". For instance, contrary to the claims of Chile, Chilean vodka drinkers do not "have a markedly greater tendency to consume that product in discos". In fact, according to the 1997 SM survey, consumption of vodka at discos only comes fourth after consumption "at home", "at friends' places" and "at pubs".

4.116 In the view of the European Communities, the survey data concerning places of consumption are by no means irrelevant in order to establish substitutability. That type of information is regularly tracked by the spirits industry for marketing purposes. Further, the European Communities notes that Korea built its unsuccessful defence in the recent *Korea - Taxes on Alcoholic Beverages* case on the allegation that soju was drunk in different places than western spirits.

4.117 According to the European Communities, the fact that Chilean consumers prefer to drink spirits "with friends" is also far from irrelevant. This points to one of the specific uses which distinguish distilled spirits from other beverages: promoting socialization. While many people prefer to drink spirits with friends, most people

would answer that they drink water when they are thirsty and not when they are with friends.

(v) Advertising

4.118 **The European Communities points out** that when it markets its product, the pisco industry appears to entertain no doubts with respect to the substitutability of pisco with other distilled spirits. Quite to the contrary, pisco's promotional claims tend to emphasize the similarity of pisco with other distilled spirits, both in terms of physical characteristics and usage.

4.119 According to the European Communities, by way of example, Control's Internet homepage answers to the question "what is pisco?" with the following description of its characteristics:

> Combine the dryness of Gin, the versatility of Vodka, the raciness of Rum and the bouquet of a delicate Cognac and you will discover the only distillation with this unique and aromatic result.[86]

4.120 According to the European Communities, also in its Internet homepage, Control describes the end-uses of pisco as follows:

> The distinct flavour and fresh aroma of Pisco control can be enjoyed by itself, on the rocks, with lemon or fruit juice, your favourite cocktail or mix as well as with popular soft drinks.[87]

4.121 The European Communities points out that the versatility of pisco is also emphasized in the drink recipe brochures (*recetarios*) distributed by Control and Capel in Chile and abroad.[88] Those brochures promote the use of pisco in the same styles that are also characteristic of the other distilled spirits: straight, on the rocks, with lemon or fruit juice, or with cola or soda.

4.122 The European Communities further notes that the recipe brochures of both Capel and Control go as far as to recommend the use of pisco in place of other distilled spirits that are customarily used in well-known mixed drink recipes. Thus, for example, Capel suggests preparing "caipirinhas" with pisco instead of cachaca (so-called "pisquinhas"), Manhattans with pisco instead of whisky (so-called "Chilean Manhattan"), or "margaritas" with pisco instead of tequila. Similarly, Control's brochure provides recipes for preparing "pisco tonics" and "Control Manhattans".

4.123 **Chile challenges** the EC argument, saying that the European Communities also looks to the internet for examples of common styles of advertising. Ironically, the European Communities chooses to quote a pisco producer who concludes by calling pisco "the only distillation with this unique and aromatic result". If the European Communities will scan further in the Internet, Chile believes the European

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[86] EC Exhibit 53. The European Communities notes that the same claim is made in Control's recipe brochure (EC Exhibit 51). It is worth noting that Control makes the same claim in the Spanish version of its home-page.

[87] EC Exhibit 53.

[88] EC Exhibits 50 and 51. The European Communities notes that the recipe brochures of Capel and Control are very similar to the promotional brochures published by the Scotch Whisky Association attached as EC Exhibit 55. According to the European Communities, that similarity constitutes a further indication of substitutability between pisco and whisky.

Communities will discover that everything a human being can ingest is advertised in rather similar terms on the internet.

4.124 **The European Communities further responds** that it has failed to find any Internet information showing that the Chilean farmers make advertising claims in the Internet comparing the "versatility" of milk to that of vodka or the "bouquet" of garlic to that of a "delicate Cognac".

(c) Tariff Classification

4.125 **The European Communities notes** that pisco and all the other distilled spirits fall within the same HS heading, namely HS 22.08.

4.126 The European Communities points out that non-alcoholic beverages, as well as alcoholic beverages obtained by fermentation such as beer or wine fall within other HS positions. As mentioned above, the characteristic of being a "distilled alcoholic beverage" is sufficient to establish that all spirits have common end-uses and, therefore, that they are "directly competitive or substitutable".

4.127 The European Communities further points out that within HS Chapter 22, HS 2208 is at the same level as the tariff positions for non-sweetened or flavoured water (HS 2201), flavoured or sweetened water (HS 2202), beer (HS 2203), wine (HS 2204) vermouth (HS 2205) and vinegar (HS 2209). Arguably, each of those products constitutes (at the very least) a single category of "directly competitive or substitutable products".

4.128 The European Communities explains that the sub-headings within HS 2208 correspond each to a well known type of spirit. The reason why specific sub-headings were created for those spirits, and not for the other spirits, was simply that brandy, whisky, gin, vodka, rum and liqueurs are the spirits which are internationally traded in largest volumes. Thus, in the 1996 HS a new tariff sub-heading was created for vodka, which previously had been classified into the residual "other" sub-heading, in recognition of the growing trade in that spirit.

4.129 **In rebuttal, Chile states** that it concedes the obvious point that all distilled spirits share a common tariff category, however, a point which is of virtually no legal significance. It is obvious that two products falling within the same four digit HS category are not necessarily "directly competitive or substitutable" because applying this reasoning, oxygen and arsenic should be considered "substitutable" because both fall under HS 2804; the same could be said then to aviation gas and vaseline white oil (HS 2710); mackerel and caviar (HS 1604) lobster and crabmeat meal (HS 0306); and ivory and nails (HS 0507). Therefore this evidence should also be rejected.

(d) Channels of Distribution

4.130 **The European Communities notes** that Table 13 below sets out the findings of the 1997 SM survey[89] with respect to the availability of pisco and other distilled spirits in different sales channels. It shows that all different types of premises market both pisco and all the other spirits and that, for all of them, the preferred sales outlets are the same (supermarkets and liquor stores).

[89] 1997 SM survey, p. iii and section 4.3 (EC Exhibit 21).

Table 13 [90]

Retail purchase outlets

	Pisco	Whisky	Liqueur	Brandy	Tequila	Gin	Rum	Vodka
Super market	61	65	61	47	50	58	46	47
Liquor store	41	26	32	39	40	43	34	43
Gift shop	3	8	6	9	5	7	6	-
Duty free	1	7	3	-	2	-	9	2
Grocery	4	1	-	5	4	-	-	3
Air lines	-	1	-	-	1	3	2	-
Other	3	6	9	-	8	-	8	7

Basis: % of consumers of each spirit

4.131 According to the European Communities, a further indication of substitutability between pisco and other distilled spirits is the similarity of their presentation in retail outlets. A selection of photographs taken from 6 retail outlets in Santiago in mid 1997[91] evidence that pisco and other spirits are shown to consumers in the same shelf space areas. This shelving is responsive to the consumers' need to make choices among substitutable products.

4.132 **Chile points out** that as to distribution channels, the European Communities puts great weight on the tendency of supermarkets to show pisco on shelves near whisky and other distilled spirits. One might on that basis argue that toothpaste and soap are substitutable, because they share shelf space.

4.133 **The European Communities states** that it does not put "great weight" on the fact that Chilean supermarkets tend to show pisco on the same shelves as whisky and other distilled spirits. The European Communities referred to that tendency as an additional indication of competition, among many other indications mentioned in its submission. For instance, the European Communities has produced detailed survey evidence showing commonality of distribution channels. The European Communities doubts that Chile would consider it irrelevant if whisky and pisco were generally sold at opposite corners of supermarkets. Finally, although toothpaste and soap may share shelf-space in some cramped night shop patronized by busy lawyers in Washington DC, they tend to be displayed separately in larger supermarkets.

4.134 **Chile contests** the EC statement that "evidence that two products are sold in the same channels .... can be taken as evidence that they are 'directly competitive and substitutable'." Common distributions channels are not strong evidence, and multipurpose channels are weaker still than dedicated channels, such as gas stations or pharmacies. Supermarkets are, by no means, a "dedicated channel", and finding that two products are sold mainly at supermarkets, doesn't prove anything about their competitiveness.

4.135 Chile further states that even if it considers dedicated distribution channels, like gas stations or pharmacies, it is hard to conclude that two products sold through

[90] EC First Submission, Table 16.
[91] EC Exhibit 56.

those channels are substitutable. For instance, medicines sold only through pharmacies are usually non-substitutable, as are gas and lubricants sold primarily at gas stations.

4.136 In Chile's view, in the case of liquor stores, the only dedicated channel that could be considered, besides spirits, they sell wine, beer and soft drinks (snacks and some confectionery could also be added to this list).

4.137 Chile explains that it has requested AC Nielsen, a marketing research firm, to provide information on distribution channels employed in Chile by different type of food industries, pisco and whisky. The results are shown in Table 14 below.

Table 14[92]

Distribution Channels

Product	**Supermarket**	**Traditional**
tea	76.6%	23.4%
tomato sauce	76.0%	24.9%
rice	83.1%	16.9%
pasta	76.7%	23.3%
hot pepper sauce	77.3%	22.7%
pisco	46.2%	53.8%
whisky	66.0%	33.3%

Source: AC Nielsen

4.138 Chile considers from these data that it can observe, that roughly 80% of tea, tomato sauce, rice, pasta and red pepper is sold in supermarkets, while the remainder is sold through what they call "traditional" channels. It is more than obvious that these products are not competitors or substitutable among themselves, yet they share basically the same distribution channel.

4.139 Chile further states that other important information provided by AC Nielsen, is that 46.2% of pisco is sold in supermarkets, while 53.8% is sold by the "traditional" channels. In the case of whisky, 66% is sold through supermarkets and only 33% through "traditional" channels. This is not surprising, because whisky is primarily consumed by the wealthier segment of population, while pisco is a more popular spirit.

4.140 According to Chile, comparing AC Nielsen's and Search Marketing's outcome results, one could question the accuracy of Search Marketing's findings, that tell us that 61% of pisco is sold through the supermarkets.

4.141 Chile indicates that it disagrees with the EC's point regarding supermarket shelving. Despite the EC's argument, the fact is that in Chilean Supermarkets lot of products that are, by no means, substitutable (as soap and toothpaste) share the same shelves.

[92] Chile Oral Statement at the Second Substantive Meeting, Table IV.

(e) Price Differentials

4.142 **In rebuttal to the EC argument, Chile stresses** the price differentials between pisco and other distilled spirits using Table 15 below.

Table 15[93]

Product	Duty Free Price US$	Alcohol Content (°)	Chilean Custom Duties	Price including Chilean Duties US$	New Chilean System	Price including new tax system US$
1	**2**	**3**	**4**	**5**	**6**	**7**
Whisky J W Red	10.96	43	11%	12.17	47%	17.88
Whisky J W Black	24.11	43	11%	26.76	47%	39.34
Whisky J W Gold	52.00	43	11%	57.72	47%	84.85
Whisky J W Blue	144.00	43	11%	159.84	47%	234.96
Canadian Club	11.41	40	0%	11.41	47%	16.77
Jack Daniels	14.07	45	11%	15.62	47%	22.96
Tequila (Cuervo)	11.97	38	0%	11.97	39%	16.64
Grappa	10.80	40	11%	11.99	47%	17.62
Pisco Especial	2.86	35	11%	2.86	27%	3.63
Pisco Reservado	3.89	40	11%	3.89	47%	5.72

SOURCES: Pisco prices from Chilean Industries.
Prices of other products, from Peter Justessen Catalogue, 1998 edition.

Note: All prices are referred to 1 litre bottle.

4.143 Chile emphasizes that pisco, in any of its different varieties, has a pre-tax price (i.e., duty free) that is substantially lower than that of whisky. As column five of Table 15 shows, whisky (at a price including Chilean custom duties of US$12.17) is 3.1 times more expensive than a pisco of same alcohol strength (price of US$ 3.89). The same column shows that when comparing whisky with Pisco Especial (35º strength) the price of the former is more than 4.2 times more expensive.

4.144 Chile further points out that the price difference between whisky and pisco of the same strength is not altered when comparing prices including the New Chilean System. Indeed, column seven of the chart, shows that the price of whisky (US$ 17.88) remains 3.1 times more expensive than pisco of same strength (price US$ 5.72). The price differential is so big that it is no wonder that consumers, particularly in a country of relatively low incomes, prefer low cost spirits.

4.145 **The European Communities responds** that Table 15 is incomplete and misleading. It compares the prices of a relatively expensive brand of whisky (Johnnie Walker) to what appears to be the price of a relatively inexpensive brand of pisco. Furthermore, the prices are at different levels of trade and, therefore, not comparable. The prices for whisky are retail prices (presumably in Chile), as shown in the catalogue of a supplier of duty free goods to the diplomatic trade, and include not only freight and insurance but also what appears to be a rather substantial margin for

[93] Chile Oral Statement at the First Substantive Meeting, Annex I.

the distributor. In contrast, the prices for pisco are producers' prices at ex factory level.

4.146 The European Communities argues that both pisco and the other spirits are sold within a wide range of prices. As shown in Table 16 below, the price differences within the category of pisco may be as large, both in absolute and in relative terms, as the price differences between pisco and whisky shown in Chile's table. The European Communities claims that Chile does not appear to contest that all types and brands of pisco constitute a single product and compete with one another.

Table 16[94]

Retail prices of pisco, February 1997

Brand	Price (pesos)	Price difference index
Valle del Limarí 30 %	869	1
Capel 30 %	999	1.15
Tres Erres 32 %	1,459	1.69
Bauza 30 %	2,468	2.84
Control 35 %	1,295	1.49
Capel 35%	1,458	1.68
Control de Guarda 35 %	2,389	2.75
Alto del Carmen 35 %	2,458	2.83
Bauza 35 %	2,480	2.85
Control 40 %	1,519	1.75
Capel 40 %	1,588	1.83
Control de Guarda 40 %	2,699	3.11
Alto del Carmen 40 %	2,998	3.45
Bauza 43 %	3,628	4.17
Alto del Carmen 46 %	3,798	4.37
Chenaral 46 %	4,790	5.51

Source: ISWR Report, EC Exhibit 19, pp. 80-81

4.147 The European Communities further argues that pisco is not less expensive than other spirits. Table 17 below evidences that, despite the price distortions caused by the differences in taxation, the prices (tax included) of pisco overlap with the prices (tax included) of other types of spirits (including whisky) which are more heavily taxed.

[94] EC Response to Questions asked at the First Substantive Meeting, Table 1.

Table 17[95]

Range of retail prices (including tax), February 1997

Spirit	Lowest price (pesos)	Highest price (pesos)
Pisco	869	4,790
Gin	2,175	5,580
Vodka	2,545	8,050
Rum	1,490	6,838
Brandy	1,375	114,900
Tequila	3,180	5,490l
Whisky	3,550	34,690

Source: ISWR Report, EC Exhibit 19, pp. 53-54, 58, 62, 65, 70, 75-76, 80-81

4.148 The European Communities also argues that in any event, a comparison of absolute price differences is of limited value in order to establish whether two products are actually competing on a given market. Basic economic theory tell us that it is more relevant to look at the response of consumers to changes in the relative prices of the products, i.e., to their rate of cross-price elasticity.[96] The European Communities claims that it has provided to the Panel ample evidence (including two studies commissioned by the pisco industry itself) showing that there is a significant degree of cross-price elasticity between pisco and the other spirits and, therefore, that they are directly competitive or substitutable.

4.149 The European Communities adds that in the present case, absolute price differences are even less relevant in view of the nature of the products concerned. Distilled spirits are consumer goods which have a small value relative to income and are purchased many times over a short period of time. This means that, even if one spirit was much more expensive than the other, a relatively small decrease in the price of the more expensive one could be sufficient for consumers to increase the number of occasions in which they drink that spirit instead of the less expensive one.[97]

4.150 The European Communities further alleges that absolute price differences can be the consequence of the measures in dispute. A comparison of pre-tax prices is not sufficient to remove all the distortions which a protective system of taxation may have caused over a long period of time. For example, one of the effects of a protective system of taxation may be to favour the sale of premium brands of imported spirits over less expensive brands. Also, protective taxes limit the sales growth of the imported spirits and keep their selling and distribution expenses at an artificially high level as compared to domestic products sold in larger volumes.[98]

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95 EC Response to Questions asked at the First Substantive Meeting, Table 2.

96 Panel Report on *Korea - Taxes on Alcoholic Beverages*, supra, footnote 56, para. 10.94.

97 *See Ibid.,* paras. 10.74 and 10.91.

98 *Ibid*., para. 10.93 and fn. 410.

4.151 The European Communities finally recalled that absolute price differences can be the consequence of conjunctural factors such as movements in the exchange rates.[99]

4.152 **In response, Chile explains** that its intention in providing Table 15 above was twofold: (1) to illustrate for the Panel the significant price difference between pisco and whisky; and (2) to illustrate for the Panel the disproportionately greater burden imposed on a low-priced product by the use of a specific tax (in this case the tax levied by some EC countries on alcohol), measured in *ad valorem* terms.

4.153 Chile considers that the most accurate basis for comparing the prices in Chile of pisco and whisky should be between ex-factory price of pisco, and the *after customs duty* price of whisky (CIF + import duties) in Chile. That comparison excludes any mark-up in the distribution channel.

4.154 Chile adds that the ex-factory prices of pisco are, on average, US$ 2.60 for pisco of 30º to 35º, and US$ 3.60 for pisco of 40º to 46º. For imported whisky the average CIF price, in 1997, according to Central Bank of Chile statistics, was US$ 5.55. Adding an 11% *ad valorem* import duty, the average *after customs* price of whisky was US$ 6.16.

4.155 Chile goes on to argue that these price differences between whisky and pisco are thus very significant, almost double between whisky and high alcohol pisco, and more than double between whisky and low alcohol pisco.

4.156 Further, Chile points out that it is unlikely that these prices are distorted by levels of trade in any material way. While much more pisco than whisky is sold in Chile, whisky is still imported in substantial quantities. Further, far more whisky than pisco is produced in the world, and that ample production would presumably allow superior economies of scale for whisky.

4.157 Also, in Chile's view, the European Communities also affirms that "Distilled spirits are consumer goods which have a small value relative to income ..." and interprets this to mean that "even if one spirit was much more expensive that the other, a relatively small decrease in price of the more expensive one could be sufficient for consumers to increase the number of occasions in which they drink this spirit instead of the less expensive one". This is highly speculative on the part of the European Communities and thus far remains unproven.

4.158 Further, Chile contests the EC statement with respect to "... the distortions which a protective system of taxation may have caused over a long period of time. For example, one of the effects of a protective system of taxation maybe to favour the sale of premium brands of imported spirits over less expensive brands". First, the effects of a repealed system are not relevant. Second, because even the previous Chilean tax system operated on an *ad valorem* bases, there was no distortion in favor of more expensive brands.

4.159 Finally, Chile disagrees with the EC's table of retail prices of pisco, which purports to show an overlap between pisco and whisky. Chile argues that this is misleading, and points out that the table does not reflect the fact that most pisco sold in Chile has a price of less that 3,000 pesos. In fact, there is very little overlap except

[99] Panel Report on *Korea - Taxes on Alcoholic Beverages*, supra, footnote 56, para. fn. 410.

for premium piscos, which will also generally be taxed at the same rate as whisky when the New Chilean System takes effect in December of 2000.

(f) Cross-Price Elasticity

(i) Market Developments

4.160 **The European Communities alleges** that sales of pisco have consistently tracked changes in factors that have a direct impact on the prices of other spirits (and in particular of whisky) but not on the prices of pisco itself, such as changes in the ILA rates applied to those spirits, changes in the level of the import duties on distilled spirits and fluctuations of the exchange rate between the Chilean peso and the US dollar. This evidences that the demand for pisco is responsive to changes in the prices of the other spirits and, therefore, that they are directly competitive or substitutable products.

4.161 According to the European Communities, the Chilean spirits market is largely dominated by pisco. As set out in Table 18 below, in 1996 sales of pisco accounted for as much as 74 % of the total quantity sold in that market. The same table shows that sales of pisco have increased considerably (by more than 400 %) since the early 1980s.[100]

Table 18[101]

Chilean spirits market 1982 - 1996: sales (thousands of litre) and market share*

	1982	1984	1986	1988	1990	1992	1994	1996
Pisco								
Sales	1,100.00	1,600.00	2,075.00	2,650.00	3,190.00	3,675.00	4,347.00	4,501.00
Share	44.1 %	59.0 %	68.8 %	70.4 %	72.5 %	70.6 %	72.9 %	73.8 %
Whisky								
Sales	497.00	258.00	223.50	249.00	224.50	224.50	249.50	264.00
Share	19.9 %	9.5 %	7.2 %	6.6 %	5.1 %	4.3 %	4.2 %	4.3 %
Vodka								
Sales	48.00	52.00	52.00	52.00	54.00	65.00	79.00	93.00
Share	1.9 %	1.9 %	1.7 %	1.4 %	1.2 %	1.2 %	1.3 %	1.5 %
Gin								
Sales	55.00	59.00	56.00	55.00	56.00	63.50	70.00	56.50
Share	2.2 %	2.2 %	1.8 %	1.5 %	1.3 %	1.2 %	1.2 %	0.9 %
Rum								
Sales**	54.00	50.00	48.50	53.00	61.75	80.50	99.50	101.00
Share**	2.2 %	1.8 %	1.8 %	1.4 %	1.4 %	1.5 %	1.7 %	1.7 %
Brandy								
Sales	55.00	80.00	130.50	164.00	209.00	265.25	289.25	194.50
Share	2.2 %	2.9 %	4.2 %	4.4 %	4.7 %	5.1 %	4.8 %	3.2 %
Tequila								
Sales	1.00	Nil	0.25	1.25	3.75	14.00	32.50	72.50
Share	0.0 %		0.0 %	0.0 %	0.1 %	0.3 %	0.5 %	1.2 %

[100] The European Communities also refers to IWSR Report, p. 77, Table A (EC Exhibit 19).
[101] EC First Submission, Table 9A.

	1982	1984	1986	1988	1990	1992	1994	1996
Liqueur								
Sales***	347.00	318.50	291.50	249.50	262.25	260.00	245.50	230.00
Share**	13.9 %	11.7 %	9.4 %	6.6 %	5.7 %	5.0 %	4.1 %	3.8 %
*								
Other								
Sales	340.00	295.00	230.00	290.00	340.00	560.00	555.00	585.00
Share	13.6 %	10.9 %	7.4 %	7.7 %	7.7 %	10.75 %	9.3 %	9.6 %
Total	2,497.00	2,712.50	3,107.25	3,763.25	4,401.25	5,207.75	5,967.25	6,097.50

* Source: ISWR report (EC Exhibit 19)

** Includes cachaca

*** Includes liqueurs, bitters, aperitifs, aniseed and fruit eaux de vie

4.162 The European Communities notes that all pisco sold in Chile is, by definition, produced domestically. Imports of pisco from Peru and other sources (which must be sold as *aguardiente*) are marginal.[102]

4.163 The European Communities further states that whisky is the best selling spirit after pisco. As shown in Table 18 above, in 1996 sales of whisky accounted for 4.3 % of the spirits market. Domestic production of whisky is negligible.[103] It can be estimated that imports represent approximately 94 % of total sales of whisky.[104] In turn, Scotch whisky accounts for 95 % of all imports.[105]

4.164 The European Communities also notes that until the mid-1970's, imports of whisky remained very small. Thus, in 1975 imports of Scotch whisky amounted to barely 165 thousand litres, based on UK Customs and Excise Export Statistics.[106] During the second half of the 1970s, imports of whisky grew spectacularly. As of 1981, when they peaked, sales of Scotch whisky had reached a volume of 5.9 million litres.[107] This increase was the result of a combination of factors. In the first place, the progressive reduction of import tariffs from 80 % at the beginning of 1976 to 10 % as of May 1979.[108] Second, a parallel reduction in the ILA from 40 % plus the *recargo* in 1974 to 30 % in 1977, i.e., only 5 percentage points more than the rate on pisco, as Table 6 above. Finally, imports of whisky benefited from a rapidly expanding economy with very high growth rates as well as, between 1979 and 1981, from a strong peso pegged to the US dollar.[109]

4.165 The European Communities further asserts that during the first half of the 1980s this trend suffered a dramatic reversal. In 1982, the Chilean economy entered into a deep recession[110] and the peso underwent the first of a series of devaluations.[111] Import duties on distilled spirits were increased from 10 % to 20 %

[102] IWSR Report, p. 78, Table C.1 (EC Exhibit 19).
[103] IWSR Report, p. 43, Tables A and A.1 (EC Exhibit 19).
[104] *Ibid.*
[105] *Ibid.*
[106] EC Exhibit 57.
[107] IWSR Report, at p. 43, Table A. (EC Exhibit 19).
[108] EC Exhibit 57.
[109] EC Exhibit 61.
[110] The European Communities refers to EC Exhibit 58, and also to the IWSR report, p. 6 (EC Exhibit 19).
[111] The European Communities refers to EC Exhibit 61.

in 1983 and again to 35 % the following year.[112] Last but not least, the ILA rate on whisky was raised to 50 % in 1983, to 55 % in 1984 and to 70 % in 1985, thus increasing the tax differential between pisco and whisky from 5 to 45 percentage points in less than two years, as shown in Table 6 above. The imposition of higher taxes and import duties, allied to the new macro-economic environment, had a devastating effect: sales of Scotch whisky dropped from 5.9 million litres in 1981[113] to just under 1.3 million litres in 1985[114], i.e., by nearly 80 %.

4.166 According to the European Communities, Chile emerged from the recession in 1987[115] and import duties were lowered to 11 % as of 1991.[116] But the remaining tax differential, together with the market dominance gained by pisco in the meantime, have so far prevented whisky from recovering its former position. By 1996 sales of whisky still represented merely 39 % of the volume sold in 1981[117], and this despite a considerable increase in the overall demand for spirits. As a result, as set out in Table 18 above, the market share of whisky shrank from 20 % in 1982 to just 4 % in 1996.

4.167 Further, the European Communities states that meanwhile, pisco sales have consistently moved in the opposite direction. Between 1976 and 1981, pisco suffered from the spectacular increase in whisky imports. Although sales of pisco continued to grow in absolute terms, they did so at a much lower rate than the sales of whisky.[118] In 1982, when Chile was hit by recession, sales of pisco fell by 20 %.[119] In reaction to this, the pisco industry stepped up the pressure to obtain additional protection against imports of whisky. As explained above, the Chilean authorities responded to those demands with a series of successive increases in the import duties and in the ILA rates on whisky. These measures proved highly effective. While sales of whisky continued to decline until 1986 and stayed relatively flat thereafter[120], sales of pisco began to increase again in 1983 and by 1984 had already exceeded their 1981 level.[121] Furthermore, the additional protection afforded by the increase in tariffs and taxes on whisky allowed the pisco industry to capture most of the growth of the spirits market that took place during the following decade as the Chilean economy resumed its rapid expansion. As a result, the market share of pisco increased from 44 % in 1982 to 74 % in 1996, as shown in Table 18 above.

4.168 Referring to these tables, the European Communities further notes that liqueurs are the third largest type of spirits in terms of sales volume, with approximately 4 % of the market. Most liqueurs sold in Chile have a relatively low alcohol content. As shown in Table 5 above, all liqueurs (with the only exception of anisettes) have a legal minimum strength below 35°. Imports represent less than 10

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112 EC Exhibit 57.
113 IWSR Report, page 43, table A (EC Exhibit 19).
114 *Ibid*.
115 EC Exhibit 60.
116 EC Exhibit 57.
117 IWSR Report, page 43, table A (EC Exhibit 19).
118 The European Communities refers to IWSR Report, p. 77, Table A (EC Exhibit 19), and for the period before 1980, to EC Exhibit 59.
119 IWSR Report, page 77, table A (EC Exhibit 19).
120 IWSR Report, page 43, table A (EC Exhibit 19).
121 IWSR Report, p. 77, table A (EC Exhibit 19).

% of total sales. Together, vodka, gin and rum hold a further 4 % of the market. Imports account for a substantial proportion of their sales: 36% of gin, 41 % of vodka and 55 % of rum. Despite the considerable overall increase in demand for spirits, sales of these three types of spirits have grown only moderately, with the consequence that they have all lost market share since the early 1980's, as shown in Table 18 above.

4.169 The European Communities states that tequila entered into the Chilean market at the beginning of the 1990's. Although it has enjoyed a considerable success, especially among young consumers, it still represents under 2 % of the market. All sales of tequila are imported from Mexico, as shown in Table 19 below.

Table 19[122]

Sales of domestic spirits v. imports in 1996 (000 9 litre cases)*

	Domestic	%	Imported	%
Pisco	4,501.00	100	Nil	0
Whisky	17.00	6.4	247.00	93.6
Vodka	55.00	59.1	38.00	40.9
Gin	36.00	63.7	20.50	36.3
Rum**	45.00	44.6	56.00	55.4
Brandy	190.00	97.7	4.50	2.3
Liqueur***	208.50	91.0	20.5	9.0
Tequila	Nil	0	72.5	100
Other	585.00	100	Min	0
Total	5,637.5	92.5	459.00	7.5

* Source: ISWR report (EC Exhibit 19)
** Includes cachaca
*** Includes liqueurs, bitters, aperitifs, aniseed and fruit eaux de vie

4.170 According to the European Communities, brandy accounts for approximately 3 % of the spirits market. Domestic production represent nearly 98 % of the sales. The vast majority of domestic sales are of the brand "Tres Palos", with an alcohol content of 38°.

4.171 The European Communities concludes that, as already explained, the sales and market share of pisco have consistently tracked changes in factors that have a direct impact on the prices of the other spirits, but not on the prices of pisco itself. Those changes include not only the changes in internal taxation, but also changes in import duty rates and exchange rate fluctuations between the Chilean Peso and the US dollar. This evidences that the demand for pisco is responsive to changes in the prices of other spirits and, therefore, that they are directly competitive or substitutable.

4.172 The European Communities adds that the correspondence between the sales/market share of pisco and the prices movements of the other spirits is particularly noticeable during the period 1982 -1986, where the changes in the prices of the other spirits were most dramatic (The European Communities claims that a large portion of that period is not covered by the regression provided by Chile).

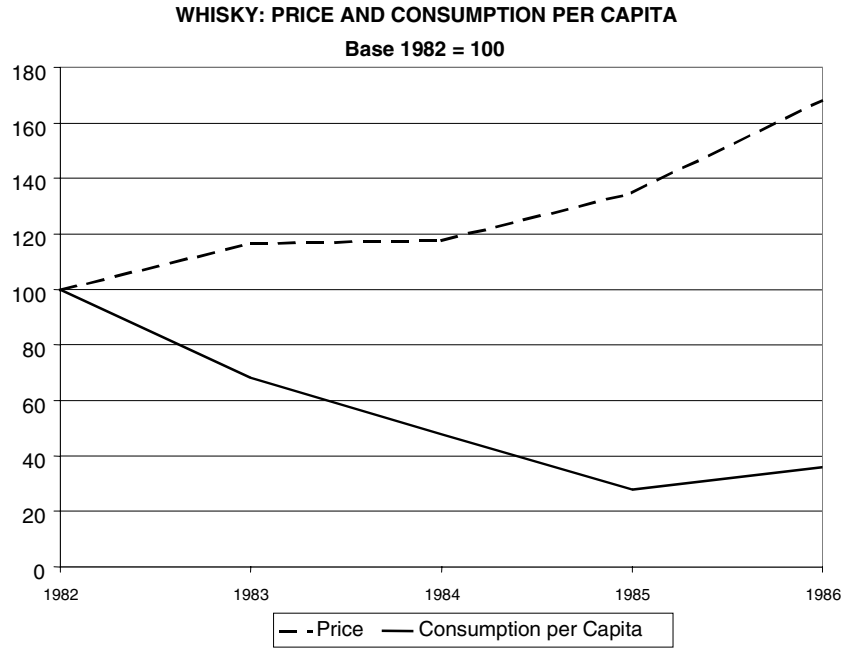
[122] EC First Submission, Table 9B.

4.173 The European Communities also explains that the correspondence is more easily observable in the case of whisky than in the case of "other spirits". Several reasons may account for this. In the first place, the tax increases were larger in the case of whisky. Second, "other spirits" started from a smaller base than whisky. In relative terms, however, the loss of market share experienced by "other spirits" is far from negligible. Gin and rum, for instance, suffered an 18 % share loss between 1982 and 1986. Finally, "other spirits" include a larger share of domestic production, which was not affected by changes in import duties and exchange rates.

4.174 **In rebuttal, Chile contends** that it should be noted that Table 18 is not based on any official statistics. Further, the European Communities with this chart attempts to prove that products are directly competitive or substitutable by assuming that they are directly competitive or substitutable, since the EC chart assumes a single market composed of the sum of the sales of each different distilled spirit. Thus, the EC's economic logic is highly faulty.

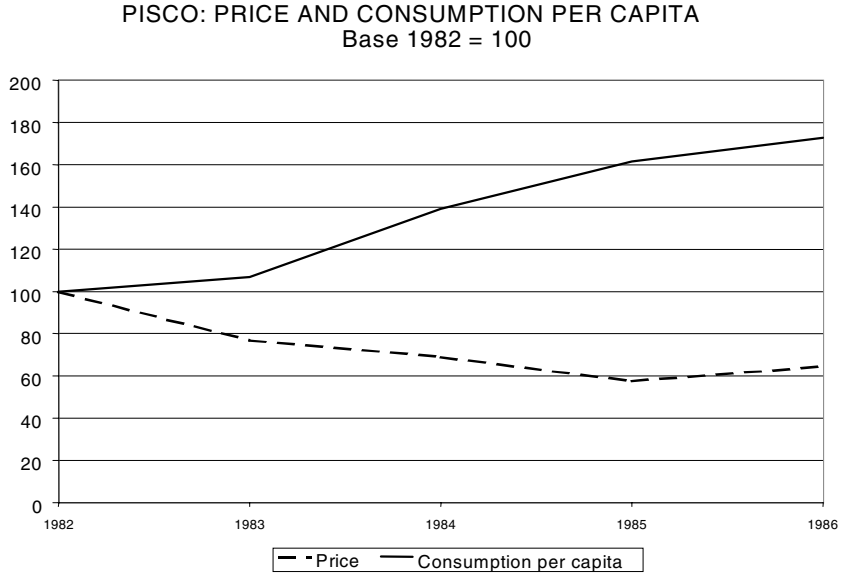
4.175 Chile analyses the evolution of the consumption of whisky and pisco on the basis of the data provided by the European Communities. Chart 1 below shows for whisky the changes in per capita consumption and prices during the period 1982-1986. As can be seen, during this period the price of whisky in real terms, that is, adjusted for internal inflation, rose 67%. Per capita consumption of whisky in this same period fell by 64%. No one should be surprised that consumption of a product fell as its price rose in this fashion.

Chart 1



4.176 According to Chile, Chart 2 shows the changes in price and per capita consumption of pisco during the same period 1982-1986. As can be seen, during this period the price of pisco in real terms fell by 35% and consumption per capita rose 69%. It is similarly not surprising that a product whose price significantly declines, increases in consumption.

Chart 2



4.177 In Chile's view, the increase in the price of whisky during the period in question, is a result of three principal factors: the depreciation of the Chilean currency, the increase of tariffs and the increase of the tax on whisky. It analyzed each factor independently:

(i) Depreciation of the Chilean currency: During the period from 1979 to 1982, the Chilean peso maintained a stable relation with the dollar (Ch$ 39 = US $1). As a result the crisis of the balance of payments and other macro-economic factors, the Chilean peso fell 88% between mid 1982 (when the first series of declines occurred) and the end of 1986.

(ii) Increase of tariffs: In 1982, the import tariff on whisky was 10 percent. The tariffs increased to 20 % in 1983, 35 % in 1984 and then were reduced to 20 % in 1985. In short, between the year of 1982 and 1986, there was a net increase in tariffs that increased the final price of the imported products by 9.09 %.

(iii) Increase in the taxes on liquor: In 1982 the tax that applied to whisky was at a rate of 30 %. These rates increased to 50 % in 1983, 55 % in 1984 and 70 % in 1985. In short, the effect of the increase in taxes on whisky in the period of 1982 to 1986 was to increase the price to the consumer by 30.8 percent.

4.178 Chile argues that taking into account of all these elements already indicated, there was an increase in the price of whisky - *ceteris paribus* - of 168 percent, most of which was caused by factors having nothing to do with the increase in the tax on whisky. As it could be seen, not all of this increase was transferred to consumer

prices. This suggests a diminution of margins, an increase in the local production of whisky and an increase in lower priced imported whisky, or some sort of a combinations of these factors. In addition, the price of pisco in Chile fell considerably, even though the tax on pisco did not change during the period in question.

4.179 Chile adds that as to other types of distilled spirits, it is not in a position to provide a similarly detailed assessment because of the wide variety of domestic and imported spirits included in that category. However, as in the case of whisky and pisco, it would not be valid to assume that sales of this array of domestic and imported products held a relatively steady share of a hypothetical "distilled spirits" market because the tax remained steady. Within that group, Chile can imagine that there would have been a wide range of price effects, on individual types of domestic and imported spirits.

4.180 Chile also contests the EC statement that the period from 1982 to 1986 was not covered in the regression study of Chile. Chile included in its regression study the period from 1983 to 1997, thereby taking into account almost all the period of time in question. By contrast, the EC's study covered a shorter period and the European Communities has presented only partial results of that study.

4.181 Chile further notes that the European Communities states that "the sales and market share of pisco have consistently tracked changes in factors that have a direct impact on the prices of the other spirits, but not on the prices of pisco itself ... This evidences that the demand for pisco is responsive to changes in the prices of the other spirits ..." The European Communities erroneously implies that the changes in the sales of pisco would be exclusively explained by the changes in such factors and their effects on the prices of the other spirits, and not because of changes in the price of pisco. The reasoning followed by the European Communities underestimates a fundamental aspect: if the price of a good diminishes, the demanded quantity of that good increases (unless the demand for the good is inelastic, which means *inter alia* that is a good with no substitutes). The relation between the price and sales of pisco is enough in order to explain the changes in the sales of pisco. As can be observed in the results of the regression submitted by Chile, the relation between the price of the other spirits (whisky) and the sales of pisco is very low and statistically not significant; therefore, this relation can not explain by itself the changes alluded to.

4.182 Chile further notes that it produces more than 70 percent of the distilled spirits that are subject to the highest tax under the New Chilean System, including whisky.

4.183 **The European Communities disagrees with** Chile's claim that the increase in consumption of pisco between 1982 and 1986 was due to the decrease of the real price of pisco and not to the increase in the price of whisky. The reduction of pisco's real price may have contributed to the increase in pisco consumption, but was not the only cause. According to Chile's own data, between 1984 and 1986, the real price of pisco remained virtually constant. Yet, consumption per capita of pisco rose by 24 %. During the same period, the real price of whisky increased by 42 % and consumption per capita fell by 25 %.

4.184 The European Communities contests Chile's argument that "[i]n short, the effect of the increase in taxes on whisky in the period of 1982 to 1986 was to increase the price to the consumer by 30.8 percent". As the tax rate increased, the tax base increased too, due to the depreciation of the peso and the increase of tariffs. As

a result, the effect of the tax increase in the final price of whisky was much more substantial. Thus, in the following table, the tax increase has the effect of increasing the final price of whisky by 286 %:

	1982	1986
Price in US$	5	5
Price in Ch$	195	1,025
Import duty	19.5	205
Tax	64.35	861
Retail Price	278.85	2,091

Contrary to Chile's claims, the tax increase accounts for the largest portion of the price increase (44 %).

4.185 **Chile further responds** that the math used by the European Communities to demonstrate the effect of taxation in the price of whisky is misleading. Chile disagrees not only with the mathematics, but also with the EC's conclusions drawn from that exercise. These conclusions show, at least, a lack of understanding of *ad valorem* taxation systems. To demonstrate its point, in Table 20 below, Chile presents an exercise, based in the EC's data in which the tax rate is maintained at a flat level of 30 % throughout the period. In this case, tax per unit of whisky will rise fromCh$64.35 to Ch$369, and the total price of whisky will rise from ch$278.85 to Ch$1,599. According to EC's argumentation, this means that taxation has an effect of raising the price by 109% (even without changing the tax rate). What really happens, is that the tax base, rose by 473%, and therefore, tax levied on an *ad valorem* base varies accordingly.

Table 20[123]

Tax effect with a 30% *ad valorem* rate

	1982	**1986**	**% Ch.**
Price in US$	5	5	0%
Price in Ch$	195	1,025	425.6%
Import duty	19.5	205	951.3%
Pre-Tax Price	214.5	1,230	473.4%
Tax (30%)	64.35	369	473.4%
Retail Price	278.85	1,599	473.4%

(ii) The 1998 Search Marketing Survey

4.186 **The European Communities further claims** that another consumer survey performed by Search Marketing S.A. at the request of the EC spirits industry (the "1998 SM survey")[124] further supports a finding that pisco and all other distilled spirits are directly competitive and substitutable.

[123] Chile Oral Statement at the Second Substantive Meeting, Table II.
[124] EC Exhibit 22.

4.187 According to the European Communities, the surveyors asked two questions to a representative sample comprising over 400 consumers who had purchased both pisco and at least one other spirit during the last six months.

4.188 The European Communities explains that the purpose of the first question was to measure the substitutability between pisco and other distilled spirits under current taxation and pricing conditions. To that effect, the question was drafted in the following terms: "if you wanted to buy a bottle of pisco, but pisco was not available, what of the following beverages would you buy instead?". Possible answers included, in addition to other types of distilled spirits, wine, beer, non-alcoholic beverages and "nothing". The same question was then repeated for each of the other types of distilled spirits covered by the survey.

4.189 The European Communities notes that Table 21 below summarizes the answers given by the respondents in the situation where they wanted to buy pisco but that spirit was not available. It indicates that a large majority of consumers regard other distilled spirits as the closest substitute for pisco.

Table 21[125]

Response to the Question: "What would you buy if pisco was not available?"

Other spirits	70 %
Wine/Beer	17 %
Non alcoholic beverages	0 %
Nothing	13 %

4.190 The European Communities points out that in *Japan - Taxes on Alcoholic Beverages II*, Japan submitted a consumer survey showing that, in case of unavailability of shochu, "only" 10 % of consumers would switch to whisky and other spirits, whereas the remaining 90 % would turn to beer or other beverages. The panel was of the view that a 10 % switch was "proof of significant elasticity of substitution" between shochu and other spirits.[126]

4.191 In the view of the European Communities, equally significant, as shown in Table 22 below, pisco was mentioned as the main alternative to each of the other spirits covered by the survey in the hypotheses where those spirits were not available.

[125] EC First Submission, Table 17.

[126] Panel Report on *Japan - Taxes on Alcoholic Beverages* II, supra., footnote 45, para 6.31.

Table 22[127]

Response to the Question: "What would you buy if [whisky/tequila/brandy/rum/vodka/gin] was not available?"

	Whisky	Tequila	Brandy	Rum	Vodka	Gin
Pisco	50 %	56 %	52 %	43 %	48 %	45 %
Other spirits	25 %	17 %	15 %	19 %	21 %	19 %
Wine/beer	3 %	2 %	2 %	2 %	2 %	2 %
Non alcoholic beverages	0 %	0 %	0 %	0 %	0 %	0 %
Nothing	22 %	25 %	31 %	36 %	29 %	34 %

Basis: % of all respondents

4.192 The European Communities further explains that the second question asked by the surveyors aimed to measure the respondents' reaction to changes in the relative price of pisco and the other distilled spirits. Respondents were initially asked to make purchase choices between all products at current prices.[128] They were then shown an estimate of the prices that would prevail if all distilled spirits were taxed at the rate of 27 % *ad valorem* (i.e., the rate that will apply to most pisco as from 1 December 2000), and asked to make a choice at those prices. For these purposes, it was estimated that the envisaged tax change would bring about an increase in the prices of pisco of 1.7 % and a simultaneous reduction in the prices of whisky and of "other spirits" of 25.3 % and 2.3 %, respectively.

4.193 According to the European Communities, the responses to this second question indicate the existence of a significant degree of cross-price elasticity between pisco and other spirits. As shown in Table 23, the share of respondents choosing whisky and other spirits instead of pisco would increase from 17.7 % to 30.5 %, i.e., by as much as 72 %. The increase is particularly large in the case of whisky, which would benefit from the largest price reduction in the event that all spirits were taxed at 27 %. The share increase is also substantial, even if less marked, in the case of "other spirits", which would benefit from a smaller price reduction than whisky. Finally, it is worth noting that the increase in the share of whisky and "other spirits" takes place at the expense of all the categories of pisco, thus refuting any possible claims to the effect that whisky and "other spirits" compete only with certain types of pisco.

[127] EC First Submission, Table 18.
[128] EC Exhibit 23.

Table 23[129]

	At current prices	At prices with 27 % tax	Variation (%)
Pisco tradicional	12 %	9.7 %	- 19.2 %
Pisco especial	47.2 %	42.3 %	- 10.4 %
Pisco reservado + Gran pisco	23 %	17.5 %	- 23.9 %
Whisky	6.3 %	14.1 %	+ 124 %
Other spirits	11.5 %	16.4 %	+ 43 %

4.194 The European Communities alleges that the 1998 SM survey can show only the immediate reaction of consumers to price changes. Yet, as discussed above, the consumption of distilled spirits is based on habits, which only change gradually. As a result, short-run elasticities of substitution between distilled spirits are, as a general rule, much lower than long-run elasticities. This mean that, over a certain period of time, the price changes resulting from the elimination of tax differentials are likely to lead to a shift in consumption from pisco to other spirits even larger than that shown in Table 23 above.

4.195 **In rebuttal, Chile argues** that given the weakness of a complaint based on cross-price elasticity (as noted in paragraph 4.[219] below, a low coefficient of 0.26 was computed as cross-price elasticity for pisco and whisky), the European Communities tries to bolster its argument with an assortment of information based on a survey of 400 "representative" Chilean consumers. The EC survey does not logically make the case that pisco is directly competitive or substitutable with other spirits.

4.196 Chile further argues that the European Communities also attempts to use marketing surveys as a kind of substitute for econometric analysis. Specifically, the European Communities refers to marketing surveys in which various consumers were asked what they would buy if there were no pisco and how they would react based on assumed increases in pisco prices accompanied by decreases in whisky prices. Such surveys are inherently much less reliable that an econometric analysis based on 15 years of data. Further, even the responses the European Communities received do not establish a directly competitive or substitutable relationship.

4.197 **The European Communities responds** that Chile seeks to discredit the consumer surveys submitted by the European Communities, but fails to advance any specific ground to cast doubt on the reliability of those surveys. Thus, for example, Chile appears to consider that it is sufficient to describe the sample of one of those surveys as being composed of 400 "representative" Chilean consumers in order to dispose *ipso facto* of that survey. The European Communities asks whether and why Chile is suggesting that the sample was not statistically representative.

4.198 The European Communities further notes that Chile argues that consumer surveys are "inherently much less reliable" than econometric studies. Previous panels, however, have not hesitated to rely upon the findings of consumer surveys in order to establish that products were "directly competitive or substitutable". In *Japan - Taxes on Alcoholic Beverages II*, the panel discarded a flawed regression submitted

[129] EC First Submission, Table 19 (p. 60).

by Japan in favour of a much more robust consumer survey presented by the complainants.[130]

4.199 **Chile further responds** that the last "evidence" provided by the European Communities, to support the idea that there is a significant cross-price elasticity between pisco and other distilled spirits, are the results of another survey conducted by Search Marketing, which is extremely weak.

4.200 Chile notes that the first piece of evidence cited by the European Communities, is the answer made by consumers to the question "what would you buy if pisco is not available". The conclusions to be drawn from this kind of question are highly questionable, because, as any marketing survey expert could tell, people facing situations that are not "normal" in their mind, tend to react in different and unpredictable ways. Also, without a very well designed system to avoid inconsistent answers (and the evidence provided by the European Communities does not lead to a conclusion as to whether those measures have been taken or not) the results are of very little significance. Last - but not least - the question was designed to actually "force" respondents to buy something else, or buy nothing, but would not provide one of the most logical alternatives "I will buy (pisco, whisky, gin, etc.) in another store".

4.201 Chile further points out that the other piece of the Survey is a "quantitative" analysis, in which the consumers, faced with a change in the prices of pisco, whisky and other liquors, show their preferences in the new situation (Table 23). A detailed analysis of this shows the inconsistency of the results, because they don't resist any serious analysis and, therefore must be discarded as evidence.

4.202 Chile also argues that in fact, Table 24[131] shows that if the price of pisco increases 1.7%, the price of whisky is reduced by 25.3% and the price of "other spirits" by 2.3%, then the consumption of pisco will decrease by 15.5%, the consumption of whisky will increase by 123.8% and the consumption of other spirits by 42.6%.

Table 24[132]

Substitution Elasticity

	PRICE CHANGE	**DEMAND CHANGE**
PISCO	+ 1.7 %	- 15.5 %
WHISKY	- 25.5 %	+123.8 %
OTHERS	-2.3 %	+42.6 %

4.203 Chile comments that some basic microeconomic discussion must be added here, in order to make its points clear. It discussed the relationship between price elasticity (that is, how much the price of the good itself influences the quantity sold

[130] The European Communities refers to Panel Report on *Japan - Taxes on Alcoholic Beverages II, supra,* footnote 45, paras. 6.28-6.32. According to the European Communities, Japan's regression had similar methodological problems to those of Chile's regression analysis.

[131] According to Chile, Table 24 is elaborated from data submitted by the European Communities.

[132] Chile Oral Statement at the Second Substantive Meeting, Table V.

of that good) and cross-price elasticity, that means, how much the price variation of competitive goods, influence the quantity of the good at stake.

4.204 In the view of Chile, in "normal" goods, that is, goods that are consumed less if the price rises and more if the price falls, the own-price elasticity must be greater or equal to the cross-price elasticity of any competitive or substitutable good. If two goods could be substituted one for the other without any cost for the consumer (that means, they are almost equal products), the cross elasticity will be the same as the price elasticity (with sign changed) that is, a 1% increase in the price of a good, has the same effect on the consumption as a 1% decrease in the price of its competitor. If there is a cost in substituting those goods, then the same percentage price variation in the competitive good price has less effect on the demand than that percentage price variation of the good at stake. Thus, normally the maximum cross elasticity is equal to the price elasticity.

4.205 With this concept in mind, Chile reviews the results of 1998 SM survey, shown at Table 23 above. The survey was conducted in such a way that the respondents faced an hypothetical "once and for all" price variation, and therefore changes in demand are not influenced by changes in personal income, tastes, habits, etc. The only variable that changes is the price of different spirits.

4.206 Chile goes on to state that if it takes the border condition, that is, that cross elasticities are equal (in absolute value) to price elasticity (something not seen in the real world, but that presents the best case to sustain the reliability of the survey), it may calculate (with the data included in Table 23) what is the underlying minimum price elasticity.

4.207 Chile presents the following results:

Whisky:	-5
Other Spirits:	+2 (that is to say, an increase in price will mean an increase in consumption)
Pisco:	-0.5

4.208 In the opinion of Chile, the findings for whisky and other spirits are absurd, and speak loudly about the lack of reliability of the survey.

4.209 Chile explains that in the case of the whisky, a price elasticity of -5, means that a 10% reduction in price (with the prices of every other spirit unchanged) will lead to an increase in terms of volume of 50%. This is absolutely out of range. The whisky industry will be very pleased to face such a price elasticity, but this is not the case. Consumer goods usually show price elasticity below 2. This "finding" is also rebutted by the experience in 1982 - 1986. By then, the price of whisky grew by 67%, and per capita consumption fell by 64%, therefore price elasticity is at the most 1 (if there is some cross elasticity with pisco, price elasticity will be even less than 1).

4.210 Chile concludes that no comments need to be made on the elasticities of other spirits, because it is clear that nobody could sustain that case. This exercise shows that the 1998 SM survey is far from being a robust consumer survey.

4.211 Chile also disagrees with the EC comment that the "decrease in pisco price may have had some influence in pisco consumption". It is easy to realize that, if a good has no response to its price (the quantity is the same no matter what its price is), its demand is said to be inelastic, and those goods has no competitors. Chile has

developed at length the reason why such goods have no competitors. Therefore, the comment made by the European Communities in its rebuttal should be regarded as a plain economic error.

4.212 Chile claims that, in summary, the European Communities has failed to provide persuasive and sufficient evidence of its assertion that pisco and other spirits are directly competitive or substitutable, as requested by Article III:2, second sentence.

4.213 **The European Communities contests** Chile's argument that the 1998 SM survey is not reliable because it did not offer as a possible survey response the option to go to another shop when asking the question "what would you drink, if pisco were not available?". The hypothetical question of the best alternative drink is part of the standard repertoire of survey design. As the survey offers both the possibility to switch to another drink or to drink nothing at all, it provides a good indicative assessment of the level of substitutability between pisco and other types of alcoholic beverages. If substitutability were nil, no choice of an alternative drink would have been made. The hypothetical question is certainly not beyond the intellectual capacity of a consumer. The proposal that the respondent should have had the choice to go to another store is not a serious suggestion.

4.214 The European Communities also argues that it was stated that the elasticities implied by the survey lead to the impossible result that the elasticity of whisky consumption with respect to pisco prices (cross-price elasticity) is higher than the own-price elasticity. These results are certainly not in violation of any economic principle. Evidently, the survey choices made are plausible and intuitive. Furthermore, the statement may confuse cross-price elasticity with elasticity of substitution. Without going into the technical details, it has to be kept in mind that the market shares of whisky and pisco are very unequal. By way of example, the European Communities refers to the own-price elasticity the Chilean delegation appears to have derived from the survey, namely of 0.5 for pisco and 5 for whisky. If whisky consumption is 8,000 cases annually and that of pisco 100,000 (the ratio roughly represents the actual proportions), a 1 % price increase for pisco will lead to a reduced consumption of 500 cases, a 1% increase in whisky prices will affect 400 cases of alcoholic drinks. It can easily be seen that a price change in pisco can have more influence on whisky consumption than a price change in whisky itself.

4.215 The European Communities asserts that this result would even be stronger if one applies own-price elasticities that are less unequal than those derived by the Chilean delegation. The European Communities has used the Chilean values only as an example, because the European Communities has no means of assessing how the Chilean delegation might have calculated them.

4.216 In conclusion, the European Communities alleges that therefore, Chile's argument does not invalidate the technical correctness of the survey. Instead it can be summarized as stating simply that the Chilean delegation believes that the substitutability is lower than those derived from the survey.

(iii) The 1995 Gemines Study

4.217 **The European Communities explains** that it has had access to a study entitled "The possible effects for the pisco industry of a reduction in the tax applied to whisky" carried out in August 1995 by Gemines, a respected firm of consultants, at the request of Chile's pisco industry (hereafter referred to as "the 1995 Gemines

study").[133] This study provides further evidence of significant cross-price elasticity between pisco and whisky.

4.218 Further, the European Communities explains that the objective of the study was to quantify the effects for the pisco industry, and more generally for the economy of the *zona pisquera*, in the hypothesis that the ILA was amended so as to equalize the tax rates applied to pisco and whisky. Gemines considered two different scenarios. According to the first scenario, pisco and whisky would be taxed at 35 %. According to the second scenario, they would be taxed at 30 %.

4.219 According to the European Communities, as a first step, Gemines estimated the cross-price elasticity rate between pisco and whisky on the basis of historical sales and price data covering the period 1985-1992. The estimated rate was 0.26. This would indicate that if, for example, the prices of whisky went up by 10 %, the sales volume of pisco would increase by 2.6 %.[134] According to Gemines, that rate of cross-price elasticity is sufficient to conclude that pisco and whisky are "substitutes, albeit to a moderate extent".[135] By contrast, on the basis of similar regressions, Gemines reached the conclusion that neither wine nor beer could be considered as substitutable with pisco.[136]

4.220 The European Communities states that Gemines then proceeded to estimate the changes in consumption of pisco and whisky that would take place in each of the two scenarios above described. As shown in Tables 25 and 26 below[137], Gemines concluded that sales of pisco would drop by 10.2 % in the first scenario and by 8.6 % in the second scenario, whereas sales of whisky would increase by 5.8 % and 6.5 %, respectively.

Table 25[138]

First scenario

Pisco and Whisky taxed at 35 %

	Pisco	**Whisky**
Price	+ 7 %	- 18.6 %
Quantity sold	- 10.2 %	+ 5.8 %

[133] EC Exhibit 20.

[134] The European Communities notes that cross-price elasticity measures the relative change in sales of one product as a result of a relative price change in another. However, cross-price elasticity itself is not neutral to the existing market shares of the product involved, and is dominated by the product with the larger share.

[135] The European Communities notes that the authors of the study cautioned that the estimated rate was likely to be lower than the current rate of cross-price elasticity. *See* 1995 Gemines Study, p. 57 (EC Exhibit 20).

[136] 1995 Gemines study, p. 61 and fn. 18 (EC Exhibit 20).

[137] 1995 Gemines study, p. 64 (EC Exhibit 20).

[138] EC First Submission, Table 19 (p. 62).

Table 26[139]
Second Scenario
Pisco and whisky taxed at 30 %

	Pisco	**Whisky**
Price	+ 3.5 %	- 21.3 %
Quantity sold	- 8.6 %	+ 6.5 %

4.221 The European Communities comments that these figures may underestimate considerably the increase in whisky consumption. In the first place, Gemines did not take into account the additional demand generated by whisky's cross-price elasticity to increases in the price of pisco, but only and exclusively the elasticity of whisky to changes in its own price. Moreover, unlike in the case of pisco, Gemines did not estimate whisky's actual rate of own-price elasticity. Instead Gemines limited itself to "assume" a rate of 0.31 on the basis of "the characteristics that exhibits this market and alternative studies".[140] That "assumed" rate, however, seems too low. In fact, that rate would be inconsistent with the cross-price elasticity rate of pisco in response to changes in the prices of whisky previously estimated by Gemines itself. On the basis of the latter rate (which itself appears to be an under-estimate), an increase of 10 % in the price of whisky would generate an increase in sales of pisco which is much larger (2.6 % of approximately 75 % of the spirits market) than the total drop in sales of whisky caused by the same price increase on the basis of Gemines' assumed rate of own-price elasticity for whisky (3.1 % of approximately 4 % of the spirits market).
4.222 The European Communities further notes that the authors of the study cautioned that in practice the decline in the sales of pisco was likely to be even greater than shown in the above tables due to the fact that in both scenarios the changes in the price of whisky were much bigger than those considered in order to estimate the cross-price elasticity rate between pisco and whisky.
4.223 **In rebuttal, Chile argues** that with regard to cross-elasticity of demand, the European Communities has been unable to demonstrate high cross-elasticity of demand. The study cited by the European Communities shows only a "moderate" substitutability between pisco and whisky, based on the 1995 Gemines study. A more thorough study over a longer period, conducted for the Chilean industry, as shown in Table 27 below, demonstrates an even lower degree of cross-elasticity. Such low cross-elasticity hardly demonstrates that the products are, in terms of Article III:2 "*directly* competitive or substitutable [emphasis supplied]".

[139] EC First Submission, Table 20.
[140] 1995 Gemines study, p. 63 (EC Exhibit 20).

Table 27[141]

Cross-price elasticity of pisco with other spirits, wine and beer

RESULTS OF THE REGRESSION

Statistics of the regression	
Multiple coefficient correlation	0,9878
Coefficient of R^2 determination	0,9758
Adjusted R^2	0,9624
Typical error	0,0640
Observations	15

ANALYSIS OF THE VARIABLE					
		Sum of the squares	*Average of the squares*	*F*	*Critical Value of F*
Regression	5	1,4895	0,2979	72,6767	5,32677E-07
Residual	9	0,0369	0,0041		
Total	14	1,5264			

ANALYSIS OF COEFFICIENTS						
	Coefficients	*Typical error*	*Statistic t*	*Probability*	*Inferior 95%*	*Superior 95%*
Interception	3,5771	3,6554	0,9786	0,3534	-4,6920	11,8461
Variable X 1 (Income)	-0,0072	1,2109	-0,0059	0,9954	-2,7465	2,7321
Variable X 2 (Pisco Price)	-1,3109	0,4574	-2,8661	0,0186	-2,3456	-0,2762
Variable X 3 (Whisky Price)	0,1248	0,5158	0,2419	0,8143	-1,0421	1,2917
Variable X 4 (Wine Price)	0,5963	0,4030	1,4796	0,1731	-0,3154	1,5079
Variable X 5 (Beer Price)	0,3622	1,2132	0,2985	0,7721	-2,3823	3,1067

4.224 Chile explains that to estimate the cross-elasticity between pisco and other alcoholic beverages, an econometric methodology analysis was developed on the basis of a time-series of data. It is worth mentioning that econometric models are widely accepted as a useful tool to determine whether two products are strong substitutes or not.

4.225 Chile goes on to explain that the econometric model reached a highly satisfactory adjustment at global level, and the coefficient values (elasticities) have the sign expected by the economic theory: an increase in per-capita income will lead towards an increase in per-capita pisco consumption; an increase in pisco price will lead towards a diminishing in pisco consumption. However the only variable that, from a statistical standpoint has a significant coefficient (with a confidence level of

[141] Chile First Submission, Annex II.

95%), was the pisco price, with a value of -1.31. That means that a 10% increase in the price of pisco, will result in a decrease of 13.1% in pisco consumption. According to the results of this mathematical model, the cross elasticity between pisco and whisky is not only very low (0.125), but statistically not significant (with 95% of confidence). An elasticity of 0.125, means that a 10% increase in the price of whisky (for whatever reason), will increase pisco consumption by 1.25%. But this elasticity, being so low that these products cannot be considered close substitutes to each other, is also not significant from a statistical standpoint, that means the elasticity could be 0.

4.226 According to Chile, in order to deepen this analysis, a second regression was made, but in this case the per capita income variable was eliminated from the equation. It shows an improvement, and the coefficients maintain the signs that the theory indicates. In this case, pisco and wine prices appear as significant variables (with 95% of confidence), with the cross-price elasticity of wine being 0.59. In this case, whisky also presents a low elasticity (0.128), which is not statistically significant (with 95% of confidence).

4.227 Further, Chile states, that in order to investigate further, the price of beer was eliminated from the second regression analysis, since its elasticity coefficient is not significant (with 95% of confidence), even though it is higher than that for whisky. In this case, the equation of the regression only considers prices for pisco, wine and whisky. With this modification, the quality of the regression improves, and the coefficients maintain the sign theoretically indicated. In this regression, the price of pisco (elasticity = -1.50) and wine (cross elasticity = 0.78) remain as significant variables (with 95% of confidence), while the price of whisky (cross elasticity = 0.07) remains as not significant.

4.228 Chile then argues that based on the previous commentaries, it can be concluded that, using the econometric analysis (widely accepted at technical level), it is not feasible to demonstrate the existence of a significant cross elasticity of demand between pisco and whisky.

4.229 Chile further explains that the methodology used in the above regression (demand model with constant elasticity, estimated under the ordinary least squares) is identical to the one employed by Gemines in the 1995 Gemines study. In this case, the results differ from those indicated in the Gemines study because the price series used in one case and in the other are different: in the case of the Gemines study, a *quarterly series of prices* was used, which covers the period 1985 - 1992 (seven years). In the present case, *an annual series* of fifteen years was used (from 1983 to 1997). It is necessary to indicate that upon using quarterly series, even though the number of observations increases, a lot of distortions are introduced because of seasonal consumption factors. Some of these seasonal factors could be eliminated upon introducing variables such as a "dummy" (which is the Gemines methodology). However, models constructed with "dummy" variables are generally of a lesser quality than those models that do not require this class of variables, and this does not seem to be the exception.

4.230 **The European Communities alleges** that the only piece of evidence put forward by Chile is the regression analysis. The European Communities made several comments on it. First, the regression has serious methodological problems. Second, in spite of those problems, the regression confirms that pisco and whisky compete with each other: pisco consumption goes up when the price of whisky increases and

falls when the price of whisky goes down. Finally, contrary to the claims made by Chile, the regression does not show a lower rate of cross-price elasticity than the 1995 Gemines study. Unlike the authors of the 1995 Gemines study, the authors of the Chilean regression analysis have used a simple linear regression. This means that the parameters estimated by them do not represent elasticities and, therefore, cannot be compared to the parameters estimated in the 1995 Gemines study.

4.231 The European Communities further contests that Chile has failed to rebut the extensive evidence provided by the European Communities showing that pisco and the other distilled spirits are "directly competitive or substitutable" in the Chilean market. The only piece of evidence adduced by Chile is the above regression analysis. That analysis concludes that the Chilean regression analysis is afflicted by fundamental multi-collinearity problems which render the results extremely unstable and deceptive. Further, the paucity of the data set used by Chile is such that it is not possible to address those problems.

4.232 The European Communities explains that a difficulty inherent to all time-series data is that many valuables are "collinear". This is the term used by econometricians in order to describe the fact that many values move in parallel over time without necessarily implying any causal relationship. An often cited textbook example is that of cumulative rainfall and the consumer price index, which both rise over time. A regression of one on the other would yield a high statistical correlation.

4.233 In addition, the European Communities recalls that cross-elasticity is not a one way relationship. Pisco prices also affect whisky sales. In light of the respective market shares of the two products, this reverse cross-price elasticity should even be larger than that the effect whisky prices have on pisco sales. In the view of the European Communities, Chile makes no effort to address this aspect.

4.234 **Chile also points out** that in the first place, it is for the European Communities to prove that the regression analysis that it has submitted to the Panel meets all the standards required to be considered a sound econometric exercise.

4.235 Chile further notes that as the European Communities pointed out, there are a number of tests to be carried out in the data employed in a regression, before one could use the results confidently. Chile acknowledges the effort put forward by the European Communities to review the Chilean regression analysis that was made with the annual data covering the 1983 - 1997 period, and agrees with the comments that the data contain some insolvable problems (namely multicolineality).

4.236 Chile argues that the EC's criticism are ironic, however, because the regression submitted by the European Communities has even more serious problems; it covers a smaller number of years (all of them included in the regression submitted by Chile) and is further distorted by the use of quarterly data. Finally, and even more important, the elasticity coefficient is not significant (at 95% confidence level).

4.237 Chile again emphasized that in short, neither regression analysis is sufficiently reliable, but the EC's is less reliable than that of Chile, and it is the European Communities, not Chile, that has the burden of the proof.

(iv) The 1996 Gemines Study

4.238 **The European Communities notes** that following the submission to Congress of the 1995 Proposal by the Chilean Government, the pisco industry commissioned from Gemines a new study in order to assess the impact of the

proposed reduction of the taxes on whisky from 70 % to 50 % (hereafter, the "1996 Gemines study").

4.239 The European Communities states that it has not been able to obtain a copy of the 1996 Gemines study. Nevertheless, its findings were widely publicized by APICH (the association of pisco producers) in July 1996, following the announcement by the Government that it intended to submit an amendment to the 1995 Proposal providing for an even larger reduction of the tax on whisky. Details of the 1996 Gemines study were also cited by some members of the Chamber of Deputies during the debate of the 1997 proposal.[142]

4.240 The European Communities notes that according to press reports[143], the 1996 Gemines study concluded that the reduction of the tax on whisky to 50 % envisaged by the 1995 Proposal would cause a 47 % drop in the price whisky and, as a consequence, a 17 % reduction in the sales of pisco. The European Communities claims that the accuracy of those reports has not been disputed by Chile.

4.241 The European Communities notes that the first document it requested was the "1996 Gemines study". The relevance for this dispute of that study is thus unquestionable. Yet, Chile's pisco industry has refused to provide the 1996 Gemines study to the Panel.

4.242 The European Communities states that according to a letter from APICH (the association of pisco producers) which has been forwarded by the Chilean Government to the European Communities, the reasons for that refusal are twofold. The first reason is that the study contains information "confidential" to Capel and Control. The second reason is that Capel and Control were not "satisfied with the results of the study, which did not achieve the expected results". For those two reasons, the letter concludes, "the study was never made public".

4.243 The European Communities then claims that to begin with, one may doubt of the "confidentiality" of business information which has been shared by the two main pisco producers without any apparent restriction. If it is true that the study contains confidential business information, then Chile's anti-trust authorities would be well advised to ask for a copy.

4.244 The European Communities further points out that, in any event, back in 1996 the pisco industry did not treat the study as "confidential". In July of that year APICH convened a press conference at which, brandishing the 1996 Gemines study as irrefutable evidence, APICH warned that if the Government proposal was adopted, sales of pisco would fall by 17 %. This was the same press conference at which the Chairman of APICH recalled that when at the beginning of the 1980s the tax differential between pisco and whisky was reduced to 5 %, "pisco producers were almost chased out of the market".

4.245 Also, the European Communities states that the press conference of July 1996 was part of a strategy aimed at stopping the Government from submitting an amendment to the proposal then pending before the Parliament that would have provided for a larger reduction of the tax on whisky. With the same purpose, the

[142] As an example, the European Communities refers to the intervention by Representative Prokurika, Minutes, p. 44 (p. 47 of the English translation).

[143] *El Diario*, 2 July 1996 (EC Exhibit 30).

1996 Gemines study was also provided by APICH to some members of the Chilean Congress, who quoted it extensively during the subsequent debate of the Government proposal.

4.246 The European Communities alleges that the inescapable conclusion is that in 1996 the pisco industry was telling to the Chilean Government and to the Chilean Parliament a totally different story from that presented to the Panel.

4.247 The European Communities argues that, in any event, neither APICH nor the Chilean authorities have explained why it is not possible to provide a non-confidential summary of the 1996 Gemines study. In view of that, the European Communities would urge the Panel to draw appropriate inferences from the attitude of Chile's pisco industry.

4.248 **In rebuttal, Chile comments** that the eagerness of the European Communities to request private documents prepared for the pisco industry as the Adimark study and Gemines 1996 study, is absolutely abnormal in this type of process. On one hand, the European Communities, not Chile's industry, has the burden of proving its assertions; on the other, nothing has prevented the European Communities or its industry from conducting all the surveys in Chile that they may wish; the Chilean industry - like the Scotch Whisky Association - is under no obligation to provide the information or advice it gets from private consultants.

(v) The Adimark Survey

4.249 **The European Communities notes** that the same press reports referred to another survey commissioned by APICH (the "Adimark survey") in order to assess the reactions of the different socio-demographic segments of the Chilean population to the proposed tax changes. The survey concluded, *inter alia*, that young consumers, in particular, considered that the reduction in the tax applied to whisky would provide a "good alternative to replace pisco".[144]

4.250 According to the European Communities, the Adimark survey is a qualitative study based on the opinions expressed by consumers within four "focus groups", composed of 6 to 8 people (all males) each. The study covers two socio-economic segments: ABC1 (which is believed to correspond to the middle-high to high income segments) and C2 (which would correspond to the middle-middle income segment); and two group ages: from 19 to 24 years and from 25 to 36 years.

4.251 The European Communities explains that although the use of "focus groups" is a usual research method for marketing purposes, its results are less reliable than those obtained through quantitative research methods (such as those used in the 1997 and 1998 Search Marketing studies submitted by the European Communities). Nonetheless, the findings of the Adimark study provide further confirmation that whisky and pisco are directly competitive and substitutable in the Chilean market.

4.252 The European Communities states that according to the Adimark study, a decrease in the price of whisky would provoke the following reactions in the ABC1 segment[145]:

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[144] *El Diario*, 2 July 1996 (EC Exhibit 30).

[145] Adimark study, submitted by Chile, p. 18. *See* also pp. 20-21.

(i) "a strong incidence in the frequency of whisky consumption (it would be purchased more often)";

(ii) "a feeling of displacement of pisco mainly (as opposed to other beverages)"; and

(iii) "a tendency to substitute [whisky] for the consumption of pisco (including for consumption in 'carretes' by the young population)".

4.253 According to the European Communities, in the case of segment C2, reactions are more nuanced, but nevertheless strongly supportive of a finding of direct competition.[146] On the one hand, the consumers in this segment express the view that, if the price of whisky decreased, they would increase their consumption of whisky at the expense of pisco. On the other hand, they anticipate that in the longer term they would progressively revert to pisco. However, the main reason given for that prediction is that pisco is a "traditional" drink with a strong Chilean identity, whereas whisky is a "foreign" spirit. Thus, the apparent resistance of consumers in this segment to a permanent change is motivated by their subjective perceptions about the identity of the products, rather than by the existence of objective differences between them. Those subjective perceptions are likely to change as the consumption of whisky becomes more frequent and whisky looses its "foreign" label in this segment (a process which, according to the study, would have already been completed in the higher income ABC1 segment, where consumers have been exposed to foreign spirits longer and are less "nationalistic" in their choices).

4.254 **Chile argues** that in regard with the Adimark survey, it is worth mentioning that it is a qualitative study, based on 4 "focus group" of 6 - 8 people each. Therefore the total sample is just about 30 people, which does not constitute, under any consideration, a sample that allows for drawing valid conclusions about market behaviour. This type of study, being a research method employed for marketing purposes, conveys only preliminary results on the issue investigated. In terms of the quality of the information provided, they are less reliable than normal and well conducted quantitative market research analysis.

4.255 Chile goes on to state that as it has shown, the illogical quantitative results of the Search Marketing study render it useless as an evidence before this Panel; *a fortiori*, the Adimark survey has even less usefulness as evidence.

4.256 Chile further argues that if, in spite of the above, the Panel would still consider the Adimark survey as evidence, the conclusions drawn from it validate Chile's position, that is, that pisco and whisky are competitive only to a very limited extend, based on the following:

(i) According to the survey pisco and whisky are both consumed by the ABC1 segment, but in different occasions: Pisco when hanging out with friends and whisky in important social events (e.g., wedding parties, official receptions at the European embassies, and the like).

(ii) The survey shows that young people belonging to the ABC1 segment will change from pisco to whisky only in case the price of whisky is

[146] Adimark study, submitted by Chile, pp. 18 and 21-23.

reduced substantially, as to reach the price of pisco, which seems extremely unlikely to occur, even if taxes are not levied at all.

(iii) The survey shows those in segment C2 (the most important segment in terms of consumption and certainly poorer than ABC1) would not substitute whisky for pisco due to considerations concerning the national attribute of pisco.

(iv) According to the survey, the only substitution that has been proved is that between whisky and high alcohol content pisco (which is taxed identically with whisky).

(vi) Position of Domestic Industry and the Government of Chile

4.257 **The European Communities also argues** that the producers of pisco have recognized openly that pisco and other spirits are directly competitive and substitutable products. As mentioned above, in July 1996 APICH gave broad publicity to the findings of the 1996 Gemines study, which concluded that lowering the tax on whisky to 50 % would result in a 17 % drop in the sales of pisco. According to the same reports, Mr. Peñafiel (the general manager of Capel, speaking as the representative of APICH) recalled on that occasion that:

> ... at the beginning of the 80s the tax difference between pisco and whisky was 5 % and pisco producers were almost chased out of the market. Nowadays, this is a latent risk. The situation may have changed a lot, but whisky is a pole of attraction for an important segment of the population.[147]

4.258 The European Communities further points out that equally open as to the existence of a competitive relationship between whisky and pisco was Mr. Elorza, general manager of Control, who reportedly stated that:

> Any change in the taxes may strongly affect us. Pisco is an agricultural product and for that reason the law is protectionist. In contrast, whisky is an industrial product.[148]

4.259 The European Communities concludes that beyond these statements by two of the industry's top managers, it is evident that the concern shown by the pisco producers throughout the amendment process of the ILA would have been totally unwarranted, had that industry not been convinced that pisco and the other spirits are directly competitive and substitutable products.

4.260 The European Communities alleges that in particular, the pisco industry's request that the tax rate be increased by 6 percentage points per degree of alcohol instead of by 5 percentage points (as provided for in the 1995 Proposal) evidences that its main concern was to limit the reduction of the taxes on whisky, rather than the increase of the taxes on high strength pisco. That concern would have been

[147] *El Diario*, 2 July 1996, (EC Exhibit 30). The European Communities adds that the successive increases of the tax rate on whisky from 30 % to 70 % between 1983 and 1985 were prompted by complaints of the pisco industry against growing imports of whisky.

[148] *Qué Pasa*, 2 March 1996 (EC Exhibit 26).

irrational unless the pisco industry had recognized the existence of direct competition between pisco and whisky.

4.261 The European Communities also claims that likewise, the strong resistance of the pisco industry to the further reduction of the tax rate on whisky to 40-45 % (instead of 50 %, as provided for in the 1995 Proposal) that was envisaged by the Government in July 1996 would have been senseless if whisky and pisco were not directly competitive products, the more so since that reduction would have benefited not only whisky but also *pisco reservado* and *gran pisco*.

4.262 The European Communities further asserts that similarly, the pisco industry's insistence on a long transitional period not just for phasing in the increase of the taxes on pisco but also the reduction of the taxes on whisky would be difficult to understand unless it was based on the assumption that those two spirits are directly competitive and substitutable.

4.263 The European Communities goes on to state that the pisco industry was not alone in considering that pisco and other spirits were directly competitive and substitutable. During the debate of the 1997 Proposal by the Chamber of Deputies, the existence of direct competition between pisco and whisky was assumed without discussion by all the speakers, including those who championed the cause of the pisco industry. Indeed, the representatives of the *zona pisquera* tended to emphasize that relationship in order to demonstrate the extent of the "sacrifice" consented by the pisco industry and, therefore, the need for public financial support to that industry.

4.264 The European Communities further alleges that the open recognition by the Chilean Government, as well as by many legislators, that the tax system in force until November 1997 needed to be amended because it was "discriminatory" against whisky and favoured the pisco producers necessarily presupposes the admission that pisco and other spirits are directly competitive and substitutable.

4.265 The European Communities notes a recent factual development of some importance for this dispute. According to press reports[149], Chile's anti-trust watchdog just authorized the merger of Control or Capel, the two largest producers of pisco, with a combined market share of 99 %. The main reason invoked by Chile's anti-trust authorities for clearing the merger was that the new company will be subject to competition from other "substitutable" liquors, including imported distilled spirits. According to the same press reports, another consideration taken into account was that the new company would be better positioned "to face external competition".

C. "Not Similarly Taxed"

1. Overview

4.266 **The European Communities argues** that under the Transitional System pisco and other "directly competitive or substitutable" distilled spirits are "not similarly taxed," and under the New Chilean System, the majority of pisco and the other distilled spirits are "not similarly taxed". In both cases, the tax differentials are well above *de minimis*.

[149] EC Exhibit 65.

4.267 The European Communities also claims that while the two panel reports on *Japan - Taxes on Alcoholic Beverages I* and *II* stand for the proposition that the application of specific taxes in direct proportion to the alcohol contained in each type of distilled spirits does not constitute "dissimilar" taxation of the spirits, this reasoning does not apply to the New Chilean System.

4.268 **In rebuttal, Chile states** that in the New Chilean System, all spirits, regardless of type and regardless of whether imported or domestic, are taxed according to the identical objective criteria of alcohol content and value, two objective criteria that have been widely accepted as taxation basis. According to Chile, objective criteria can result in taxation that, by some alternative measures, is not identical; for example, a specific tax system results in a higher tax on low priced goods, measured in *ad valorem* terms as well as distorting price relationships. However, in the view of Chile, GATT Article III does not prohibit a tax or regulation simply because, as a result of the application of objective criteria, some or even many imported products are by some measures treated worse than some or many like or competing domestic products. This position is supported by past panel reports and the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*.

2. EC Main Argument

4.269 **The European Communities states** that, as confirmed by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*, two competitive or substitutable products must be considered as not being "similarly taxed" whenever the difference in taxation between them is more than *de minimis.*[150] According to the same report, whether any particular tax differential is or not *de minimis* must be determined on a case-by-case basis.[151]

(a) Transitional System

4.270 **The European Communities points out** that as shown in Table 1 above, the rate on whisky will be higher than the rate on pisco throughout the duration of the transitional period. Moreover, despite the progressive reduction of the rate on whisky, the tax differential will remain very large. As from 1 December 1999, when the tax differential will reach its lowest level, the rate on whisky (53 %) will still be more than twice the rate on pisco (25 %). A tax differential of such magnitude is more than *de minimis*.

4.271 The European Communities also notes that as shown in the same table, pisco will also be taxed at a lower rate than the category of "other spirits" during the transitional period. The European Communities argued that although the tax differential is smaller than the differential between pisco and whisky, it is still large enough to be capable of affecting the competitive relationship between the products concerned, as attested by the findings of the 1998 SM survey discussed above.

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[150] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra*, footnote 41, at 115-116.

[151] *Ibid.*

(b) New Chilean System

4.272 **The European Communities claims** that the Appellate Body considered a similar situation in *Canada - Periodicals*. One of the measures in dispute in that case was an internal excise tax applied by Canada to "split-run" periodicals (both imported and domestic), which was not imposed on "non-split-run" periodicals (whether imported or domestic). Canada claimed that there was no violation of Article III:2 because imported periodicals "as a class" were not taxed in excess of domestic products "as a class". The Appellate Body rejected this argument. According to the Appellate Body, although all "split-run" periodicals were equally taxed irrespective of their origin, the fact that imported "split-run" periodicals were not similarly taxed to domestic "non-split run" periodicals was sufficient to establish that there was "dissimilar taxation" for the purposes of Article III:2, second sentence:

> Following the reasoning of the Appellate Body in Japan - Taxes on Alcoholic Beverages, dissimilar taxation of even some imported products as compared to directly competitive or substitutable products is inconsistent with the provisions of the second sentence of Article III:2.[152]

4.273 The European Communities further explains that in reaching that conclusion, the Appellate Body invoked the well-known principle established by the Panel Report on *United States - Section 337 of the Tariff Act of 1930*, according to which:

> ... the "no less favourable treatment" requirement of Article III:4 has to be understood as applicable to each individual case of imported products.[153]

4.274 The European Communities then states that as evidenced by Table 3 above, under the New Chilean System the majority of pisco will continue to be taxed at a lower rate than the main types of imported spirits. Whereas *pisco tradicional* and *pisco especial* (which together account for 90 % of the sales of pisco) will be taxed at 27 %, whisky, vodka, rum, gin and tequila will be taxed at 47 % and brandy at a rate ranging from 39 % to 47 %. Those tax differentials are well above the *de minimis* threshold.

4.275 In the view of the European Communities, the fact that under the New Chilean System some pisco is taxed at the same rate as the main types of imported spirits does not mean that pisco and those spirits are "similarly taxed" for the purposes of the second sentence of Article III:2. The imported spirits in question do not compete with *pisco reservado* or *gran pisco* only. They are "directly competitive or substitutable" with all types of pisco and, therefore, should be taxed "similarly" to all pisco.

4.276 The European Communities also argues that the two panel reports on *Japan - Taxes on Alcoholic Beverages I* and *II*[154] suggest that the application of specific taxes

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[152] Appellate Body Report on *Canada - Periodicals, supra,* footnote 41, at 474.

[153] Panel Report on *United States - Section 337 of the Tariff Act of 1930 (hereafter "United States - Section 337")*, BISD 36S/345, para. 5.14.

[154] The European Communities notes that the taxes applied by Japan in that case were expressed in terms of a certain amount of Yen per litre of beverage. That amount varied according to (but not proportionally) to the alcohol content.

on alcoholic beverages according to alcohol content does not constitute "dissimilar taxation" for the purposes of Article III:2, provided that the tax rate per degree of alcohol is the same, irrespective of the beverage in which the alcohol is contained. The underlying rationale is that those taxes are not so much taxes on the alcoholic beverages themselves as taxes on their principal common ingredient: the alcohol content.

4.277 The European Communities refers to the Panel Report on *Japan - Taxes on Alcoholic Beverages I*, which stated that:

> [The] unqualified wording [of Article III:2, first sentence] does not necessarily mean that there could never be circumstances in which different tax treatment of "like products" was compatible with the General Agreement. The panel noted, for instance, that GATT Article III:2, a) [*sic*] permitted the non-discriminatory taxation "of an article from which the imported product has been manufactured or produced in whole or in part" and that such a non-discriminatory alcohol tax on like alcoholic beverages with different alcohol contents could result in differential tax rates on like products.[155]

4.278 The European Communities then claims that the present dispute, however, is concerned with a totally different system of taxation. To begin with, the ILA is an *ad valorem* tax and not a specific tax. Furthermore, although the applicable rates vary according to alcohol content, the ILA is assessed on the value of the beverage, which is not directly related to the value of the alcohol content. For those reasons, unlike the specific taxes considered by the two panel reports on *Japan - Taxes on Alcoholic Beverages I* and *II*, the ILA cannot be characterized as a tax on the alcohol content.

3. Chile - "Objective Criteria" Argument

4.279 **Chile replies** that there is no precedent for holding inconsistent with GATT 1994 a system of taxation that does not discriminate based on nationality and that employs strictly objective criteria for any differentiation in taxes. Indeed, the same panels that condemned the Japanese System - and even the European Communities itself in arguing those cases - observed that distinctions based on objective and neutral criteria are permissible under Article III:2.

4.280 Chile also states that Article III does not prohibit a tax or regulation simply because, as a result of the application of objective criteria, some or even many imported products are by some measures treated worse than some or many like or competing domestic products. The drafting history of Article III makes this clear. In the latter stages of the drafting of what became Article III of the GATT, the negotiating Sub-Committee responsible for this Article reported:

> The Sub-Committee was in agreement that under the provisions of Article 18 [Article III of the GATT], regulations and taxes would be permitted which, while perhaps having the effect of assisting the production of a particular domestic product (say, butter) are directed as much against the domestic production of another product (say,

[155] Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra*, footnote 50, para. 5.9 d).

> domestic oleomargarine) of which there was a substantial domestic production as they are against imports (say, imported oleomargarine).[156]

4.281 In the view of Chile, the logic of this unanimous understanding of the negotiators is compelling. All WTO Members make tax and regulatory distinctions that fall unevenly by some measures among products that might be considered like or directly competitive or substitutable in the sense of Article III. Sometimes these distinctions will mean that many domestic products will, by some measures, be taxed or regulated more favorably than many like or competing imports. But that is not a violation of Article III, where criteria for the distinctions are objective and neutral.

4.282 Chile also argues that past panels have repeatedly acknowledged these considerations, noting also that Article III is not intended to be used as a tool for harmonizing the tax systems of the WTO Members,[157] and WTO Members retain almost complete freedom with respect to domestic policies that do not distinguish between the origin or destination of goods.[158] In *United States - Measures Affecting Alcoholic and Malt Beverages*, the panel noted that:

> The purpose of Article III is not to harmonize the internal taxes and regulations of contracting parties, which differ from country to country.[159]

4.283 Chile further argues that in *Japan - Taxes on Alcoholic Beverages I*, the panel affirmed this principle with respect to Article III:2, noting that this Article "prohibits only discriminatory or protective taxation of imported products but not the use of differentiated taxation methods as such ..."[160] The panel went on to say "that Article III:2 does not prescribe the use of any specific method or system of taxation ...".[161] This position was also endorsed by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*.[162]

4.284 Chile then claims that the EC argument against the Chilean system ignores these precepts of Article III, and instead asks the Panel to strike down an objective and neutral tax system merely because a result of the application of that system is that those EC beverages of high alcohol content (and high price) will face higher taxes than those Chilean beverages (primarily certain kinds of pisco) that are of relatively low alcohol strength (and price). In making this argument with respect to the New Chilean System, the European Communities ignores that many European products, including those most similar to pisco, will benefit from the same lower rates of tax, while other European products could be adapted for the Chilean market merely by diluting with water the current relatively high strength of the products - as

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156 Reports of the Committees and Principal Sub-Committees, ICITO 1/8, 64 (Geneva, Sept. 1948).

157 *See* Panel Report *Japan - Taxes on Alcoholic Beverages I*, *supra,* footnote 50.

158 Panel Report on *United States - Measures Affecting Alcoholic and Malt Beverages* (hereafter, *"United States - Malt Beverages"*), BISD 39S/206, para. 5.25 and Panel Report on *United States - Taxes on Automobiles*, 33 I.L.M. 1397 (1994), para. 3.108.

159 Panel Report on *United States - Malt Beverages*, para. 5.71.

160 Panel Report on *Japan - Taxes on Alcoholic Beverages I, supra*, footnote 50, para. 5.9 b).

161 *Ibid*., para. 5.9 c).

162 *See* Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 118.

the European Communities has suggested could be done by pisco producers. Equally, the European Communities ignores that under the New Chilean System many Chilean distilled spirits, including Chilean whisky, brandy and gin and very substantial quantities of pisco that are marketed at relatively high prices and alcohol strength, will face the highest rate of taxation.

4.285 Chile then concludes that the New Chilean System thus presents precisely the kind of regulatory system that Article III is not intended to condemn:

(i) there is no distinction in taxation based on origin or on type;

(ii) many imports can benefit from the lowest tax and all others could be easily diluted for that purpose;

(iii) many domestic products of Chile will face the highest tax rates under the New Chilean System; and

(iv) the objective standards mean that foreign producers can readily adapt their products to lower their taxes by a simple process.

4.286 In its support, Chile adds that the Appellate Body has properly noted that "Article III protects expectations not of any particular trade volume but rather of the equal competitive relationship between imported and domestic products".[163] Foreign and domestic producers have an equality of competitive opportunities, as they have an equal opportunity to adapt their production, if they so choose, in the way implicitly preferred under the New Chilean System, i.e., by reducing alcohol content.

4.287 Further, Chile notes that the European Communities itself in this matter recognizes that "the New Chilean System abolishes formally the distinction between pisco and the other types of distilled spirits". The criterion of alcohol content is neutral and objective, and one that past panels and the European Communities itself have cited as an example of a tax category corresponding to objective product differences.

4.288 Chile further argues that the panel in *Japan - Taxes on Alcoholic Beverages I* endorsed use of alcohol content as a permissible objective means of taxation. The panel suggested that the application of different tax rates would be consistent with Article III:2 if the different tax rates were based on objective criteria, and relative alcohol content was specifically cited and endorsed as an example of an approach that could be acceptable. In rejecting the Japanese tax structure subject to dispute in *Japan - Taxes on Alcoholic Beverages I*, the panel observed that it:

> was unable to find that the differences as to applicability and non-taxable thresholds of the *ad valorem* taxes were based on corresponding objective product differences (*e.g.,* alcohol contents) and formed part of a general system of internal taxation equally applied in a trade-neutral manner to all like or directly competitive liquors.[164]

4.289 It should be observed, according to Chile, that the panel did not object to the existence of non-taxable thresholds, nor did the panel require that the system apply taxes in direct proportion to alcohol content. Rather, the panel found the Japanese

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[163] *See* Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 110 (citations omitted).

[164] Panel Report on *Japan - Taxes on Alcoholic Beverages I, supra*, footnote 50, para. 5.9 b).

system deficient in applying a different scale to different types of distilled spirits that had been found directly competitive or substitutable.

4.290 In its further support, Chile points out that in the *United States - Taxes on Automobiles* case, the European Communities argued that the Japanese tax system examined by the panel in *Japan - Taxes on Alcoholic Beverages I*, "did not correspond to a rational overall system for taxing all liquors, such as one based on *alcohol content*".[165]

4.291 Chile also notes that the European Communities itself, in its challenge of the Japanese system of taxation of alcoholic beverages specifically commended both alcohol content and value as acceptable neutral ways of varying taxes on like and directly competitive practices. In this respect, the European Communities argued that the panel in its analysis of an alleged violation of Article III should:

> determine whether the category as a whole is taxed in excess of the corresponding category of domestic products. This would not be the case if the proportional variations in taxation on the basis of, e.g., alcohol content, are equally and uniformly applied to this category of like products, both domestic and imported.[166]

4.292 Chile further notes that similar views have been expressed before the European Court of Justice ("ECJ"). The ECJ in Case 170/78, *Commission v United Kingdom*, 1983 ECR 2265 noted that:

> [T]he Commission has recommended that spirits should be charged at a higher rate of duty according to alcoholic strength than liqueur wines. It appears, therefore, to have accepted that there are social reasons for imposing a relatively higher rate of taxation on beverages with a higher alcoholic content.

4.293 In the view of Chile, on the contrary, the European Communities argues that under the New Chilean System many spirits imported from the European Communities are and will be of relatively high alcohol content, and therefore more heavily taxed, while many spirits produced in Chile are and will be of relatively lower alcohol content and hence less heavily taxed. While those points are true, they present an incomplete picture of the facts and an inadequate basis to find a violation of Article III:2. Much Chilean pisco is taxed at the lowest rate of 27%, but Chile also produces a large volume of products containing 40° alcohol content or more, including domestically produced whisky, gran pisco, pisco reserved, 40° brandy, rum, gin, and vodka, and these products will be taxed at a rate of 47%, the highest tax bracket. It is also significant that many distilled spirits produced in Europe and elsewhere contain 35° alcohol or less and will be taxed in Chile at a rate of 27%, including aguardiente, grappa, fruit liquors, cocktails, other liquors, and even shochu. Therefore, just as some domestically produced products benefit from the lowest tax bracket, it is equally true that a significant amount of domestically produced whisky and gran pisco faces the highest tax rate of 47%.

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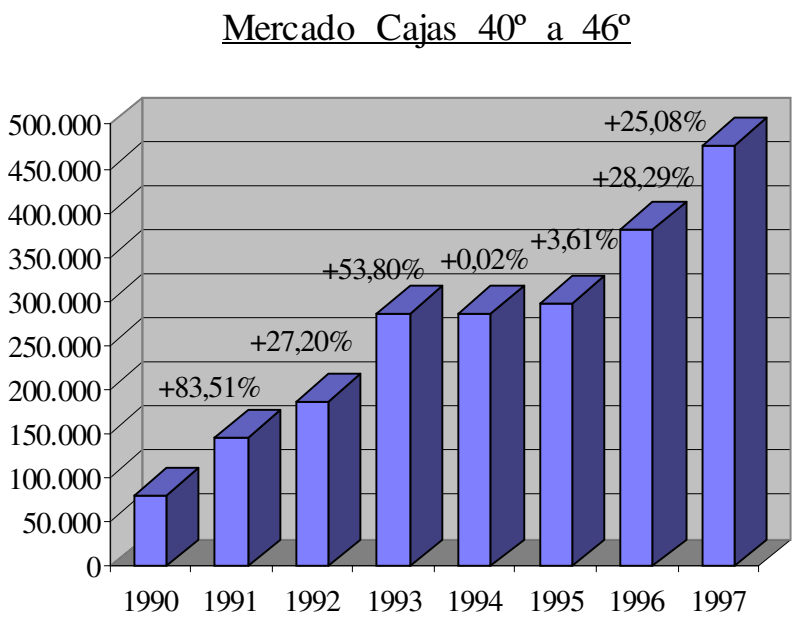
[165] Panel Report on *United States - Taxes on Automobiles, supra.,* para. 3.92 (emphasis added by Chile). Chile also referred to Panel Report on *Japan - Taxes on Alcoholic Beverages II, supra,* footnote 45, para. 4.45.

[166] Panel Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 45, para. 4.48.

4.294 Chile further provides Chart 3 to show the growing volume of sales of premium grades of pisco with relatively high alcohol content that will face the highest rates of taxation under the New Chilean System.

Chart 3

Sales volume and growth rates of premium grades of Pisco
(Pisco from 40º to 46º)



4.295 Chile also presents tables showing the best available information concerning production and sales of various types of distilled spirits in Chile.[167]

4.296 Chile then concludes that in any event, where objective standards are applied, GATT Article III does not require that internal taxes and measures must always *result* in proportional effect on imported and domestic products. To take an obvious example, *ad valorem* taxes are permissible under GATT, even though imported products that are higher priced or already face customs duties may thereby have to face higher tax per unit than domestic products. The European Communities itself has endorsed the idea that horsepower or engine displacement taxes are permissible. Chile agrees, even though such taxes almost certainly fall disproportionately heavily on automobiles of the type that Americans or Canadians are more likely to produce.

[167] Chile First Submission, Annex III.

4.297 Chile further rebuts the EC argument that the New Chilean System cannot be characterized as a tax on alcohol content because it is based on an *ad valorem* tax rather than a specific tax. The European Communities states that the Chilean tax, although varying according to alcohol content, is "assessed on the value of the beverage, which is not directly related to the value of the alcohol content" and thus cannot be "characterized as a tax on the alcohol content". It is not clear what point the European Communities is trying to make here or how it furthers their argument, but in any event their analysis is fundamentally irrelevant and leads to an incorrect conclusion. The New Chilean System is based on both alcohol content and *ad valorem*; two criteria that have been recognized and accepted by previous panels under GATT as objective criteria.

4.298 Chile further argues that panels have even found that different systems could be used for imported and domestic products, if objectively based. It is not necessary for this Panel to go that far in this dispute, since the New Chilean System applies an identical system without regard to whether distilled spirits are imported or domestically produced. Nevertheless, it is instructive that the panel in *Japan - Taxes on Alcoholic Beverages I* noted that:

> Article III:2 does not prescribe the use of any specific method or system of taxation … there could be objective reasons proper to the tax in question which could justify or necessitate differences in the system of taxation for imported and for domestic products.[168]

This position was also endorsed by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*.[169]

4.299 Chile also argues that the overriding requirement of Article III:2 is not to discriminate in favor of domestic goods and against imported goods on the basis of national origin of a product. Almost all cases brought to GATT and WTO panels under Article III:2 have involved measures that, on their face, afforded more favorable treatment to some or all domestic goods than to imported goods.

4.300 Chile explains that a legislator should also be aware that a measure that formally does not discriminate based on nationality may nevertheless be found to contravene Article III:2, second sentence, if the effect of the measure is to make more favorable treatment available exclusively or virtually exclusively to domestic products to the disadvantage of imported products. GATT and WTO panels have gone furthest in extending the concept of *de facto* discrimination based on national origin of a product in the recent alcoholic beverage taxation cases against Japan and Korea. Both of those countries had tax systems in which one type of distilled spirit was taxed at a far lower rate than other distilled spirits. Further, in each case, domestic producers accounted for virtually all domestic consumption of shochu or soju, because various measures effectively prevented imports of shochu/soju from competing in the domestic market. In these circumstances, where there was no possibility for foreign producers to obtain the benefits of the low tax accorded to shochu/soju, and where the panel found that the favoured product was like or directly

[168] Panel Report on *Japan - Taxes on Alcoholic Beverages I, supra*., footnote 50, para. 5.9 c).
[169] *See* Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 118.

competitive or substitutable with other types of distilled spirits, these systems were held to contravene Article III:2.

4.301 In the view of Chile, on the other hand, laws and regulations based on objective criteria such as those used in the New Chilean System have rarely been challenged in the GATT and have never been successfully challenged, even when the tax system may result in less favorable treatment for some or many imported goods than for some or many domestic goods. For example, in the *United States - Taxes on Automobiles* case, the panel found that the United States had *not* breached Article III:2 by imposing a luxury tax on vehicles above a certain threshold value.[170] The U.S. tax resulted in far higher taxes on certain European products, which dominated the U.S. market for cars priced significantly above the threshold price and thus accounted for the vast majority of the revenue collected from the tax on European cars. However, far more imports, including a significant number of imports in the price categories most directly competitive with U.S. "luxury cars," paid a minimal tax or no tax at all.

4.302 Chile further argues that while the reasoning of the *United States - Taxes on Automobiles* panel (the so-called "aim and effects" test) was not followed subsequently by the Appellate Body, it believes that the result would have been the same under the three part test applied by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*.[171] The luxury tax imposed by the United States was based on objective criteria (a tax on the value of cars in excess of a fixed luxury level) that applied to both domestic and imported cars, and imported cars could and did benefit from the tax exemption granted to all cars below the exemption.

4.303 Chile then points out that comparing that system to the Chilean system of taxation of alcoholic beverages, it might be noted that it is easier as a practical matter for foreign producers to adapt the alcohol strength of their product than for car producers to reduce their prices.

4.304 Chile also notes that similarly, even though specific taxes such as those imposed on alcoholic beverages in several EC Member States have a marked discriminatory effect on low priced imported products relative to high priced domestic products such as Scotch whisky or even imported high priced products such as U.S. or Canadian whisky, Chile has believed that a challenge of such tax systems under Article III (or Article I which requires most favoured nation treatment with respect to matters covered by Article III:2) would probably not be successful because the tax standard is objective, even if its effect disfavours low price products.

4.305 Chile also argues that it is likewise inconceivable that members of the WTO, particularly developing country members, thought or think that, in joining the WTO and accepting thereby the obligations of Article III:2, they were foregoing the right to use fiscal policy tools such as luxury taxes or exemptions or reduced taxes for goods purchased primarily by poor consumers, even if such policies result in higher taxes on many imports than on many like or directly competitive products.

4.306 **The European Communities replies** that Chile's defence in this case is built upon the argument that tax distinctions linked to differences in alcohol content do

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[170] *See* Panel Report on *United States - Taxes on Automobiles, supra.*

[171] *See* Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra,* footnote 41.

not constitute "dissimilar taxation" because they are "objective" and "neutral". While those two terms are constantly repeated by Chile, their precise meaning is nowhere explained. As shown below, the legal test embodied in Chile's argument would lead in practice to unacceptable consequences.

4.307 The European Communities argues that to begin with, one may wonder what qualifies as an "objective" tax distinction. Or, rather, one should ask what does not qualify as an "objective" tax distinction. Differences between spirits with respect to factors such as ingredients, colour or even taste are no less "objective" than differences in alcohol content. They are as readily observable and can be measured with the same precision. In view of that, why should tax distinctions based on one or more of those characteristics be treated differently than the tax distinctions based on alcohol content?

4.308 The European Communities further states that on the other hand, if one accepts the view that "objective" tax distinctions between products may never constitute "dissimilar" taxation, the second sentence of Article III:2 becomes redundant. Indeed, the existence of two "directly competitive or substitutable" products presupposes, by definition, that there is some sort of "objective" difference between them. Otherwise, they would be "like" products and any difference in taxation between them would be caught by the first sentence of Article III:2.

4.309 The European Communities states that the relationship between the two terms of Chile's test is also far from clear. Does Chile consider that tax distinctions based on "objective" differences are *per se* "neutral"? That proposition can be easily refuted. Many tax distinctions based on "objective" differences are demonstrably protectionist, both in purpose and in effect.

4.310 The European Communities asks the Panel to consider, for instance, the tax distinction made by Japan between shochu and whisky. That distinction is by no means a "subjective" one. There are "objective" differences between those two spirits, including differences in alcohol content which are even larger than those between whisky and pisco.[172] If Chile's interpretation was upheld, Japan could re-introduce the same tax differentials that have already been condemned in two panel reports, simply by replacing the explicit distinction between shochu and whisky with a distinction based on alcohol content or on any other of the "objective" characteristics (or a combination of them) that differentiate shochu from whisky.

4.311 The European Communities alternatively asks the Panel to consider the hypothesis that a vodka producing country (say Finland) levied a tax based on the degree of optical density (i.e., the colour of the beverage), which results in the application of a 1000 % tax on "brown spirits" and a 1 % tax on "white spirits". Would that be a "neutral" tax distinction simply because it is based on an "objective" characteristic?

4.312 The European Communities argues that Chile itself has conceded implicitly that the "neutrality" of a tax distinction cannot be presumed *a priori*. In fact, as part of its discussion under the second element of Article III:2, Chile sets out to demonstrate why the New Chilean System is actually "neutral". However, if the neutrality of a tax distinction had to be ascertained already as part of the second

[172] The European Communities notes that the most usual strength of shochu is 25°.

element, the third element of Article III:2, second sentence, would become superfluous. This point is illustrated by Chile's First Submission, where the arguments made by Chile under the second element with respect to the alleged the "neutrality" of the New Chilean System are then repeated almost without variation in connection with the third element.

4.313 In conclusion, the European Communities states that it would agree that Article III:2, second sentence, does not prohibit tax distinctions between directly competitive or substitutable products which are "neutral". But the "neutrality" of tax distinction is not something which can be inferred from the mere fact that the tax distinction is based on differences on alcohol content or on any other "objective" product difference. The "neutrality" of tax distinction has to be established, on case-by-case basis and having regard to all relevant factors, under the third element of Article III:2, second sentence. In *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body found that the panel had erred "in blurring the distinction between [the issue of whether the products were similarly taxed] and the entirely separate issue of whether the tax measure in question was applied so as to afford protection". The test put forward by Chile in this case incurs in the same mistake.[173]

4.314 The European Communities further contests Chile's argument that in the New Chilean System "differentiation in taxation is based on alcohol content, not type of distilled spirit". This claim, however, involves an obvious fallacy. Each type of spirit is typically produced within a certain range of alcohol content. This difference has been recognized by Chile's regulations, which prescribe a different minimum alcohol content for each of the most common types of spirits. As a result, tax distinctions based on alcohol content lead necessarily to tax distinctions between types of spirits.

4.315 The European Communities maintains that the New Chilean System ensures that the main types of imported spirits (whisky, gin, rum, vodka and tequila, all of which have a minimum alcohol content of 40°) are taxed at the highest rate possible: 47 %. Meanwhile, the vast majority of pisco (which has a minimum alcohol content of 30°) is taxed at the lowest rate possible: 27 %. Thus, it is indisputable that in the New Chilean System pisco and the other spirits in dispute are still not "similarly" taxed.

4.316 The European Communities further argues that *Japan - Taxes on Alcoholic Beverages II* stands for the proposition that the application of specific taxes in direct proportion to the volume of alcohol contained in each type of distilled spirit does not constitute "dissimilar" taxation. The underlying reasoning is that, in that system of taxation, the taxed product is not the spirituous beverage but the alcohol contained in the beverage.

4.317 In the view of the European Communities, this reasoning is not applicable in the case at hand. The measure in dispute is an *ad valorem* tax and not a specific tax. And it is calculated on the basis of the value of the beverage as a whole and not on the basis of the value of the alcohol content. Therefore, unlike the measures applied by Japan, it cannot be characterized as a tax on the alcohol content. For that reason, the European Communities considers that the Panel should compare the absolute

[173] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 118-119.

rates applied to each spirit, rather than the rates per degree of alcohol contained in each type of spirit.

4.318 The European Communities argues that in any event, it has demonstrated that pisco and the other spirits are also "not similarly" taxed even if one compares the rates per degree of alcohol. Each degree of alcohol in whisky, gin, vodka, rum and tequila is taxed at a rate which is more than 50 % higher than the rate applied to each degree of alcohol in pisco of 35°.

4.319 The European Communities points out that Chile has acknowledged this tax differential, but claims that the lack of proportionality between differences in taxation and differences in alcohol content does not constitute "dissimilar" taxation. According to Chile, a difference in alcohol content between two types of spirits (however small) could justify any conceivable difference in taxation between them (no matter how large) that a Member may chose to apply. By way of justification, Chile argues that alcohol content is an "objective" product characteristic and that distinctions based on that criterion are always "neutral".

4.320 The European Communities maintains that Chile's position is refuted by *Japan - Taxes on Alcoholic Beverages I* and *II*. The second panel report is particularly clarifying in this regard. In that report, the panel based its conclusion that whisky and shochu were not "similarly" taxed on the fact that the tax rate per degree of alcohol applied to whisky of 40° was higher than the rate per degree of alcohol applied to shochu of 25°. This comparison would have been totally irrelevant if, as claimed by Chile, differences in alcohol content could justify non-proportional differences in taxation. If Chile's position was correct, the panel could not have reached the conclusion that shochu and whisky were not "similarly" taxed except by comparing the rates per degree of alcohol applied by Japan to whisky and shochu with the same alcohol content, something which the panel did not consider necessary to do.

4.321 Agreeing with Chile in that Article III:2, second sentence, does not prohibit tax distinctions between directly competitive or substitutable products which are "neutral," however, the European Communities argues that, contrary to Chile, it believes that the "neutrality" of a tax distinction is not something which can be presumed from the mere fact that the distinction in question is based on alcohol content or on any other "objective product difference". The "neutrality" of a tax distinction has to be established, on a case-by-case basis and having regard to all relevant factors, under the third element of Article III:2, second sentence.

4.322 The European Communities also contests Chile's invocation as authority for its sweeping proposition that tax distinctions based on differences in alcohol content never constitute "dissimilar taxation", of a somewhat obscure passage contained in the Panel Report on *Japan - Taxes on Alcoholic Beverages I*:

> The Panel was unable to find that the differences as to the applicability and non-taxable thresholds of the *ad valorem* taxes were based on corresponding objective product differences (e.g., alcohol contents) and formed part of a general system of internal taxation equally applied in a trade-neutral manner to all like or directly

> competitive liquors (e.g., "alcohol taxes" equally applied to all alcoholic beverages).[174]

4.323 The European Communities argues that the above passage, however, is inapposite for a number of reasons. The European Communities explains that first, it relates to the interpretation of the first sentence of Article III:2, a provision which has a different scope and structure. The test laid down by the panel is superfluous in the context of the second sentence of Article III:2, because tax distinctions between "directly competitive or substitutable products" are always permissible, provided that they are not applied "so as to afford protection".

4.324 The European Communities goes on to state that second, the meaning of the passage is notably ambiguous. The reading made by Chile is contradicted by several other passages in the same report where the panel stated very clearly that tax distinctions between "like" alcoholic beverages with different alcohol content may be compatible with the first sentence of Article III:2 to the extent that they can be explained as a non-discriminatory tax on the alcohol content:

> The Panel was unable to find that these tax differentials corresponded to objective differences of the various distilled liquors, for instance that they could be explained as a non-discriminatory taxation of their respective alcohol contents.[175]
>
> It followed from the clear wording of Article III:2 that imported liquors "shall not be subject … to internal taxes … in excess of those applied … to like domestic products". The Panel was of the view that this unqualified wording must not necessarily mean that there could never be any circumstances in which different tax treatment of "like products" was compatible with the General Agreement. The Panel noted, for instance, that GATT Article III:2 [*sic*] permitted the non-discriminatory taxation "of an article from which the imported product has been manufactured or produced in whole or in part", and that such a non-discriminatory alcohol tax on like alcoholic beverages with different alcoholic contents could result in different tax rates on like products.[176]

4.325 The European Communities argues that finally, Chile's reading is incompatible with the findings of *Japan - Taxes on Alcoholic Beverages - II*, where the Appellate Body confirmed that the "aim-and-effect" of a tax distinction is irrelevant for the purposes of the first sentence of Article III:2.[177]

4.326 Further, the European Communities maintains that the statement made by the European Communities in *Japan - Taxes on Alcoholic Beverages II* which is cited by Chile has been taken out of context. In *Japan - Taxes on Alcoholic Beverages - II*, the proponents of the "aims-and-effect" test argued that the so-called "two-step" test

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[174] Panel Report on *Japan - Taxes on Alcoholic Beverages I, supra*, footnote 50, para 5.9 b).
[175] *Ibid*., para 5.9 a).
[176] *Ibid*., para 5.9 d). *See* also para 5.13.
[177] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra,* footnote 41. *See* also Appellate Body Report on *European Communities - Regime for the Importation, Sale and Distribution of Bananas*, WT/DS27/AB/R, DSR 1997:II, 591, para. 241.

put forward by Canada and the European Communities was too rigid. In response to a question from the Panel, the European Communities suggested that the two-step approach could be assorted of two "flexibilities". The first flexibility was to make a "narrow" interpretation of the term "like". The second "flexibility" amounted in practice to the creation of a praetorian exception for graduated systems, subject to certain conditions aimed at ensuring their neutrality. The passage quoted by Chile purports to describe the scope of the suggested second "flexibility". Eventually, the panel, and later the Appellate Body, accepted the first flexibility, but not the second one. In any event, the second "flexibility" did not offer an unqualified exception for all tax distinctions based on alcohol content. The passage quoted by Chile refers to "proportional" tax variations, which are "equally and uniformly applied" to both imported and domestic products. Chile's tax system does not satisfy any of those requirements. Furthermore, the second "flexibility" is unnecessary in the context of Article III:2, second sentence, because the third element ("so as to afford protection") already serves that function.

4.327 The European Communities then concludes that in any event, the passage invoked by Chile makes it clear that tax distinctions based on "objective product differences", including distinctions based on differences in alcohol content, cannot be presumed to be "neutral". Rather, it must established in each particular case that they are "equally applied in a trade-neutral manner to all like or directly competitive liquors". As demonstrated by the analysis made by the European Communities under the third element of Article III:2, second sentence, Chile's measures do not meet this standard.

4.328 Also, the European Communities refers to Chile's citation of the following passage of *Japan - Taxes on Alcoholic Beverages I*:

> Article III:2 does not prescribe the use of any specific method or system of taxation … there could be objective reasons proper to the tax in question which could justify or necessitate differences in the system of taxation for imported and for domestic products.[178]

The European Communities then argues that the passage is both irrelevant and misleading. It is irrelevant because the present dispute does not concern the application of two different taxation methods to domestic and imported products, but rather the application of a single taxation method which affords protection to domestic production.

4.329 The European Communities also explains that it is misleading because, read in isolation, it could suggest that the panel accepted that "objective" reasons could justify the application of different taxes to domestic and imported products. In reality, however, the point made by the panel was that the application of two different taxation methods to domestic and imported products (*in casu* the application of different methods for assessing the tax base) is not *per se* contrary to Article III:2. Rather, in order to establish a violation of that provision, the complainant has to demonstrate that the application of two different methods results in the imposition of a higher tax burden on imports than on domestic products. This becomes clear in the two sentences that follow the passage cited by Chile:

[178] Panel Report on *Japan - Taxes on Alcoholic Beverages I, supra*, footnote 50, para. 5.9 c).

> The Panel found that it could also be compatible with Article III:2 to allow different methods of calculation of price for tax purposes. Since Article III:2 prohibited only discriminatory or protective tax burdens on imported products, what mattered was, in the view of the Panel, *whether the application of the different taxation methods actually had a discriminatory or protective effect against imported products.*[179]

4.330 The European Communities points out that these two sentences have been omitted by Chile, but not in the citation of the same passage made by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II.*[180] Significantly, the Appellate Body referred to this passage in the context of its discussion of the third element of Article III:2, second sentence, and not in connection with the second element.

4.331 The European Communities also contests Chile's invocation of the findings of the Panel Report on *United States - Taxes on Automobiles* with respect to a luxury tax applied by the Unites States on vehicles over a certain threshold value. That Panel Report, however, was never adopted because both the complainant and the defendant were dissatisfied with the panel's reasoning.

4.332 The European Communities further points out that although the Panel Report on *United States - Taxes on Automobiles* is based on the so-called "aims-and-effects" approach, according to which whether or not two products are "like" depends on whether the regulatory distinction has the purpose and the effect of affording protection to domestic production, this approach was rejected by the panel[181], and then by the Appellate Body in the *Japan - Taxes on Alcoholic Beverages II* case.[182] The Appellate Body has confirmed its rejection of that approach in *EC - Measures affecting the Importation, Sale and Distribution of Bananas.*[183]

4.333 Moreover, the European Communities argues that even under the "aims-and-effects" approach, the mere fact that a tax distinction is based on an "objective" criterion is not sufficient to exclude *per se* the application of Article III:2. In *United States - Taxes on Automobiles* the panel examined whether *in casu* the tax distinction had the "purpose" and the "effect" of affording protection to domestic production. According to the European Communities, Chile's strategy in the present case, however, is to prevent the Panel from conducting that type by analysis by arguing that since the products are "similarly" taxed, it is not necessary for the Panel to look at the third element of Article III:2, second sentence.

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[179] Panel Report on *Japan - Taxes on Alcoholic Beverages I, supra.,* footnote 50, para 5.9 c). [emphasis added by the European Communities).

[180] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 120-121.

[181] Panel Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 45, para. 6.18.

[182] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 108-115.

[183] Appellate Body Report on *European Communities - Regime for the Importation, Sale and Distribution of Bananas, supra*, footnote 177, para. 241.

4. Reach of Japan/Korea - Taxes on Alcoholic Beverages Cases

4.334 **Chile disagrees** with the EC's evident determination to portray the New Chilean System as a replication of the tax systems of Japan and Korea that previous panels found inconsistent with Article III:2, second sentence. The New Chilean System is fundamentally different from the Japanese and Korean tax systems for alcoholic beverages, both of which discriminated based on type of distilled spirits and both of which favoured a type that was and could be only supplied domestically for all practical purposes. By contrast, the New Chilean System does not differentiate by type of distilled spirit, but instead applies an **identical** tax scale, imposing an **identical** *ad valorem* tax depending on degree of alcohol content to all distilled spirits (except beer and wine) regardless of type and whether imported or domestic. Ironically, the European Communities asks the Panel to condemn the Chilean system by analyzing that system in terms of effects on a subjective classification system (i.e., type) that Chile explicitly abandoned as a matter of tax classification in enacting Chilean Law 19,534.

4.335 Chile contends that the EC effort to wrap this case in the mantle of successful challenges of the Korean and Japanese systems fails because it ignores fundamental differences between the cases and the systems. The Panel should reject the EC's unjust and ill-founded effort to stretch prior rulings in ways that do not conform with the language, practice, or intent of Article III:2.

4.336 Chile explains that while there are many differences between the Japanese and Korean cases and this case involving Chile, the most fundamental difference is that the systems at issue in the Japanese and Korean cases both taxed by type of distilled spirits, whereas the New Chilean System taxes all types identically, according to alcohol content and value.

4.337 Chile maintains that the European Communities tries to avoid this distinction by ignoring it. Thus the European Communities starts off its case with a lengthy argument about whether different distilled spirits are directly competitive or substitutable. That issue was critical in the Japan and Korea cases, precisely because those tax systems imposed different taxes according to the type of distilled spirit. Japan and Korea each created ten or more tax categories, based on different types of distilled spirit, each bearing its own separate rate or scale of taxation, with shochu in Japan and soju in Korea having the lowest rate or scale of taxation. There was virtually no doubt that the differences in taxation were more than *de minimis* and that imports had no prospect of benefiting from the lowest rates of taxation (since shochu and soju were effectively not imported). Thus the only critical question under Article III:2, second sentence, was whether the types of products taxed at a low rate were directly competitive or substitutable with the types taxed at higher rates.

4.338 In the view of Chile, the New Chilean System, however, does not so differentiate by type. That is why Chile has repeatedly pointed out that whether different types of spirits are directly competitive or substitutable in the Chilean market is essentially irrelevant under the New Chilean System, since that system does not make distinctions by type. Chile does not, in fact, consider that pisco is directly competitive or substitutable with whisky for the reasons stated in previous submissions by Chile. However, Chile does not rely on the differences between pisco

and other types of distilled spirits in claiming the consistency of the New Chilean System with Article III:2, because the system does not impose taxes based on type.

4.339 According to Chile, the European Communities tries to obscure this fundamental difference by arguing that the effect of the New Chilean System is to tax types of distilled spirits that are customarily or by law sold at higher degrees of alcohol strength at higher *ad valorem* rates than types sold at lower alcohol strengths. Undoubtedly that is true, but that result does not infringe Article III:2. The reason the Korean and Japanese systems were found inconsistent with GATT 1994 was not because tax distinctions based on type of distilled spirit *per se* violate Article III:2. The core problem with those systems was that the effect of the particular type distinctions in those systems was to favor a particular product that was effectively not imported, and thus the type distinction had the effect of discriminating in favor of an almost exclusively national product.

4.340 Chile further argues that the critical flaw in the EC's analysis arises from the EC's effort to stretch the analysis of past panels considerably beyond any past precedents, including the Japan and Korea alcoholic beverage tax cases. The panels in the Japan and Korea cases were dealing with discrimination based on the subjective concept of type of distilled spirits, where products are distinguished according to how and sometimes where they are made. The use of those subjective criteria had the direct effect of limiting the benefits of the most favorable tax to a type of product which was produced locally and which, in practice, could not be imported into those countries.

4.341 Chile maintains that faced with an entirely different situation with the New Chilean System, the European Communities asks this Panel to go one gigantic and impermissible step further than past panels. It takes a Chilean System that differentiates by the objective standard of alcohol content, and asks the Panel to view that system in terms of its effect on different types of distilled spirits. The European Communities argues as though previous panels had established a rule that Article III requires no tax discrimination based on types of distilled spirits, and therefore that distinctions that *de facto* have different impacts on different types are then also inconsistent with Article III:2, or at least should be so considered.

4.342 Chile emphasizes that beyond the point that nothing in the Japan or Korea cases mandates such a further extension of the holding of those cases, there are very significant legal, logical and practical differences between systems such as those of Japan and Korea that codify a distinction based on a subjective and qualitative concept such as "types" of products and systems based on objective criteria applied equally to all products that are directly competitive or substitutable, regardless of type. According to Chile, the European Communities tries to give the objectively based Chilean system an aura of subjectivity by analyzing the New Chilean System on the basis of its effect on different subjective types of products. Then, ignoring or dismissing inconvenient facts - the significant and increasing quantity of pisco and other products that will be subject to high taxes and the actual and potential trade in low-tax products - the European Communities claims that the *de facto* discrimination by type that the European Communities claims to see in turn constitutes a *de facto* discrimination based on nationality. If this unprecedented theory is sustained, all that will be required to find a violation of Article III:2 will be to conjure the right kind of subjective classification system that will validate a case based on differential effects of an objective tax system. It would not even affect the analysis if the more heavily

taxed type of product is produced in substantial quantities in the taxing country as well as imported, since that fact existed in the Japan case, but did not affect the Appellate Body's ruling.

4.343 Chile argues that many of the claims of the European Communities are absolutely wrong since the new Chilean taxation system for alcoholic beverages is based on an objective criterion and the fact that the tax paid by each product is based in two factors: alcohol content and price (i.e., *ad valorem*) of the product, regardless from its type, origin and labeling.

4.344 According to Chile, the European Communities confuses the issue when pointing out that the system is conceived so that pisco, which has a lower alcohol content, will pay less taxes, while other imported products will pay higher taxes. The truth and the correct and fair way of describing the New Chilean System is that the system is conceived so that pisco having a low alcohol content, as well as all other domestic or imported spirits of low alcohol content, will be subject to lower tax rates, while pisco with high alcohol content, as well as all other domestic or imported spirits of high alcohol content, will be subject to higher tax rates. Consequently, the higher or lower tax rate is solely determined by the alcohol content of the product and not by its origin, as the European Communities seems to suggest. In any system within this "philosophy" (i.e., to tax based on alcohol content), the result will be that those products with less alcohol will be subject to a relatively lower tax also.

4.345 Chile explains that concerning the *ad valorem* component of the new system, it has opted to maintain an *ad valorem* system since in an economy as open as the one in its country, competition factors, such as product price relationships, have to be preserved. The *ad valorem* taxation system does not alter this competitive attribute of products (i.e., price relationships), as opposed to those in which an absolute value is determined according to alcohol content, thus introducing a degree of distortion biased for the benefit of products of higher prices since the tax is a lower proportion of in its final price.

4.346 Chile further argues that *ad valorem* taxes are not illegal simply because domestic products are cheaper than imports, and thus bear less tax per unit. To take an example, EC Member States impose *specific* taxes on distilled spirits that, measured in *ad valorem* proportional terms, result in low-priced Chilean products bearing much greater proportionate taxes than spirits that the EC considers directly competitive or substitutable. The following chart demonstrates how the tax system of four Member States all impose these proportionately higher taxes on Chilean pisco than on their own domestic products.

4.347 As an example, Chile presents Table 28[184] which compare the specific tax on pisco of 35º, pisco of 40º, whisky 43º, cognac VSOP, brandy Fundador and brandy Carlos I in some EC Member States, and Table 29[185] which also compares the specific tax applied in these EC Member States in *ad valorem* terms.

[184] Chile Oral Statement at the First Substantive Meeting, p. 4.
[185] *Ibid*.

Table 28[186]

SPECIFIC TAX TO ALCOHOLIC BEVERAGES IN SOME EC MEMBER STATES (US$/lt)							
MEMBER STATES	Pisco	Pisco	Whisky	Whisky	Cognac	Brandy	
	35°	40°	43°	43°	VSOP	Fundador	Carlos I
Spain	2.66	3.04	3.26	3.26	3.04	2.88	3.04
Great Britain	11.37	13.00	13.97	13.97	13.00	12.35	13.00
France	6.34	7.05	7.47	7.47	7.05	6.76	7.05
Germany	5.60	6.40	6.88	6.88	6.40	6.08	6.40

Table 29[187]

SPECIFIC TAX TO ALCOHOLIC BEVERAGES IN SOME EC MEMBER STATES MEASURED IN *AD VALOREM* PROPORTIONAL TERMS (%)							
MEMBER STATES	Pisco	Pisco	Whisky	Whisky*	Cognac*	Brandy*	
	35°	40°	43°	43°	VSOP	Fundador	Carlos I
Spain	92.9	78.1	57.3	29.8	9.6	37.4	13.4
Great Britain	397.9	334.2	245.1	127.5	40.9	159.9	57.2
France	221.9	181.2	131.0	68.1	22.2	87.6	31.0
Germany	195.9	164.6	120.7	62.8	20.2	78.8	28.2
Notes: Prices in US$/lt CIF/ex-factory: Pisco 35°: US$ 2.86; Pisco 40°: US$ 3.89; Whisky 43°: US$ 5.70; Whisky* 43°: US$ 10.96; Cognac Remy VSOP* 40°: US$ 31.74; Brandy Fundador* 38°; US$ 7.72; Brandy Carlos I* 40°: US$ 22.72. *Prices: Duty Free							

4.348 According to Chile, this shows that the specific tax on alcoholic beverages applied in these EC Members States is relatively higher to those alcoholic beverages with lower alcohol content. Chile indicates that it is not asking the Panel to deal with a new complaint, but rather to demonstrate that neutral, objective systems can have these disproportionate effects shown, without infringing Article III.

4.349 Further, Chile notes that European Communities complains that the New Chilean System is based on both alcohol content and value, which the European Communities terms a hybrid. The real EC complaint here appears to be that Chile should copy the EC Member State systems, which apply a specific tax per degree of alcohol. Again, Chile has noted that *ad valorem* taxes have long been endorsed by the WTO and by economists, whereas specific taxes are much more likely to distort competition. Further, there is no element of Article III that forbids using both objective criteria, which in tandem also serve the objective of making the New Chilean System materially more progressive than using a flat *ad valorem* rate or worse, the EC's specific tax system, which would be that much more regressive.

[186] Chile Oral Statement at the First Substantive Meeting, p. 4.
[187] *Ibid.*

4.350 **The European Communities replies** that Chile insists that its New Chilean System is different from the Japanese tax system and the Korean tax system. In reality, however, the differences are only superficial.

4.351 The European Communities states, in response to Chile's claim that the New Chilean System does not differentiate "by type," that a trick as old as protectionism is to base regulatory distinctions on product characteristics which distinguish indirectly between domestic and imported products. Chile's system is slightly more sophisticated than the Japanese system or the Korean system, but no less protective in both purpose and effect.

4.352 The European Communities claims that the alcohol content thresholds chosen by Chile evidence that the New Chilean System has been devised so as to replicate the effects of the explicit tax distinctions between "types" made in the old system. The minimum alcohol content of most imported spirits is 40°, whereas 35° is the most usual alcohol content of *pisco especial*, which together with *pisco tradicional* of 30° accounts for more than 90 % of the sales of pisco. As confirmed by Chile's responses to the questions posed by the Panel, there can be no rational explanation for choosing precisely those two thresholds, other than affording protection to pisco.

4.353 The European Communities contests Chile's argument that another "fundamental" difference would be that its New Chilean System is based on "objective" criteria, whereas the Japanese and the Korean system were based on "subjective" criteria. Chile, however, never explains what distinguishes an "objective" criterion from a "subjective" one. The differences between whisky and shochu did not exist only in the minds of the Japanese taxmen. There are "objective" differences between shochu and whisky, including differences in alcohol content which are even larger than those between pisco and whisky. Those "objective" differences, however, were not considered as a valid justification for taxing whisky more heavily than shochu.

4.354 The European Communities also contests Chile's argument that shochu and soju were "effectively not imported" into Japan and Korea, respectively. This misrepresents the facts of those two cases. Shochu and soju were imported in relatively small quantities, compared to domestic production, but neither of them was an "inherently" domestic product. For example, in 1995, imports of shochu accounted for 2.4 % of the sales of shochu in Japan.[188] In comparison, in 1996 imports into Chile of low strength liqueurs (the only imported products which in practice will benefit from the lowest tax rate) represented less than 0.4 % of the domestic sales of spirits with a minimum alcohol content of 35 % or less, as shown in Table 19 above. Thus, the New Chilean System is more protective than the Japanese system by Chile's own standard.

4.355 The European Communities maintains that Chile's strategy in this case is to divert the Panel's attention from the examination of Chile's own tax system. Chile attempts to do so by focusing the discussion on other tax systems (both real and hypothetical), which are fundamentally different from the New Chilean System. With the same purpose, Chile tries to focus the debate on a number of superficial differences between this case and previous cases.

[188] Panel Report on *Japan - Taxes on Alcoholic Beverages II, supra*, fotnote 45, para 4.175.

5. "Direct Proportionality" Argument

4.356 **The European Communities also points out** that the two panel reports on *Japan - Taxes on Alcoholic Beverages I* and *II* stand for the proposition that the application of specific taxes in direct proportion to the alcohol contained in each type of distilled spirit does not constitute "dissimilar" taxation of the spirits. The underlying reasoning is that, in such a system of taxation, the taxed product is not the spirit but the alcohol contained in the beverage. For example, the European Communities applies a uniform specific tax per hectolitre of pure alcohol to all the products containing ethyl alcohol, including, but not limited to, distilled spirits falling within HS 2208.[189]

4.357 The European Communities maintains that this reasoning does not apply in the case at hand. The measure applied by Chile is an *ad valorem* tax applied on the value of the beverage as a whole and not on the value of the alcohol content. Moreover, the value of the beverage is not directly related to the value of the alcohol content. Therefore, Chile's measure cannot be characterized as a tax on the alcohol content. For that reason, the European Communities considers that, in order to determine whether pisco and the other spirits are "similarly taxed", the Panel should compare the rates per bottle of each spirit, and not the rates per degree of alcohol.

4.358 The European Communities claims that in any event, it has shown that pisco and the other spirits are also "not similarly" taxed when one compares the rates per degree of alcohol. Specifically, each degree of alcohol contained in a bottle of whisky, gin, rum, vodka or tequila is taxed at rate which is more than 50 % higher than the rate applied to each degree contained in a bottle of *pisco especial*.

4.359 The European Communities notes that Chile has acknowledged that the rates per degree of alcohol vary from one spirit to another, but that it claims that the lack of proportionality between differences in taxation and differences in alcohol content does not amount to "dissimilar" taxation. In other words, according to Chile, if there is a difference in alcohol content, however small, between two spirits, then no conceivable tax differential which a Member may see fit to apply can be considered as "dissimilar" taxation of those spirits.

4.360 In the view of the European Communities, Chile's position is logically untenable. If the taxed product is the alcoholic beverage, then one should compare the rates per unit of beverage volume, irrespective of their alcohol content. On the other hand, if the taxed product is the alcohol content, the comparison should be made between the rates per unit of alcohol volume, regardless of the beverage in which it is contained.

4.361 The European Communities notes that in any event, as shown in Table 30, in the amended ILA the tax rate per degree of alcohol is not uniform but varies from product to product. Each degree of alcohol in whisky, gin, vodka, rum and tequila is taxed at 1.175 % while each degree of alcohol in pisco of 35° is taxed at only 0.771 %. Thus, pisco and the main types of imported spirits are not "similarly" taxed even if the comparison is made by reference to their alcohol content.

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[189] *See* Council Directive 92/83/EEC, of 19 October 1992 (OJ No L 316 of 31.10.92) and Council Directive 92/84/EEC, of 19 October 1992 (OJ No L 316 of 31.10.92).

Table 30[190]

Alcohol content	*Ad valorem* rate	Percentage points per degree of alcohol
15°	27 %	1.8 %
20°	27 %	1.35 %
25°	27 %	1.08 %
30°	27 %	0.9 %
35°	27 %	0.771 %
38°	39 %	1.026 %
40°	47 %	1.175 %
43°	47 %	1.093 %

4.362 The European Communities also points out that if the rate per degree of alcohol was the same for all spirits as the rate currently applied to pisco of 35°, the resulting *ad valorem* rates would be as follows:

Table 31[191]

Alcohol content	Current *ad valorem* rate	*Ad valorem* rate if the rate per degree of alcohol was 0.771 %
15°	27 %	11.57 %
20°	27 %	15.42 %
25°	27 %	19.28 %
30°	27 %	23.13 %
35°	27 %	27 %
38°	39 %	29.30 %
40°	47 %	30.84 %

4.363 The European Communities then concludes that if the taxed product is the alcoholic beverage, then one should compare the rates per unit of beverage volume, irrespective of their alcohol content. On the other hand, if the taxed product is the alcohol content, the comparison should be made between the rates per unit of alcohol volume, regardless of the beverages in which it is contained.

4.364 **In rebuttal, Chile notes** that the European Communities implies that it could accept the *ad valorem* and alcohol content standards of the Chilean law, if only the taxes were proportional. Then, Chile argues that there is no rule of proportionality in the WTO and, if there were, the European Communities would be in violation of its own rule because wine and beer are taxed less per degree of alcohol than whisky and other distilled spirits. Indeed, the EC's argument in this respect with regard to Chile is remarkably similar to the complaint of the Scotch Whisky Association about tax systems that favor wine and beer in Member Countries of the European Union. There are many other "non-proportional" taxes, *including all specific taxes*, for example. Furthermore, the European Court of Justice upheld a non-proportional tax on engine displacement under the EC's own national treatment provisions. The United States also taxes wine and beer at much lower rates per degree of alcohol, using a system

[190] EC First Submission, Table 21.
[191] *Ibid*., Table 22.

that also produces large variations in tax for small differences in alcohol content of its wines.[192]

4.365 Chile points out that ultimately, the European Communities itself seems to recognize that Article III does not require taxes or regulations to have equal effects by all standards of measurement, as the European Communities ultimately appears to rely on a theory that the deficiency of the New Chilean System is not that the taxes vary by alcohol strength, but rather that the tax does not vary in direct proportion to alcohol strength, as shown for example in Tables 30 and 31 above. Chile does not deny the veracity of those charts, but Chile strongly disagrees that Article III requires a rule of direct proportionality with respect to alcoholic beverage taxes.

4.366 Chile notes that the European Communities appears to suggest that decisions on *Japan - Taxes on Alcoholic Beverages I* and *II* support the EC proposition that taxes employing an alcohol content standard must establish tax rates directly proportional to the degree of alcohol in order not to constitute dissimilar taxation. In fact, the panels in those cases did not decide that issue. The panels only said that taxation must be based on objective criteria, and that Japan could not use a different scale of alcohol-based taxation for different types of directly competitive or substitutable alcoholic beverages, but the panels did not say that taxes must be directly proportional to alcohol strength.

4.367 Chile maintains that GATT Article III:2 has never been interpreted to require such a direct proportionality rule. As Chile has already noted above, the Japanese systems were faulted for establishing significantly different tax scales for different types of distilled spirits that the panels held to be like, directly competitive or substitutable. The panels did not find fault, however, with the lack of direct proportionality to liquor content.

4.368 **The European Communities replies** that contrary to Chile's protestations that this issue has not been decided by previous panels, Chile's position is refuted by the findings of the two Panel Reports on *Japan - Taxes on Alcoholic Beverages I* and *II*. The second panel report is particularly clear in this regard. In that report, the panel based its conclusion that whisky and shochu were not "similarly" taxed on the fact that the rate per degree of alcohol applied to whisky of 40° was higher than the rate per degree of alcohol applied to shochu of 25°.[193] This comparison would have been totally irrelevant if, as claimed by Chile, differences in alcohol content could justify non-proportional differences in taxation. If Chile's position was correct, the panel could not have reached the conclusion that shochu and whisky were not "similarly" taxed except by comparing the rate per degree of alcohol applied by Japan to whisky of 40° and to shochu of 40°, something which the panel did not consider necessary to do.[194] The European Communities maintains that similarly, the panel reached the

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[192] 26 U.S.C.A. § 5001.

[193] The European Communities notes that under Japan's Liquor Tax Law, the tax rate varied within each of the four tax categories ("shochu", "whisky/brandy", "spirits" and "liqueurs") according to alcohol content. For example, the tax rate on shochu B of 25° was Y102,100 per kiloliter and the rate on shochu B of 40° Y284,100 per kiloliter. Shochu is produced within the range of 20° to 45°, but 25° is the most usual strength.

[194] Panel Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 45, paras. 6.33 and 2.3.

conclusion that vodka was taxed "in excess of" shochu by comparing the rate per degree of alcohol applied to vodka of 38° to the rate per degree of alcohol applied to shochu of 25° and not the rate per degree of alcohol applied to shochu of 38°.[195]

4.369 **Chile further responds** that it should also be born in mind that requiring a direct proportionality rule is not only unprecedented and unwarranted under the plain language of Article III:2, but it serves no valid policy purposes not already served simply by requiring objective standards. A large benefit for international trade in having objective standards such as the alcohol strength criterion of the New Chilean System is that domestic and foreign producers have the ability to adapt their production to reduce the tax or regulatory burden, if they so choose. As discussed below under the third element of the Article III:2 test, the New Chilean System allows foreign producers, if they so choose, to dilute their product to qualify for lower levels of Chilean taxes. While in some cases that may be inconvenient for exporters in much the way different national labeling or packaging requirements can be inconvenient, Article III does not require harmonization of standards to the convenience of large global exporters.

4.370 In the view of Chile, thus, the European Communities recognizes the right to differentiate products based on objective criteria such as the alcohol content of a beverage and in doing so implement a neutral based system that does not infringe Article III. Chile has enacted such a law based on the very same objective criteria that the European Communities has recognized as valid: the alcohol content of the various spirits, which does not discriminate among the various domestic and foreign participants.

4.371 Chile argues that similar views have been expressed before the European Court of Justice ("ECJ"). The ECJ in Case 170/78, *Commission v United Kingdom*, 1983 ECR 2265 noted that:

> [T]he Commission has recommended that spirits should be charged at a higher rate of duty according to alcoholic strength than liqueur wines. It appears, therefore, to have accepted that there are social reasons for imposing a relatively higher rate of taxation on beverages with a higher alcoholic content.[196]

4.372 Chile reiterates that the New Chilean System does not make distinctions based on type of distilled spirits, but rather taxes every distilled spirit (except wine and beer) according to the same scale based on alcohol content and value. The European Communities uses a different objective scale for taxation of alcoholic beverages, levying a specific tax per degree of alcohol content for distilled spirits. Both the Chilean and EC systems by some measures discriminate against products based on price and alcohol content. *Ad valorem* systems, measured by specific rate per volume unit, fall most heavily on high priced goods, but economists agree that *ad valorem* systems are fairest in preserving competitive relationships. Specific rate taxes by comparison distort competition in favor of high price goods, if measured on an *ad valorem* basis.

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[195] Panel Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 45, paras 6.24 and 2.3.

[196] The ECJ in Case 170/78, *Commission v United Kingdom*, 1983 ECR 2265.

4.373 According to Chile, the European Communities continues to attack the New Chilean system based on an unfounded theory that taxation based on alcohol content must be proportional. In some respects, the EC's argument seems to be motivated by an effort to make the EC's own tax system into a fixed GATT rule, as the European Communities insists on the use of not just directly proportional but specific taxes. There is no basis for such a claim. Chile has already pointed out that the European Communities does not even follow its own rule of proportionality with respect to beer and wine. The U.S. system for wine is even less proportionate.
4.374 Chile contends that if the EC's rule is applied to the effect that tax rates must be constant per degree of alcohol in order to meet the non dissimilar taxation test, it follows that an *ad valorem* flat rate would breach that test, as it shown in Table 32.

Table 32[197]
TAX PER DEGREE OF ALCOHOL
ASSUMING A 30% FLAT *AD VALOREM* RATE

Alcohol Content	Tax per degree of alcohol
25°	1.20 %
30°	1.00 %
35°	0.86 %
40°	0.75 %
45°	0.67 %

4.375 Chile maintains that such a proportionality test would invalidate luxury taxes that fall more heavily on luxury goods, or more lightly on low-priced staples, since such taxes are unlikely to be directly proportionate, which would be contrary to their very purpose.
4.376 Chile states that while the EC practices are not at issue, it hopes that the broader perspective of the Panel will lead it to reject the EC's insistence on a proportionality test and preference for specific duties as the preferred or only analytical perspective for assessing compliance with Article III of the GATT 1994.
4.377 According to Chile, both the EC and Chilean systems treat wine and beer separately. Chile taxes beer and wine relatively higher, measured in terms of degrees of alcohol, and the European Communities taxes wine and beer lower per degree of alcohol.
4.378 Chile notes that in another effort to bolster its complaint, the European Communities argues at several points that the *Japan - Taxes on Alcoholic Beverages II* case settles the issue whether there can be non-proportionate increases in tax based on alcohol content. Japan's system taxed shochu and whisky according to two very different scales of specific taxes, which significantly favoured shochu over whisky. Contrary to the EC's rather surprising claim, the panel did not reject the Japanese system because of a non-proportionate distinction in tax per degree of alcohol content, but rather because the scale for two different types of spirit was entirely different and advantageous only and at all points to shochu.

[197] Chile Oral Statement at the Second Substantive Meeting, Table I.

4.379 Chile further maintains that it is likewise inconceivable that members of the WTO, particularly developing country members, thought or think that, in joining the WTO and accepting thereby the obligations of Article III:2, they were foregoing the right to use fiscal policy tools such as luxury taxes or exemptions or reduced taxes for goods purchased primarily by poor consumers, even if such policies result in higher taxes on many imports than on many like or directly competitive products.

4.380 In the view of Chile, the kind of flawed interpretation proposed by the European Communities in this case would set a bad precedent for not just alcoholic beverage cases, but also for other cases in which countries differentiate in the application of internal taxes on the basis of objective criteria. For example, virtually any luxury tax will have the effect of taxing high priced products more, even proportionately more than low-priced goods. Borrowing one of the examples from the Panel's questions, a Boss suit is surely as substitutable with a suit sold in a discount store as Scotch whisky is with Pisco Corriente. The EC's analysis would therefore prohibit a luxury tax on high priced suits, if most taxed suits were imported and there was substantial production of untaxed suits domestically. An even more closely analogous case would be an exemption from tax for low-price cooking oil, which would inevitably result in olive oil bearing a higher tax than, for example, palm oil or soybean oil. Such a tax would be illegal under the EC's analysis of Article III, and no exemption would save it.

4.381 Chile further argues that similarly, horsepower or engine displacement taxes, both of which have been common in Europe, would also breach Article III, if, as a result, some types of imported vehicles were treated less favorably than some types of vehicles predominantly produced domestically. Under the EC's theory, the United States and Canada would have justifiable complaints against the EC Member States because such taxes result in imported types of vehicles bearing higher taxes than domestic types.

4.382 Chile emphasizes that the New Chilean System does explicitly impose taxes according to alcohol content. However, that kind of objectively based discrimination, like discrimination by horsepower, engine displacement, or (in luxury tax systems) value, has not been considered to violate Article III:2. Yet, by the EC's logic, if it could be shown, for example, that an engine displacement tax resulted in higher taxes on, for example, sport utility vehicles that were largely imported, and lower taxes on small commuter cars that were largely produced domestically, then the engine displacement tax would become inconsistent with Article III:2 for distinguishing in its effects between types of directly competitive or substitutable vehicles.

4.383 Chile further puts forth that the European Communities itself does not observe a rule of direct proportionality for its own alcoholic beverages. Many EC Member States impose proportionately much lower taxes per degree of alcohol on beer and wine than on distilled spirits. The Scotch Whisky Association shows the following discrepancy in tax per degree of alcohol in various Member States of the European Communities:

Table 33[198]

Proportionality of taxes per degree of alcohol on several The European Communities members

	Austria	**Belgium**	**Denmark**	**Finland**	**France**
Wine	Nil	426	856	2,162	30
Beer	347	425	780	2,888	257
Spirits	723	1,651	3,674	5,097	1,440
	Germany	**Greece**	**Ireland**	**Italy**	**Luxembourg**
Wine	Nil	Nil	2,559	nil	Nil
Beer	196	309	2,049	351	197
Spirits	1,297	999	2,847	648	1,035
	NL	**Portugal**	**Spain**	**Sweden**	**UK**
Wine	441	Nil	Nil	2,937	1,911
Beer	424	275	168	1,746	1,619
Spirits	1,497	814	686	5,955	2,843

(ECU per hectoliter of pure alcohol)[199]

4.384 Chile notes that it cites this chart not to criticize the EC Member State tax systems nor to argue that beer and wine, which are not at issue in this dispute, should be regarded as competitive or substitutable products (though it is very clear that the Scotch Whisky Association believes that to be the case and is promoting arguments in that regard that are remarkably similar to the EC's arguments in this dispute). Rather, Chile refers to the chart to demonstrate that even the European Communities (despite the Scotch Whisky Association) does not really believe in a rule of direct proportionality for alcohol taxes. It might be added that tax systems of other countries exempt low value items from some forms of indirect taxes, such as low cost clothing or food. Luxury taxes and other kinds of progressive taxes similarly are particularly likely to have substantial effects on imports - but such taxes are not considered to violate Article III merely because of a lack of direct proportionality.

4.385 **The European Communities notes** that Chile incorrectly argues that the fact that the EC Member States apply different rates per degree of alcohol to wine, beer and spirits involves a "recognition" by the European Communities that tax differentials do not have to be proportional to alcohol content. Contrary to what appear to be Chile's expectations, the European Communities does not consider it necessary to deny that wine, beer and spirits are not "similarly" taxed in the European Communities. It is self-evident from the table produced by Chile that they are not. This, however, is far from constituting *per se* a violation of Article III:2, as Chile implies. To begin with, it would have to be established that wine, beer and spirits are "directly competitive or substitutable" products, something which could be rather difficult, especially by Chile's own strict standard. Even then, it would still be necessary to show that the tax differentials afford protection to the EC domestic production. One may suspect that the very successful Chilean wine exporters would

[198] Chile First Submission, Table 3.

[199] The Scotch Whisky Association, *Bulletin Board - Case for Taxation Reform* (visited 24 Sept. 1998) <http:www.scotch-whisky.org.uk/bb-txrfm.htm>.

not subscribe the argument that, by taxing more heavily whisky than wine, the United Kingdom affords protection to its non-existent production of wine.

4.386 The European Communities also notes that Chile states the following in support of its allegation that the European Communities has "recognized" that the application of taxes that do not vary in proportion to alcohol content does not constitutes dissimilar taxation:

> The ECJ in case 170/78, *Commission v. United Kingdom*, 1983 ECR 2265 noted that:
>
> ... the Commission has recommended that spirits should be charged a higher rate of duty according to alcoholic strength than liqueur wines. It appears, therefore, to have accepted, that there are social reasons for imposing a relatively higher rate of taxation on beverages with a higher alcohol content.

4.387 The European Communities contests that to begin with, this is not something which the ECJ said. Instead, this was an argument made by the United Kingdom, the defendant in that case. In any event, the quoted passage does not support Chile's position. The quoted statement argues in favour of imposing a higher rate on spirits than on liqueurs "for social reasons". It does not argue that doing so would not constitute "dissimilar" taxation. To the contrary, to the extent that it refers to a "higher rate of taxation" the quoted statement admits explicitly the obvious fact that under the proposed system liqueurs and spirits would not be "similarly" taxed.

4.388 The European Communities also states that for the same reasons, the arguments drawn by Chile from the fact that some EC Member States apply car taxes that vary according to horsepower are also irrelevant.[200] If a country applies higher taxes to large cars than to small ones, then it is indisputable that large cars and small cars are "not similarly" taxed. A different matter is whether small cars are "directly competitive or substitutable" with large cars. And still a different matter, whether applying higher taxes to large cars "affords protection to domestic production".

4.389 The European Communities goes on to argue that in this connection, it is worth noting that, contrary to Chile's assertions, the European Court of Justice ("ECJ") has never given an unconditional endorsement to the application of car taxes linked to engine power. The ECJ has ruled that those taxes may be compatible with Article 95 of the EC Treaty provided only that they are "free from any discriminatory or protective effect".[201] In a number of decisions, the ECJ has found that the application of car taxes linked to engine power was contrary *in casu* to Article 95 because it afforded protection to the domestic car production of the Member State concerned. The tax systems condemned by the ECJ had features which made them very similar to Chile's liquor tax system, such as arbitrary thresholds or

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[200] The European Communities notes that the suggestion to the effect that the US "is more likely" to produce cars with higher horsepower than the European Communities is simply wrong. Most Mercedes, BMWs and Jaguars, as well as Porsches or Ferraris, are still assembled in the European Communities.

[201] *See* e.g. the Judgement of 9 May 1985, Case 112/84, *Michel Humblot v. Director des services fiscaux* (ECR 1985, pages 1367-1380); and the Judgement of 17 September 1987, Case 433/85, *Jacques Feldain v. Directeur des services fiscaux du departement du Haut-Rhin* (ECR 1987, p. 3521).

disproportionately steep increases beyond the point where there is no significant domestic production.[202]

D. "So as to Afford Protection to Domestic Production"

1. Overview

4.390 **The European Communities first notes** that in *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body provided the following approach for establishing whether dissimilar taxation of directly competitive or substitutable products is applied "so as to afford protection to domestic production":

> [W]e believe that an examination in any case of whether dissimilar taxation has been applied so as to afford protection requires a comprehensive and objective analysis of the structure and application of the measure in question on domestic as compared to imported products. We believe it is possible to examine objectively the underlying criteria used in a particular measure, its structure, and its overall application to ascertain whether it is applied in a way that affords protection to domestic products.
>
> Although it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the design, architecture and revealing structure of a measure. The very magnitude of the dissimilar taxation in a particular case may be evidence of such protective application …. Most often, there will other factors to be considered as well. In conducting this inquiry, panels should give full consideration to all the relevant facts and all the circumstances in any given case.[203]

4.391 The European Communities goes on to state that an example of how this approach is to be applied is provided by the analysis made by the Appellate Body in *Canada - Periodicals.*[204] In that case, the Appellate Body concluded that the "design and the structure" of the measure was to afford protection to domestic production on the basis of the following factors:

(i) the magnitude of the tax differential;

(ii) several statements by the Canadian authorities recognizing that the protection of domestic production was one of the measures' policy objectives; and

(iii) the demonstrated actual protective effect of the measures.

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[202] The European Communities points out that for example, in *Humblot* (para. 16) the ECJ ruled that:
"Article 95 of the EEC treaty prohibits the charging on cars exceeding a given power rating for tax purposes of a special fixed tax, the amount of which is several times the highest amount of the progressive tax payable on cars of less than the said power rating for tax purposes, where the only cars subject to the special tax are imported, in particular from other member States".

[203] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 120.

[204] Appellate Body Report on *Canada - Periodicals, supra,* footnote 41, at 474-476.

4.392 The European Communities points out that similarly, in *Korea - Taxes on Alcoholic Beverages*[205], the panel based its finding that the measures afforded protection to domestic production on the following elements:

(i) the magnitude of the tax differentials;

(ii) the structure of Korea's Liquor Tax Law, and more specifically the lack of rationality of the product categorization; and

(iii) the fact that there was virtually no imported soju, so that the beneficiaries of the measure were almost exclusively domestic producers.

4.393 **Chile first responds** that given that the taxation is not dissimilar, it is not surprising that the European Communities likewise fails to demonstrate the third element of a violation of Article III - that the dissimilar taxation operates so as to afford protection to domestic production. In fact, since the European Communities needs to demonstrate all three elements of a violation of Article III:2, second sentence, the Panel could forego a decision on the first and third elements in the interest of judicial economy. Considerations of judicial economy may be especially pertinent here, since a system that does not discriminate based on nationality and uses neutral, objective standards cannot be considered protectionist in any event.

4.394 Chile also replies that there is no precedent for holding inconsistent with GATT 1994 a system of taxation that does not discriminate based on nationality and that employs strictly objective criteria for any differentiation in taxes. Indeed, the same panels that condemned the Japanese system - and even the European Communities itself in arguing those cases, observed that distinctions based on objective and neutral criteria are permissible under Article III:2.

4.395 Chile further states that Article III does not prohibit a tax or regulation simply because, as a result of the application of objective criteria, some or even many imported products are by some measures treated worse than some or many like or competing domestic products. The drafting history of Article III makes this clear. In the latter stages of the drafting of what became Article III of the GATT, the negotiating Sub-Committee responsible for this Article reported that:

> The Sub-Committee was in agreement that under the provisions of Article 18 [Article III of the GATT], regulations and taxes would be permitted which, while perhaps having the effect of assisting the production of a particular domestic product (say, butter) are directed as much against the domestic production of another product (say, domestic oleomargarine) of which there was a substantial domestic production as they are against imports (say, imported oleomargarine).[206]

4.396 In the view of Chile, the logic of this unanimous understanding of the negotiators is compelling. All WTO Members make tax and regulatory distinctions that fall unevenly by some measures among products that might be considered like or directly competitive or substitutable in the sense of Article III. Sometimes these

[205] Panel Report on *Korea - Taxes on Alcoholic Beverages, supra*, footnote 56, paras 10.101-10.102.

[206] Reports of the Committees and Principal Sub-Committees, *supra*.

distinctions will mean that many domestic products will, by some measures, be taxed or regulated more favorably than many like or competing imports. But that is not a violation of Article III, where criteria for the distinctions are objective and neutral.

4.397 Chile also argues that past panels have repeatedly acknowledged these considerations, noting also that Article III is not intended to be used as a tool for harmonizing the tax systems of the WTO Members,[207] and that WTO Members retain almost complete freedom with respect to domestic policies that do not distinguish between the origin or destination of goods.[208] In *United States - Malt Beverages*, the panel noted that:

> The purpose of Article III is not to harmonize the internal taxes and regulations of contracting parties, which differ from country to country.[209]

4.398 Chile further argues that in *Japan - Taxes on Alcoholic Beverages I*, the panel affirmed this principle with respect to Article III:2, noting that this Article "prohibits only discriminatory or protective taxation of imported products but not the use of differentiated taxation methods as such ..."[210] The panel went on to say "that Article III:2 does not prescribe the use of any specific method or system of taxation ..."[211] This position was also endorsed by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*.[212]

4.399 Chile notes that the EC argument against the Chilean system ignores these precepts of Article III, and instead asks the Panel to strike down an objective and neutral tax system merely because a result of the application of that system is that those EC beverages of high alcohol content (and high price) will face higher taxes than those Chilean beverages (primarily certain kinds of pisco) that are of relatively low alcohol strength (and low price). In making this argument with respect to the New Chilean System, the European Communities ignores that many European products, including those most similar to pisco, will benefit from the same lower rates of tax, while other European products could be adapted for the Chilean market merely by diluting with water the current relatively high strength of the products - as the European Communities has suggested could be done by pisco producers. Equally, the European Communities ignores that under the New Chilean System many Chilean distilled spirits, including Chilean whisky, brandy and gin and very substantial quantities of pisco that are marketed at relatively high prices and alcohol strength, will face the highest rate of taxation.

4.400 Chile concludes that the New Chilean System thus presents precisely the kind of regulatory system that Article III is not intended to condemn:

(i) there is no distinction in taxation based on origin or on type;

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[207] *See* Panel Report on *Japan - Taxes on Alcoholic Beverages I, supra,* footnote 50.

[208] Panel Report on *United States - Malt Beverages, supra*., para. 5.25 and Panel Report on *United States - Taxes on Automobiles, supra*., para. 3.108.

[209] Panel Report on *United States - Malt Beverages, supra*., para. 5.71.

[210] Panel Report on *Japan - Taxes on Alcoholic Beverages I, supra*, footnote 50, para. 5.9 b).

[211] *Ibid*., para. 5.9 c).

[212] *See* Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 118.

(ii) many imports can benefit from the lowest tax and all others could be easily diluted for that purpose;

(iii) many domestic products of Chile will face the highest tax rates under the New Chilean System; and

(iv) the objective standards mean that foreign producers can readily adapt their products to lower their taxes by a simple process.

4.401 Chile adds that the Appellate Body has properly noted that "Article III protects expectations not of any particular trade volume but rather of the equal competitive relationship between imported and domestic products".[213] Foreign and domestic producers have an equality of competitive opportunities, as they have an equal opportunity to adapt their production, if they so choose, in the way implicitly preferred under the New Chilean System, i.e., by reducing alcohol content.

2. Transitional System

4.402 **The European Communities argues** that the following facts and circumstances regarding the "design, structure and architecture" of the transitional system, as well as its "overall application on domestic as compared to imported products" constitute evidence that it is applied "so as to afford protection" to Chile's domestic production:

(i) the very magnitude of the tax differentials;

(ii) the absence of any legitimate policy purpose for applying a lower tax rate to pisco;

(iii) the fact that pisco is, by law, a domestic product;

(iv) the fact that pisco accounts for the vast majority of the Chilean production of distilled spirits;

(v) the fact that almost all whisky, as well as a significant proportion of the main liquors falling within the category of "other spirits" are imported; and

(vi) the admission by the Chilean authorities that the adoption of Law 19,534 was necessary because the system in place was "discriminatory".

4.403 In the view of the European Communities, in *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body observed that the very magnitude of the difference in taxation between Japanese shochu and other distilled spirits was sufficient evidence to conclude that the Japanese Liquor Tax Law was applied so as to afford protection to the domestic production of shochu.[214]

4.404 The European Communities then argues that the same is true in the present dispute. The tax differential between pisco and whisky is so large that it can only be explained by the purpose to afford protection to pisco.

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[213] *See* Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 110 (citations omitted).

[214] *Ibid*., p. 29.

4.405 The European Communities also points out that in *Japan - Taxes on Alcoholic Beverages II*, the taxes in dispute were specific taxes per litre of beverage instead of *ad valorem* taxes. This makes it extremely difficult to compare the tax differentials at issue in the two cases. Nevertheless, it is worth noting that, according to the complainants, in *Japan - Taxes on Alcoholic Beverages II* the differences in specific taxes translated into a difference in tax/price ratios between shochu and whisky of between 10 % and 32 % of their retail sales price.[215]

4.406 The European Communities further notes that according to the explanations provided by Chile during the consultations, the tax differentials between pisco, on the one hand, and whisky and "other spirits", on the other hand, purport to serve two different objectives:

(i) Protection of public health: it was sought to create a disincentive for the consumption of spirits with a higher alcohol degree, in order to reduce the negative social impact associated with excessive alcohol consumption;

(ii) Fiscal policy: those liquors, which are subject to higher taxes, are those with the characteristic of luxury goods. The higher tax applied to those goods fulfils the objective that indirect taxes apply in a differentiated manner to luxury goods as a mechanism of income redistribution. Those taxes, known as "luxury taxes", are applied also to other products, both in Chile and in other countries.

4.407 The European Communities then maintains that it is obvious, however, that the application of a much lower rate to pisco than to whisky and "other spirits" cannot be justified by either of those two alleged objectives.

4.408 The European Communities further explains that in the first place, pisco does not always have a lower alcohol content than whisky or "other spirits". Approximately 10 % of the sales of pisco have 40° or more. Moreover, the remaining 90 % of pisco has between 30° and 35°, i.e., only 5 to 10 degrees less than most imported spirits. It is manifestly disproportionate to attach to such a small difference in strength a tax differential of as much as 28 to 45 percentage points *ad valorem*. Finally, the category of "other spirits" includes many liquors (*e.g.,* most liqueurs) that have a lower alcohol content than pisco.

4.409 The European Communities then argues that the Chile claim that the application of a lower rate to pisco is justified for reasons of income distribution is also spurious. Pisco is not inherently less expensive than other spirits. Moreover, there is evidence that pisco is consumed by all social groups and not just by the less affluent.[216] Similarly, whisky and the other liquors are widely consumed across social boundaries.[217] In any event, previous panels have established that this type of consideration cannot provide a valid justification for taxing dissimilarly two directly competitive or substitutable products.

4.410 In support of this argument, the European Communities points out that in *Japan - Taxes on Alcoholic Beverages I*, Japan claimed that the tax differentials at

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[215] *See* Panel Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 45, para. 4.159.
[216] The European Communities refers to the 1997 SM survey, p. iv (EC Exhibit 21).
[217] *Ibid.*

issue in that case were not contrary to Article III:2 because they were based on "... the tax-bearing ability on the part of consumers of each category of liquor". The panel rejected this defence in the following terms:

> The Panel was of the view that the use of product and tax differentiations with the view of maintaining or promoting certain production and consumption patterns could easily distort price-competition among like or directly competitive products by creating price differences and price-related consumer preferences which would not exist in case of non-discriminatory internal taxation consistent with Article III:2. The Panel noted that the General Agreement did not make provision for such a far-reaching exception to Article III:2 and that the concept of "taxation according to tax bearing ability of prospective consumers" of a product did not offer an objective criterion because it relied on necessarily subjective assumptions about future competition and inevitably uncertain consumer responses.[218]

4.411 The European Communities further notes that, in *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body noted that Japanese shochu was insulated from imports of shochu originating in Korea and other third countries by tariff barriers. As a result, by applying a lower tax rate to shochu, Japan favoured exclusively domestic production.[219]

4.412 The European Communities then argues that Chilean pisco is even more effectively isolated from imports of like products. "Pisco" is a geographical denomination reserved by law to certain spirits produced in certain regions of Chile. Thus, the tax advantage provided to pisco benefits exclusively domestic products, not merely *de facto* (as in *Japan - Taxes on Alcoholic Beverages II*) but also *de jure*.

4.413 The European Communities goes on to claim that it may be estimated that pisco accounts for approximately 80 % of the Chilean production of distilled spirits, as shown in Tables 18 and 19 above. For comparison, in *Japan - Taxes on Alcoholic Beverages II*, sales of shochu represented, according to the complainants, "almost 80 %" of Japan's total production of distilled spirits.[220] Therefore, by applying a lower tax rate to pisco, Chile affords protection not just to its domestic production of pisco but more generally to the majority of its domestic industry of distilled spirits.

4.414 In the view of the European Communities, whereas pisco is an exclusively domestic product, approximately 95 % of whisky, the main spirit after pisco, as well as a substantial proportion of the liquors falling within the category of "other spirits" are imported.[221]

4.415 The European Communities further notes that as stated by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*[222] in order to establish that a tax measure is applied "so as to afford protection to domestic production", it is not necessary to show that the legislators had the subjective intent of affording such protection. On

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218 Panel Report on *Japan - Taxes on Alcoholic Beverages I, supra*, footnote 50, para. 5.13.
219 Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 122.
220 Panel Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 45, para. 4.95.
221 *Ibid*.
222 Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 119.

the other hand, it is evident that where the existence of that intent can be clearly established, it may constitute additional evidence that the measures in dispute are applied in a protective manner.

4.416 The European Communities adds that in *Canada - Periodicals*, the Appellate Body relied upon some statements by the Canadian Government regarding the policy objectives of a measure as one of the factors supporting the finding that the measures at issue were applied "so as to afford protection to domestic production".[223]

4.417 The European Communities then claims that the Chilean Government (through its Minister of Foreign Affairs) as well as many legislators of all political parties recognized openly that the tax system in place until November 1997 had to be amended because it was "discriminatory" and favoured the pisco producers. The transitional regime provided in Law 19,534 will prolong that system into the year 2000. Consequently, the admission by the Chilean authorities that the system in force until November 1997 afforded protection to the pisco producers, also involves an admission that the Transitional System will continue to do so.

4.418 **Chile responds** that the purpose of the Transitional System was to allow time for domestic and foreign producers and distributors to prepare for the changes under the New Chilean System, and also to begin phasing in immediate benefits for whisky producers.

4.419 Furthermore, in Chile's view, pisco and the imported products are not directly competitive or substitutable and, therefore, the Panel need not reach this issue with respect to the Transitional System. Chile also indicates that the Transitional System is an issue of little practical consequence, as it will expire soon.

3. New Chilean System

4.420 **The European Communities claims** that the following factors and circumstances constitute evidence that the New Chilean System will also be applied "so as to afford protection" to Chile's domestic production:

(i) the magnitude of the tax differentials;

(ii) the tax distinctions do not serve any legitimate policy purpose;

(iii) the majority of Chile's domestic production of distilled spirits is taxed at the lowest tax rate;

(iv) nearly all imports are taxed at the highest tax rate;

(v) the New Chilean System reflects the terms previously agreed by the Chilean authorities with the pisco industry; and

(vi) the positions taken by the pisco industry during the amendment process of the ILA involve a recognition that maintaining a tax differential between low strength pisco and whisky will afford protection to the pisco industry as a whole.

4.421 **Chile replies** that it is readily apparent, if the Panel chooses to consider this element, that the New Chilean System does not operate "so as to afford protection to domestic production". The European Communities offers up six reasons that the New

[223] Appellate Body Report on *Canada - Periodicals, supra,* footnote 41, at 44-476.

Chilean System should be considered "to afford domestic protection". None of the six contentions have merit when applied to the New Chilean System.

4.422 In the view of Chile, it is also essential to note in this regard that, unlike systems based on distinctions between different types of distilled spirits, it is a relatively simple matter for foreign and domestic producers to adapt to the neutral and objective standards of the Chilean system. A whisky producer cannot readily become a pisco producer, but a producer of any spirit of 40° alcohol can readily dilute the product to 35°. The European Communities already produces many products (grappa, fruit liqueurs, etc.) that qualify for the lowest taxes and even more products that would qualify if only, as the European Communities suggests be done for pisco, some water is added to the current high alcohol products before bottling. Article III simply does not obligate sovereign Member governments to harmonize their neutral taxation system to the convenience of foreign producers in the way sought by the European Communities in this case. The New Chilean System affects domestic producers of spirits in the same manner as it affects importers of alcoholic beverages, and does not prevent foreign producers of spirits from importing any low alcohol content spirits benefiting from a lower level of taxation on the basis of their alcohol content.

4.423 Chile further states that the European Communities devotes many pages listing excerpts from Chile's legislative debate about the new taxation system. Some of these examples show that legislative representatives of the regions that produce pisco in Chile were seeking to minimize the adverse effects of a New Chilean System on pisco producers and, because adverse effects could not be avoided, also sought other governmental help for their constituents. At least in the case of the legislative history, the European Communities, while presenting a distorted picture, did note many remarks from legislators who announced that the new system was eliminating discrimination against foreign products. Chile submits that if such developments infringe Article III or are even evidence of such infringement, then all WTO Members are in deep peril, not least the European Communities.

4.424 Chile points out that the Appellate Body has already cautioned against this kind of subjective effort to discern motivation. In *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body stated that the issue of "affording protection to domestic production" is an objective question of *effect*, not a subjective question of the intent of legislators.[224]

(a) Magnitude of Tax Differentials

4.425 **The European Communities points out** that in *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body observed that the very magnitude of the difference in taxation between Japanese shochu and other distilled spirits was sufficient evidence to conclude that the Japanese Liquor Tax Law was applied so as to afford protection to the domestic production of shochu.[225]

4.426 The European Communities then maintains that under the new system the tax differentials will still be large enough to be, in and of themselves, evidence of

[224] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 119.
[225] *Ibid*.

protective application. Indeed, in the case of spirits of 40° or more other than whisky the tax differentials will be even larger than under the preceding system.

4.427 **In response, Chile first contests** the citation by European Communities of "the magnitude of the tax differentials of the New Chilean System". The EC's analysis of this point fails for the same reason that the EC's allegations of dissimilar taxation fail. The EC's argument makes no more sense than a claim that *ad valorem* taxes are illegal in any country where imports are generally more expensive than the domestic products with which they compete. The differential in the New Chilean System is nil because all products face the same tax scale and all products have the same opportunity to be adapted in a way that will minimize their tax burden.

4.428 Chile argues that perhaps the European Communities may see the fallacy of its logic more clearly if that logic is applied to the systems of taxation of alcoholic beverages that are used by EC Member States. Chile has already shown, in Tables 28 and 29 above, how the use of specific rate taxes per degree of alcohol (which is the tax system used by a number of EC Member States) discriminates against low price beverages and in favor of higher priced beverages, which are more commonly produced in the European Communities. These points are elaborated further in Tables 34 and 35 below. Applying the same logic that the European Communities seeks to apply to the New Chilean System, the EC Member States would be guilty of violating Article III:2, second sentence. In the European Communities, the result of the use of specific taxes is that pisco is taxed relatively heavily compared to expensive cognac. According to the European Communities, cognac and pisco are directly competitive and substitutable. Cognac is thereby protected from imported pisco (evidenced by the low import penetration in the European Communities of pisco and other imported brandies).

4.429 Chile further maintains that even ignoring for the moment the discrimination in *ad valorem* terms that arises from a specific rate tax, the EC Member States would still be in violation of Article III:2 if the EC's analysis in this dispute were applied to the Member States who impose taxes per degree of alcohol content. The tax per degree of alcohol results in a substantially higher tax on two beverages of the same price, for example, one having 46° alcohol, the other 35°. Therefore, in both absolute and *ad valorem* terms, an imported Gran Pisco would face a substantially higher tax than a low-alcohol European product such as Campari. By the theory that the European Communities seeks to apply to Chile, this means that the EC Member States' systems have the result of discriminating by type, and a type of imported spirit (Gran Pisco) is taxed significantly more heavily than the directly competitive or substitutable domestic product, Campari.

4.430 According to Chile, by the application of the EC's logic, the differences in tax on different types of competing spirits that result from Member State tax systems similarly would easily be found to operate "so as to afford protection to domestic production". The difference in tax alone might be enough to establish the protective effect of the EC Member States' taxation systems. In addition, one might note the obvious "architectural" features favoring low alcohol beverages such as those commonly produced in the European Communities, which means only certain types of distilled spirits are favoured in these countries. To complete the analogy to the logic that the European Communities seeks to apply to Chile, one might also seek evidence that some politician from the area where the low -taxed product is made had boasted of his or her success in helping the domestic industry. Thus guilt under

Article III:2 would be complete, by the standard of analysis that the European Communities wishes to apply to Chile in this dispute.

4.431 Chile notes that the European Communities will perhaps protest that the EC system is nevertheless GATT-legal because it is necessary, in terms of Article XX of GATT 1994, to protect human health from the effects of alcohol. That explanation, however, is difficult to sustain in the face of other EC alcoholic beverage laws that prescribe *minimum* alcohol content, and that tax the alcohol content of wine and beer much less than distilled spirits. As the European Communities points out in the literature appended to its responses to the Panel's questions, some EC authorities believe that health problems are connected to the issue of amount of alcohol consumed, not the concentration in different beverages.

4.432 Chile further notes that in pointing out the above, it is not asking the Panel to find the EC Member States guilty, an issue that is not even before this Panel. Chile is seeking to demonstrate, however, the fallacy and dangers of the EC analysis, which seems to have been drawn more from the Scotch Whisky Association's crusade to equalize alcohol taxes in the EC Member States than from a correct analysis of Article III:2.

4.433 Chile then extends its analysis to demonstrate that the alleged protection that the Chilean taxation system provides to pisco is far less significant than the protection offered to whisky by the taxation system applicable in various EC Member States, as can be observed in the following table.[226] In effect, the Chilean taxation system offers a 16% protection to spirits of 35° or less (including pisco 35°) vis-à-vis spirits of 39° or more (including whisky), regardless of national origin. Protection for pisco of 40º or more is nil. In contrast, the taxation system of several Member States of the European Communities results in between 23% and 44% protection for whisky *vis-à-vis* pisco 35º; and between 13% and 26% protection for whisky *vis-à-vis* pisco 40º. This is due, as Chile has pointed out in several instances, to the fact that pisco costs much less than whisky, and thus is affected proportionally much more than whisky by a specific tax.

[226] Chile explains that the methodology that was used for the calculation of the Protection of the Special Tax of Whisky (in the selected country members of the European Communities) is:

$$\textit{Protection} = \frac{\text{RPDI}}{\text{PAI}}$$

where:
RPDI: is the Price ratio after Tax.
RPAI: is the Price ratio before Tax.
In this methodology, the calculation comprises both the protection of custom duties and taxes.
In the case of the protection of Pisco in Chile, the methodology used is:

$$\textit{Protection} = \frac{\text{RPDI}}{\text{RPAI}} - 1$$

Table 34[227]

DEGREE OF PROTECTION OF WHISKY IN COMPARISON TO PISCO
IN SOME COUNTRY MEMBERS OF THE EUROPEAN COMMUNITIES

	Price (US$/lt)			Price ratio		Protection Special Tax	
	Pisco 35º	**Pisco 40º**	**Whisky 43º**	**Whisky/ Pisco 35º**	**Whisky/ Pisco 40º**	**Whisky/ Pisco 35º**	**Whisky/ Pisco 40º**
CIF/ex-factory	2.60	3.60	5.70	2.19	1.58		
Price after duty							
Spain	2.86	3.89	5.70	1.99	1.47		
United Kingdom	2.86	3.89	5.70	1.99	1.47		
France	2.86	3.89	5.70	1.99	1.47		
Germany	2.86	3.89	5.70	1.99	1.47		
Price after duties and special tax							
Spain	5.51	6.93	8.96	1.63	1.29	23%	13%
United Kingdom	14.23	16.89	19.67	1.38	1.16	44%	26%
France	9.20	10.94	13.17	1.43	1.20	39%	22%
Germany	8.46	10.29	12.58	1.49	1.22	34%	20%

Table 35[228]

DEGREE OF PROTECTION OF PISCO WITH REGARD TO WHISKY IN CHILE

	Price (US$/lt)			Price ratio		Protection Special Tax	
	Pisco 35º	**Pisco 40º**	**Whisky 43º**	**Whisky/ Pisco 35º**	**Whisky/ Pisco 40º**	**Whisky/ Pisco 35º**	**Whisky/ Pisco 40º**
CIF/ex-factory	2.30	3.30	6.00	2.61	1.82		
Price after duties							
Chile	2.30	3.30	6.66	2.90	2.02		
Price after duties and special tax							
Chile	2.92	4.85	9.79	3.35	2.02	16%	0%

4.434 **The European Communities notes** that Chile raised the argument that the EC system of taxation of spirits affords protection to the EC domestic production because, on an *ad valorem* basis, pisco is taxed more than the EC spirits. Chile explained that its intention in making this argument was not to question the compatibility of the EC system with Article III:2, but rather to illustrate the point that "neutral" tax distinctions may nevertheless have an incidental protective effect.

4.435 The European Communities goes on to state that Chile's argument is not only irrelevant for this dispute, but also wrong, both as a matter of law and of fact. First and foremost, the EC system is based on the application of a uniform specific tax per

[227] Chile Rebuttal Submission, Annex B, p.13.
[228] Chile Rebuttal Submission, Annex B, p.14.

hectolitre of pure alcohol to all the products containing ethyl alcohol.[229] Thus, unlike in the Chilean system, in the EC system all ethyl alcohol is equally taxed, irrespective of the product in which it is contained. Therefore, the question whether protection is afforded to domestic production through "dissimilar" taxation does not even arise.

4.436 The European Communities maintains that in any event, the EC system does not have the effect alleged by Chile. EC produced spirits are often less expensive than imported spirits. This can be easily demonstrated with the help of Chile's own price data. Table 15 above shows that Canadian whisky, US whisky and Mexican tequila are more expensive (and, therefore, less taxed in *ad valorem* terms under the EC system) than a relatively expensive brand of Scotch whisky such as Johnnie Walker Red Label.

4.437 The European Communities further argues that when sold in the EC market, Chilean pisco may be as expensive as good quality EC spirits. Tables 34 and 35 above compare the producer's ex-factory price of pisco in Chile with the retail prices of some EC spirits (including insurance, freight and distribution expenses) charged by a duty-free supplier (presumably, also in Chile). Given the differences in level of trade, it would have been surprising if Chilean pisco was not less expensive than the EC spirits. The table below compares the actual retail prices in a supermarket in Brussels of *pisco especial* Capel of 35° (a relatively inexpensive brand in Chile) and a sample of well-known (and relatively up-market) brands of EC produced spirits. It shows that, contrary to Chile's claims, pisco is taxed in *ad valorem* terms at a similar rate as the EC spirits.

Brand (all bottles are 70 cl)	**Price (BEF)**	**Tax (BEF)**	**Equivalent *Ad valorem* rate**
Pisco Capel 35°	410	155.6	37.95 %
Vodka Smirnoff	415	166.7	40.17 %
Gin Gordon's	409	166.7	40.76 %
Brandy Veterano	477	160	33.54 %
J. Walker Red Label	494	177.8	35.99 %

Source: Retail prices at the supermarket Delhaize Chazal, Brussels, on 28/10/98. See EC Exhibit 64.

4.438 With regard to the effect of specific taxes, **Chile maintains** that Tables 34 and 35 above are accurate. In those tables, the calculations indicated in the first 3 columns (labelled pisco 35º, pisco 40º and whisky 43º) are based on *after customs* price for pisco in Europe, and producers prices for whisky.[230] From those tables it can easily be seen that a specific tax levied on alcohol content produces a dissimilar taxation, if the comparison is made on an *ad valorem* base. Chile asks the Panel to note that this dissimilarity is much larger that the dissimilarity generated by the Chilean system alleged by the European Communities. For clarity purposes, Table 35 above is summarized below:

[229] Council Directive 92/83/EEC, of 19 October 1992 (OJ No L 316 of 31.10.92) and Council Directive 92/84/EEC, of 19 October 1992 (OJ No L 316 of 31.10.92).

[230] Chile adds that after customs price of Pisco was estimated considering producers price in Chile, transportation to Europe and related insurance costs and customs duties in Europe. Producers price of whisky, was estimated in US$ 5.70.

SPECIFIC TAX ON ALCOHOLIC BEVERAGES IN SOME EC MEMBER STATES MEASURED IN *AD VALOREM* TERMS (%)			
Member State Estimated Price	**Pisco 35º US$ 2.90**	**Pisco 40º US$ 3.90**	**Whisky 43º US$ 5.70**
Spain	92.9	78.1	57.3
Great Britain	397.9	334.2	245.1
France	221.9	181.2	131.0
Germany	195.9	164.6	120.7

(b) Legislative Objective

4.439 **The European Communities maintains** that the tax distinctions in dispute do not serve any legitimate purpose. They are simply a subterfuge to replicate the protective effects of the preceding system. Alcohol content has been chosen as a taxation criterion merely because it allows Chile to distinguish indirectly between the majority of pisco, on the one hand, and the majority of imported spirits, on the other hand, and not because the ILA purports to discourage the consumption of alcohol.

4.440 In support, the European Communities goes on to state that the New Chilean System is a rather unusual method of taxing alcoholic beverages. In fact, that method does not correspond to any of the three methods commonly applied by most countries, and which are: a) *specific* taxes based on the alcohol content (e.g., x pesos per litre of pure alcohol or per degree of alcohol); b) *specific* taxes based on the volume of beverage (e.g., x pesos per litre of pisco); and c) *ad valorem* taxes on the price of the beverage.

4.441 According to the European Communities, instead, the method devised by Chile is a hybrid one in which *ad valorem* rates vary according to alcohol content. The rationality of that method in terms of fiscal policy is questionable. The price of distilled spirits is not correlated to their alcohol content. Indeed, if there was such a direct correlation, high strength ethyl alcohol would be more expensive than any other distilled spirit. The absence of a direct correlation between price and alcohol content means that the goal of *ad valorem* taxation (imposing a higher burden on the more valuable products) and the goal of taxing alcohol content (discouraging the consumption of alcohol) may conflict and ultimately cancel each other.

4.442 The European Communities also argues that the absence of any legitimate policy purpose is further evidenced by the lack of internal coherence of the ILA, and in particular by the following aspects of its "design, structure and architecture".

4.443 First, the European Communities points out that all liquors of 35° or less are taxed at the same *ad valorem* rate. As a result, low strength liquors (e.g., light liqueurs) are taxed more heavily per degree of alcohol than pisco of 35°. Thus, contrary to Chile's claims, the ILA actually encourages the consumption of alcohol, rather than discourages it.

4.444 Second, the European Communities notes that there is no objective reason that can explain why the *ad valorem* rate starts to increase from precisely 35°. The only reason for choosing that strength level as the starting point is simply that 35° is the most usual alcohol content of *pisco especial*, which together with *pisco corriente* of less than 35° accounts for 90 % of the sales of pisco.

4.445 The European Communities explains that if the rate had started to increase from 0° instead of 35°, the applicable rate on pisco of 35° would have been much higher (140 %) unless, of course, the rate increased by smaller increments than the

current 4 percentage points per degree of alcohol. But if Chile had applied a smaller increment per degree of alcohol, the applicable *ad valorem* rate on spirits of 40° would have also been lower, a result unacceptable to Chile's pisco industry.

4.446 Third, the European Communities notes that between 35° and 40°, the tax rate increases very rapidly, by no less than 4 percentage points for each additional degree of alcohol. As a result, a difference of merely 5 degrees of alcohol content leads to the application of a tax on spirits of 40° which is 74 % higher than the tax on spirits of 35°. Such a tax differential is disproportionate to the additional damage to human health or other undesirable social effects (if any at all) which may result from drinking spirits of 40° instead of spirits of 35°. The magnitude of that tax differential is even more arbitrary in view of the fact that similar differences in alcohol content outside the 35°- 40° bracket do not entail any difference in taxation at all. For instance, *pisco corriente* is typically bottled at 30°, five degrees less than *pisco especial*. Yet, both *pisco especial* and *pisco corriente* are taxed at the same rate.

4.447 Fourth, the European Communities states that all spirits above 39° are taxed at the same rate. Again, this has the paradoxical result that the alcohol contained in very high strength liquors such as *gran pisco* of 46° or even 50° is taxed less than the alcohol contained in spirits of 40°.

4.448 The European Communities adds that in the 1995 Proposal, the rate continued to increase until 42°. As shown in Table 5, all the main types of imported spirits can be legally sold in Chile (and are usually bottled in their countries of origin) at 40°. Thus, in practice the imposition of higher tax rates above 40° would have had little impact on imports. For instance, the exporters of whisky would have reacted to the imposition of a much higher tax on whisky of 43° than on whisky of 40° simply by replacing current exports of whisky of 43° by shipments of whisky of 40°. This development was anticipated by the pisco industry, which explains its quiet acquiescence to what in practice was but a purely "cosmetic" amendment of the 1995 Proposal. Thus, according to press reports, when presenting the 1996 Gemines study, Mr Peñafiel (general manager of Capel) noted that:

> [A]lthough nowadays, the largest part of [whisky] imported [into Chile] has 43°, so that the tax will decrease only to 65 %, in the future the product will arrive at 40°, something which, [Mr Peñafiel] underlined, is already a characteristic of all whisky sold in Europe.[231]

4.449 **In rebuttal, Chile points out** that it has explained to the European Communities that the Chilean tax system serves legitimate revenue, health and social purposes, primarily by taxing more heavily products that are more costly and higher in alcohol content. It is not for the European Communities to second guess those purposes. While there are trade-offs in fulfilling these objectives, the relevant point is that the system is indeed neutral and objective. One might indeed question the motivation and effectiveness of countless internal measures of the European Communities or any other WTO Member, but Article III was not established so that the WTO could sit in judgement on the "legitimacy" of the policy objectives of its

[231] *El Diario*, 2 July 1996, (EC Exhibit 30).

Members, so long as the measures themselves objectively conform with the WTO Agreement.

4.450 Chile alleges that in amending its laws, it had had in mind several objectives, including:

(i) maintaining fiscal revenue;

(ii) eliminating type distinctions such as those that had existed in Japan (which also would eliminate the alleged discrimination against whisky in the previous system);

(iii) discouraging alcohol consumption; and

(iv) minimizing the potential regressive aspects of reforming the tax system.

4.451 Chile points out that because the New Chilean System will change the rate of tax paid with respect to various products, there is the Transition System, under which the whisky tax is phased down immediately, but the remainder of the system takes full effect on 1 December 2000. In the intervening time, whisky producers will enjoy continuing tax reductions, while other producers can decide how they wish to approach the Chilean market under the New Chilean System.

4.452 Chile argues that the new Chilean law completely reforms Chilean taxation of alcoholic beverages and advances the objectives noted above, while conforming to Article III.

4.453 Chile goes on to explain that in November 1997 it enacted new legislation substantially reforming the Chilean system of taxation of distilled spirits. Within this new system, spirits of 35° or less will be taxed at 27% *ad valorem*. The *ad valorem* tax will rise 4 percentage points for each additional degree of alcohol content above 35°, but with the rate capped at 47% for spirits above 39° of alcohol content. Therefore, lower alcohol content products have a lower tax rate, while those having a higher alcohol content have a higher tax rate. The new Chilean system will make no tax distinction by type of distilled beverage or origin. (i.e., domestic or imported). The same *ad valorem* tax rate is applied to all distilled spirits having the same alcohol content.

4.454 Chile further argues that, concerning tax differentials, there is no difference in that all distilled spirits of the same alcohol strength are subject to an identical *ad valorem* tax. The European system is the same, in that all distilled spirits of the same alcohol strength face the same rate of tax, except that the EC tax is a specific one, which, of course, falls more heavily on lower priced products than on higher priced products. Both tax systems use identical scales for all distilled spirits (except beer and wine, which are taxed less in the European Communities and more in Chile), but the EC's system is more distortive because of the use of specific taxes per degree of alcohol.

4.455 Chile further explains that within this context, the new system is built around objective and non-discriminatory criteria has the effect *inter alia* of reducing the present tax rate applied to some products, as is the case for whisky, and of increasing it for others, as is the case for pisco in all its categories (i.e., pisco of high and low alcohol content).

4.456 According to Chile, the new Chilean System is based on two objective criteria: alcohol content and price (i.e., *ad valorem*) of the product, regardless of its type, origin and labeling. Taxation based on alcohol content and on an *ad valorem*

basis is not against Article III of GATT or any other provision of the multilateral trading system and both are widely used.

4.457 Chile notes that the *ad valorem* taxation system does not distort competitive attributes of products (i.e., price relationships), as opposed to those which an absolute value is imposed according to alcohol content. Such specific tax systems introduce a distortion biased in favor of products of higher price since a fixed tax will be a smaller percentage of the value of a high priced product.

4.458 Chile poses a question: why did the European Communities insist on pursuing the WTO challenge against the New Chilean System? Chile considers that is not so hard to understand. The major exporters of distilled spirits want to minimize their tax burdens in all markets, and such exporters would prefer not to have to adapt their products to individual markets. Chilean exporters, similarly would prefer not to have to adapt their products to individual markets.

4.459 Chile goes on to state that, in this sense, it can understand why European exporters of distilled spirits would be willing to take a chance on continuing their old GATT challenge against the Chilean system even after its reform, since failure would leave them no worse off while the possibility of success might reduce their taxes.

4.460 Chile further notes that the European Communities continues its attacks on the motivations for Chile's tax laws. For example, Chile is accused both of hiding its motivations and failing to achieve the objectives in a fashion that the European Communities finds sufficiently coherent. Chile has freely conceded that its objectives required a measure of compromise between different objectives, but not a compromise on GATT compliance.

4.461 Further, Chile claims that it is not revealing a secret that WTO member governments all over the world tax alcoholic beverages at higher rates than most products, partly for revenue reasons that contradict to some extent the health reasons. If that establishes a violation of GATT obligations, then the European Communities will have much policing and self-policing to do in the world and at home.

4.462 Chile indicates that it is not critical of the European Communities for having their system, because a multiplicity of motivations is common for all kinds of taxes in every country. It is not Chile who is attacking objective systems that have differential results. Nevertheless, the European Communities should see that objective tax systems can have uneven results when measured by a subjective categorization system. Chile also cannot help being bemused by the EC's diligent efforts to find a justification for its specific tax on ethyl alcohol. Neither the Chilean nor the EC system appears to qualify under the Article XX exception. At least, Chile believes that the European Communities would have a difficult time explaining the necessity of this tax to discourage consumption of ethyl alcohol in distilled spirits (does wine or beer alcohol not impair the senses?). Chile also wonders what scientific analysis produced the varying scales of taxation, and how the EC's health goals are reconciled with the EC's minimum alcohol requirements for various spirits and with its socialization objectives for distilled spirits.

4.463 In the view of Chile, like nearly all tax measures in nearly all countries, the New Chilean System serves various objectives, and to some extent is a compromise among these objectives. Chile understands that the issue before this Panel is the conformity of the New Chilean System with Article III:2 rather than the various policy objectives that may have been considered by different legislators and

government agencies involved in developing that law. Nevertheless, Chile provided some explanations in order to understand the Chilean legislation.

4.464 Chile explains that in Chile, as in many countries, the Finance Ministry has a significant role in tax policy. In providing its input into the development of the New Chilean System, the Chilean Finance Ministry sought to achieve two broad objectives: tax revenues that would be approximately equivalent to those obtained under the Old Chilean System; and a distribution of the burden of the taxes that would not be more regressive than that of the Old Chilean System, i.e., that would not increase the relative tax burden on the poorer income-earners relative to the wealthier income-earners.

In its support, Chile puts forward Tables 36 and 37.

Table 36[232]

Weighting Factors for Expenditure on Alcoholic Beverages Per Quintile

	Overall	**Q1 (<Income)**	**Q2**	**Q3**	**Q4**	**Q5 (>Income)**
Total	**100.000**	**100.000**	**100.000**	**100.000**	**100.000**	**100.000**
Alcoholic Beverages	0.930	0.985	1.124	1.107	1.061	0.781
Wine	0.301	0.362	0.350	0.328	0.318	0.269
Champagne	0.025	0.033	0.017	0.019	0.035	0.023
Chicha	0.010	0.005	0.024	0.020	0.010	0.006
Beer	0.295	0.384	0.488	0.467	0.352	0.172
Pisco	0.172	0.166	0.185	0.194	0.213	0.147
Whisky	0.050	0.000	0.011	0.026	0.050	0.072
Other spirits	0.077	0.035	0.049	0.053	0.083	0.092
Number of households	1,363,706	272,741	272,741	272,741	272,741	272,741
Total expenditure	607,718	38,728	60,757	83,591	123,755	300,888

Percentage Distribution of Expenditure Per Quintile

	Overall	**Q1 (<Income)**	**Q2**	**Q3**	**Q4**	**Q5 (>Income)**
Alcoholic beverages	100%	6.7%	12.1%	16.4%	23.2%	41.6%
Wine	100%	7.7%	11.6%	15.0%	21.5%	44.2%
Champagne	100%	8.4%	6.8%	10.5%	28.5%	45.6%
Chicha	100%	3.2%	24.0%	27.5%	20.4%	29.7%
Beer	100%	8.3%	16.5%	21.8%	24.3%	28.9%
Pisco	100%	6.2%	10.8%	15.5%	25.2%	42.3%
Whisky	100%	0.0%	2.2%	7.2%	20.4%	71.3%
Other liqueurs	100%	2.9%	6.4%	9.5%	22.0%	59.2%

Source: Survey of household budgets 1996/1997 (National Institute of Statistics) (to be published).
Q = Quintile.

[232] Chile Response to Questions asked at the First Substantive Meeting, p. 35.

Table 37[233]

Distribution of Revenue by Income Quintile
Additional Tax on Alcoholic Beverages
Millions of Chilean Pesos ($), May 1997[234]
Case 1: Former System vs. Law No. 19534 (1997)

	Weighting factors for expenditure		**Revenue**	**Revenue under new system**	
	Q: I, II, III	**Q: IV, V**	**1996**	**e=0**	**e=1**
Pisco	32.4%	67.5%	12,012	14,512	13,799
Whisky	9.4%	91.7%	7,090	4,760	5,505
Spirits	18.7%	81.1%	4,844	5,998	5,617
Burden 1996	5,464	18,540	24,004		
Burden under new system e=0	6,273	19,028	25,301		
Burden under new system e= 1	6,040	18,920	24,960		
Change e=0	14.8%	2.6%	5.4%		
Change e=1	10.5%	2.1%	4.0%		

Case 2: Former System vs. Uniform *Ad valorem* Rate (34%)

	Weighting factors for expenditure		**Revenue**	**Revenue under new system**	
	Q: I, II, III	**Q: IV, V**	**1996**	**e=0**	**e=1**
Pisco	32.4%	67.5%	12,012	16,337	15,240
Whisky	9.4%	91.7%	7,090	3,444	4,369
Spirits	18.7%	81.1%	4,844	5,490	5,326
Burden 1996	5,464	18,540	24,004		
Burden under new system e=0	6,646	18,642	25,289		
Burden under new system e= 1	6,346	18,616	24,963		
Change e=0	21.6%	0.6%	5.4%		
Change e=1	16.1%	0.4%	4.0%		

Source: Survey of household budgets 1996/1997 (National Institute of Statistics) Ministry of Finance model.
Q = Quintile

4.465 Chile indicates that Table 36 sets forth the weighting factors for expenditure by the different income quintiles of the population on the most commonly consumed alcoholic beverages. By analyzing the distribution of expenditure on each type of beverage according to income quintile, it is easy to appreciate that in the case of both whisky and the other non-pisco beverages, it is the higher income groups that account proportionally for the greatest consumption. Whisky, in particular, has always been considered as a luxury good consumed for the most part (92 per cent) by

[233] Chile Response to Questions asked at the First Substantive Meeting, p. 36.
[234] Chile explains that the measurement can be made under two hypothetical elasticity scenarios: e=0: constant consumption, and e=1: constant expenditure.

the high income groups. The source of this information is the Survey of Household Budgets 1996/1997 by the National Institute of Statistics.

4.466 Chile further claims that Table 37 shows the impact of different tax structures on different socio-economic groups. Quintiles I, II and III (lower income), and quintiles IV and V (higher income), have been grouped together. With the revenue obtained from the model described above (Section I) and the distribution of expenditure according to the above table it is possible to estimate the change in the tax burden on the different socio-economic groups, for the products concerned, under the new tax structure and under the flat structure (both having the same effect on aggregate revenue). The results show that the flat structure involves a greater change in the tax burden (16-22 per cent) than under the new structure (11-15 per cent) for the lower income groups. For the higher income groups, the tax burden under the flat rate remains practically unchanged (<1 per cent) in relation to the new structure (2-3 per cent).

4.467 According to Chile, the first of these Finance Ministry objectives - approximate equality of tax revenues - could have been achieved through a flat *ad valorem* tax. However, such a tax would have been materially more regressive in its effects than the Old Chilean System in terms of income distribution. In Chile, with the exception of certain specialty liqueurs primarily imported from Europe (such as Campari), there tends to be a correlation between higher prices and higher alcohol strength. Thus, by having the *ad valorem* tax rise with alcohol content, the progressive distribution of tax revenues is enhanced.

4.468 Chile states that two further points should be noted in this regard. First, notwithstanding the objective not to have a more regressive incidence of taxation on the different quintiles of the population, the New Chilean System is slightly more regressive than the Old Chilean System. That is primarily because of the drastic reduction in tax on whisky, which is a relative luxury good in Chile, and the increase in tax on the cheapest grades of pisco, the most common drink for poorer Chileans. (Ironically, in light of Europe's current complaint, the only motivation for this regressive step of reducing the tax on whisky was to respond to the trade complaint of the European Communities).

4.469 Chile further notes that the second point that should be noted is that the Finance Ministry assessment was a static analysis, based on two arbitrary assumptions:

(i) that there would be no adjustment by consumers in their spending patterns as a result of the changed tax system; and

(ii) that there would be no adjustment of the alcohol strength of their products by producers to try to take advantage of the lower *ad valorem* rates applied to lower alcohol strength products.

4.470 Chile also notes that as to whether producers will adjust the alcohol strength of their products, that is difficult to tell. Chile would guess that, if the United States adopted the Chilean Tax System tomorrow, within weeks Chile would see distilled spirits producers of the world undertaking the simple dilution that is required to qualify for lower taxes. Thus would be born "Johnny Walker Light," "Beef Eaters Lean," etc., all marketed at lower alcohol strength. The highest quality producers (like producers of *gran pisco*) might not wish to adjust their products, but those

wishing to compete on price at the low end of the market might well decide to adapt their products.

4.471 Chile further explains that consumer health is one of the considerations that led to higher taxation of higher alcohol strength beverages in Chile, as Chile assumes is the case in other countries, including the European Communities and the United States. Health is not the only objective however, or Chile would have imposed still higher taxes on beverages over 40º alcohol, a step that would have led to even higher taxation of European whisky.

4.472 Chile then maintains that increasing the *ad valorem* tax rate as alcohol content increases has both health benefits (by discouraging consumption of high alcohol products) and "social" benefits (because it makes the tax system more progressive). Chile points out these considerations to enhance the Panel's understanding of the Chilean law, but Chile does not claim an Article XX exception, which in any case is unnecessary given the conformity of Chile's law with Article III.

4.473 Chile states that doubtless, different beginning and ending points for the tax might have been chosen, especially if health had been the only motivating factor for the New Chilean System. However, Chile was also seeking to reduce the tax on whisky in response to the trade complaints of the European Communities, to reform the old system based on type of distilled spirits and to maintain both gross tax revenues, and to avoid making the system more regressive in the distribution of the relative tax burden on different income groups in Chile.

4.474 Chile further explains that the system finally enacted addressed all these objectives. Most importantly for purposes of this proceeding, the New Chilean System also conforms with Article III. The New Chilean System does not discriminate between domestic and foreign products. The identical scale of taxation, based entirely on objective criteria is applied to all products, whether or not those products are like, directly competitive, or substitutable.

4.475 **The European Communities contends** that Chile's manifest inability to reconcile the tax distinctions with the stated policy objectives of the New Chilean System provides further confirmation that, in reality, those distinctions are applied with the exclusive purpose to afford protection to its domestic production.

4.476 In the view of the European Communities, in essence, Chile argues that the policy objectives of its New Chilean System are none of the EC's business and should not be examined by this Panel. The European Communities has acknowledged that it is for each Member to choose its own taxation objectives. At the same time, it is obvious that the inadequacy of a tax system to achieve its self-stated objectives is highly probative that the system is in fact being applied so as to afford protection to domestic production. This type of analysis is part of the examination of the "design, the architecture and the revealing structure" of tax measures which panels have been enjoined to conduct by the Appellate Body.[235]

4.477 The European Communities explains that its intention in making this argument was simply to demonstrate that the New Chilean System is objectively inapt to serve the taxation goals stated by Chile itself. Additional confirmation of this is provided by the fact that, to the EC's best knowledge, no other country in the world

[235] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 120.

applies the same system, even though many countries pursue similar taxation objectives. The inadequacy of the New Chilean System to achieve Chile's purported policy goals evidences that, in reality, that tax system has been designed with the exclusive purpose to continue to afford protection to Chile's domestic production of spirits. The European Communities does not exclude, however, that there may be other taxation methods which permit Members to attain the policy goals stated by Chile without affording protection to Chile's domestic production.

4.478 The European Communities further claims that it is only in response to a question from the Panel that Chile has eventually acceded to explain in some detail its purported taxation objectives. The response furnished by Chile fully explains its reluctance to let the Panel address this question.

4.479 The European Communities goes on to state that Chile acknowledges that the tax differentials cannot be explained by health protection reasons, because in that case the tax rate should have continued to increase above 40°. To this, it should be added that, if health considerations played a genuine role, alcohol contained in pisco would not be taxed less than alcohol contained in low strength liqueurs. Furthermore, health considerations cannot explain the huge tax differential between spirits of 35° and spirits of 39°.

4.480 In the view of the European Communities, Chile also admits that the tax distinctions are not necessary in order to preserve the previous level of tax revenues. That objective could have been achieved as well by applying a flat *ad valorem* rate at an appropriate level on all alcoholic beverages. Or, in case the concern with health protection was real, by applying a flat specific rate on alcohol content, also at an appropriate level.

4.481 According to the European Communities, in view of the above, it must be concluded that the very peculiar features of the New Chilean System are considered necessary by Chile in order to achieve the third policy objective mentioned in its response to the Panel, namely the objective that the new system should not be more "regressive" than the previous one. As shown below, this justification is spurious.

4.482 The European Communities then argues that the only alternative to the New Chilean System which appears to have been considered by Chile's Ministry of Finance is the application of a pure *ad valorem* rate at 34% (hereafter, the "Alternative System"). Chile does not argue that the Alternative System would be "regressive", in the sense that the poor would pay a higher share of their income than the rich. Rather, Chile's contention is that the Alternative System would be less "progressive" than the New Chilean System, because the poor would contribute a larger portion of the tax proceeds. The difference, nevertheless, is very small. According to the estimates of the Ministry of Finance, under the New Chilean System the three lowest income quintiles would pay between 24.2 % and 24.8 % of the total tax revenue. Under the Alternative System, those quintiles would contribute between 25.4 % and 26.2 % of the total tax revenue.[236]

[236] The European Communities notes that the analysis made by Chile's Ministry of Finance obscures how small is the difference by focusing on the differences in the percentage by which the tax burden on the three lowest income quintiles increases in the New Chilean System and the Alternative System, compared to the old system.

4.483 The European Communities further argues that at any rate, Chile's contention that the chosen system is less "progressive" is based on two erroneous assumptions.
4.484 The European Communities first explains that Chile assumes that there is a direct correlation between alcohol content and price. Yet the European Communities has already demonstrated that there is no such correlation. Chile's own data provide further confirmation of this. Contrary to Chile's claims, it is not only certain imported "speciality liqueurs" which are more expensive than high strength spirits. One of the tables given by Chile shows that, for example, pisco of 35° is more expensive than *aguardiente* of 50°, brandy of 38° and rum of 40° and as expensive as gin of 40°.
4.485 The European Communities goes on to state that on Chile's own construction, even if there existed now a correlation between alcohol content and price (*quod non*), such correlation would be broken as a result of the systematic dilution of high strength spirits in order to escape the highest tax rates (unless Chile is arguing that diluted premium Scotch will be sold at the same price as cheap *pisco corriente*). Thus, eventually the New Chilean System would be as "regressive" as a pure *ad valorem* system. Further, if imported high strength spirits were diluted to 35°, the New Chilean System could not, unlike the Alternative System, achieve the objective of maintaining the same level of tax revenues.
4.486 In the view of the European Communities, the second mistaken assumption is that the consumption patterns of the different income groups are not affected by the level of the taxes applied to each type of spirit, and therefore, by their level of prices. In other words, Chile assumes that the tastes of the poor will remain forever different from the tastes of the rich. As admitted by Chile itself, that assumption is "arbitrary".
4.487 The European Communities explains that if the Alternative System appears to be more "regressive" than the New Chilean System in the analysis made by the Ministry of Finance, it is simply because the burdens on each income group are calculated on the basis of their spending patterns under the old tax system in force in 1996, when whisky was taxed at 70 % and pisco at 25 %. In view of that tax differential, it is hardly surprising if in 1996 the two top income quintiles accounted for a large portion of the consumption of whisky. If in 1996 the taxes on whisky (and consequently the prices) had been lower, consumption of whisky by the remaining income quintiles would have accounted for a higher percentage.
4.488 The European Communities concludes that, in sum, Chile's attempted justification rests on purely circular reasoning. Whisky is taxed at a higher rate because it is considered to be the drink of the rich. Yet, the reason why it is assumed to be the drink of the rich is because in the past the poor drank less whisky compared to pisco than the rich. But one of the reasons why the poor drank less whisky compared to pisco than the rich was precisely because whisky was taxed much more heavily than pisco.
4.489 The European Communities further argues that the same type of argument now made by Chile was raised by Japan in *Japan - Taxes on Alcoholic Beverages I*. It was rejected by the panel in categorical terms:

> The Panel noted the Japanese submission that … generally "taxes on liquors are levied according to the tax bearing ability on the part of consumers of each category of liquor". The Panel was of the view that the use of product and tax differentiations with the view of maintaining or promoting certain production and consumption patterns could easily distort price competition among like or directly

> competitive products by creating price differences and price-related differences which would not exist in case of non-discriminatory internal taxation consistent with Article III:2. The Panel noted that the General Agreement does not make provision for such a far-reaching exception to Article III:2 and that the concept of "taxation according to tax-bearing ability of prospective consumers" of a product did not offer an objective criterion because it relied on unnecessarily subjective assumptions about future competition and inevitably uncertain consumer responses.[237]

4.490 In conclusion, the European Communities states that, in sum, the New Chilean System that has the clear effect of favouring pisco, the local spirit, over other types of spirits imported from the European Communities and other Members. Furthermore, the "structure", the "design" and the "architecture" of the system cannot be rationally explained except as being pre-ordained to achieve precisely that protective effect. The inescapable conclusion is that the New Chilean System is applied "so as to afford protection to domestic production", contrary to Chile's obligations under GATT Article III:2.

(c) Percentage of Less Taxed Products in Domestic Products

4.491 **The European Communities claims** that as shown in Table 3 above, approximately 90 % of pisco is bottled at 35° or less and is therefore eligible for the lowest applicable tax rate of 27 % *ad valorem*. Furthermore, there is nothing that prevents Chile's pisco manufacturers from replacing their current production of pisco of more than 35° by pisco bottled at a lower strength so as to benefit from the lowest tax rate.

4.492 In the view of the European Communities, the only other spirit types with a significant volume of sales that may qualify for the lowest tax rate are liqueurs and *aguardiente,* virtually all of which are domestically produced. It can be estimated that, together, pisco, liqueurs and *aguardiente* of 35° or less may account for as much as 75 % to 85 % of Chile's total production of distilled spirits. Thus, the New Chilean System will continue to favour a large majority of Chile's production of distilled spirits.

4.493 The European Communities argues that finally, Chile has failed to rebut the EC's evidence showing that the New Chilean System is applied "so as to afford protection to domestic production". Under the New Chilean System, more than 95 % of imports will be taxed at the highest tax rate. In contrast, between 75 and 85 % of domestic spirits (including 90 % of pisco) will be taxed at the lowest rate. Moreover, sales of domestic spirits with a minimum alcohol content of more than 35° represent only 6 % of domestic production.[238] Thus, potentially nearly all domestic production qualifies for the lowest tax rate. The mere fact that some domestic products fall within the more taxed category is not sufficient, in light of previous panel reports, to

[237] Panel Report on *Japan - Taxes on Alcoholic Beverages I, supra*, footnote 50, para. 5.13.
[238] *Ibid.*

exclude a finding of protective application. What really matters is that the vast majority of Chile's domestic production falls within the most favoured category.

4.494 The European Communities notes that Chile claims that domestic production accounts for 70 % of the spirits subject to the highest tax rate. That figure, however, is deceptive. The supporting tables[239] shows that only 26 % of domestic production consists of spirits with a minimum alcohol content of more than 39°. Furthermore, domestic brands of high strength spirits of more than 39° such as gin, vodka, rum or whisky are generally low quality products positioned at the low end of the market. So-called "Chilean whisky" is a case in point. According to the International Wine and Spirits Record, the largest part of Chile's "whisky" production is used for re-filling bottles of imported brands.[240] This is not the type of "domestic production" which a Government may be interested in protecting.

4.495 **Chile replies** that in assessing effects of the New Chilean System, the European Communities asks the Panel to look only at existing EC production that would face high taxes and existing Chilean production that would face relatively lower taxes. As just noted, that ignores both the EC production that would face low taxes if exported to Chile and the substantial Chilean production that will face relatively high taxes.[241] The European Communities already produces grappa, for example, a spirit distilled from grapes that is quite similar to pisco, and it could readily be marketed in Chile, if the EC producers so chose. In addition, nothing under Chilean law prevents the EC producers of spirits from diluting their products to a lower alcohol strength and commercializing them in Chile provided that they comply with the provisions of the Chilean law regarding health and food. In that very real sense, the European Communities has the equality of competitive opportunities which it claims to seek. Very simply, the New Chilean Law applies to and affects domestic producers of spirits in the same manner as it applies to and affects importers of alcoholic beverages. It in no way prevents foreign producers of spirits from importing any low alcohol content spirits benefiting from a lower level of taxation on the basis of their alcohol content.

4.496 **The European Communities further responds** that Chile also argues that the New Chilean System is "neutral" because there are some imports in the less taxed category. The actual fact, however, is that imports of spirits with a minimum alcohol content of 40° account for 95 % of imports. In practice, the only imported products which could benefit from the lowest tax rate in the New Chilean System are certain types of low strength liqueurs.[242]

4.497 In the view of the European Communities, Chile's assertions to the effect that in previous cases the favoured product was always one that "could be only domestic" misrepresent the findings of those reports. For example, just like Chile in this case,

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[239] Chile First Submission, Annex III.

[240] EC Exhibit 19, p.43.

[241] Chile argues that local production accounts for 71.6% of the alcoholic beverages with alcohol content of more than 39° in 1995, which will be subject to the highest rate of taxation under the New Chilean System.

[242] The European Communities notes as regards grappa that it should be noted that in the European Communities its minimum alcohol content is 37.5 % vol. Therefore, it would have to be diluted in order to benefit from the lowest tax rate in Chile.

Japan claimed that its tax system was "neutral" because shochu was not an "inherently" Japanese product.[243] Indeed, there were imports of shochu into Japan.[244] Furthermore, the panel accepted the evidence submitted by Japan according to which shochu was produced in substantial quantities outside Japan, in countries such as Korea, China, Singapore and even the United States.[245] Similarly, in *Korea - Taxes on Alcoholic Beverages*, the panel based its conclusion that the measures were protective on the fact that the current volume of imports of soju were very small, and not on the fact that soju was an "inherently" Korean product.[246]

4.498 The European Communities continues to state that in the same vein, Chile argues that in *United States - Malt Beverages*, the small breweries exception was found to violate Article III:2 because "only small US breweries could qualify". This is a gross misrepresentation of the panel's findings. The panel did not condemn the small brewery exception because it was not available to foreign products, but because beer from small breweries is "like" beer from large breweries, and Article III:2, first sentence, does not tolerate any tax differential between "like" products:

> The Panel further noted that the parties disagreed as to whether or not the tax credit in Minnesota were available in the case of imported beer from small foreign breweries. The Panel considered that beer produced by large breweries is not unlike beer produced by small breweries …. Therefore, in the view of the Panel, even if Minnesota were to grant the tax credits on a non-discriminatory basis ... there would still be an inconsistency with Article III:2, first sentence.[247]

4.499 In the view of the European Communities, Chile's argument turns upside down the well-established principle that Article III is concerned with the protection of competitive opportunities and not of actual trade flows.[248] The thrust of that principle is that in order to establish a violation of Article III:2, it is not necessary to show that a measure has actually restricted imports. A violation of Article III:2 may be found even if there are no imports at all. It is sufficient to show that the measure may limit potential imports. Chile subverts this principle by arguing that the fact that actual imports are restricted is irrelevant, if potential imports of a different product are not.

4.500 Further, the European Communities states that Chile's argument does not take into account the specific nature of the products at issue. Spirits are not commodities. Spirits are "experience goods"[249], whose consumption is largely based on habit. For that reason, market penetration tends to be slow and requires considerable marketing efforts. It may require some time and advertising expenditure to convince a hardened pisco drinker to switch to whisky, just as it may require some time and advertising to

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[243] *See* Panel Report on *Japan - Taxes on Alcoholic Beverages II, supra,* footnote 45, paras. 4.19 and 4.175-4.179.
[244] *Ibid*., para. 4.177.
[245] *Ibid*., para. 6.35.
[246] Panel Report on *Korea - Taxes on Alcoholic Beverages*, supra, footnote 56, para. 10.102.
[247] Panel Report on *United States - Malt Beverages, supra.,* para. 5.19.
[248] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra,* footnote 41, at 109-110.
[249] *See* Panel Report on *Korea - Taxes on Alcoholic Beverages, supra*, footnote 56, para. 10.75.

convince a smoker of Camel to try Marlboro. Even though all distilled spirits and liqueurs are, by reason of their physical characteristics and potential end-uses, "directly competitive or substitutable" products, currently the main competitive threat to pisco comes from whisky and the other high strength spirits which are already present in the Chilean market. It could take many years before other (low strength) spirits which are currently not exported to Chile, or only so in small quantities, could represent a comparable threat for pisco. Thus, the New Chilean System does afford effective protection to pisco even if it does not protect pisco against potential imports of low strength spirits.

4.501 **Chile further responds** that the European Communities itself has made an analogy between type names such as whisky, vodka, shochu, etc, and brand names, such as Camel or Marlboro cigarettes. The analogy is correct, at least insofar as the laws would prevent a whisky producer from calling his product vodka, just as the intellectual property laws of most countries would prevent Camel from calling its cigarettes Marlboros, or, for that matter, a sparkling wine producer from Italy or Chile calling its product Champagne in the European Communities.

4.502 According to Chile, the panels in the Korean and Japanese cases decided that tax distinctions based on such type distinctions are not permissible, if the two types of product are directly competitive or substitutable and if they are dissimilarly taxed, and if that dissimilar taxation creates a favoured group that is essentially all produced domestically. In other words, a distinction that may be perfectly acceptable, indeed mandated for purposes of marketing products under a certain name, cannot be used to justify tax or regulatory distinctions under Article III if the named products are otherwise directly competitive or substitutable and the other tests of an Article III violation are met.

4.503 Chile states that it does not contest that thesis. Indeed, distinctions based on intellectual property, or subjective classification systems could be very harmful to a developing country such as Chile if used to discriminate against Chilean products. Products that may qualify to be treated differently for intellectual property or similar purposes may still be directly competitive or substitutable for Article III purposes.

4.504 Chile claims that in this dispute, however, the European Communities is not simply asking the Panel to prohibit tax distinctions based on type names. Indeed, Chile has done that, eliminating all distinctions based on types of distilled spirits. The European Communities is asking this Panel to take the interpretation of Article III significantly farther so as to create an affirmative obligation for WTO members to ensure that their internal taxes accommodate precisely the same marketing standards that the European Communities insists are insufficient to make the products not directly competitive or substitutable. For the European Communities, it is not sufficient to abandon tax distinctions that are based on concepts such as types or brands. The European Communities argues that the tax laws and regulations must not have the effect of diminishing whatever marketing or intellectual property value is thought to be associated with the name or brand.

4.505 Chile further contends that this theory would go too far as a matter of interpretation of Article III. It is one thing to say that qualitative distinctions, even though sought by the industry and mandated by law or regulation, are not necessarily sufficient to justify tax or regulatory distinctions that otherwise would violate Article III. It is quite another thing to say that Article III carries an implicit obligation

affirmatively to protect or enhance such an intellectual property right or subjective classification system.

4.506 In the view of Chile, primarily at the urging of the European Communities and other developed countries, the WTO now includes the TRIPS Agreement. The European Communities is free, if it wishes, to seek to negotiate further intellectual property rights and protections, such as a right to market under type names like whisky with high minimum alcohol requirements and immunity from adverse tax consequences flowing from that high alcohol content. But there is no basis for attributing such an obligation to Article III of GATT 1994.

4.507 Chile reiterates that in the meantime, under the New Chilean System, EC producers will have the same choice as Chilean producers and all third-country producers of alcoholic beverages. They can sell products that already are of low alcohol strength at the lowest rate of taxation. They can sell high alcohol products without dilution, but also without discrimination between domestic and imported product and, in the case of whisky, at a substantially lower tax rate than has prevailed. They can also elect to dilute their high alcohol products with a relatively small amount of water and similarly benefit from low taxation. Despite the EC's protestations. Chile cannot fail to note that dilution with water is hardly an onerous process for a product that, in the EC's words, is already "99% water and alcohol" and whose last stage of production is already dilution with water to the desired alcohol strength. Further, the European Communities itself has noted the large tendency for consumers themselves to dilute their product with water, ice, or various mixers.

4.508 Chile notes that, even after dilution, Chile's intellectual property laws will protect the EC's trademarks in Chile, whether those producers market their brands as whisky or some other product. Chile has a chart demonstrating various diluted alcoholic beverages on sale in Chilean supermarkets, using their brand names and the alcoholic beverage with which they are mixed, as indicated in Table 38.

Table 38[250]

Beverage	Alcohol Content	Brand name	Origin
Margarita	13	Careye's	Mexico
Vodka and peach	25	Artic	Italy
Vodka and coconut	25	Artic	Italy
Vodka and melon	25	Artic	Italy
Vodka and apple	25	Artic	Italy
Vodka and pineapple	30	Artic	Italy
Vodka and cranberry	30	Artic	Italy
Lemon rum	35	Finlandia	Finland
Pisco sour	22	La Serena	Chile
Pisco sour	22	Capel	Chile
Pisco sour	22	Control	Chile
Pina colada	20	Mitjans	Chile
Whisky and cola	8	Jack Daniel's	U.S.A.
Cola de mono	16	Vina Mendoza	Chile

(d) Percentage of More Taxed Products in Imported Products

4.509 **The European Communities further points out** that in contrast, nearly all imports of spirits will be taxed at the highest rate. As shown in Table 19 above, imports of whisky, gin, vodka, rum and tequila (all of which will be taxed at the rate of 47 % *ad valorem*) account for more than 95 % of imports of spirits into Chile.

4.510 The European Communities contests the Chile argument that the New Chilean System is "neutral" because some domestic production will be taxed at the highest rate. In reality, however, the share of current domestic production falling within the most taxed category is relatively small: between 15 % and 25 %. Furthermore, sales of domestic spirits with a minimum alcohol content of more than 35° represent as little as 6 % of total domestic production. In turn, domestic spirits with a minimum alcohol content above 39° account for barely 2.7 % of total domestic production, based on the data shown in Table 19 above. Thus, potentially nearly all domestic production of spirits qualifies for the lowest or the intermediate tax rate. For comparison, in *Japan - Taxes on Alcoholic Beverages I* and *II*[251], the share of domestic production falling within the less taxed category was 80 %.

4.511 The European Communities also considers that in any event, as Chile itself has acknowledged, previous panel reports confirm that the presence of some domestic production in the most taxed category does not exclude a violation of Article III:2, second sentence. Thus, for example, in *Japan - Taxes on Alcoholic Beverages II*[252], domestic production accounted for no less than 75 % of the sales of whisky, 72 % of the sales of brandy, 82 % of the sales of spirits and 97 % of the sales of liqueurs. In *Korea - Taxes on Alcoholic Beverages*, 80% of gin, 50 % of rum

[250] Chile Oral Statement at the Second Substantive Meeting, Table I-A.
[251] Panel Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 45, para 4.95.
[252] *Ibid.,* Annex IV.

and 30 % vodka were imported.[253] What really matters is whether the majority of domestic production falls within the favoured category.

4.512 The European Communities further claims that unlike pisco those spirits do not have the flexibility to move down the scale in order to benefit from the lowest tax rate. In conformity with Chilean regulations, all of them must be bottled at a minimum alcohol content of 40° and, therefore, are automatically locked in to the highest rate of 47 %.

4.513 **In rebuttal, Chile contests** the EC complaint that Chilean Law 18,455 will prevent producers of distilled spirits such as whisky, gin and rum from marketing their products at the lowest rate of taxation, because Chilean regulations under that law established minimum alcohol standards for those products that preclude sale at less than 40° of alcohol. That misstates the requirements of Chilean Law 18,455 and regulations thereunder, which in any event are not at issue in this dispute. It is true that products cannot be marketed, for example, as "whisky" unless the product contains at least 40° alcohol. However, there is nothing in Chilean law or regulations that preclude a whisky producer from adding water to the product to reduce its strength to 35° before bottling, so long as the product is not marketed as whisky.

4.514 In the view of Chile, while producers of whisky (or rum, gin, etc.) might prefer to market their products under the traditional type name, those producers cannot have it both ways when seeking the benefits of Article III. The distilled spirits industry cannot insist when taxation is at issue that all distilled spirits products be treated in the identical way as measured by whatever standards of equivalency best suit the commercial interests of the large export industries, but then claim at the same time that fine distinctions between essentially identical products, often based almost exclusively on origin or minute differences of process or ingredients, be vigorously enforced and accommodated.

4.515 Chile goes on to state that whisky producers in Europe, like whisky producers in Chile, cannot market their product as whisky in Chile unless it is at least 40° alcohol by strength. That is a requirement of both European Communities and Chilean regulations, and in both cases it is applied equally to imported and domestic products. That is, a product that is "like" whisky in every way but its alcohol strength cannot be marketed as whisky.[254]

4.516 Chile states that it is ironic that the European Communities also requires minimum alcohol levels in order to be able to market products in the Community as different kinds of spirits. For example, the commercially desirable name of Scotch whisky can only be applied to a product that meets the minimum alcohol standard imposed by the European Communities[255], as also confirmed by the ECJ.[256] An imported product that is identical in every other way cannot use this desirable term Scotch whisky if it has one percent less alcohol than the minimum - yet, such

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[253] *See* Panel Report on *Korea - Taxes on Alcoholic Beverages, supra*, footnote 56, para. 3.17.

[254] Council Regulation 1576/89 of 29 May 1989 Establishing General Rules on the Definition, Description and Presentation of Spirits, Art. 5, 1989 J.O. (L160) 1.

[255] *Ibid.*

[256] Case C-136/96, *Scotch Whisky Association v Compagnie Financiere Europeenne de Prises de Participation*, 696J0136, 1998 ECJ Celex Lexis 1211 (16 July 1998).

distinctions have not been considered to violate Article III:4 requirements for no less favorable treatment with respect to internal laws, regulations and requirements.

4.517 According to Chile, the EC's own practice under the national treatment provisions of the Treaty of Rome has developed in such a way that, according to the European Communities, "Article III:2 of GATT contains provisions broadly corresponding to Article 95 [EEC]".[257] In interpreting the national treatment rules of Article 95 of the Treaty of Rome, the European Court of Justice stated that:

> In the present state of Community law Article 95 EEC does not prohibit Member-States, in the pursuit of legitimate economic or social aims, from granting tax advantages, in the form of exemptions from or reduction of taxes, to certain types of spirits or to certain classes of producers, provided that such preferential systems are extended without discrimination to imported products conforming to the same conditions as the preferred domestic products.[258]

4.518 Chile states that it is interesting to note that the European Court of Justice decided that:

> A system does not favor domestic producers if a significant proportion of domestic production of alcoholic beverages falls within each of the relevant tax categories.[259]

4.519 Chile goes on to state that the same can be inferred from *a contrario* analysis of the European Court of Justice ruling that:

> [A] criterion for the charging of higher taxation which by definition can never be fulfilled by similar domestic products cannot be considered to be compatible with the prohibition of discrimination laid down in Article 95 of the Treaty.[260]

4.520 Thus, Chile mentions that the European Communities recognizes that "Article III:2 is concerned with the protection of competitive *opportunities* and not of *actual* competition". (emphasis supplied by Chile) It is clear from the preceding arguments that EC producers of alcoholic beverages have the same competitive opportunities as domestic producers of spirits and it is up to EC producers to seize the opportunities that the New Chilean System offers them.

4.521 Chile contests the objection of the European Communities that the New Chilean System results in relatively high taxes on many imports and relatively lower taxes on many domestic products. That may be true, assuming that the current configuration of EC (and Chilean) production continue. But it is equally true that the New Chilean System results in relatively high taxes of high alcohol premium domestic products, which constitute a substantial and growing segment of Chilean

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[257] Case 148/77, *H. Hansen jun. & O. C. Balle GmbH & Co. v Hauptzollamt Flensburg*, 1978 E.C.R. 1787, 1 C.M.L.R. 604 (1979).

[258] Case 196/85, *Natural Sweet Wines: Commission v. France*, 1987 E.C.R. 1597, 2 C.M.L.R. 851 (1988); *See also*, Case 127/75, *Bobie Getrankevertrieb GmbH v Hauptzollamt Aachen-Nord*, 1976 E.C.R. 1079; and Case 148/77, *H. Hansen jun. & O.C. Balle GmbH & Co. v. Hauptzollamt Flensburg* 1978 E.C.R. 1787, 1 C.M.L.R. 604 (1979).

[259] Case 243/84, *John Walker & Sons Ltd v. Ministeriet for Skatter og Afgifter*, 1986 E.C.R. 875, 2 C.M.L.R. 278.

[260] Case 319/81, *Commission v Italy*, 1983 E.C.R. 601, 2 C.M.L.R. 517, para. 17.

production, a pattern of consumption which is consistent with the level of distribution and income of a developing country. In fact the New Chilean System is biased in tax terms against relatively high alcohol products and against relatively expensive products, but that does not constitute a violation of the "so as to afford protection to domestic production" standard.

4.522 Chile argues that it is also essential to note in this regard that, unlike systems based on distinctions between different types of distilled spirits, it is a relatively simple matter for foreign and domestic producers to adapt to the neutral and objective standards of the Chilean system. A whisky producer cannot readily become a pisco producer, but a producer of any spirit of 40° alcohol can readily dilute the product to 35°. The European Communities already produces many products (grappa, fruit liqueurs, etc.) that qualify for the lowest taxes and even more products that would qualify if only, as the European Communities suggests be done for pisco,[261] some water is added to the current high alcohol products before bottling. Article III simply does not obligate sovereign Member governments to harmonize their neutral taxation system to the convenience of foreign producers in the way sought by the European Communities in this case. The New Chilean System affects domestic producers of spirits in the same manner as it affects importers of alcoholic beverages, and does not prevent foreign producers of spirits from importing any low alcohol content spirits benefiting from a lower level of taxation on the basis of their alcohol content.

4.523 In the view of Chile, the overriding requirement of Article III:2 is not to discriminate in favor of domestic goods and against imported goods on the basis of national origin of a product. Almost all cases brought to GATT and WTO panels under Article III:2 have involved measures that, on their face, afforded more favorable treatment to some or all domestic goods than to imported goods.

4.524 Chile states that a legislator should also be aware that a measure that formally does not discriminate based on nationality may nevertheless be found to contravene Article III:2, second sentence, if the effect of the measure is to make more favorable treatment available exclusively or virtually exclusively to domestic products to the disadvantage of imported products. GATT and WTO panels have gone furthest in extending the concept of *de facto* discrimination based on national origin of a product in the recent alcoholic beverage taxation cases against Japan and Korea. Both of those countries had tax systems in which one type of distilled spirit was taxed at a far lower rate than other distilled spirits. Further, in each case, domestic producers accounted for virtually all domestic consumption of shochu or soju, because various measures effectively prevented imports of shochu/soju from competing in the domestic market. In these circumstances, where there was no possibility for foreign producers to obtain the benefits of the low tax accorded to shochu/soju, and where the panel found that the favoured product was like or directly competitive or substitutable with other types of distilled spirits, these systems were held to contravene Article III:2.

[261] Chile notes that producers of pisco reservado or gran pisco might choose not to dilute, because they would then lose the right to market under those more prestigious names, which are also associated with more elaborated processes and select ingredients.

4.525 Chile goes on to state that on the other hand, laws and regulations based on objective criteria such as those used in the New Chilean System have rarely been challenged in the GATT and have never been successfully challenged, even when the tax system may result in less favorable treatment for some or many imported goods than for some or many domestic goods. For example, in the *United States - Taxes on Automobiles* case, the panel found that the United States had *not* breached Article III:2 by imposing a luxury tax on vehicles above a certain threshold value.[262] The U.S. tax resulted in far higher taxes on certain European products, which dominated the U.S. market for cars priced significantly above the threshold price and thus the vast majority of the revenue collected from the tax on European cars. However, far more imports, including a significant number of imports in the price categories most directly competitive with U.S. "luxury cars," paid a minimal tax or no tax at all.

4.526 Chile states that while the reasoning of the *United States - Taxes on Automobiles* Panel (the so-called "aims and effects" test) was not followed subsequently by the Appellate Body, Chile believes that the result would have been the same under the three part test applied by the *Japan - Taxes on Alcoholic Beverages II* Appellate Body.[263] The luxury tax imposed by the United States was based on objective criteria (a tax on the value of cars in excess of a fixed luxury level) that applied to both domestic and imported cars, and imported cars could and did benefit from the tax exemption granted to all cars below the exemption.

4.527 Chile further argues that comparing that system to the Chilean system of taxation of alcoholic beverages, it might be noted that it is easier as a practical matter for foreign producers to adapt the alcohol strength of their product than for car producers to reduce their prices.

4.528 Also, Chile maintains that similarly, even though specific taxes such as those imposed on alcoholic beverages in several EC Member States have a marked discriminatory effect on low priced imported products relative to high priced domestic products such as Scotch whisky or even imported high priced products such as U.S. or Canadian whisky, Chile has believed that a challenge of such tax systems under Article III (or Article I which requires most favoured nation treatment with respect to matters covered by Article III:2) would probably not be successful because the tax standard is objective, even if its effect disfavours low price products.

4.529 Chile notes that it is likewise inconceivable that members of the WTO, particularly developing country members, thought or think that, in joining the WTO and accepting thereby the obligations of Article II:2, they were foregoing the right to use fiscal policy tools such as luxury taxes or exemptions or reduced taxes for goods purchased primarily by poor consumers, even if such policies result in higher taxes on many imports than on many like or directly competitive products.

4.530 Chile believes that the European Communities errs in the following principal ways chiefly because the European Communities ignores significant differences between the Chilean law and market and those of Japan and Korea or because the European Communities tries to equate differences between the Chilean and EC systems of taxation with a violation of Article III:2.

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[262] Panel Report on *United States - Taxes on Automobiles, supra*.

[263] *See* Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra,* footnote 41.

4.531 Chile argues that the European Communities ignores that, unlike the situation under the Japanese and Korean Systems, imported products can readily benefit from the lowest rates of taxation in Chile.

4.532 In the view of Chile, the European Communities accepts taxation based on alcohol content, but tries to argue that such taxes must be both specific and strictly proportional to alcohol content, when such a test is not required by Article III, not equitable by many standards, and not consistent with wine tax policies and policies such as luxury taxes.

4.533 According to Chile, the European Communities asks this Panel to assess the Chilean objective tax system in terms of its effect on precisely the subjective categorization system that is abandoned in the New Chilean System.

4.534 Chile maintains that having successfully argued in the Japan and Korea cases that a subjective system for typing and naming products cannot necessarily justify different treatment of those products under Article III:2, the European Communities now tries to argue that there is an affirmative duty to ensure even objective criteria - such as those employed by Chile - accommodate the subjective marketing system. This is tantamount to creating a new intellectual property right and insisting that Article III affirmatively protect that right.

4.535 Chile considers that panels and the Appellate Body applied the broadest interpretation of Article III:2 in the recent cases against Japanese and Korean alcoholic beverage taxes. In those cases, the measures in question were held inconsistent with Article III:2, second sentence, even though:

(i) there was no explicit discrimination based on nationality; and

(ii) at least in the case of Japan, there was very substantial domestic production of unfavourably taxed products that the panel found to be directly competitive or substitutable.

4.536 Then Chile argues that though those elements might suggest a non-discriminatory system, there were critical additional aspects to both systems. In those cases, the tax systems of Japan and Korea discriminated according to **type** of distilled spirit, and the type that was most favorably taxed was virtually entirely insulated from import competition. That is the element that does not exist in the New Chilean System.

4.537 In the view of Chile, the European Communities criticized Chile because it mis-described shochu and soju as "inherently" domestic products. Indeed, that was not the panel finding in either case. Instead the panel found that those particular types of distilled spirits in those countries were essentially insulated from import competition by Japanese and Korean measures. Thus imports could not benefit from the lower rate of taxation. They could not benefit by producing shochu or soju, because those products effectively could not be imported. They could not benefit otherwise, because only the product named shochu or soju could benefit, and the criteria for using those names did not allow adaptation of other products to qualify as shochu/soju.

4.538 Chile notes that the European Communities also seems to imply that there was an opportunity for imports to take advantage of the low tax category in the Korean and Japanese systems, when in fact the panels found quite the contrary. Notwithstanding the existence of productive capacity abroad, the panel found that domestic production of shochu and soju were insulated from that competition.

Foreign shochu/soju producers could not enter the relevant markets because of trade restrictions, and foreign producers of other distilled spirits could not alter their products to make them into shochu or soju. Whisky could not be diluted into soju or shochu, and Vodka could not simply rename itself without changing its production method and becoming subject to essentially insuperable trade barriers.

4.539 Chile argues that by contrast, the Chilean system, using alcohol content without type distinctions, allows imports to take advantage of the low tax category of Chile.

4.540 Chile thus concludes that the Japanese and Korean systems employed subjective distinctions, while the Chilean System is objective. Use of type names to make tax categories had the effect in Japan and Korea of excluding from the lowest tax category distilled spirits not meeting the standards to be called shochu or soju. At the same time, import restrictions prevented products that could qualify as soju or shochu from entering. Thus, once the panel determined that shochu and soju were competitive or substitutable with other products, the panel could also conclude that a virtually exclusively domestic product was being afforded protection by dissimilar taxation.

4.541 **In rebuttal, the European Communities stresses** the unequal impact of the measure on imported as compared to domestic products. The measure's structure ensures that between 75 % and 85 % of Chile's domestic production of spirits (including more than 90 % of all pisco sales) will be eligible for the lowest tax rate possible. In contrast, 95 % of imported products (including all imports of whisky, vodka, rum, gin and tequila) will be taxed at the highest rate possible.

4.542 In the view of the European Communities, Chile has not challenged those figures. Still, Chile pretends that the measure affords the same competitive opportunities to the EC exporters than to the Chilean producers of pisco. According to Chile, the EC exporters of whisky could take advantage of the lowest rate simply by diluting their whisky to 35°. Yet, that diluted beverage would no longer be considered as whisky in most countries. In Chile itself, the law prescribes that whisky must have no less than 40 °. This means that if the EC producers diluted whisky to 35°, the resulting product could not be sold under the term "whisky". As mentioned before, the same minimum alcohol content requirement applies also to gin, rum, vodka and tequila.

4.543 The European Communities notes that likewise, the fact that a few imports of low strength liqueurs will benefit from the lowest tax rate does not exclude a violation of Article III:2, second sentence. The possibility to dilute high strength spirits to 35° is not a real option for the EC spirits producers. To begin with, because by doing so the EC producers of spirits would forfeit the right to sell their products under their traditional, well reputed names. Moreover, the degree of alcohol content is one of the essential features which define the identity of each type of spirit. Whisky drinkers would simply not consider diluted whisky as real whisky.

4.544 The European Communities states that it seems almost unnecessary to state that this is not really an option for the EC producers of spirits. In the first place, as acknowledged by Chile, whisky, vodka, gin, rum and tequila (which together account for 95 % of imports) simply could not be lawfully marketed at 35° or less, unless at the price of losing their names.

4.545 The European Communities notes that Chile seems to consider as an obvious fact that foreign producers "could not hope to sell something called shochu in the Japanese or Korean market". On the other hand, it pretends that selling in Chile something called "*aguardiente de cereales*" would be no more difficult than selling something called "whisky". This is incorrect. "Whisky", "rum", "gin", "vodka" and "tequila" are all well-established product names which enjoy worldwide consumer recognition. In order to build up a totally new product name with the same reputation as "whisky", the EC producers would have to invest considerable financial resources over a long a period of time. Asking the EC producers to forfeit the prestigious name "whisky" in order to qualify for the lowest tax rate amounts to asking them to write off all their previous marketing efforts in Chile. If Chile is truly convinced that the use of a well-known and reputed name does not improve the "competitive opportunities" of a spirit, why does it insist on reserving the name "pisco" exclusively for domestic pisco?

4.546 The European Communities further notes that Chile quotes the following passage of the ECJ decision in the Case 319/81, *Commission v. Italy*, as supporting *a contrario* Chile's argument that the presence of domestic products in the more taxed category excludes protective application:

> ... a criterion for the charging of higher taxation which by definition can never be fulfilled by similar domestic products cannot be considered to be compatible with the prohibition laid down in Article 95 of the Treaty ...

4.547 In the view of the European Communities, Chile's argument provides an excellent illustration of the well-known fact that *a contrario* inferences are often wrong. It is obvious that from the fact that a condition which cannot be fulfilled by domestic production is contrary to Article 95 ECT, it cannot be logically inferred that all other conditions are always compatible with Article 95. By now, it is a well-established principle of both EC law and GATT law that *de facto* discrimination (as opposed to *de jure* discrimination, including indirect *de jure* discrimination such as the one at issue in Case 319/81) is contrary to Article 95 of the Treaty of Rome and Article III GATT, respectively.

4.548 The European Communities further argues that on the other hand, it is worth noting that this ECJ judgement refutes Chile's dilution argument. The measure in dispute in case 319/81 was the application by Italy of the VAT at a higher rate on spirits which benefited from a designation of origin (*e.g.,* Cognac). This condition could not be met by domestic production, because Italian law does not recognize designations of origin for spirits. If one follows Chile's logic, there would be no violation of Article 95, because foreign producers could avoid paying the higher tax simply by selling their products under a generic name. For instance, the exporters of cognac would have qualified for the lowest rate simply by selling its product under the name "wine brandy", something which according to Chile would not have impaired their competitive opportunities.

4.549 According to the European Communities, moreover, even if Chilean regulations were amended so that whisky, gin, rum, vodka and tequila could be lawfully marketed at 30°-35° without forfeiting their name, the New Chilean System would still fail to afford "equality of competitive opportunities". Contrary to Chile's argument, minimum alcohol standards are not a capricious invention of some wicked multinationals. The level of alcohol content is one of the essential characteristics

which define the identity of each type of spirit. Consumers associate each type of spirit with a certain range of alcohol content. For many whisky consumers, whisky of 30° would simply not be "real" whisky, irrespective of the name written on the label. It is in recognition of this fact that the regulations of both Chile and the European Communities, and of many other countries, prescribe a minimum alcohol content for whisky of 40°.[264]

4.550 The European Communities also argues that in practice, by putting forward its dilution suggestion Chile admits that its New Chilean System places foreign producers in the following dilemma. Those producers can either choose to preserve their products' name, as well as the properties with which they are traditionally known in Chile and worldwide at the cost of being subjected to higher tax rates. Or they can obtain a more favourable tax treatment, but at the price of losing both the product's name and the product's identity.

4.551 The European Communities further claims that that sacrifice is not required of the producers of pisco. Indeed, pisco does not need to forfeit its name or suffer any alteration of its traditional characters in order to benefit from the lowest tax rate and thus can "have it both ways".

4.552 According to the European Communities, already more than 90% of pisco is 35° or less and, therefore, qualifies for the lowest tax rate. Moreover, pisco producers could dilute the remaining production to 35°, without losing the right to use the name "pisco". All they would lose is the right to use the names *"gran pisco"* and *"pisco reservado"*. Those names enjoy less consumer recognition than names such as "whisky" and have only a limited commercial value.

4.553 In the view of the European Communities, moreover, unlike in the case of whisky and the other main types of imported spirits, a relatively high alcohol content is not one of the essential features that define the identity of pisco. To the contrary, traditional pisco is 30°-35° (recall that pisco of 30° to 35° is called precisely *"tradicional"*). Thus, consumers of pisco, unlike consumers of whisky, would be neither surprised nor disappointed by pisco diluted to 35°. Chile's argument to the effect that sales of high strength pisco have grown rapidly over the last decade only serves to underscore that high strength is not one of the traditional characteristics of pisco. The growth of high strength pisco is the result of a relatively recent marketing strategy which could be easily reversed so as to take advantage of the lowest tax rate.

4.554 Further, the European Communities maintains that the positions taken by the pisco industry during the process leading to the adoption of the New Chilean System confirms beyond any possible doubt that, for the pisco industry, the "sacrifice" of *gran pisco* and *pisco reservado* is indeed a small one, compared to the benefit they derive from the application of a higher tax rate to whisky. As explained below, the pisco industry petitioned the Chilean Parliament to increase the tax rate on spirits of 40° (including *pisco reservado*) to 50% (instead of 45%, as proposed by the Government) and the rate on spirits of 43° (including *gran pisco*) to 73% (instead of 65%). Later on, the pisco industry opposed an amendment of the Government proposal that would have lowered the rate on both *pisco reservado* and *gran pisco* to

[264] *See* US Exhibit 1.

40-45% (instead of 50 % and 65 %, respectively, as proposed originally by the Government).

4.555 In the view of the European Communities, the truth of the matter is that the Chilean Government does not really believe that dilution is a realistic option for the EC spirits producers. The "dilution" argument is but an *ex-post facto* rationalization. When estimating the impact on the level of tax revenue of the New Chilean System, the experts of the Chilean Ministry of Finance assumed that all whisky would continue to be sold at the same strength as before. Chile now describes that assumption as "arbitrary". However, given that maintaining the level of tax revenues is one of Chile's paramount objectives, making that assumption would have been not only "arbitrary" but also irresponsible.

4.556 **Chile replies** that as can be seen in the EC's own Table 8 above, the last stage of production of distilled spirits of virtually every kind is to add water to achieve the desired alcohol strength. EC producers have themselves produced lower alcohol versions of virtually all types of spirits sold in the European Communities, and could do so again.

4.557 Chile notes that the European Communities and the intervening parties have objected that they do not want to have to dilute their products further in order to qualify for a lower tax rate in Chile, and that EC and Chilean regulations would preclude marketing their products under certain type names unless minimum alcohol strength requirements for those types are observed. Chilean producers of Pisco Reservado and Gran Pisco have made the same objection. However, neither the Chilean nor the EC regulations governing minimum alcohol contents for marketing distilled spirits under particular type names are at issue in this Panel proceeding. Further, Article III does not require WTO members to design their laws and regulations to accommodate the manner or name under which foreign producers might prefer to market their products. The benefit of marketing under particular type names such as Gran Pisco or whisky is similar to the benefits from marketing under marks of origin or trademarks. Article III does not require protection or accommodation of rights or regulations, so long as the law does not impose discriminatory restrictions.

4.558 In the view of Chile, some producers also complain that dilution with water will affect the taste of their products. However, most products are consumed diluted by the consumer. Producers of the few products that are most often consumed undiluted (such as cognac or Gran Pisco), may decide not to lower their alcohol content, but these products tend all to be taxed with one another at the highest tax level in any case. In its support, Chile refers to Table 38 above.

(e) Position of Domestic Industry toward New Chilean System

4.559 **The European Communities claims** that the terms of Law 19,354 were negotiated and agreed formally by the Government with the pisco industry and are largely responsive to the interests and demands of that industry. As discussed below, those demands were by no means circumscribed to the level of the taxes applied to pisco.

4.560 **Chile replies** that the European Communities devotes many pages to an entirely irrelevant description of past taxation of alcoholic beverages in Chile and an

even longer and also irrelevant purported "drafting history of Law 19,534," in which the European Communities claims to know the Chilean legislative process and even motivations of elected officials and industry groups. The "drafting history" is particularly curious, in that the European Communities apparently intended to try to establish protectionist motivations, but even the selective and partial record to which the European Communities refers includes ample demonstration that the motivation of many legislators was to remove discrimination and protectionism in the old system that the European Communities had previously attacked.

4.561 In the view of Chile, in any event, the previous tax system of Chile and the motivations of Chilean legislators and industries are not at issue in this dispute, nor are they relevant to the interpretation of Article III:2.

4.562 **The European Communities alleges** that Law 19,534 was adopted in an attempt to address longstanding complaints from the European Communities and other WTO members to the effect that the ILA was contrary to GATT Article III:2. The European Communities had requested formal consultations with Chile under GATT Article XXIII with respect to the ILA already in 1989.[265] Following the conclusion of the Uruguay Round, the European Communities renewed its requests to Chile to bring the ILA in conformity with its GATT obligations. The EC complaints were expressly mentioned in the message of the President of the Republic attached to the first of the Executive's proposals for amending the ILA[266] and were extensively discussed during the subsequent debate by the Chilean Congress.

4.563 In the view of the European Communities, at first, the pisco industry and the representatives of the *zona pisquera* in Congress were opposed to any modification of the ILA. Eventually, however, even the pisco industry accepted that an amendment of the ILA was inevitable in order to avoid an outright condemnation of Chile in the WTO. The Foreign Relations Minister Mr Insulza summed up accurately the prevailing view in Chile when, following a meeting with representatives of the pisco industry, he declared that "consensus exists that the current legislation is discriminatory and a change must be made[267]". Similarly, during the debate by Congress of Law 19,534, many legislators (including the representatives of the *zona pisquera*) admitted openly that a reform of the ILA was necessary because the existing legislation was "discriminatory" and "favoured" the pisco industry.[268]

4.564 The European Communities then argues that although the pisco industry realized that it was no longer possible to maintain the formal discrimination between pisco and other spirits, it had no intention to renounce the protection which it had enjoyed for decades. Rather, according to the European Communities, the objective of the pisco industry was to perpetuate the tax differentials between pisco and other spirits in a less conspicuous manner. The European Communities argues that the process of amendment of the ILA was driven by the purpose to find a formula that,

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265 Gatt doc. DS9/1.

266 Presidential Message No 78-332, 26 October 1995 (EC Exhibit 14).

267 *La Tercera*, 10 June 1997 (EC Exhibit 46).

268 *See* the Minutes of the debate by the Chamber of Deputies of 27 July 1997, EC Exhibit 16 and *Las Ultimas Noticias*, 7 November 1996, EC Exhibit 37, and *El Diario*, 13 February 1997 (EC Exhibit 41).

whilst being ostensibly less inconsistent with GATT Article III:2, allowed Chile to preserve to the largest extent possible the tax differentials between pisco and whisky.

4.565 The European Communities goes on to claim that in the course of that process, the Chilean Executive submitted two formal proposals for amending the ILA. The first proposal was tabled as early as October 1995[269] (the "1995 Proposal"). That proposal was even more favourable to the interests of the pisco industry than the amendment eventually adopted in November 1997. As shown in Table 39, the 1995 proposal differed from Law 19,534 in three respects:

(i) the rate on spirits of 35° or less was 25 % instead of 27 %;

(ii) from that base, the rate increased in increments of 5 percentage points per each additional degree of alcohol content instead of 4 percentage points per degree;

(iii) the tax rate continued to increase until 42° instead of peaking at 39°.

Table 39[270]

1995 Proposal for amending the ILA

Alcohol strength	**Tax rate *ad valorem***
Less or equal to 35°	25 %
Less or equal to 36°	30 %
Less or equal to 37°	35 %
Less or equal to 38°	40 %
Less or equal to 39°	45 %
Less or equal to 40°	50 %
Less or equal to 41°	55 %
Less or equal to 42°	60 %
Over 42°	65 %

4.566 According to the European Communities, in addition, the 1995 Proposal differed from Law 19,534 in that it did not envisage any transitional period. Instead, the new tax rates would have become applicable immediately after the entry into force of the amendment.

4.567 The European Communities argues that the 1995 Proposal was strongly supported by the pisco industry. That support was expressed at the hearing of interested parties hold by the Committee on Foreign Relations of the Chamber of Deputies. On that occasion, the only request made by the pisco industry was that, between 35° and 42°, the tax rate should increase by 6 percentage points per each additional degree of alcohol instead of by 5 percentage points.[271] Had this demand been accepted, the applicable rate on *pisco reservado* would have been 55 % instead of 50 %, and the rate on *gran pisco* 73 % instead of 65 %. According to the

[269] Presidential Message No. 78-332, 26 October 1995 (EC Exhibit 14).

[270] EC First Submission, Table 8.

[271] *See* the Report of the Committee on Foreign Relations, Inter Parliamentary Affairs and Latin American Integration, Bulletin No L732-05, dated 6 August 1996 (hereafter, "Report of the Committee on Foreign Relations"), p. 5. A translation into English is attached as EC Exhibit 17. *See also* Minutes, p. 16 (p. 2 of the English translation) (EC Exhibit 16).

European Communities, this request shows that Chile's pisco industry was more concerned by the reduction of the taxes applied to whisky than by the increase of the taxes on high strength pisco.

4.568 The European Communities further argues that, significantly, the 1995 Proposal was vigorously opposed by all the other interested parties that expressed their opinion before the Foreign Relations Committee. The opponents to the bill included not only the importers of spirits (represented by the *Asociación Nacional de Importadores*) but also the *Sociedad de Fomento Fabril* (the "SFF", Chile's federation of industrialists) and the *Asociación Gremial de Licoristas* (a trade association of liquor producers), as well as *Chile Vid* (the association of producers of fine export wines) and the *Asociación de Exportadores y Embotelladores de Vino* (the association of exporters and bottlers of wine).[272]

4.569 The European Communities further claims that according to the SFF, the 1995 Proposal was still contrary to GATT Article III:2 because although it "eliminate[d] the explicit discrimination against whisky … it replace[d] it by disguised discrimination".[273] Furthermore, both the SFF and the *Asociación Gremial de Licoristas* noted that the 1995 Proposal would give pisco even a greater advantage with respect to other spirits.[274] Similar views were expressed by the producers and exporters of wine.[275]

4.570 According to the European Communities, the 1995 Proposal failed to attract sufficient support within the Foreign Relations Committee due to its perceived incompatibility with Chile's WTO obligations. According to the chairman of the Committee, Mr Renán Fuentealba, the 1995 Proposal:

> … does not resolve the problem for Great Britain nor the WTO. We are not giving a voluntary political signal of eliminating the [tax] discrimination and we are running the risk that they will take us to a panel and we will lose.[276]

4.571 The European Communities goes on to argue that, confronted with the opposition of the Foreign Relations Committee, the Government announced that it would present to Congress an amendment ("*indicación*") to the 1995 Proposal providing for a larger reduction of the tax differential between pisco and whisky. According to press reports, the Government was envisaging to set the tax rate on whisky of 40° in the range of 40 % to 45 %, instead of at 50 %, as provided by the 1995 Proposal.[277]

4.572 The European Communities further contends that the pisco industry and the representatives in Congress of the *zona pisquera*[278] staunchly resisted any such

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272 Report of the Committee on Foreign Relations, pp. 5-7 (EC Exhibit 17).
273 SFF's submission to the Committee on Foreign Relations, p. 6 (EC Exhibit 18).
274 *Ibid*., p. 7. *See also* the Report of the Committee on Foreign Relations, p. 6 (EC Exhibit 17).
275 *Ibid*., pp. 6-7 (EC Exhibit 17).
276 *El Diario*, 4 June 1996 (EC Exhibit 27).
277 *El Diario*, 23 de Julio 1996 (EC Exhibit 32).
278 *See, e.g.*, the statements made by Representative Encina to *La Epoca*, 12 June 1996 (EC Exhibit 28); by Representative Pizarro to *El Diario*, 23 July 1996 (EC Exhibit 32) and *El Mercurio*, 24 July 1996 (EC Exhibit 33); and by Representative Munizaga (of the opposition party *Renovación Nacional*) to *Estrategia*, 31 July 1996 (EC Exhibit (36).

modification of the 1995 Proposal. In order to pre-empt the Government from presenting the announced amendment, the opposition parties forced a vote on the 1995 Proposal by the Foreign Relations Committee on 30 July 1996. This strategy failed because the members of the governmental coalition voted against the Government's own proposal.[279]

4.573 According to the European Communities, the support of the pisco industry to the 1995 Proposal was reiterated at a seminar of pisco producers organized by APICH (the national association of pisco producers) in La Serena in June 1996. Significantly, the seminar was entitled: "Pisco industry: challenges and threats". According to press reports, one of the main conclusions of that seminar was that:

> [T]he pisco producers … rejected any [modification by the Government] to its proposal to amend Article 42 of Decree Law No 825 now under the discussion, even if that proposal is not totally satisfactory for the industry, [since such a modification] could leave pisco in an even more disadvantageous position with respect to whisky.[280]

According to the same reports, the seminar was attended by Mr A. Gutiérrez Ortega, Under-Secretary of Agriculture.

4.574 The European Communities emphasizes that the reduction of the tax on whisky to 40%-45 % envisaged by the Government would have benefited not only whisky, but also all other spirits over 39°, including *pisco reservado* and *gran pisco*. The European Communities claims that the opposition of the pisco industry to that reduction constitutes additional proof that its overriding concern was to preserve a large tax differential between whisky and a large majority of pisco, even if that required "sacrificing" high strength pisco.

4.575 The European Communities also contends that, as soon as it became apparent that the 1995 Proposal would not be approved by Congress, the Government entered into negotiations with the pisco industry to try and agree on a new proposal that was (or, at least, appeared to be) less plainly inconsistent with Chile's obligations under the GATT. Those discussions led to the signature in September 1996 of a "protocol" by representatives of the Chilean Government and of the pisco industry. During the consultations with the European Communities, the Chilean Government described the contents of that protocol in the following terms:

> The so-called protocol contains the summing up of the consultations held with the private sector as normally done in matters of public interest. It contains three distinct parts: the first simply reflects the acquiescence of the private sector with the Government's proposal to send a bill to Congress with the tax scale and transition period that later became law. The second and third part refer to other unrelated

[279] *See El Diario*, 31 July 1996 (EC Exhibit 34); *El Mercurio*, 31 July 1996 (EC Exhibit 35); *Estrategia*, 31 July 1996 (EC Exhibit 36); and *La Epoca*, 31 July 1996 (EC Exhibit 37).

[280] *El Mercurio*, 30 June 1996 (EC Exhibit 29).

> matters such as the agreement to initiate efforts at promoting exports of pisco through the governmental agency Pro - Chile.[281]

4.576 The European Communities further argues that, despite its carefully chosen terms, this statement constitutes a recognition that the second proposal submitted by the Executive to Congress had been previously agreed with the pisco industry and, therefore, reflected the interests of that industry. According to the European Communities, the terms of that agreement were that in exchange for its acceptance of a marginal increase in the rate applied to *pisco corriente* and *pisco especial* and of a greater reduction of the tax rate on whisky than had originally been proposed (from 70 % to 47 %, instead of 50 %), the pisco industry would obtain financial "compensation" for the reduction of the level of protection.

4.577 According to the European Communities, in addition, the pisco industry would benefit from a long transitional period to adapt itself to the new situation. At the insistence of the pisco industry, that transitional period would apply not only with respect to the increase of the taxes in pisco but also with respect to the decrease of the taxes on whisky. The European Communities argues that this demonstrates, once again, that it was the reduction of the taxes on whisky, and not the increase of the taxes on pisco, which worried most the pisco industry.

4.578 The European Communities further claims that, following the signature of the protocol, the Chilean Government appears to have had second thoughts with respect to the WTO compatibility of the terms agreed with the pisco industry. Indeed, although the protocol was signed in September 1996, the Chilean Government failed to act upon it for nearly one year, which caused considerable alarm among the pisco producers.[282]

4.579 The European Communities argues that, following insistent calls by the pisco industry and the representatives of regions III and IV in Congress[283], a new proposal embodying the terms of the protocol was eventually presented by the Government to Congress on 9 June 1997. This bill was approved by the Chamber of Deputies on 30 September 1997, and by the Senate (without debate) on 4 November 1997.

4.580 According to the European Communities, the minutes of the Chamber of Deputies' debate on 17 July 1997[284] provide an extensive record of the objectives pursued by its proponents, among whom the representatives of regions III and IV figured very prominently. While declaring their support for the amendment, the representatives of those regions emphasized its negative impact for the pisco producers in their constituencies. The European Communities argues that, in doing so they were led to admit openly that pisco is directly competitive and substitutable with other distilled spirits (and in particular with whisky) and that the ILA had been effective in providing protection to the pisco industry.

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[281] The European Communities notes that to the best of the EC's knowledge, the Chilean Government did not sign similar "protocols" with any other interested party of the "private sector", such as the importers of whisky.

[282] *See El Mercurio*, 10 April 1997 (EC Exhibit 45).

[283] *Ibid*. *See also Las Ultimas Noticias*, 7 November 1996 (EC Exhibit 38); *La Segunda*, 12 February 1997 (EC Exhibit 41); and *El Diario*, 13 February 1997 (EC Exhibit 43).

[284] Attached as EC Exhibit 16.

4.581 The European Communities claims that the positions taken by the pisco industry during the amendment process of the ILA show that its overriding concern was to preserve a large tax differential between low strength pisco and whisky, even at the expense of increasing the tax on high strength pisco. According to the European Communities, this concern would have been totally irrational unless maintaining a tax differential between low strength pisco and whisky served to afford protection to the pisco industry.

4.582 The European Communities goes on to state that the pisco industry requested that the 1995 Proposal be amended so that, between 35° and 42°, the tax rate increased by 6 percentage points per each additional degree of alcohol instead of by 5 percentage points. This request would have increased the rate on *pisco reservado* from 50 % to 55 % and the rate on *gran pisco* from 65 % to 73 %. The European Communities claims that, for the pisco industry it would have been senseless to make such a demand unless it had been convinced that increasing the tax on whisky would afford additional protection to the pisco industry as a whole.

4.583 The European Communities further states that later in the legislative process, the pisco industry opposed an amendment of the 1995 Proposal that would have lowered the tax rate on spirits above 39 ° to 40-45 % (instead of 50 %). This amendment would have benefited not only whisky and other imported spirits above 39°, but also *pisco reservado* and *gran pisco*. Again, according to the European Communities, the pisco industry's position would have been irrational unless it was premised on the conviction that, overall, a larger tax differential between low strength pisco and whisky would afford additional protection to pisco, despite the "sacrifice" of high strength pisco.

4.584 The European Communities also claims that according to the official reports of the Foreign Relations Committee of Chile's Chamber of Deputies, Capel and Control submitted two requests to that Chamber in the course of the parliamentary debate of the New Chilean System. Specifically, the Committee's reports read in relevant part as follows:

> [Capel and Control] point out that in accordance with the wording of the draft, pisco is withdrawn as a taxed substance since the draft refers to spirits, in which category pisco is not included; the same holds for pisco which is excluded from the regulation as a specific concept.
>
> They propose that the rate should vary by 6 % for each degree in alcohol instead of the 5 % proposed by the single article of the draft. They also suggest editorial changes to avoid confusion arising from vagueness in concepts used.[285]

4.585 In the view of the European Communities, in any event, a document provided by Chile in response to questions deals exclusively with the first of the two requests above mentioned. The reasons which led the pisco industry to demand an increase of the taxes on high strength pisco (the second of the above mentioned requests) still await an explanation by Chile. According to the European Communities, the only rational explanation for such an unusual demand is that the pisco industry was

[285] *See* EC Exhibit 17, p.5.

seeking to increase the tax differential between whisky and low strength pisco, which accounts for the vast majority of pisco sales.

4.586 **In rebuttal, Chile argues** that such points argued by the European Communities are simply an attempt to impugn the New Chilean System because, in Chile's democracy, a domestic industry seeks to have the tax or trade system be as favorable to it as possible, and the Chilean Government tried to obtain an understanding of a domestic industry that faced a wrenching change to the tax system that had been in effect for many years.

4.587 In the view of Chile, in the same vein, the European Communities devotes many pages listing excerpts from Chile's legislative debate about the new taxation system. Some of these examples show that legislative representatives of the regions that produce pisco in Chile were seeking to minimize the adverse effects of a New Chilean System on pisco producers and, because adverse effects could not be avoided, also sought other government help for their constituents. At least in the case of the legislative history, the European Communities, while presenting a distorted picture, did note many remarks from legislators who announced that the new system was eliminating discrimination against foreign products. Chile submits that if such developments infringe Article III or are even evidence of such infringement, then all WTO Members are in deep peril, not least the European Communities.

4.588 Chile contends that the Memo No. 5886 was prepared in connection with the first bill submitted to Congress in November 1995, for amending the tax system on alcoholic beverages. As the Panel and the European Communities are aware, this bill was eventually replaced by the Government and some time later an amendment bill was introduced which eventually became actual Law No. 19.534. The memo is therefore completely irrelevant to this case. In addition, this Memo was originally an internal document prepared by a lawyer of Cooperativa Control for his General Manager, whereby he gives certain explanations about the system apparently used in the bill before Congress for taxing different alcoholic beverages, according to the definitions of the same contained in several Chilean Regulations.

4.589 Chile argues that it appears worth pointing out to the Panel, that any motivation the industry or other sectors in Chile may have had during the rather lengthy discussing process that eventually led to the inacting of Law 19,534, are at this stage completely irrelevant. It has already been ruled in GATT-WTO dispute settlement system, that panels should concentrate on the results and effects of the prevailing governmental measure or piece of legislation, and not on their possible aims. Such rulings are perfectly appropriate and understandable, even more in a Civil Law system, where the text of the law - particularly when it is crystal clear as in this case - will always prevail over any interpretation.

4.590 Chile reiterates that the issue before this Panel is not the objectives of the Chilean pisco industry (or those of the Scotch Whisky Association). It is curious that the European Communities, which laboured so hard in *Japan - Taxes on Alcoholic Beverages II* to discredit the "aims and effects" test, now seems to want to revive the test for private industry. Chile has no doubt that private industry associations want to do well by their private members, and be seen to have been successful on behalf of their members.

4.591 In the view of Chile, the issue is not the motive of the different private distillers of Chile or Scotland; both doubtless would like to make as much money as possible. That is not surprising, nor does it constitute a violation of the GATT.

However, the issue before the Panel is whether the European Communities has demonstrated the three elements of a violation of Article III:2, second sentence.

4.592 Chile indicates that the Appellate Body has already cautioned against this kind of subjective effort to discern motivation. In *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body stated that the issue of "affording protection to domestic production" is an objective question of *effect*, not a subjective question of the intent of legislators.[286]

4.593 Chile further argues that the European Communities likewise has not demonstrated that the New Chilean System operates so as to afford protection to domestic production. It is true that the result of the application of Chile's uniform, objective system of taxation may be that the majority of domestic distilled spirits will be taxed at a relatively low tax rate and the majority of imports will be taxed at a relatively high tax rate (if foreign producers or importers choose not to adapt their products in the simple manner required to benefit from the lowest tax category). However, that result does not constitute a violation of Article III:2. As to the EC's claims that the New Chilean System is GATT - illegal as evidenced by political statements and the ultimate acceptance of the pisco industry of the need for this change in Chile's law, such "evidence" has about the same value as a claim that the European Communities must be violating its obligations because politicians claim to have done well by domestic farmers or because EC farmers cease demonstrating after the European Communities makes a change in farm policy. Finally, Chile has explained that there are multiple considerations behind the legislation, including significantly minimizing the regressive effects of a flat tax rate.

4.594 Chile also claims that it, in an attempt to avoid a burdensome and costly dispute settlement procedure and to address EU complaints, did not wait for a panel to decide on whether or not it ought to modify its legislation regarding its tax regime for alcoholic beverages. Chile after much consideration adopted a new final regime that Chile believes both fully complies with the GATT 1994 rules and provides immediate commercial benefit to the European Communities.

4.595 According to Chile, the Chilean legislature promulgated Law No. 19.534 on taxes on alcoholic beverages on 13 November 1997. This law provides a transitional period from 1997 to 2000 in order to permit a progressive and orderly change of the taxation regime applicable to alcoholic beverages in Chile. However, under the Old Chilean System whisky had been subject to a tax significantly higher than any other distilled spirit, which was the primary complaint of the European Union concerning the old law. To respond to those complaints, it was considered important to begin immediate phased reductions of the tax on whisky.

4.596 Chile states that it is worth recalling that the European Communities originally challenged in the WTO the Old Chilean System, which imposed taxes according to type of distilled spirits, with pisco taxed at 25%, whisky at 70% and all other spirits at 30%. Chile believed - and still does believe - that the old Chilean law was defensible because pisco is not directly competitive or substitutable with other distilled spirits in the Chilean market.

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[286] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 119-120.

4.597 According to Chile, Chile amended its tax laws, in large part because of the complaints of the European Communities, especially in regard to whisky. In addition, the decision of the Appellate Body in the *Japan - Taxes on Alcoholic Beverages II* case suggested that, if the European Communities were able to show that pisco is directly competitive or substitutable with other distilled spirits, then a tax system that differentiated by type was likely to be found inconsistent with Article III:2.
4.598 In the view of Chile, pisco has not been shown to be directly competitive or substitutable with other distilled spirits. Nevertheless Chile enacted fundamental changes in this law.
4.599 Chile claims that in amending its laws, Chile had in mind several objectives, including:

(i) maintaining fiscal revenue;
(ii) eliminating type distinctions such as those that had existed in Japan (which also would eliminate the alleged discrimination against whisky in the previous system);
(iii) discouraging alcohol consumption; and
(iv) minimizing the potential regressive aspects of reforming the tax system.

(f) Low Import Duty on Alcoholic Beverages

4.600 **Chile claims** that a second point worth noting is that Chile is not protecting its industry as the European Communities claims. If that would have been the case Chile would have concentrated its "protectionist battery" on the tariff rate. A truly effective protectionist approach would have been to increase its applied tariff from 11 % up to 25 % (its own bound rate). Chile argues that it is moving in an opposite direction than that suggested by the European Communities: Chile is about to reducing its tariff to an a-cross-the-board rate of 6% (certainly including the most diverse spirits). Instead of protecting its producers, Chile is liberalizing unilaterally.
4.601 According to Chile, products of some countries like Mexico and Canada, face no duty because they have signed free trade agreement with Chile. The European Communities can also do the same if they decide to accept its invitation to begin negotiations for a free trade agreement early next year.
4.602 **In rebuttal, the European Communities claims** that this argument of Chile conceals the fact that since the 1970s Chile has applied a single flat rate to imports of all products. This is considered as one of the basic principles of Chile's trade policy. If the Chilean authorities were to make now an exception to that principle in favour of the pisco industry, it would be difficult for them to resist similar requests from other domestic industries.
4.603 The European Communities further notes that, as noted by Chile itself, two of the main producers of spirits (Mexico and Canada) have already concluded Free Trade Agreements ("FTAs") with Chile, while the EC Commission has formally proposed to the EC Council the opening of negotiations with Chile for the conclusion of an Association agreement comprising the establishment of an FTA. Similarly, the US Executive has requested fast-track authority to negotiate a FTA with Chile. It is clear, therefore, that in the long term tariffs could not afford to Chile's pisco industry the desired level of protection. In fact, the perspective of concluding an FTA with the European Communities was precisely one of the reasons

invoked by the pisco industry during the process of adoption of the New Chilean System in order to justify its request for limiting the reduction of the taxes on whisky.[287]

V. THIRD-PARTY ARGUMENTS

A. *Canada*

1. *Introduction*

5.1 Canada indicates that it has a substantial interest in this dispute. According to Canada, Chile's tax regime imposes a much higher tax burden on imported distilled spirits than that imposed on the directly competitive or substitutable domestic distilled spirit, pisco. The taxes afford protection to the domestic pisco industry by denying imported distilled spirits, including Canadian whisky, the competitive opportunities available to pisco. This has an adverse impact on the ability of Canadian distilled spirits to compete effectively with pisco; this situation discourages efforts by Canadian exporters, and thus serves to frustrate penetration of the Chilean market. Canada restates that it was a complainant in the Japan - Taxes on Alcoholic Beverages II[288] case, and as a consequence, has an active interest in the legal issues which arise from a very similar dispute.

5.2 Canada has reviewed the submissions of the European Communities and Chile, and supports the EC position in this proceeding.

2. *Legal Arguments*

5.3 Canada welcomed the outcome of the *Japan - Taxes on Alcoholic Beverages II* case and was pleased with the principles set out by the Appellate Body for the interpretation and application of Article III:2 of GATT 1994. Canada notes that the issues which arise in the context of the Chilean liquor tax regime bear strong resemblance to matters which were under dispute in *Japan - Taxes on Alcoholic Beverages II*[289], and accordingly, the panel's disposition of the present dispute should

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[287] *See* EC Exhibit 30.

[288] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra,* footnote 41.

[289] *Ibid*., p. 27 [*sic*], in which the Appellate Body set out the issues:

> Unlike that of Article III:2, first sentence, the language of Article III:2, second sentence, specifically invokes Article III:1. The significance of this distinction lies in the fact that whereas Article III:1 acts implicitly in addressing the two issues that must be considered in applying the first sentence, it acts explicitly as an entirely separate issue that must be addressed along with two other issues that are raised in applying the second sentence. Giving full meaning to the text and to its context, three separate issues must be addressed to determine whether an internal tax measure is inconsistent with Article III:2, second sentence. These three issues are whether:
>
> (1) the imported products and the domestic products are "directly competitive or substitutable products" which are in competition with each other;
>
> (2) the directly competitive or substitutable imported and domestic products are "not similarly taxed"; and

be guided by the principles established in the panel and Appellate Body Reports[290] in that case. These principles were followed recently in a panel decision in another dispute, *Korea - Taxes on Alcoholic Beverages*.[291]

(a) "Directly Competitive or Substitutable"

5.4 Canada notes that the European Communities correctly points out that Article III:2, second sentence, applies not only to products that are actually competitive or substitutable in a particular market, but also to those that are potentially competitive or substitutable.[292] However, in Canada's view this should not be a central issue in this dispute.

5.5 Canada believes that the European Communities has adduced conclusive evidence of existing competition between pisco and imported distilled spirits in the Chilean market.[293] The reaction of the pisco industry in Chile to proposed reductions in the taxes on whisky (and increases in taxes on pisco) provides compelling evidence for the panel to deduce that there is direct competition between pisco and imported distilled spirits.

5.6 With respect to potential competition, Canada notes that the Appellate Body in *Japan - Taxes on Alcoholic Beverages II* held that GATT Article III:

> [p]rotects potential competition ... of the equal competitive relationship between imported and domestic products.[294]

5.7 Also in connection with the issue of potential competition, Canada supports the arguments made by the European Communities, and submits that the reasoning of

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> (3) the dissimilar taxation of the directly competitive or substitutable imported domestic products is "applied ... so as to afford protection to domestic production".

Canada notes that these are three separate issues. Each must be established separately by the complainant for a panel to find that a tax measure imposed by a Member of the WTO is inconsistent with Article III:2, second sentence.

[290] Panel Report on *India - Patent Protection for Pharmaceutical and Agricultural Chemical Products*, adopted on 2 September 1998, WT/DS79/R, DSR 1998:VI, 2661, para. 7.30, the panel indicated that panels:

> ….should give significant weight to both Article 3.2 of the DSU, which stresses the role of the WTO dispute settlement system in providing security and predictability to the multilateral trading system, and to the need to avoid inconsistent rulings.

[291] Panel Report on *Korea - Taxes on Alcoholic Beverages, supra,* footnote 56.

[292] Canada states that imported products that may only be potentially competitive with a domestic product should not be categorically excluded from the scope of Article III:2, second sentence. Otherwise, internal regulatory regimes that favour domestic production to such an extent that imported products are effectively barred from entering the domestic market could be rendered beyond challenge.

[293] According to Canada, the products at issue share similar physical characteristics, the same end-uses, the same HS heading, the same sales outlets, and even share the same shelf space (*see*, for example, subsections IV.D.3-6 of the EC's first written submission). There is also evidence of significant cross-price elasticity and elasticity of substitution (*see*, for example, subsection IV.D.7. of the EC's first written submission). Of course the ultimate corroboration for this view is that both Chilean authorities and the pisco industry have expressly and implicitly recognized that pisco and other distilled spirits are directly competitive and substitutable (*See*, for example, subsection IV.D.8 of the EC's first written submission).

[294] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra,* footnote 41, at 110.

the panel in *Korea - Taxes on Alcoholic Beverages*[295] is compelling for the resolution of the present dispute.

5.8 Moreover, the imported products, such as Canadian whisky, unquestionably fall within the meaning of "substitutable" products. From Canada's perspective, it is particularly noteworthy that Chilean whisky and pisco drinkers "each prefer the other spirit as a first alternative"[296] Thus, it is submitted that the products at issue are both directly competitive and substitutable.

(b) "Not Similarly Taxed"

5.9 In Canada's view, there is no doubt that pisco and the imported spirits are not similarly taxed. The Panel should reject Chile's attempt to divert attention away from the fundamental question of whether this particular measure in this particular set of circumstances constitutes dissimilar taxation. All aspects of the measure, from its transitional phase through to its final form, involve more than a *de minimis* differential in the taxation of directly competitive or substitutable products.

5.10 For example, under the transitional phase whisky is currently taxed at 65% *ad valorem*, while pisco is taxed at only 25% *ad valorem*. Although the rate for whisky will be reduced over the next few years, the lowest rate it will achieve during the transition phase is 53%, while pisco remains at 25%. It is indisputable that this constitutes dissimilar taxation.

5.11 Canada further argues that, even in its final form (i.e., the "New Chilean System") the measure taxes the products dissimilarly. Chile appears to take the position that the products are taxed similarly because the differences in taxation correspond to differences in alcohol content. Such an argument is untenable for several reasons. First, the measure is not purely a tax on alcohol content. The tax is calculated on the value of the beverage as a whole. Second, if it were purely a tax on alcohol content one would expect a uniform rate per degree of alcohol. However, the rate per degree of alcohol for pisco at 35^{o} is 0.771%, while whisky at 40^{o} is taxed at 1.175% per degree of alcohol, a level which is 50% higher. Third, if it were purely a tax on alcohol content one would not expect the same rate of tax to be applied to beverages with different alcohol strengths. However, the tax rate for whisky at 40^{o} (47% *ad valorem*) is the same as that applicable to gran pisco at 50^{o}, despite the ten degree difference in alcohol content.[297]

5.12 Canada states that in any event, the measure is a tax on the value of the beverage, not the value of that which is purportedly being taxed - alcohol content. Viewed from this perspective, the tax of 47% of the value of a bottle of whisky at 40^{o} alcohol content, is dissimilar to the 27% *ad valorem* tax on a directly competitive or substitutable bottle of pisco with 35^{o} alcohol content.[298]

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[295] Panel Report on *Korea - Taxes on Alcoholic Beverages, supra*, footnote 56, paras. 10.47 - 10.50.

[296] 1997 SM survey (referenced at para. 130, and EC Exhibit 21at page iv).

[297] The measure provides that the tax rate applicable to spirits with an alcohol content over 39° is 47%. *See* paragraph 52 and Table 5 of the EC's first written submission.

[298] Canada points out, that as noted by the EC (at paragraph 173 of EC First Submission), such a tax differential is greater than *de minimis*.

5.13 In short, according to Canada, Chile is attempting to hide a discriminatory regime behind the facade of a purportedly "objective" product difference. However, dissimilar taxation is evident irrespective of whether the tax is viewed as tied to the value of the beverage, or to alcohol content. If Chile's transitional and new tax regimes on spirits are accepted by the Panel, this would provide WTO Members with a blueprint for circumventing their Article III:2 second sentence obligation simply by establishing spurious product categories. The Chilean regime is a thinly disguised discriminatory measure that maintains the protection of the domestic pisco industry. If this regime were to be found consistent with GATT Article III:2, other Members may be tempted to implement similar regimes in order to protect domestic production, with the ultimate effect that Article III could be seriously undermined.

5.14 Canada concludes, that the Chilean argument that there is no jurisprudence establishing that taxes must be proportional, should not cloud the issue whether Chile's taxes are dissimilar. In Canada's view, an examination of the taxation rate per degree of alcohol or of the taxation rate per bottle, demonstrates that the taxes applicable to the majority of domestic pisco are not similar to the taxes for the majority of the directly competitive or substitutable imported distilled spirits.

(c) "So As to Afford Protection"

5.15 Canada recognizes that an *ad valorem* tax is not inherently inconsistent with Article III:2, second sentence. Rather, it is the manner in which Chile is applying this particular *ad valorem* tax that is contrary to Article III:2, second sentence. As previous panels have found, and the Appellate Body has affirmed:

> Article III:2 does not prescribe the use of any specific method or system of taxation. ... Since Article III:2 prohibited only discriminatory or protective tax burdens on imported products, what mattered was, in the view of the Panel, whether the application of the different taxation methods actually had a discriminatory or protective effect against imported products.[299]

5.16 Canada argues that several aspects of the design, architecture and structure of Chile's tax regime establish its protective application. First, the sheer magnitude of the tax rate differential in this case is sufficient to establish that the measure is applied so as to afford protection to the domestic pisco industry in Chile. Second, the measure's structure ensures that the vast majority of Chile's production of distilled spirits (primarily pisco) will continue to be eligible for the lowest possible tax rate (27%), while almost all imported distilled spirits will continue to be taxed at the highest rate (47%). Protection for pisco is further ensured by legislation requiring certain imported distilled spirits (notably those that appear to be most competitive with and substitutable for pisco, such as whisky) to have a minimum alcohol strength of 40^{o}. As applied, the tax rates would create a wide, protective buffer zone for domestic pisco in relation to imported distilled spirits.

[299] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 123 [sic], citing the Panel Report on *Japan - Taxes on Alcoholic Beverages I, supra*, footnote 50, para. 5.9 c).

5.17 Canada argues that the combination of these and the other factors identified by the European Communities is to deny imported distilled spirits the competitive opportunities available to Chilean pisco. Canada notes that, similar to the situation in *Japan - Taxes on Alcoholic Beverages II*,[300] the Chilean measure fails to guarantee equality of competitive conditions between the imported and domestic products, and makes it difficult for imported distilled spirits to penetrate the Chilean market. In effect, it "isolates" pisco from foreign competition by imported distilled spirits.

5.18 Canada notes, that while the European Communities correctly challenges the absence of a legitimate policy purpose, it is important that its assertion not be interpreted to suggest that the existence of such a purpose would make the regime consistent with Article III:2. The fact that a measure may have a non-protectionist policy objective does not make that measure consistent with Article III:2, second sentence.[301] As noted by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*:

> If the measure is applied to imported or domestic products so as to afford protection to domestic production, then it does not matter that there may not have been any desire to engage in protectionism in the minds of the legislators or the regulators who imposed the measure. It is irrelevant that protectionism was not an intended objective if the particular tax measure in question is nevertheless, to echo Article III:1, "*applied* to imported or domestic products so as to afford protection to domestic production".[302]

5.19 Canada further notes that it is equally important to remember that the Appellate Body has made it clear that it is not necessary to provide evidence of protectionist intent in order to prove that a measure affords protection to domestic production.[303] However, this does not mean that the statements of Chilean officials

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[300] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 123 [sic], citing the Panel Report on *Japan - Taxes on Alcoholic Beverages I, supra*, footnote 50, para. 5.9 c).p. 34 [*sic*], where the Appellate Body, in discussing the protective application of the measure, quotes paragraph 6.35 of the Panel Report as follows:

> [W]e conclude that [the panel] reasoned correctly that in this case, the Liquor Tax Law is not in compliance with Article III:2. As the Panel did, we note that:
> [t]he combination of customs duties and internal taxation in Japan has the following impact: on the one hand, it makes it difficult for foreign-produced shochu to penetrate the Japanese market and, on the other, it does not guarantee equality of competitive conditions between shochu and the rest of 'white' and 'brown' spirits. Thus, through a combination of high import duties and differentiated internal taxes, Japan manages to "isolate" domestically produced shochu from foreign competition ...

[301] Canada notes that if a WTO Member wants to maintain a measure that is inconsistent with Article III:2, it must meet the conditions set out in GATT Article XX.

[302] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 122 [sic].

[303] In *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 122), in describing what must be shown in order to establish that a tax is "protective", the Appellate Body stated:

> This is not an issue of intent. It is not necessary for a panel to sort through the many reasons legislators and regulators often have for what they do and weigh the relative significance of those reasons to establish legislative or regulatory intent.

and the Chilean pisco industry are irrelevant. Their statements regarding the need and means to protect the pisco industry help to confirm the protective design, architecture and structure of the measure.

5.20 Canada argues that, in any event, claims about the protection of public health are not supported by the facts. Such claims can only be viewed as *ex post facto* justification, in the light of statements by Chilean officials and pisco industry representatives, to the effect that the taxation regime is designed to protect the pisco industry from competition by imported distilled spirits.

5.21 Canada stresses that Chile cannot justify the dissimilar taxes on the basis that certain Chilean products may be subject to the higher tax rates, while certain imported products may benefit from the lower tax rates. There is nothing in Article III:2, nor any of the GATT or WTO panel or Appellate Body reports, that can be used to justify a taxation measure that benefits the majority of a domestic industry's production, and places the majority of the directly competitive or substitutable products at a competitive disadvantage to the domestic products. To the contrary, following the reasoning of the Appellate Body in the *Japan - Taxes on Alcoholic Beverages II* case, if there is dissimilar taxation of some imported products in comparison with directly competitive or substitutable domestic products, this is sufficient to meet the test of "not similarly taxed".[304]

5.22 Canada concludes that Chile misconstrues the concept of equality of competitive opportunities, by suggesting that foreign producers can adapt their production to benefit from lower taxes. In Canada's view, the converse is true, i.e. if foreign producers must adapt their production and thereby lose the value of their product name in order to benefit from the lower tax, their imported products would be at a competitive disadvantage to the vast majority of pisco, which would not have to meet these burdens.

B. Mexico

1. Introduction

5.23 Mexico does not agree with Chile that the Transitional System is not at issue in this dispute. On the contrary, Mexico considers that since the system has been incorporated into the transitional period, it corresponds to "the matter referred to the DSB", and that the Panel must determine whether the two systems i.e. the Transitional and New Chilean Systems are inconsistent with Article III.2 of the GATT 1994.

5.24 As mentioned by the European communities in their submission, the products at issue are, on the one hand, pisco, and, on the other hand, all the other distilled spirits falling within the heading HS 22:08 of the Harmonized System (HS)

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[304] *Japan - Taxes on Alcoholic Beverages II*, *supra*, footnote 41, at 119. Moreover, it is noteworthy that in *United States - Section 337*, the panel found:

> ... that the "no less favourable" treatment requirement of Article III:4 has to be understood as applicable to each individual case of imported products. The Panel rejected any notion of balancing more favourable treatment of some imported products against less favourable treatment of other imported products.
> Panel Report on *United States - Section 337, supra*., para. 5.14.

nomenclature. The European Communities provided an illustrative list of these products, expressly including tequila.

5.25 Mexico insists that tequila and pisco are "like products" in the sense of Article III.2, first sentence, of the GATT 1994, but is merely requesting the Panel to find that tequila and pisco are directly competitive or substitutable products[305] in the sense of Article III.2, second sentence, of the GATT 1994.

5.26 In this connection, Mexico agrees with the parties to the dispute in their endorsement of the conclusions of the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*[306] according to which the following rules must be applied to determine the inconsistency of an internal tax measure with Article III.2, second sentence:

(i) The imported products and the domestic products must be "directly competitive or substitutable products" which are in competition with each other;

(ii) the directly competitive or substitutable imported and domestic products must not be *"similarly taxed"*; and

(iii) the dissimilar taxation of the directly competitive or substitutable imported and domestic products must be applied "… so as to afford protection to domestic production".

2. Legal Arguments

(a) "Directly Competitive or Substitutable"

5.27 In order to determine which products belong to this category, the following criteria should be applied[307]:

(i) Physical characteristics;

(ii) common end-uses;

(iii) tariff classification;

(iv) the "market-place".

(i) Physical Characteristics

5.28 Mexico disagrees with Chile's assertion that the products under consideration have virtually no characteristics in common. The two characteristics mentioned in the Panel Report on *Korea - Taxes on Alcoholic Beverages*[308] are fully applicable to the comparison between pisco and tequila as well: they are both distilled spirits, bottled and labelled in a similar manner.

5.29 Mexico notes that the Panel Report on *Japan - Taxes on Alcoholic Beverages II* states that the physical characteristics are not the decisive criterion for determining

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[305] Panel Report on *Korea - Taxes on Alcoholic Beverages, supra*, footnote 56, para. 10.38, agrees with the statement by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II, supra,* footnote 41, that the category of "directly competitive or substitutable products" is broad.

[306] Appellate Body Report *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 116.

[307] These criteria were established by the panel and adopted by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II* , *supra*, footnote 41, at 117.

[308] Panel Report on *Korea - Taxes on Alcoholic Beverages*, *supra*, footnote 56, para. 10.67.

whether products are competitive or substitutable.[309] However, Mexico agrees with the European Communities when it asserts that "if two products have sufficiently similar physical characteristics, such similarity may of itself be sufficient to conclude that the products in question are apt to serve for the same end-uses".[310]

(ii) End-Uses

5.30 Mexico notes that the European Communities, in their submission, refers to the findings of the Panel in *Japan - Taxes on Alcoholic Beverages II* according to which the end-uses are the "decisive criterion" for establishing whether two products are directly competitive or substitutable.

5.31 Mexico further notes that the 1997 SM Survey[311] shows that tequila and pisco have the same end-uses in at least the following respects:

(i) drinking styles: both spirits are most likely to be consumed with a mixer beverage (such as cola);

(ii) drinking occasions: Chilean consumers of spirits considered "parties", "with friends", "family meetings" and "weekends" to be the most common occasions for the consumption of pisco or tequila, while the categories "after work", "aperitif", "during week" and "digestive" were considered less common;

(iii) drinking places: both spirits are mainly consumed "at home" or at a "friend's house";

(iv) availability in sales channels: the most common sales channels for both beverages are "supermarkets" and "liquor stores", while "gift shops", "duty-free", "others" and "airlines" are uncommon as sales channels in both cases; and

(v) types of consumers: in the Chilean market, women tend to drink more pisco and/or tequila than men.

5.32 Furthermore, the recipe brochures mentioned by the European Communities[312] suggest that the producers of pisco themselves perceive pisco and tequila as products with a common final use, i.e. the preparation of "margaritas".

(iii) Tariff Classification

5.33 Mexico notes that both beverages come under HS subheading 2208.90, i.e. they are at the same six-digit level, which is the Harmonized System's most advanced and specific classification. In Mexico's view, it is also worth noting that the Appellate Body in *Japan - Taxes on Alcoholic Beverages II* pointed out that if "sufficiently detailed, tariff classification can be a helpful sign of product similarity".[313]

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[309] Panel Report on *Japan - Taxes on Alcoholic Beverages II,* supra, footnote 45, para. 6.22.

[310] *See* EC First submission, para. 109.

[311] *See* EC Exhibit 21.

[312] *See* EC First submission, para. 140.

[313] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 41. Various panels shared that opinion, such as *EEC - Measures on Animal Feed Proteins, supra*,

5.34 Regarding the mutual substitutability of tequila and pisco in the Chilean market, Mexico refers to the EC's Exhibit 22, Table 4.1.2, which purportedly shows that 17 per cent of consumers of Chilean spirits would buy tequila if they intended to buy pisco and did not find it, while 56 per cent would buy pisco if they could not find tequila.

5.35 As regards cross-price elasticity, the analysis submitted by the European Communities[314] shows a 44.8 per cent change in response to a 27 per cent tax on all spirits instead of the tax currently applied. The table shows a considerable price elasticity.

(iv) Recognition of Government of Chile

5.36 Mexico points out that in addition to the evidence presented by Mexico, it should be noted that Chile implicitly accepted that pisco and the other spirits at issue in this case are directly competitive or substitutable. More specifically, Chile states that the examples provided by the European Communities concerning the background to the new law "show that legislative representatives of the regions that produce pisco in Chile were seeking to minimize the adverse effects of a New Chilean System on pisco producers and, because adverse effects could not be avoided, also sought other government help for their constituents".[315] Mexico asks rhetorically, what adverse effects would the new system have if the products were not "directly competitive or substitutable"?

(b) "Not Similarly Taxed"

5.37 As can be seen in Table I of Mexico's submission, the tax differentials show a margin of discrimination of 120 per cent and 174.4 per cent between pisco and tequila under the "Old Chilean System" and the "New Chilean System" respectively.

5.38 Moreover, Mexico agrees with the panel and the Appellate Body in *Japan - Taxes on Alcoholic Beverages II* when they argue that the amount of differential taxation must be more than *de minimis*, as determined on a case-by-case basis.[316] In the case at issue, the differentials in the rate of taxation suffice to establish that they are in excess of any *de minimis* criterion.

(c) "So as to Afford Protection"

5.39 Mexico notes that the panel in *Korea - Taxes on Alcoholic Beverages*[317] endorses the conclusion of the Appellate Body in *Japan - Taxes on Alcoholic Beverages II,* focussing on the objective factors underlying the tax measure in question including its design, architecture and the revealing structure.

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footnote 51, *Japan - Taxes on Alcoholic Beverages I, supra*., and *United States - Standards for Reformulated and Conventional Gasoline, supra,* footnote 60.

[314] *See* Table 4.2.2, EC Exhibit 22.

[315] *See* Chile First submission, para. 71.

[316] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 119. This same argument was used by the Panel in *Korea - Taxes on Alcoholic Beverages, supra*, footnote 56, para. 10.100.

[317] Panel Report on *Korea - Taxes on Alcoholic Beverages*, *supra*, footnote 56, para. 10.101.

5.40 In the case at issue, the following elements show that Chile imposed its tax scheme in order to afford protection to its domestic industry:

(i) the amount of the differential taxation (see Table I);

(ii) the structure of the Chilean tax system;

(iii) the fact that the great majority of distilled spirits produced on the Chilean market have an alcohol strength of 35° or less;

(iv) the fact that most imported distilled spirits have an alcohol strength of more than 35° and, in many cases, more than 39°.

5.41 Mexico notes that as regards design, architecture and the revealing structure of the measure, Chile accepted that its new system was "biased" against relatively higher alcohol products. Chile denied however, that this was a means of affording protection to domestic production[318] on the grounds that the producers of other spirits could benefit from the system by diluting their products with water or switching their exports to beverages benefiting from a lower level of taxation.[319]

5.42 According to Mexico, Chile's proposals are obviously not only unworkable, but also irrelevant. The product that Mexico is interested in exporting to Chile is tequila. Apart from the fact that under Chilean law, tequila must have a minimum alcohol strength of 40°[320], and that it must comply with the corresponding Mexican Official Standard to be marketed under that name, it is obvious that the consumer of tequila wants tequila and not water. Mexico points out that if its intention had been to export spirits with a strength of 35° or less, it would not have bothered to participate as a third-party in this dispute. In Mexico's view, these arguments by Chile simply confirm that the protection afforded to national production is so high that the only way of competing on an equal footing with Chilean beverages would be to change the quality of the imported products or the products themselves.

5.43 Mexico further notes that Chile agrees with the European Communities that in its system, different levels of alcohol strength are taxed differently, but argues that Article III:2 of the GATT 1994 has never been interpreted to require a direct proportionality rule. It points out that the Panel in *Japan - Taxes on Alcoholic Beverages I*, only suggested that taxation must be based on objective criteria. The Chilean system of taxation is not, nor can it be considered to be, based on "objective criteria". Chile gives no satisfactory explanation of how a margin of discrimination of 174.07 per cent[321] applied to the difference of little more than 4° in alcohol strength under the Chilean tax structure (between 35° and 39°) can be seen as being based on "objective criteria". Mexico is not challenging the fact that the Chilean tax varies according to the alcohol strength of the beverages: it is challenging the way in which that tax is applied. Mexico further argues that, the purpose and effect of the Chilean system is to protect national production against imports of products that are directly competitive with or substitutable for Chilean beverages.

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[318] Chile First submission, para. 68.

[319] *Ibid.*, para. 73.

[320] *See* Article 12 of the Regulation Implementing Law No. 18455, published in the Official Journal of 23 October 1986 and appearing as Appendix 2.2 of EC Exhibit 12.

[321] *See* Table I.

5.44 Mexico argues that in considering the fact that the national production of spirits in Chile is dominated by pisco with an alcohol strength of 35° or less, it is interesting to refer to Table II below. Mexico points out this table was prepared on the basis of Table 8 which forms part of Annex III of Chile's written submission, and shows, in terms of volume, the share of pisco with a strength of 30° and 35° in the Chilean market. Moreover, according to the European Communities, with the exception of 1992, the share of pisco in the Chilean spirits market grew constantly from 44.1 per cent in 1982 to 73.8 per cent in 1996.

5.45 Mexico notes that Chile, in its own written submission,[322] reveals the substantial share of imports of spirits with a strength of 40° or more in the Chilean market. It should be observed that tequila is not expressly mentioned[323], so that the percentage shares are in fact higher than those shown.[324]

5.46 Mexico further notes that according to the European Communities, imports of whisky and tequila (the two most popular beverages after pisco) account for 93.6 per cent and 100 per cent respectively of the Chilean market for those spirits.[325] It is curious that under the New Chilean System, these two products are taxed the most heavily; and, the tax applied to tequila will now increase from 30 per cent to 47 per cent. This in itself should be sufficient evidence that the Chilean system is designed to protect domestic production.

5.47 Mexico concludes that it has proved that the Chilean tax system is contrary to the provisions of Article III.2, second sentence, of the GATT 1994, and therefore requests that the Panel:

(a) find that the Chilean system for the taxation of spirits violates the second sentence of Article III.2 of the GATT 1994 in order to help the DSB in making the recommendations or issuing the resolutions provided for under the GATT 1994;

(b) find that the measure at issue nullifies or impairs benefits under the GATT 1994 by favouring pisco in a manner contrary to that Agreement.

Table I

Margins of Discrimination

	Pisco	**Tequila**	**Margin of discrimination**
Tax applied under the "old system"	25%	30%	120%
Tax applied under the "new system"	27%	47%	174.07%

[322] *Ibid.,* Annex III, Tables 1-7.

[323] The table provided by Chile only mentions the following spirits as having a strength of 40° or more: whisky, rum and other white spirits, gin and geneva, and, for 1996 and 1997, vodka as well.

[324] *See* Table III.

[325] Tables 9.A and 9.B of EC First submission, p. 36

Table II

Share of Pisco with a Strength of 35° or Less in the Chilean Spirits Market

	1991	**1992**	**1993**	**1994**	**1995**
Pisco 30°	64.51%	60.50%	52.29%	41.57%	33.53%
Pisco 35°	5.27%	8.45%	17.56%	26.69%	35.57%
Total of the two piscos	69.78%	68.95%	69.85%	68.26%	69.10%

Table III

Market Share of Spirits with a Minimum Strength of 40°

	1991	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**
Volume	82.65%	81.31%	76.37%	66.81%	60.00%	50.83%	54.37%
Value	86.57%	84.69%	79.38%	78.02%	71.09%	59.5%	59.63%

C. Peru

5.48 Peru briefly stated that it considers that the Chilean system of taxation of alcoholic beverages is discriminatory, contrary to Article III:2 of GATT 1994, and causes harm to Peruvian exports of alcoholic beverages to Chile.

5.49 Peru also referred to an issue it has raised in two DSB meetings, regarding the propriety of the use of the term pisco by Chile.[326] Peru stated that it was an exporter of pisco to Chile and since the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) would only enter into force in Chile and Peru in the year 2000, Peru wished to reserve its rights to invoke Article 22.1 of the TRIPS Agreement and other provisions related thereto. Peru considered that the geographical indication "Pisco" was Peruvian and as such gave Peru exclusive rights.

D. United States

1. Introduction

5.50 The United States asserts that Latin America is a key growth market for its distilled spirits producers, who have undertaken significant efforts to promote U.S. products in the region. U.S. exports of distilled spirits to Peru and Venezuela have grown by 52% and 116% respectively over the past two years, following the elimination of discriminatory measures.[327] However, despite significant economic growth in Chile, U.S. distilled spirits exports have not witnessed similar growth, due to Chile's history of discriminatory taxation.

[326] Peru has previously expressed its position at two DSB meetings on 18 November 1997, and 25 March 1998 (*see* WT/DSB/M38 & WT/DSB/M/44).

[327] According to the United States, in June 1993 Peru replaced its discriminatory selective consumption tax (10% for pisco and 50% for other spirits) with a single ad valorem tax of 10%. Similarly, Venezuela presently assesses a rate of Bs.10 per liter for all alcoholic beverages.

5.51 The United States further asserts that in 1996, it exported approximately $1.1 million in distilled spirits to Chile.[328] Whiskey, which includes Bourbon and Tennessee whiskey, two distinctive types of American whiskies produced from fermented grains, accounted for 29.7% of the total U.S. exports of the distilled spirits at issue in this dispute.[329] Other traditional spirits at issue are rum, gin and vodka, which accounted for 61.4% of these exports. The remaining 9% of U.S. exports to Chile include liqueurs (3.3%) and pre-mixed cocktails.[330]

5.52 The facts developed by the European Communities conform to the experience of the U.S. exporting industry. Chile's measures at issue consist of two elements: (1) the current Transitional System, which applies different tax rates for particular product categories, and (2) the New Chilean System, which will tax on the basis of alcohol content (through Law 19.534, an amendment to its Decree-Law 825/1974).

5.53 As a legal matter, the United States considers that:

(i) The Transitional System on distilled spirits, applicable until 30 November 2000, is inconsistent with the second sentence of Article III:2 of GATT 1994 because it provides for lower internal taxes on the domestic spirit "pisco" than on directly competitive or substitutable imported spirits falling into the tax categories of "whisky" and "other spirits", and is applied so as to afford protection to Chile's domestic production of pisco; and

(ii) The New Chilean System on distilled spirits, applicable as of 1 December 2000, is inconsistent with the second sentence of Article III:2 of GATT 1994 because it results in the imposition of lower taxes on domestic spirits with an alcohol content of 35 degrees or less than on directly competitive or substitutable imported spirits that have a higher alcohol content, and is applied so as to afford protection to Chile's domestic production.

2. Legal Arguments

(a) General

5.54 As the European Communities notes in its submission, the Appellate Body has clarified the interpretation of Article III:2, second sentence in *Japan - Taxes on Alcoholic Beverages II*. The Appellate Body stated that in order to find an internal tax measure inconsistent with the second sentence of Article III:2, three separate elements must be satisfied:

(i) the imported products and the domestic products must be "directly competitive or substitutable products" which are in competition with each other;

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[328] *See* U.S. Exhibit 1, the 1996 data on U.S. distilled spirits exports to Chile (by class). The 1996 data are the most recent and most complete available.

[329] *See* 27 CFR Sec. 5.21.

[330] The United States notes that the majority of the 5.7% of the "other" category in U.S. Exhibit 1 consists of ethyl alcohol, a product used for industrial purposes and as a primary input for the production of other distilled spirits; ethyl alcohol is not at issue in this dispute. A *de minimis* portion of the "other" category includes pre-mixed cocktails.

(ii) the directly competitive or substitutable imported and domestic products must be "not similarly taxed"; and

(iii) the dissimilar taxation of the directly competitive or substitutable imported domestic products must be "applied ... so as to afford protection to domestic production",[331] which requires an examination of "the underlying criteria used in a particular tax measure, its structure, and its overall application..."[332] These underlying criteria include the "design, the architecture, and the revealing structure of a measure", the "magnitude of the dissimilar taxation", and "all the relevant facts and all the relevant circumstances in any given case".[333]

5.55 The United States notes that, with respect to the first element - whether two products are "directly competitive or substitutable" - the European Communities argues convincingly that all types of pisco, regardless of alcohol content, are the same product; that pisco and all other distilled spirits share the same basic physical characteristics; that pisco and all other distilled spirits have the same end-uses; that pisco and all other distilled spirits fall within the same HS heading, HS 22.08; that pisco and all other distilled spirits are sold in the same sales channels; and that there is significant cross-price elasticity between pisco and the all other distilled spirits. In fact, the European Communities establishes that not only is there a close competitive relationship between imported spirits and domestic pisco, but that all distilled spirits at issue are directly competitive or substitutable with each other.

5.56 According to the United States, there is also ample evidence that both the Transitional System and the New Chilean System involve dissimilar tax treatment as between domestic and imported products, and afford protection to domestic production.

(b) Old Chilean System: Background

5.57 The United States argues that an examination of the tax system immediately preceding the present Transitional System helps to show the protective structure of both the present regime and the regime to take effect in the year 2000. The EC's account of the debate in the Chilean government concerning the Old Chilean System and the process of adopting the Transitional System and the New Chilean System demonstrates that protectionist forces prevailed in their effort to ensure that the new systems would create the same protective effect as the Old Chilean System they were introduced to replace.[334]

5.58 The "Old" Chilean System, established by Decree-Law 825/1974, was in effect from June 1979 to 30 November 1997. It explicitly classified all distilled spirits into three particular product categories: pisco, whisky, and "other spirits".

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[331] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41. The three elements approach was most recently used in the Panel Report on *Korea - Taxes on Alcoholic Beverages*, *supra*, footnote 56, paras. 10.34-10.102.

[332] *Ibid*., p. 29.

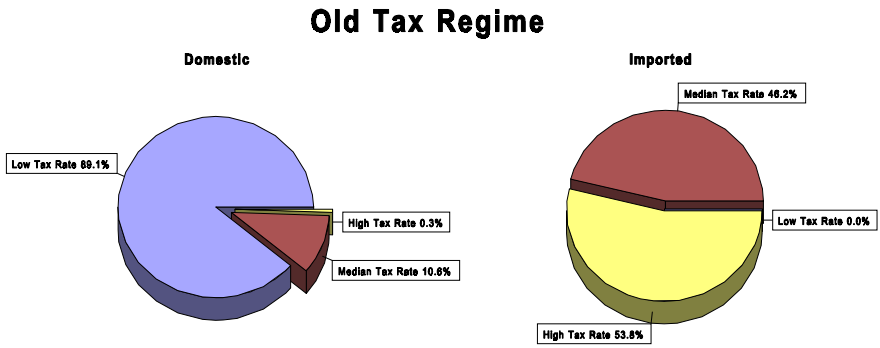
[333] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II,* supra, footnote 41, at 120.

[334] *See* EC First Submission, paras. 61-78.

Prior to its termination it applied an *ad valorem* tax rate of 25% to pisco, 70% to whisky, and 30% to all other spirits.[335]

5.59 According to the United States, the Old Chilean System taxed imports and domestic products in a dissimilar fashion, thus satisfying the second element of the Appellate Body's approach to the second sentence of Article III:2. The magnitude of the difference between the rates for whisky and pisco speaks for itself; the 5% differential in the tax rates applied to pisco and other imported distilled spirits is also beyond *de minimis.* Given the tight competition between distilled spirits, for example those that are used with mixers (e.g., pisco and Puerto Rican rum), even a small variation in price such as a 5% difference in taxation can sufficiently skew purchasing decisions.

5.60 Turning to the third element of the Appellate Body's analysis, that of protective application, the United States argues that because pisco has a 73.8% share of the Chilean distilled spirits market as of 1996,[336] the higher relative taxes on all other distilled spirits could be expected to afford protection to pisco. Furthermore, all pisco is by definition domestic. According to Chilean Law No. 18,455/85 and Law-Decree 78/1986, "pisco" is a protected geographical indication that can only be used for Chilean-made pisco. Therefore, the dissimilar taxation of the Old Chilean System was applied so as to afford protection to domestic production.



5.61 The United States argues that the Old Chilean System resulted in the taxation of 89.1% of all domestic spirits at the lowest rate, 10.6% of all domestic spirits at the median rate, and a mere 0.3% of all domestic spirits at the highest rate. In turn, the Old Chilean System taxed 53.8% of all imported spirits at the highest rate, 46.2% of all imported spirits at the median rate, and no imported spirits at the lowest rate.[337]

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[335] Throughout the existence of Decree-Law 825/1974, the tax rates for whisky and for other distilled spirits fluctuated repeatedly; however, the tax rate for pisco remained steady at 25%.

[336] *See* Table 9A in EC First Submission.

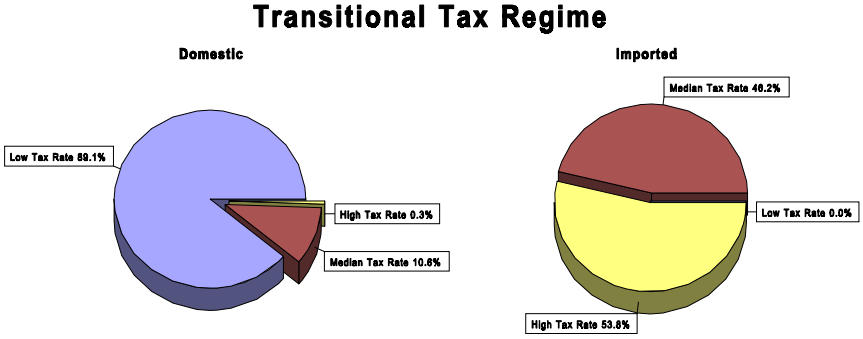
[337] *See* Graph 1. To calculate the Chilean market shares of domestic and imported products in each tax regime (Graphs 1, 2 and 3), the United States utilises the 1996 sales data from the ISWR report, as provided in EC Exhibit 19, and Tables 1, 9A and 9B of EC First Submission. The 1996 data are the most recent and most complete available. Furthermore, the submission excludes from these calculations the "other" spirits category from the ISWR report, because the report is silent as to the

5.62 The highest tax rate, applied almost exclusively to imports, was 180% greater than the lowest rate. In the *Japan - Taxes on Alcoholic Beverages II* and *Korea - Taxes on Alcoholic Beverages* cases, the differences in the arbitrary rates and their relative effects on imports and domestic products were themselves evidence of a protective structure; in the case of the Old Chilean System, the structure was also arbitrary in that it established different tax rates for the three product categories, with no discernible rationale.

(c) Transitional System

5.63 The United States notes that the present tax system is a transition from the old to the new one. Established by Law 19,534, it will remain in place until 30 November 2000. Even Chilean government officials recognized the discriminatory nature of the Old Chilean System, and the features duplicated in the transitional regime permit a similar conclusion with respect to this substitute.

5.64 According to the United States, an examination of the Transitional System reveals that pisco and directly competitive or substitutable imported distilled spirits are also not "similarly taxed". The Transitional System maintains the same, distinct product categories as the Old Chilean System for pisco, whisky and other spirits. And although the Transitional System reduces the tax rate for whisky from 70% to 53% over a span of three years, the tax discrimination remains, since whisky is still taxed much more than pisco (25%) and other spirits (30%).



5.65 With respect to the third element of the analysis, the Transitional System's design, architecture and structure reveals a measure that again taxes 89.1% of all domestic spirits at the lowest rate, 10.6% of all domestic spirits at the median rate, and a mere 0.3% of all domestic spirits at the highest rate. Similarly, it taxes 53.8% of all imported spirits at the highest rate, 46.2% of all imported spirits at the median rate, and no imported spirits at the lowest rate. In fact, the only difference between the Old Chilean System and the Transitional System is the magnitude of the dissimilar taxation: While the medium tax rate remains 20% greater than the lowest tax rate, the highest tax rate is reduced from 180% greater than the lowest rate to

identity and the alcohol content of the vast majority of these spirits. *See* EC Exhibit 19, p. 97. (Also, *see* U.S. Exhibit 2 for details of these calculations).

112% greater than the lowest rate. Yet despite this reduction, the tax differential remains grossly disproportional. As with the Old Chilean System, the application of taxes based solely on the identification of directly competitive or substitutable products, the fact that the protected product is exclusively domestic, and the magnitude of the tax differentials between imports and domestic products, together establish a protective structure.

(d) New Chilean System

5.66 The United States notes that the New Chilean System, also established by Law 19,534, is scheduled to take effect on 1 December 2000. While this regime is not yet in effect, it is nevertheless the proper subject of these proceedings as it is a mandatory measure the details of which have already been determined.[338]

5.67 The New Tax System will differ from the Old and Transitional Systems in that it will tax on the basis of alcohol content. Distilled spirits with an alcohol content of 35 degrees or less will be taxed at 27% *ad valorem*. Yet for distilled spirits with an alcohol content of over 35 degrees, the rate will escalate in 4 percent increments for each additional degree of alcohol, topping off at the 47% rate for spirits bottled at over 39 degrees alcohol content.

5.68 The United States notes that the EC submission demonstrates that despite eliminating the explicit product categories found in the two previous regimes, the New Chilean System will maintain dissimilar taxation between domestic and imported distilled spirits: 89.6% of all pisco sold is bottled at 35 degrees or lower, whereas whisky, vodka, rum, gin and tequila by law must all be bottled at 40 degrees or higher. The New Chilean System thus will continue to ensure that a tax rate of 27% is to be applied to most domestic spirits, while a 47% rate be applied to most imported spirits.

5.69 As for protective application, the United States notes that the New Chilean System will differ from past systems by relying on apparently neutral criteria, i.e. alcohol content and value. However, these criteria will continue to afford protection to domestic production. The vast majority of products to which the lowest tax rate will apply will still be pisco, an inherently domestic product which is also the major distilled spirit sold in Chile, while the highest tax rate will still apply to most imported products.

5.70 The United States argues that in the context of the facts and circumstances of this case, Chile's use of alcohol content for taxation purposes is an effort to perpetuate the relatively higher rates applied to imports. The alcohol content of most imported spirits is well known, and in fact fixed by Chilean law. By statute, Chile requires that whisky, rum, vodka, gin and tequila be at least 40 degrees in alcohol content. The same law dictates that brandy must be a minimum of 38 degrees, pisco must be a minimum of 30 degrees, and liqueurs can range from 25 degrees and upwards, depending on the type of liqueur.[339] Thus, for example, whisky can only be sold as "whisky" in Chile if it is subject to the maximum tax rate possible.

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[338] *See* Panel Report on *United States - Taxes on Petroleum and Certain Imported Substances, supra*., para. 5.2.2.

[339] Chilean Decree 78/1986, implementing Law No. 18,455/85.

5.71 The United States further argues that, as a result of well-established industry practices and legal standards required by many of the major distilled spirits markets, most international whisky producers bottle their product at a minimum alcohol content of 40 degrees. Similarly, most international producers of rum, vodka, gin and tequila bottle their products at around 40 degrees (typically no lower than 37.5 degrees).[340] Producers generally prefer to maintain the same alcohol content, regardless of market requirements, because of the fact that alcohol strength contributes to each product's characteristics and taste. Thus, by pegging the tax rates to alcohol content, the Chilean regime will apply its rates on the basis of a well-known, inherent attribute of each product and will thereby continue to protect pisco from competition from whisky and other imports.

5.72 According to the United States, further evidence of the Chilean law's protective structure is the arbitrary choice of 35 degrees as the dividing line between a straight ad valorem rate of 27% and rates that increase considerably. Very few imported spirits are bottled under 35 degrees alcohol content; indeed, most imported spirits are legally required to be over this 35 degree threshold. As pisco is the only major distilled spirits category with the flexibility to fall below the threshold, and in fact most are bottled at an alcohol content of 35 degrees or less, pisco will once again be effectively singled out for preferential tax treatment.

5.73 The United States argues that the steeply increasing tax rates on imports of over 35 degrees alcohol content, compared to the flat rate applied to pisco below that threshold, can only be explained as taxation applied to afford protection to pisco. Although one GATT panel properly found that gradual increases in rates may support the determination that a progressive tax structure is non-protectionist in its structure,[341] in this case the four percent tax increase for each additional degree of alcohol content will create a disproportionate increase in tax for spirits with 40 degrees alcohol content or more. Thus when comparing two bottles of spirits with equal value, the tax on the 40 degrees spirit will be 74% greater than the tax on the 35 degrees spirit. Moreover, the EC submission describes evidence of the anticipated discriminatory effect of the new tax regime and the protective purpose of the threshold, as revealed from the drafting process of the new legislation.[342]

5.74 The United States further argues that the protectionist structure is further evidenced by the overall relative impact of the new regime on imports and domestic products. The New Chilean System will tax the vast majority, 83.9%, of all domestic spirits at the lowest possible rate, and only 12.3% of all domestic spirits at the highest possible rate. Conversely, the new regime will tax 94.5% of all imported spirits (a share higher than the previous two regimes) at the highest possible rate, but only a mere 4.5% of all imported spirits at the lowest possible rate.[343]

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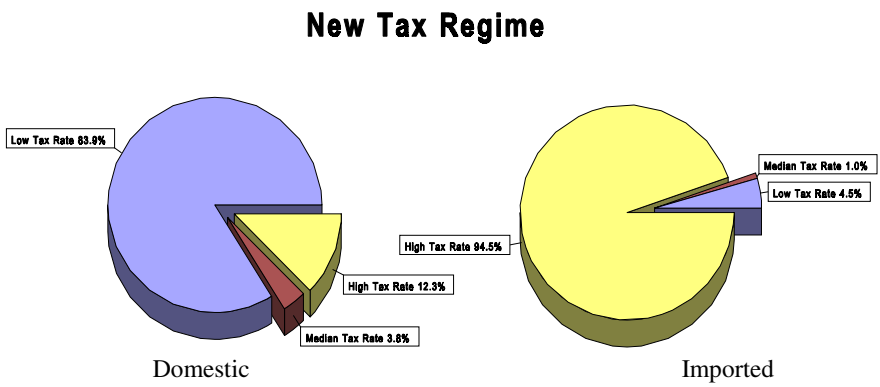
[340] *See* U.S. Exhibit 3.

[341] *See* Panel Report on United States - Taxes on Automobiles, supra., para. 5.14.

[342] *See* EC First Submission, paras. 61-78.

[343] The United States notes that these calculations for the new tax regime are made with the assumption that all liqueurs are taxed at the lowest rate possible, given their ability to be bottled at 35 degrees alcohol content or less (in reality, while most domestically produced liqueurs (*e.g.*, creme de menthe, flavoured brandies) are bottled at below 35 degrees, most imported liqueurs (*e.g.*,



5.75 The United States observes that the 12.3% of all domestic spirits to be taxed at the highest possible rate, stated above, will consist mostly of *pisco reservado* and *gran pisco*, two brands of pisco.[344] However, one must bear in mind that pisco is the only major distilled spirits category given the flexibility by law to be bottled at 35 degrees alcohol content or below. Thus, while the domestic producers of pisco may purport to bottle a small portion of their production (10.4%) at 40 degrees or more, they can at any time choose to reduce the alcohol content of these brands and still retain the identity of "pisco". On the other hand, Chile does not provide this freedom to the producers of the major imported spirits, therefore ensuring that in the New Chilean System, whisky, rum, gin, vodka and tequila will all be "locked" into the highest tax rate imposed.

5.76 According to the United States, the New Chilean System is promulgated to provide continued protection to domestic spirits. In the US view, Chile would have the Panel conclude that its New Chilean System is non-discriminatory simply because it will allow some imported spirits to enjoy the lowest tax rate possible while imposing the highest tax rate on a few of its domestic products. However, the products in these circumstances are few and far between, and act as no more than mere token gestures. In short, Chile will again fail to provide non-discriminatory treatment for its distilled spirits market.

5.77 The United States concludes that Old Chilean System applied its lowest tax rate to 89.1% of all domestic spirits and its highest tax rate to 53.8% of all imported spirits. This uncontested discriminatory treatment between domestic and imported spirits continues in the transitional tax regime which, while lowering the magnitude of the tax differential (between the highest tax rate and the lowest tax rate) from 180% to 112%, is a mirror image of the Old Chilean System. Then in the year 2000, the New Chilean System will further forward this tradition of dissimilar treatment by providing its lowest tax rate to 83.9% of all domestic spirits, while imposing its highest tax rate on 94.5% of all imported spirits. Furthermore, the New Chilean

Drambuie, B&B) are bottled at above the threshold). Furthermore, these calculations exclude brandy because, with an ability to be bottled at 38 degrees alcohol content, it can be taxed at 39%, a median tax rate.

[344] *See* U.S. Exhibit 2.

System will effectively increase the *ad valorem* tax for most U.S. imports from 30% to 47%.[345] It is obvious that all three tax regimes operate with the same practical effect.[346] And in all cases, the exclusive carve-out of preferential tax treatment for domestic production is clear.

Table 1

	OLD REGIME		TRANSITIONAL REGIME		NEW REGIME	
	Domestic	**Imported**	**Domestic**	**Imported**	**Domestic**	**Imported**
Low Tax Rate	89.1%	0.0%	89.1%	0.0%	83.9%	4.5%
Median Tax Rate	10.6%	46.2%	10.6%	46.2%	3.8%	1.0%
High Tax Rate	0.3%	53.8%	0.3%	53.8%	12.3%	94.5%
TOTAL	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

VI. INTERIM REVIEW

6.1 In letters dated 25 February 1999, the European Communities and Chile requested an Interim Review by the Panel of certain aspects of the Interim Report issued to the parties on 15 February 1999. The parties did not request an Interim Review meeting.

6.2 The European Communities has argued that paragraphs 2.1 and 2.3 and footnote 1 should be amended to reflect the fact that Chilean Law No. 19.534 did not repeal and replace Decree 825/74, but instead amended it. We changed the Descriptive Part of the Report in this regard to reflect Chile's legal characterization of its own law. While the EC has pointed out that the title of Law No. 19.534 refers to it as a modification, we will accept Chile's characterization of its legislation in this regard. As we noted in footnote 1, we do not find the characterization of whether the law is a replacement or a modification to be of any substantive importance to our Findings.

6.3 With respect to the Findings, the European Communities has made suggestions for clarifications with respect to paragraph 7.46 and footnotes 370, 390 and 407. We generally agree with these points and have made changes accordingly.

6.4 With respect to paragraph 7.35, the European Communities argues that the proper reference is to the 1998 SM Survey rather than to the 1997 SM Survey and that this paragraph and the following one should be moved. However, these paragraphs refer to Chile's disagreement with both surveys. One of the references in paragraph 7.35 was incorrect and we have changed it. Otherwise the paragraphs are accurate and have not been amended.

[345] According to the United States, in the old and transitional regimes, approximately 61.4% of all U.S. exports to Chile (rum, gin and vodka) are categorized as "other distilled spirits", and taxed at the 30% rate. However, in the new regime, these spirits will be taxed at the maximum 47%, an increase in tax rate of 56.7%.

[346] *See* Table 1 and U.S. Exhibit 4.

6.5 The European Communities claims that the statements in paragraph 7.60 were not in reference to the 1998 SM Survey, but instead referred to another section of the EC's First Submission. The references in paragraph 7.60 et seq., are taken from the section of the EC's first submission beginning at paragraph 145 and were direct references to the 1998 SM Market Survey. The Tables referred to therein are derived from that survey. Upon further consideration, we decided that it would be helpful to reverse the data references in paragraphs 7.60 and 7.61 and modify the language of these paragraphs in order to further clarify this point.

6.6 With respect to paragraphs 7.71 and 7.77, the European Communities strongly objects to the characterization of the cross-price elasticity shown in the 1995 Gemines study as being "low". We continue to be of the view that a cross-price elasticity of .26 is low. However, we also note our extensive discussion of the reasons why this *estimated* cross-price elasticity is lower than the actual ratio would be, which is also the conclusion reached by the authors of the study. Therefore, we decline to change the paragraphs.

6.7 The European Communities argues that paragraph 7.100 does not accurately reflect their argument. After reviewing their statement and submissions to the Panel, we have made some modifications to this paragraph.

6.8 The European Communities states that the third sentence of paragraph 7.105 is not accurate in that an *ad valorem* system would not provide similar taxation unless it applied the same rates or rates with less than *de minimis* differences. This is what we intended when referring to "purely" *ad valorem* systems. Nonetheless, we will clarify the reference. We consider the remainder of the paragraph accurate and appropriate in its qualifications and decline to further modify it.

6.9 The European Communities requests that we eliminate footnote 420 because reference to other taxation systems is not relevant to this dispute. Furthermore, the European Communities argues that the discussion is beyond the Panel's Terms of Reference. As the European Communities correctly notes, we stated in footnote 430 that inquiry into other tax systems for alleged inconsistency with GATT rules is not relevant. However, Chile offered this argument by analogy and, in our view, it is worth noting some of the specific problems that can arise from such arguments. In our view, this fuller explanation serves a useful purpose in this regard. We specifically noted in the footnote that the examination required to determine the accuracy of the analogy would in fact be beyond the Panel's terms of reference. Accordingly, we decline to delete this footnote.

6.10 The European Communities objects to paragraph 7.109 for the same reasons described above in regard to footnote 420. We decline to make the requested change for the same reasons discussed in regard to that footnote.

6.11 The European Communities argues that paragraph 7.121 mis-characterizes their position on the question of the Chilean legislative process. In our view, the language requested by the European Communities is merely a more in-depth description of their position than what is contained in paragraph 7.121. We note that a full description of the EC position can be found in the Descriptive Part of the report at paragraphs 4.559-4.585. In our view, paragraph 7.121 is accurate and we decline to make the requested change.

6.12 The European Communities argues that paragraph 7.122 does not address the EC argument. In its interim review request, the European Communities states that:

> The Pisco industry was not trying to "push a tax burden onto another" but, rather to attract upon itself an additional tax burden. Neither Chile, nor now the Panel, have given any satisfactory explanation for that unusual request.

6.13 The European Communities then goes on to argue that we should draw inferences from the alleged willingness of the Chilean government to negotiate certain benefits with one constituent but not another. In our view, there is no basis for the EC's demand that the Panel provide it with a "satisfactory explanation" of the Chilean legislative process. Indeed, the inferences that it wishes us to draw are precisely the sort of delving into domestic politics that previous panels and the Appellate Body have declined to do. The European Communities does not provide direct evidence of the Chilean government position. Rather it wishes us to conduct an investigation to draw inferences from a series of policy negotiations. It is manifestly unclear what standards we should use to evaluate such discussions and negotiations or what the authority is for conducting such an investigation of the Chilean legislative processes. We agree with the guidance provided by the Appellate Body in this regard and decline to make the changes requested by the European Communities.

6.14 The European Communities requests that we change subparagraph 7.131(iv) for the reasons it requested we change paragraph 7.121. We decline to make this change for the same reasons we declined to change paragraph 7.121.

6.15 The European Communities has asked us to revise the summary of its argument in paragraph 7.137 to better reflect its argument. We have made some changes to that paragraph to better reflect its argument.

6.16 With respect to paragraph 7.146, the European Communities suggests that it is inaccurate to state that "to a certain extent both parties are correct in their arguments" because the Panels conclusions in the following two paragraphs accord with the EC position. We noted that Chile argued that we should not review the legitimacy of its policy objectives. We agree. However, we also agree with the EC's argument that the lack of a rational connection between the stated objectives and the measure was evidence of protective design, structure and architecture. Thus, we consider our summary in paragraph 7.146 accurate and decline to make the requested change.

6.17 Chile notes its disappointment in and disagreement with the Panel's conclusions in this dispute.

6.18 In its specific comments, Chile disagrees with our characterization of their position in paragraph 7.28. Chile states that it provided arguments against the determination that HS 2208 is the "relevant market". However, this paragraph is not concerned with a determination of "relevant markets" and we did not use that term. Rather it deals on the one hand, with the identification of the appropriate category of certain imports and, on the other, with the appropriate categorization of certain domestic products. We have reviewed the record once again and do not find where Chile argued that the list of distilled alcoholic beverages identified by HS 2208 was not the appropriate category of imported products. Chile also never argued that particular sub-categories of HS 2208 should be excluded, as was done, for example, in the panel findings in *Korea -Taxes on Alcoholic Beverages*.

6.19 While Chile did argue that various distinctions between products undercut the EC's arguments with respect to the question of directly competitive or substitutable products, this does not go to the question of whether certain distilled alcoholic

beverages contained within HS 2208 should be grouped separately or excluded from the Findings. Furthermore, we discussed various sub-categories of products at various points in the Findings when there were differences in products that we felt warranted further examination (see, for example, paragraph 7.54). Had such examination revealed differences that justified finding certain products not within the groupings utilized or not directly competitive or substitutable, we would have made such a determination. Finally, in discussing this question in paragraph 7.28, we specifically discussed why such grouping of products would not prejudge the substantive discussion of the question of whether the imported and domestic products are directly competitive or substitutable.

6.20 Chile also made the following argument in regard to paragraph 7.28:

> Chile also provided information proving that the different kinds of pisco are marketed in different markets and are produced using different technology. If it is later argued that a diluted whisky is not whisky, why should a 43° pisco diluted to 30° continue to be a *Gran Pisco*.

6.21 We note again that this argument really goes elsewhere; namely, to the substantive Findings on "dissimilar taxation" or "so as to afford protection" relating to Chile's argument that products can easily be diluted to achieve tax parity. However, we note that it is a matter of Chilean law that all pisco is grouped together regardless of its strength in the Old Chilean System and the Transitional System and that the geographic denomination under Chilean law of "pisco" does not refer to alcohol strength. We also note that it is a matter of Chilean regulation that whisky and other products lose their generic names if they are diluted. Thus, the term pisco is available to spirits at various levels of alcohol content while the term whisky is available only at 40° of alcohol content and above. We are not convinced to change paragraph 7.28.

6.22 Chile further argued that it showed that "when wine is included in the regression, for example the coefficient ceases to become statistically significant". This argument also does not really go to the point of the discussion in paragraph 7.28. Nonetheless, we note that Chile supplied a new regression analysis, so it is not accurate to state that the results change when wine is added to *the* regression. We discussed the methodological problems with the new Chilean analysis as well as the others submitted. We also discussed the question of including wine (and beer) in our overall analysis. Our conclusion was that it was possible that wine and beer are also directly competitive or substitutable with pisco. However, that does not refute the extensive evidence that pisco is directly competitive or substitutable with the other distilled spirits. This also appears to be the conclusion recently reached by the Chilean competition authorities.

6.23 With respect to paragraph 7.41, Chile disagrees with our use of the Adimark Survey as relevant evidence. We recognized its limitations based on sample size and we specifically stated that we did not wish to make too much of the survey. However, we found it both relevant and useful in that it was a study presented to the Chilean legislature and not one developed for purposes of this dispute. Chile states that we should not draw any conclusions about its value "without proper knowledge of the market". However, we specifically stated that we took note of the survey because of its consistency with other market information.

6.24 Chile also argued with respect to the Adimark survey that the panel attached greater validity to one segment of the market than another. Chile's criticism implies that there must be high degree of current substitutability among all portions of Chilean society for products to be considered directly competitive or substitutable. That is not correct. We found it to be relevant evidence that a focus group representing a significant portion of Chilean society (the portion with the highest disposable income and therefore a proportionally greater share of domestic consumption) showed a high level of willingness to substitute whisky for pisco. We also noted that another segment would be interested in trying whisky although the second group of respondents thought they would revert to consumption of pisco later. Complainants do not have to show that all consumers would shift all consumption; rather, that some portion would under some circumstances. There is then a question which we have addressed at length as to whether such amount of substitutability is sufficient. In our view, the weight we have accorded to the Adimark survey is consistent with its limitations and its conclusions. We decline to make the changes requested by Chile.

6.25 Chile disagrees with footnote 393 regarding its inability to provide the 1996 Gemines Study pursuant to requests by the European Communities and the Panel. In Chile's view this footnote mis-allocates the burden of proof and implies an uncooperative position by Chile. Chile further notes that it is not obligated to provide evidence contrary to its own arguments. Chile also states that the Panel should have given more credence to the fact that the study was the property of a private party. First, the question here is not one of allocation of the burden of proof. The European Communities is required to present evidence to establish its claims. With respect to this piece of its overall evidence, the European Communities presented statements made in the Chilean press to the effect that the 1996 Gemines Study showed a high degree of substitutability between whisky and pisco. Our statement in footnote 393 was that Chile (and its industry) had foregone the opportunity to rebut this evidence by not presenting the study for examination. Second, we made no statement about Chile being uncooperative. Chile adopted a fully cooperative position during the whole period of the proceeding, of which we are appreciative. Third, we specifically noted that the study was in the pisco industry's hands and the industry had refused to provide it. As we noted, it would be an artificial distinction to state that we would refuse to accept the unrebutted information provided by the European Communities as it referred to a study that we could not see ourselves because it was retained in the hands of the directly interested domestic Chilean industry.

6.26 Finally, we specifically noted that there is no compulsory discovery under the DSU. However, we do find it regrettable that any industry (or any Member, whether complainant or respondent) would not submit requested relevant evidence for consideration by a panel. We note that we are troubled by Chile's statement that its only duty is in "not obstructing the work of the panel". Article 13 of the DSU states that:

> A Member should respond promptly and fully to any request by a panel for such information as the panel considers necessary and appropriate.

6.27 We think this treaty obligation calls for something more than a lack of obstruction. And, in fact, Chile's approach throughout the proceedings was constructive. Our only conclusion here was that, given that the Chilean industry had

refused the repeated requests to produce the report, we would accept the EC's unrebutted evidence about the report's conclusions. Accordingly, we decline to make the requested changes.

6.28 With respect to paragraph 7.74, Chile notes that its initial basis for comparing prices was mistaken but was later corrected. We agree and will change the paragraph accordingly.

6.29 Chile claims that, with respect to paragraph 7.76, the conclusions on cross-price elasticity of pisco and imported distilled spirits is not based on any evidence and notes that only two products were involved: whisky and pisco. As we noted, pisco and whisky are two of the most dissimilar products involved. It follows that the evidence for the intermediate products would be supportive of the same conclusions. We must also note that we discussed at great lengths the weaknesses of the studies submitted, but found them useful supportive evidence to be considered along with other factors also discussed at length. We decline to make the change requested.

6.30 Chile has requested that in paragraph 7.105 we not state that specific tax systems are not generally considered to be applying dissimilar taxation. While not necessarily agreeing with some of Chile's reasoning in its comments, we note that we have found that the New Chilean System is an *ad valorem* system qualified by reference to alcohol content and that it is not a specific tax system. Therefore, the statement is irrelevant and we agree to remove it.

6.31 Chile disagrees with our statements in paragraph 7.109 regarding luxury tax systems and claims that the New Chilean System is a type of luxury tax system. As pointed out in this paragraph, we disagree. A system where *ad valorem* rates change according to alcohol content rather than value is not a luxury tax system. The paragraph illustrates our conclusion and we decline to change it in this regard.

6.32 Chile objects to footnote 430 claiming that it did not attempt to justify its own measures by reference to other Member's policies. It is the case that Chile did not admit that its measures were GATT-inconsistent and then attempt to defend them by reference to other Members' laws. However, as Chile again acknowledges, it did argue at great length that, in its view, to find Chile's measures GATT-inconsistent would compel a finding that other Members' laws were also inconsistent. Either way, the other Members' laws are irrelevant to our analysis. We will amend this footnote to further clarify Chile's position and our conclusions on this matter.

6.33 Chile argues that paragraph 7.143 is not correct because Chile disagrees that the products discussed are directly competitive or substitutable. Chile states in its Interim Review comments that such competitive conditions exist only with respect to directly correlated alcoholic content beverages. Chile did not present its arguments in this fashion during the meetings or in its submissions. We are unaware of any evidence that supports an argument that distilled alcoholic beverages are directly competitive or substitutable only with those that contain the same alcohol content. Nonetheless, we will amend the paragraph to more clearly reflect that the statements are our conclusions and not Chilean arguments.

6.34 Chile disagrees with paragraph 7.149 and claims that we have confused two different concepts. According to Chile "revenue neutrality" does not refer to maintaining the same tax revenue but also takes into account issues of progressivity or regressiveness of application. We disagree. It is quite obvious that "revenue neutrality" refers to just what it says: achieving the same amount of *revenue*. In our

view, it is not correct to conclude that "revenue neutrality" also includes an element of social impact neutrality. To so argue ignores the plain meaning of the word "revenue" and is unsupported by either logic or the evidence. We decline to change paragraph 7.149.

6.35 With respect to paragraph 7.150, Chile notes that there is more local production of some high alcohol spirits than imports. This is already noted and considered in our Findings. We decline to change this paragraph.

6.36 In paragraph 7.152, we stated that there "appears to be no correlation between value and alcohol consumption." That is our conclusion. We then continue by noting that there would be an inverse relationship, *if any*. Chile disagrees with the reference to a possible inverse relationship, stating that this further statement would only be true if the products were perfect substitutes. Chile's comment is not on our conclusion, as much as it is on the further statement about a possible inverse relationship. We do not see the basis for Chile's statement that this further statement is only true if products are "perfect substitutes". We acknowledge that Chile would not agree with the point given its disagreement with our conclusions on the issue of "directly competitive or substitutable". Nonetheless, given our conclusions on that issue, we think the paragraph is accurate and decline to change it.

6.37 Chile disagrees with our assessment in paragraph 7.154 that the stated policy objectives are not achieved and that, even if they were, it would not be evidence of discrimination but could be due to some other factor. We found no evidence of these other factors here. Therefore, we found this to be supporting evidence of our Finding. As with many other points discussed in the Findings and in this Interim Review, it must be remembered that we did not view any single factor in isolation. In weighing all the evidence, such things as a lack of rational connections between stated objectives and resulting measures constitutes *a* factor among others. Chile also argued here that competing objectives results in achievement of second best solutions to all the problems. However, we found a lack of rational connections, including second best ones. We decline to change paragraph 7.154.

6.38 With respect to paragraph 7.155, Chile argues that there is an important distinction between laws and regulations specifically with respect to the regulation concerning minimal alcohol content of beverages. In Chile's view, regulations are more flexible. We think the term "laws" is broad enough to cover both legislation and regulations. Nonetheless, we will change paragraphs 7.145, 7.155 and 7.159 and footnote 437 to reflect Chile's distinction. As we explicitly noted, we make no findings concerning this regulation, but it does constitute a relevant fact of our inquiry. Also, we stated that the Chilean argument concerning dilution of products was not persuasive because such products would need to change both their generic names *and* certain physical characteristics.

6.39 In regard to paragraph 7.156, Chile states that it does not attempt to justify its tax regime by referring to the fact that it applies duties lower than the bound rates. Rather, Chile states that it provided this as an example of how Chile does not use such instruments despite their legality. Chile says it offers the example as an indication of the intent and nature of its policy instruments. The very point we made in paragraph 7.156 is that such good intentions in one area are not relevant to an examination of a completely different measure. We do, however, agree that Chile did not attempt to "justify" the tax measure in question, because Chile in fact still

maintains that the measure is GATT-consistent and therefore not needing justification. We amended the paragraph accordingly.

6.40 Chile disagrees with the summary paragraph 7.159. On one particular point, Chile notes that its prior tax systems have not been found inconsistent with GATT or WTO obligations. We note that the structure of the Old Chilean System is *precisely* the same as the Transitional System. Only the rates of taxation differ. Other than changing the reference to the product labelling measure (which is not at issue) to reflect Chile's prior comment that it is a regulation not legislation, we decline to further amend this paragraph.

VII. FINDINGS

A. Claims of the Parties

7.1 The claim of the European Communities is that both the Transitional System and the New Chilean System are inconsistent with Chile's obligations under GATT Article III:2, second sentence.

7.2 The European Communities claims that[347]:

(i) the Transitional System, which is applicable through 30 November 2000, is contrary to GATT Article III:2, second sentence, because it provides for the imposition of lower internal taxes on pisco than on other directly competitive or substitutable imported spirits, which fall within the tax categories of "whisky" and "other spirits", so as to afford protection to Chile's domestic production;

(ii) the New Chilean System, which will become applicable as of 1 December 2000, is also contrary to Article III:2, second sentence, because it results in the imposition of lower taxes on pisco with an alcohol content of 35° or less than on other directly competitive or substitutable imported spirits which have a higher alcohol content, so as to afford protection to Chile's domestic production.[348]

7.3 In response, Chile claims that this Panel should reject the unwarranted and intrusive interpretation of the reach of Article III that the European Communities has put forward in this dispute, and that in keeping with the plain language and the history of Article III, the Panel should find that the New Chilean System is fully consistent with Article III:2, second sentence.

7.4 Chile also argues that to the extent that the Panel considers the Transitional System to be at issue notwithstanding the short time in which it will remain in effect,

[347] The European Communities notes that in its panel request, it also invoked a violation of GATT Article III:2, first sentence. Even though certain spirits exported from the European Communities to Chile (including in particular certain types of brandy) may be considered as being "like" to pisco, the European Communities has decided not to pursue that claim, given that those spirits are in any event "directly competitive or substitutable" with pisco.

[348] The European Communities argues that the New Chilean System already constitutes mandatory legislation, and as such, it may be the subject of dispute settlement under the WTO Agreement, citing Panel Report on *United States - Taxes on Petroleum and Certain Imported Substances,* BISD 34S/136, paras 5.2.1-5.2.2.

it would be appropriate for the Panel to find that pisco is not directly competitive or substitutable with other distilled spirits in Chile, and hence that the Transitional System also conforms with Article III:2, second sentence.

B. Interpretation of Article III:2

7.5 Article III:2 provides two standards for examining complaints about a Member's internal taxation laws. The first sentence of Article III:2 provides:

> The products of the territory of any Member imported into the territory of any other Member shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products.

The second sentence provides:

> Moreover, no Member shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.

Paragraph 1 of Article III in turn provides:

> Members recognize that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production.

7.6 The meaning of the second sentence in light of its reference to the first sentence is further clarified in *Ad* Article III as follows:

> A tax conforming to the requirements of the first sentence of paragraph 2 would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed.[349]

7.7 Thus, the first sentence of Article III:2 examines whether products of an exporting country are taxed in excess of the taxes on the "like" domestic product. The second sentence examines whether products of an exporting country are taxed similarly to domestic products which are "directly competitive or substitutable." Both sentences first examine the relationship between the domestic and imported products; however, the second sentence involves additional and different inquiries with respect to two other elements; namely, an examination of the *extent* of the difference in

[349] *Ad* Article III has equal stature under international law as the GATT language to which it refers, pursuant to Article XXXIV. *See also* Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra,* footnote 41, at 116.

taxation[350] and whether the taxation differences are applied so as to afford protection to the domestic industry.

7.8 In *Japan - Taxes on* Alcoholic *Beverages II,* the Appellate Body considered the overall interpretation of Article, and stated that:

> The broad and fundamental purpose of Article III is to avoid protectionism in the application of internal tax and regulatory measures. More specifically, the purpose of Article III is to ensure that internal measures are "not applied to imported or domestic products so as to afford protection to domestic production."[351]

7.9 According to the Appellate Body, the terms of Article III:1 must be given their ordinary meaning, in light of the overall object and purpose of the WTO Agreement. Taking this approach, the Appellate Body affirmed that Article III:1 contains a general principle, while Article III:2 provides for specific obligations regarding internal taxes and internal charges. The Appellate Body stated that:

> Article III:1 articulates a general principle that internal measures should not be applied so as to afford protection to domestic production. This general principle informs the rest of Article III. The purpose of Article III:1 is to establish this general principle as a guide to understanding and interpreting the specific obligations contained in Article III:2 and in other paragraphs of Article III.[352]

7.10 The Appellate Body noted that Article III:2, second sentence, unlike the first sentence, specifically invokes Article III:1. In this regard, the Appellate Body noted that three issues must be addressed to determine whether an internal tax measure is inconsistent with Article III:2, second sentence:

(i) the imported products and the domestic products are "directly competitive or substitutable products";

(ii) the directly competitive or substitutable imported and domestic products are "not similarly taxed"; and

(iii) the dissimilar taxation of the directly competitive or substitutable imported domestic products is "applied so as to afford protection to domestic production".[353]

7.11 We also note that the burden of proof in cases such as this has been discussed at length by the Appellate Body in *United States - Shirts and Blouses*.[354] It is up to the European Communities as complainant to present evidence sufficient to establish

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[350] If the products are determined to be "like" then *any* taxation of the imported product in excess of the domestic product is prohibited. There is no *de minimis* possibility as there is under the second sentence where *Ad* Article III provides only that they must be "similarly taxed."

[351] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 109.

[352] *Ibid*., at 111.

[353] *Ibid*., at 116. *See also* Appellate Body Report on *Canada - Periodicals* and Appellate Body Report on *Korea - Taxes on Alcoholic Beverage*, adopted on 17 February 1999, WT/DS75/AB/R, WT/DS84/AB/R, DSR 1999:I, 3, para. 107.

[354] Appellate Body Report on *United States - Measures Affecting the Imports of Woven Shirts and Blouses from India* WT/DS33/AB/R, adopted 23 May 1997, DSR 1997:I, 323, at 333-338. *See* also Appellate Body Report *on Korea - Taxes on Alcoholic Beverages, supra*, footnote 353, paras. 155-158.

the case that the Chilean measures in question are inconsistent with Chile's obligations under Article III. If they do so, it is then necessary for Chile to bring forward evidence and arguments to disprove the claim. At that point, it is up to a panel to carefully weigh all the evidence and reach its conclusions based upon the results of that weighing.

C. "Directly Competitive or Substitutable"

1. General

7.12 The complainant in this case has not argued that any of the imported or domestic products are "like". We shall, therefore, proceed exclusively under Article III:2, second sentence, which is concerned with the question of direct competitiveness or substitutability.

7.13 As a prerequisite to the analysis of the evidence presented, it is important to establish the correct interpretation of the term "directly competitive or substitutable". In this regard, the Panel is guided by Article 31 of the Vienna Convention on the Law of Treaties ("Vienna Convention"), that summarizes the international law rules for the interpretation of treaties. Article 31.1 of the Vienna Convention provides that terms shall be interpreted in good faith, in accordance with the ordinary meaning of the terms in their context, and in light of the object and purpose of the treaty. Article 31.2 provides further, that the context includes the full text, the preamble, the annexes and any mutually agreed interpretive language. Article 31.3 provides that account shall also be taken of any subsequent practice or interpretations as well as relevant rules of international law.

7.14 The category of "directly competitive or substitutable" products is broader than the "like product" category covered under the first sentence. The Appellate Body in *Japan - Taxes on Alcoholic Beverages II* stated that how much broader this category should be "is a matter for the panel to determine based on all the relevant facts in that case".[355] It will be important to look at not only such matters as physical characteristics, common end-uses, and tariff-classifications, but also at the market. The Appellate Body also stated that it is appropriate to examine elasticity of substitution as a means of examining the relevant markets.

7.15 The Appellate Body in *Japan - Taxes on Alcoholic Beverages II* agreed with the reasoning of the panel with regard to the analysis of directly competitive or substitutable products. That panel made two important observations. First, the panel noted that the responsiveness of consumers to various products offered in the market may vary from country to country.[356] Second, the panel cautioned that differences in responsiveness of consumers to various products should not be influenced or determined by internal taxation because "a tax system that discriminates against imports has the consequence of creating or even freezing preferences for domestic

[355] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra,* footnote 41, at 117.
[356] Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra*, footnote 45, para. 6.28, citing Working Party on Border Tax Adjustments, para. 18.

goods."[357] The Appellate Body stated that no single criterion is decisive in determining whether any two products are "directly competitive or substitutable".

7.16 The question for us to decide is whether, in Chile, the domestic and imported products at issue in this case are directly competitive or substitutable. This requires evidence of the relationship between the products, including, in this case, comparisons of their end-uses, physical characteristics, channels of distribution and prices.

7.17 There have been two relatively recent disputes dealing with taxes on alcoholic beverages, *Japan - Taxes on Alcoholic Beverages II* and *Korea - Taxes on Alcoholic Beverages*. The findings in these two cases can offer, in our view, instructive guidance on the determination of the various questions at issue in this dispute. However, we are mindful of the statement of the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*, that these disputes must be determined on a case-by-case basis taking into account the conditions prevailing in the particular market at issue.

7.18 Consequently, we will draw guidance from the general analyses used in these two earlier cases, among others, but the determination of the central question whether the two categories of products are directly competitive or substitutable will be based on the facts and circumstances prevailing in this case.

7.19 The definition of "like" products is narrow for purposes of Article III:2. The definition of "directly competitive or substitutable" products is broader. The question is how much broader. In this regard, we note the analysis of the panel in *Korea - Taxes on Alcoholic Beverages* concerning the negotiating history of Article III:2, second sentence. That panel stated:

> Article 32 of the Vienna Convention provides that it is appropriate to refer to the negotiating history of a treaty provision in order to confirm the meaning of the terms as interpreted pursuant to the application of Article 31. A review of the negotiating history of Article III:2, second sentence and the *Ad* Article III language confirms that the product categories should not be so narrowly construed as to defeat the purpose of the anti-discrimination language informing the interpretation of Article III. The Geneva session of the Preparatory Committee provided an explanation of the language of the second sentence by noting that apples and oranges could be directly competitive or substitutable. Other examples provided were domestic linseed oil and imported tung oil and domestic synthetic rubber and imported natural rubber. There was discussion of whether such products as tramways and busses or coal and fuel oil could be considered as categories of directly competitive or substitutable products. There was some disagreement with respect to these products.[358]

[357] Panel Report on *Japan - Taxes on Alcoholic Beverages II*, citing the Panel Report on *Japan - Taxes on Alcoholic Beverages I, supra,* footnote 50.

[358] Panel Report on *Korea - Taxes on Alcoholic Beverages*, *supra*., para. 10.38, citing EPCT/A/PV/9, p.7; E/Conf.2/C.3/SR.11,p.1 and Corr.2; and E/Conf.2/C.3/SR.40/footnote 56 , p.2.

2. *Evidentiary Matters*

(a) Potential Competition

7.20 The European Communities submitted that Article III:2, second sentence, is concerned not only with tax differentials between products that are actually competitive or substitutable in a given market, but also with tax differentials between products that are potentially competitive or substitutable. The European Communities further argued that the notion of potential competition must be deemed to include not only competition that would exist "but for" the tax measures at issue, but also competition that could reasonably be expected to develop in the near future.[359]

7.21 It is well established in GATT jurisprudence, that Article III does not protect export volumes but, instead, protects competitive opportunities. In this regard the Appellate Body stated in *Japan - Taxes on Alcoholic Beverages II* that:

> [I]t is irrelevant that the "trade effects" of the tax differential between imported and domestic products, as reflected in the volumes of imports, are insignificant or even non-existent. Article III protects expectations not of any particular trade volume but rather of the equal competitive relationship between imported and domestic products.[360]

7.22 We agree with the panel in *Korea -Taxes on Alcoholic Beverages* (which reasoning was upheld by the Appellate Body)[361] when it stated that:

> We will not attempt to speculate on what could happen in the distant future, but we will consider evidence pertaining to what could reasonably be expected to occur in the near future based on the evidence presented. How much weight we will give to such evidence must be decided on a case-by-case basis in light of the market structure and other factors, including the quality of the evidence and the scope of the inferences to be drawn. If one is dealing with products that are experience based consumer items, then trends are particularly important and it would be unrealistic and, indeed, analytically unhelpful to attempt to separate every piece of evidence and disregard that which discusses implications for market structure in the near future.[362]

7.23 The Appellate Body further explained in its Findings in that case that:

> In view of the objectives of avoiding protectionism, requiring equality of competitive conditions and protecting expectations of equal competitive relationships, we decline to take a static view of the term "directly competitive or substitutable." The object and purpose of Article III confirms that the scope of the term "directly competitive or substitutable" cannot be limited to situations where consumers *already* regard products as alternatives. If reliance could be placed

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[359] *See* EC First Submission at para. 102. We note that Chile did not address this issue.

[360] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*., footnote 41, at 110.

[361] Appellate Body Report on *Korea - Taxes on Alcoholic Beverages, supra*, footnote 353, paras. 112- 124.

[362] Panel Report on *Korea - Taxes on Alcoholic Beverages, supra*, footnote 56, para. 10.50.

> only on current instances of substitution, the object and purpose of Article III:2 could be defeated by the protective taxation that the provision aims to prohibit.[363]

7.24 We agree that panels should look at evidence of trends and changes in consumption patterns and make an assessment as to whether such trends and patterns lead to the conclusion that the products in question are either directly competitive or substitutable now or can reasonably be expected to become directly competitive or substitutable in the near future.

7.25 In the case before us, as in the Korea case, potential competition is relevant for several reasons. Until 30 November 1997, whisky faced very high rates of taxation (45 percentage points higher than pisco). We must take into consideration the possibility that the current level of actual competition between pisco and other spirits is less than the level that could have developed under equal tax conditions. It is possible that the tax system in question (in conjunction with other measures not at issue, such as previously higher duties) may have inhibited consumers from choosing imports.

(b) Product Categories

7.26 The European Communities submitted that all pisco must be considered as a single product for the purposes of the determination whether it is directly competitive or substitutable with imported distilled spirits. The European Communities argued that the four varieties of pisco are distinguished solely in terms of alcoholic strength, and as such the difference does not warrant treating each of them as a distinct product for the purposes of Article III:2, second sentence since there is no correlation between the alcoholic strength of pisco and its quality/price.

7.27 The Appellate Body is of the view that the grouping of products is "a practical device to minimize repetition when examining the competitive relationship between a large number of differing products."[364] The Appellate Body has gone further to state that whether, and to what extent, products can be grouped is a question to be determined on a case-by-case basis.[365] In determining this question, a panel has to take into account the components of the products that are being grouped to determine whether there is enough similarity to warrant their being grouped together, notwithstanding some variation in composition, quality, function or price.[366]

7.28 In the case before us Chile did not argue that the various types of pisco constituted different products for either analytical purposes or for determining whether the imports and pisco were directly competitive or substitutable. The European Communities also argued that the appropriate category of imported products for consideration is all distilled alcoholic beverages identified in HS 2208 as described in the request for establishment of a panel. Chile has not made any arguments to the contrary. This is the category of imported products identified as

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[363] Appellate Body Report on *Korea - Taxes on Alcoholic Beverages*, *supra*, footnote 353, para. 120.

[364] *Ibid*., para. 142.

[365] *Ibid*., para. 143.

[366] *Ibid*., para. 142.

appropriate by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*. To take as the appropriate grouping of imports all products contained in HS 2208 does not, in this case, prejudge the matter as the panel and Appellate Body were concerned *might* happen in *Korea - Taxes on Alcoholic Beverages*. This is because, in effect, Chile argued that the whole category of pisco is sufficiently distinct from all other distilled alcoholic beverages that this is the proper basis for comparison with respect to the analysis of the issue of directly competitive or substitutable. Under Chilean law pisco is an appellation of origin referring to spirits made from grapes grown in a particular region of Chile. Thus pisco is exclusively a domestic product and reference to imports identified by HS 2208 does not include pisco. "Pre-judgment" is not an issue in this case.

7.29 We take the parties' positions *in this case* as strong evidence that the appropriate category of imports *with respect to the Chilean market* is all distilled alcoholic beverages identified in HS 2208 and the relevant domestic products for purposes of the issue of directly competitive or substitutable is all pisco. The Panel shall proceed accordingly.

3. Product Comparisons

(a) General

7.30 The next step is to consider the various attributes of the products at issue to determine whether these attributes support a conclusion that there is a directly competitive or substitutable relationship between the imported and domestic products. In this regard, we will examine the end-uses of the products, their physical characteristics, the channels of distribution, price relationships (including cross-price elasticities), and other relevant characteristics.[367]

(b) End-Uses

7.31 Overlap in end-use determines to a great extent direct competitiveness or substitutability. The Appellate Body *in Japan - Taxes on Alcoholic Beverages II* specifically agreed with the panel finding to the effect that:

> [T]he decisive criterion in order to determine whether two products are directly competitive or substitutable is whether they have common end-uses, *inter-alia,* as shown by elasticity of substitution.[368]

7.32 In other words, the overall inquiry focuses on whether there are common end-uses by examining a number of factors which can include elasticity of substitution. It is worth examining the extent of the current overlap of the end-uses as well as the appropriate definition of what a common end-use is for purposes of this inquiry. The current overlap of end-uses can be limited due to, *inter alia*, the very measures at issue, protective tariffs, resulting low volumes and high sales costs or other factors. It is also possible that the inquiry in some cases can include an

[367] These are the criteria we have examined in this case. There may be other criteria more or less relevant in other situations depending on the facts available.

[368] Appellate Body Report on *Japan -Taxes on Alcoholic Beverages II*, *supra*, footnote 41, at 117, quoting the Panel Report, para. 6.22.

examination of other relevant markets than the one in question to see if there is evidence of common end-uses of the products and take that into consideration.

7.33 In this regard, it is worth noting that the panel in *Korea - Taxes on Alcoholic Beverages* observed that:

> End-uses constitute one factor which is particularly relevant to the issue of *potential* competition or substitutability. If there are common end-uses, then two products may very well be competitive, either immediately or in the near and reasonably predictable future.[369]

7.34 The European Communities asserts that pisco and the imported distilled spirits are already used by Chilean consumers for similar end-uses. The European Communities refer to a market research done on the drinking habits of a representative sample of consumers.[370] The European Communities argues that on the basis of the 1997 SM Survey, pisco and the imported distilled spirits are consumed in the same way (straight, diluted with water, ice, soft drinks or fruit juice, and in cocktails). The European Communities thus argues that there is a substantial overlap of end-use between whisky and pisco, the two spirits which Chile emphasizes as being the most different.

7.35 Chile raises questions on the probative value of the consumer surveys being relied on by the European Communities. With respect to the discussion of end-uses, Chile disagrees with the results of the 1997 SM survey. In Chile's view, questions that ask consumers what they would choose if their preferred spirit were unavailable can only lead to abnormal and unpredictable answers. Chile also points out that the data in the 1998 SM Survey[371] is a purported quantitative analysis, in which consumers were faced with a hypothetical change in the prices of whisky, pisco and other spirits, the results of which can only be misleading.

7.36 Chile argues that it is oversimplistic to conclude that all spirits whose basic constitution is water and alcohol, and which are drunk mixed in not too different a manner, have necessarily the same end-uses. In Chile's view, this argument is tantamount to saying that consumers' only consideration is simply to have alcohol, irrespective of the form in which it is contained. Chile argues that even wine and beer share these characteristics and end-uses despite being different forms of alcoholic beverages.

7.37 Chile further argues that assertions by the European Communities that the 1997 SM Survey shows that both pisco and imported distilled spirits are consumed by Chileans in roughly similar percentages at various occasions and in various places, e.g., discos, bars, at home after work, at friends' homes etc., has no probative value. According to Chile, the categories of end-uses offered by the European Communities are simply too broad. Chile argues that pisco is more of a popular spirit in Chile than the imported spirits, such as whisky, which tend to be more expensive and, consequently, are consumed by the wealthier segment of the population.

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[369] Panel Report on *Korea - Taxes on Alcoholic Beverages, supra*, footnote 56, para. 10.78.

[370] Comprehensive survey done by Search Marketing S.A., Santiago, December 1997 ("the 1997 SM Survey"), EC Exhibit 21. *See also* the 1998 SM Survey (EC Exhibit 22) discussed more fully below.

[371] *See* Table 23 in Descriptive Part of this Report.

7.38 The parties disagreed over the appropriate breadth of categories of end-uses. The European Communities' position is that if two spirits have similar end-uses, it is a factor tending to show that the two products are directly competitive or substitutable. On the other hand, Chile asserts that similar end-uses are common features applicable to every alcoholic beverage without being in any way determinative of the question of direct competitiveness or substitutability.

7.39 In our view, the 1997 SM Survey provides some useful evidence about overlapping end-uses. It tends to confirm the observation that distilled alcoholic beverages are used for relaxation and socialization in appropriate social settings. Chile's rebuttal largely turns on the observation that the evidence submitted by the European Communities proves too much due to the broad nature of the proposed categories of end-uses. Indeed, it may very well be that beer and wine can be used for some of the same purposes and may very well share some of the same end-uses as distilled alcoholic beverages. Beer and wine might be directly competitive or substitutable with some or all distilled alcoholic beverages in the Chilean market, but that is not the subject of our inquiry. Moreover, that does not detract from the probativeness of the evidence in regard to the substitutability of distilled alcoholic beverages.

7.40 We note that, while we find the 1997 SM Survey useful, we do not rely on this single piece of evidence for our analysis. Rather, in the process of weighing all the evidence presented, we take the 1997 SM Survey into consideration in determining whether the imported and domestic distilled alcoholic beverages are directly competitive or substitutable. That some portions of the survey are broad and *if* applied to other non-distilled alcoholic beverages *might* also show overlap of end-uses, does not mean that the survey is irrelevant to our inquiry. To put it another way, it may be that distilled alcoholic beverages are a subset of a broader category of directly competitive or substitutable products (and we make no findings in that regard), but that does not lead to the conclusion that the subset at issue here is not made up of directly competitive or substitutable products.

7.41 We also note that there was a survey produced by the Adimark company (the "Adimark Survey") for the Chilean industry and provided to the Chilean legislature during its deliberations on changing the tax system for distilled alcoholic beverages. This survey was based on a very limited number of persons, but persons who were chosen presumably quite carefully to be representative of specific categories of Chilean customers. According to the survey, certain categories of consumers found whisky and pisco quite substitutable and would shift consumption to whisky in favorable price conditions which could result from tax equalization. This was particularly pronounced for young consumers. Another category showed a willingness to increase whisky consumption initially in response to these price changes, but could return more to pisco over the long run because of its identification as a traditional Chilean drink.

7.42 While we note the limited nature of the samples in this study, it confirms and highlights the data and conclusions of other evidence such as the 1997 and 1998 SM Surveys. There appears to be no question that pisco is identified as the traditional drink of Chile. It is probable that pisco will retain such identity regardless of the tax structure. However, the argument becomes tautological if it should be claimed that pisco is the traditional drink and is, therefore, perceived somewhat differently so that it may receive favorable tax treatment based on its character as a traditional drink.

This would amount to a difference in perception that is reinforced by the tax system and then used as justification to maintain the favourable tax treatment itself.

7.43 Products do not have to be substitutable for all purpose at all times to be considered competitive. It is sufficient that there is a pattern that they may be substituted for some purposes at some times by some consumers. The Adimark Survey shows this. It is not extensive enough to show the extent of such willingness, but we note that it was based on representative groups. The Adimark Survey shows the price sensitivity of the demand for the product. There is an increased willingness to try imports as the price changes in a manner reflective of tax equalization. The Adimark Survey also shows the nature of alcoholic beverages as an experience good. The sections of Chilean society most reluctant to switch from pisco to imports is the group with least exposure to such products. They show a willingness to try imports if available at lower prices, but think they would go back to pisco in the long run. Those with the greatest experience already with imports showed the willingness to switch more readily. Furthermore, the Adimark survey shows the nature of the consumption decisions at issue here. Distilled alcoholic beverages are products with low prices relative to income, and therefore it is relatively easy to switch consumption to another product for a portion of needs and still maintain loyalty to familiar brands on a broader basis. There can be some level of substitution without fundamental changes in consumption patterns such as might be required with respect to high priced consumer durables.

7.44 We do not wish to over-emphasize the Adimark Survey. It is useful evidence, particularly given that it was produced for use by the legislature and not commissioned strictly for the purposes of this dispute, and that it was based on representative samples of Chilean society. It is consistent with other evidence.

7.45 As the Appellate Body has noted, Article III cases deal with markets.[372] The panel in *Korea - Taxes on Alcoholic Beverages* noted the usefulness of examining marketing strategies in determining whether products are substitutable.[373] Marketing strategies that highlight fundamental product distinctions or, alternatively, underlying similarities may be useful tools for analysis.

7.46 The evidence of trends towards increasing overlap in end-uses is supported by the marketing strategies of the domestic Chilean companies. These companies met the threat of imports of distilled alcoholic beverages by, among other things, creating and selling premium pisco, which is more expensive than ordinary pisco and is usually colourfully presented as an up-market distilled spirit generally having an alcohol content comparable to whisky, cognac or up-market brandy. The complainants also produced evidence that these products were being advertised as competitive with up-market imported distilled spirits.[374]

7.47 There is evidence that imported spirits and pisco are used similarly in various social settings - homes, bars, discos etc. The advertising of pisco indicates to consumers that it is suitable as an up-market distilled spirit which shows that the intention by the producers is to put it in the same competitive category with such

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[372] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 117.

[373] Panel Report on *Korea - Taxes on Alcoholic Beverages, supra*, footnote 56, para. 10.95.

[374] *See* EC Exhibit 51, Control's Recipe Brochure, EC Exhibit 52, Capel's Internet home page & Exhibit 54, Capel's advertising brochure.

up-market imports as whisky, cognac, brandy, etc. The various surveys reviewed also show that consumers have an increased willingness to shift between domestic and imported spirits for at least some purchases and some occasions. The current actual overlap in end-uses plus the evidence of potential overlap, is supportive of a conclusion that pisco and the imported distilled spirits are directly competitive or substitutable.[375]

(c) Physical Characteristics

7.48 It is necessary to examine the physical characteristics of the products at issue. In our view, the closer the physical similarity the greater the likelihood of a directly competitive or substitutable relationship.

7.49 The European Communities argues that pisco and the imported distilled spirits share the same basic physical characteristics in that all have the essential feature of being beverages containing alcohol obtained using naturally fermented ingredients by similar distillation processes. The differences between pisco and whisky, according to the European Communities, are no greater than, for example, differences between brandy and whisky. This implies that the different substances from which brandy and whisky are distilled, that is grape wine and malted barley, are not fundamental physical characteristics in determining substitutability. Other differences arise from post-distillation processes such as ageing, colouring or flavouring that confer on each type of distilled spirit its own identity. In the EC's view, however, the differences are not so important as to render the various types of distilled spirits incapable of being directly substituted with each other by consumers.

7.50 Chile's response is that pisco and the imported distilled spirits share virtually no common physical characteristic other than containing alcohol and water. According to Chile, the ingredients of pisco and say, whisky, are markedly different. Chile points out these two spirits are made from different ingredients, pisco from grapes and whisky from grain. Chile further argues that the basic similarities the European Communities refers to are mere characteristics of all distilled spirits and that the ultimate physical characteristics, which consumers use to distinguish between different types of spirits, are determined by the other processes involved in the production of spirits.

7.51 We are of the view that an examination of the physical characteristics of products is more critical in determining whether two products are "like" than in the determination of whether two products are directly competitive or substitutable. This does not mean, however, that products' physical similarities should not be examined when determining whether products are directly competitive or substitutable. The Appellate Body has noted that:

> "Like" products are a subset of directly competitive or substitutable products: all like products are, by definition, directly competitive or

[375] We note that these conclusions with respect to end-uses support our conclusion that the identified imported products should be considered as a single category.

> substitutable products, whereas not all directly competitive or substitutable" products are "like".[376]

7.52 Consequently, if two products are nearly physically identical, they are "like".[377] Because it necessarily follows that they are also then directly competitive or substitutable, physical similarity is a useful category of examination for our analysis in this case. This is relevant where such activities as marketing campaigns or government tax regimes, have created a distinction in consumer perceptions between very similar products. Such distinctions that result from consumer perception are relevant but not determinative of the *nature* of an actual or potential competitive relationship.

7.53 These physical similarities are relevant to the inquiry, particularly with respect to potential competition. We regard the aspect of a product being a potable distilled spirit with a high alcohol content as an important defining characteristic.[378] We note that all the products presented to the Panel have this significant common feature.

7.54 In our view, the post-distillation differences due to the filtration, colouring or aging processes of the beverages are not so important as to render the products non-substitutable.[379] We find these differences relatively minor. There are some differences imparted from such things as aging in wooden barrels. Some spirits have added flavourings such as juniper berries in gin. But we also note that pisco shares many identical physical characteristics with other spirits made from grapes such as grappa, cognac, brandy or "Peruvian pisco".[380] Overall, weighing the evidence presented, we find that the common physical features of the imported and domestic products are supportive of a finding that the imported and domestic products in question are directly competitive or substitutable.[381]

(d) Channels of Distribution and Points of Sale

7.55 The European Communities argues that the 1997 SM Survey shows that all types of premises market both pisco and the imported distilled spirits together. For both categories, the preferred outlets are the same, supermarkets and liquor stores. The European Communities also argue that their presentation in the retail outlets in the same shelf space is evidence of their substitutability.

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[376] Appellate Body Report on *Korea - Taxes on Alcoholic Beverages*, *supra*, footnote 353, para. 118.

[377] Panel Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 45, para. 6.22.

[378] We note that alcoholic beverages containing only fermented ingredients cannot achieve as high a concentration of alcohol as is possible through the distillation process.

[379] *See* Tables 7 and 8 of the Descriptive Part of this Report. Indeed the panel in *Korea - Taxes on Alcoholic Beverages* found that post-distillation differences between soju and imported spirits at issue in that case were relatively minor compared to the common feature of being potable distilled spirits. Panel Report on *Korea - Taxes on Alcoholic Beverages*, *supra*, footnote 56, para. 10.67.

[380] We note that the product labelled pisco by Peru is not allowed to use that appellation in Chile. Peru claims that it has a disagreement with Chile over who has rights to the appellation. That question is outside our terms of reference and we take no position on it and no implication should be drawn from our use of the term "Peruvian pisco."

[381] We note that these conclusions with respect to physical characteristics support our conclusion that the identified imported products should be considered as a single category.

7.56 Chile does not dispute the factual assertion that pisco and imported distilled spirits are sold in the same sales channels and can even share shelf space, but does not agree that this is evidence of substitutability. According to Chile, such an argument is as unreasonable as an assertion that toothpaste and soap are substitutable because they are sold in the same channels and share shelf space. Chile also presented evidence showing that imports, and not pisco, are more likely to be distributed in supermarkets than pisco, while pisco is more commonly available in traditional stores.

7.57 The Panel in *Korea - Taxes on Alcoholic Beverages* noted that:

> [C]onsiderable evidence of overlap in channels of distribution and points of sale…..is supportive of a finding that the identified imported and domestic products are directly competitive or substitutable.[382]

We agree with that panel's finding on this point. In the case before us, there is no dispute that the two categories of distilled spirits are sold in similar sales channels, albeit arguably in somewhat different proportions, and indeed actually share shelf space. Chile has pointed out that many products share shelf space, but cannot be considered substitutable because of that. That is of course true. However, the *consistent* practice of putting these products on adjoining shelf space in similar outlets is *one* piece of evidence supporting a finding of substitutability. If it is a coincidence that products happen to be next to each other on shelves, one would not expect it to be repeated consistently.

7.58 It is also the case that complementary products are often grouped together to help in their marketing. However, as revealed in our discussion of overlapping end-uses above, we find no evidence that pisco and the imports are considered as complements by consumers in the way, in Chile's example, soap and toothpaste might be.

7.59 In our view, if products have quite distinct channels of distribution that could be a negative indicator with respect to substitutability. For example, if the products were regularly presented separately, it would be *one* piece of evidence that perhaps consumers did not group them together in their perceptions. In our view, the facts before us indicate an overall pattern of use of channels of distribution, including the presentation of the products within those channels, that is supportive of a finding that the domestic and imported products are directly competitive or substitutable.[383]

(e) Prices

7.60 The European Communities submitted that the consumer survey in the 1998 SM Survey[384] shows that factors that have a direct impact on the prices of other spirits but not on the price of pisco itself, affect the demand for pisco, which shows a directly competitive or substitutable relationship between pisco and those other spirits. According to the European Communities, the survey measured respondent's reaction to changes in the relative price of pisco and the other distilled spirits, and

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[382] Panel Report on *Korea - Taxes on Alcoholic Beverages*, supra, footnote 56, para. 10.86.

[383] These conclusions with respect to channels of distribution and points of sale support our conclusions that the identified imported products should be considered as a single category.

[384] EC Exhibit 22.

their response indicates a significant degree of cross-price elasticity between pisco and other spirits. In such a scenario, the share of respondents choosing whisky and other spirits instead of pisco would increase from 17.7% to 30.5%.[385]

7.61 The European Communities further argues that the survey showed that pisco consumers, by an overwhelming majority (70%), would opt for other spirits if pisco was unavailable, and only 17% would opt for wine or beer.[386]

7.62 The European Communities asserts that the 1998 SM Survey shows the immediate reaction of consumers to price changes. Bearing in mind that the consumption of distilled spirits is based on habit, which changes very gradually, short-term elasticities are bound to be much lower than long-term elasticities. What this means, according to the European Communities, is that over a period of time, the price changes resulting from the elimination of tax differentials are likely to lead to a shift in consumption from pisco to other spirits by a larger degree.

7.63 To back up their claims on cross-price elasticity, the European Communities submitted a study conducted on the Chilean distilled spirits market in 1995 by the Gemines consulting group.[387] Chile also submitted a separate study with respect to the cross-price elasticity of pisco and imported distilled spirits.[388] We note at the outset, that both this study and the Chilean data lack a model incorporating the supply side, and as such all the variation in the data is interpreted as movements along, or shifts of, the demand curve.

7.64 We also note that the studies relied on by both parties rely on small samples. In the case of the Chilean data, the number of observations is particularly low. In the case of the 1995 Gemines study, it lacks data for the key independent variable, the price of whisky, for almost half the sample period. For these reasons we treat these studies with caution.

7.65 The European Communities argues that the 1995 Gemines study, which was actually done for the Chilean pisco industry, provides further evidence of significant cross-price elasticity between pisco and whisky. The European Communities notes that the Gemines study, which estimated the cross-price elasticity between pisco and whisky on the basis of historical sales and price data in the period 1985-92, found a cross-elasticity rate between pisco and whisky of 0.26%, indicating that if the price of whisky went up by 10%, the sales volume of pisco would increase by 2.6%. The European Communities point out that the Gemines study found that on this basis, pisco and whisky are "substitutes albeit to a limited extent".[389]

7.66 The European Communities states that another Gemines study done in 1996, whose findings were widely published, concluded that a reduction in the tax on

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385 *See* EC First Submission, Table 19.

386 *See* EC First Submission, Table 17.

387 *The Possible Effects on the Pisco Industry of a Reduction in the Tax on Whisky*, Gemines, August 1995 (the 1995 "Gemines Study"). This study apparently was commissioned by the Chilean pisco industry.

388 *See* Annex II, Chile First Submission.

389 1995 Gemines study, p.61, EC Exhibit 20.

whisky by 50% would lead to a 47% drop in the price of whisky, which would in turn lead to a 17% drop in the demand for pisco.[390]

7.67 Chile points out that the EC's main evidence, 1998 SM survey, shows a remarkable lack of reliability. For instance, in the case of whisky, Chile argues that a more detailed analysis shows that whisky has a price elasticity of negative 5, meaning that a 10% reduction in price will lead to a 50% increase in volume, a result which is, according to Chile, completely out of range.[391] Chile further argues that the elasticities on the other spirits do not deserve any comment because of their unrealistic results. We note, however, that the surveyors compared the envisaged reaction of the survey respondents to preferences expressed after the prices of pisco, whisky, and "other spirits", have changed in response to a hypothetical situation of a tax of 27% *ad valorem* being applied uniformly to all distilled spirits. Elasticity of substitution is a "partial concept" in that it is a measure of the relationship between one quantity and one price and assumes that all other factors are held constant. For example, a cross-price elasticity measurement could hold the price of pisco constant, decrease the price of whisky and determine the changes in quantity of pisco. In this study, because prices change simultaneously, the outcome of changes in the quantity demanded do not allow the accurate computation of either own-price or cross-price elasticities since the other explanatory variables did not remain unchanged (i.e., the *ceteris paribus* requirement in this type of analysis has not been provided for, and partial derivatives have not been determined).

7.68 The question arises, as to how a panel should deal with concepts such as cross-price elasticity in determining whether two classes of products are directly competitive or substitutable. In *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body affirmed the decision of the panel to look at the economic concept of "substitution" as one means of examining relevant markets. However, the Appellate

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[390] 1996 Gemines study, as reported in *El Diario*, 2 July 1996, EC Exhibit 30. This evidence submitted by the European Communities indicating a significant cross-price elasticity is all the information we have about this report. We note that Chile was requested to submit a copy of this report. Chile was unable to do so. According to Chile, the study is the property of the pisco industry which refused to make it available due to alleged flaws in the results as well as confidential business information contained therein. Chile argues that neither it nor its industry is compelled to submit such information. We find the decision of Chile and its industry regrettable. Confidential business information can be protected. If there are alleged flaws in an otherwise relevant study, the party can submit comments in that regard. Chile has done so with respect to the 1995 Gemines study which was also a study commissioned by the Chilean industry. It is true that there is no compulsory discovery process in WTO dispute settlement proceedings. However, the overall dispute settlement process cannot work fairly and efficiently either at the consultation or panel stage if relevant evidence is withheld. In this case, the Chilean pisco industry decided to withhold this evidence. While it is the Chilean government which is party to this case, it would be unrealistic and artificial to argue that the panel should not address the issue based on this distinction given the direct underlying economic interest of the Chilean industry. Thus, Chile did not avail itself of the opportunity to rebut the evidence presented by the European Community. (*See also* the Panel Report on *Indonesia - Certain Measures Affecting the Automobile Industry*, adopted on 23 July 1998, WT/DS54, WT/DS55, WT/DS59, WT/DS64, DSR 1998:VI, 2201, paras. 14.230-14.235. We note that this case involved the failure of a *complainant's* industry to submit evidence supporting complainant's case, but we agree generally with the point that parties and their industries should not be able to withhold relevant evidence and expect panels to view it favourably.).

[391] *See* Chilean Statement at Second Meeting at pp. 12-14.

Body emphasized that this should be considered together with all other legitimate considerations, in the aggregate, in determining direct competitiveness and substitutability, i.e., the use of cross-price elasticity of demand is not the decisive criterion, but merely one among other criteria, such as physical characteristics, common end-uses, etc.[392]

7.69 The Panel wishes to emphasize that the concept of substitution in markets should not be confused or equated with a numerical measurement of the extent of substitution as found in the co-efficient of cross-elasticity. The existence of substitution between pisco and imported distilled beverages lies at the heart of this dispute and is the fundamental issue in light of both the treaty text and in terms of analytical approach. However, the econometric measurement of the degree of substitution may not, partly for the reasons discussed below, always adequately reflect the extent of substitution.

7.70 A high coefficient of cross-price elasticity would of course lend more credence to a claim of direct competitiveness or substitutability, although a low coefficient of cross-price elasticity is not necessarily fatal to a claim of direct competitiveness or substitutability. Indeed, a low coefficient of cross-price elasticity may be due to the very measures in question in the dispute. In this regard, the Appellate Body stated that:

> [A] tax system that discriminates against imports has the consequence of creating and even freezing preferences for domestic goods. In the Panel's view, this meant that the consumer surveys in a country with such a tax system would likely understate the degree of potential competitiveness between substitutable products.[393]

7.71 It is our view that in general economic terms, a high estimated coefficient of elasticity would be important evidence to demonstrate that products are directly competitive or substitutable provided that the quality of the statistical analysis is high. In this case, in the 1995 Gemines study, for example, a cross-price elasticity of demand for pisco with respect to whisky of 0.26 was obtained, which is low (a 10% rise in the price of whisky will lead to an increase of only 2.6% in the demand for pisco). Nonetheless, we accept this as evidence of substitutability, recognizing that some of the other factors discussed below are also indirectly influenced by the price of whisky and may have an impact on the market. We continue to recognize the above-mentioned need for caution in light of concerns about the quality of a particular statistical study.

7.72 Customs, traditions and consumer preferences embodied in brand loyalties could render demand less sensitive in the short run to changes in price and income than would otherwise be expected. It has been noted that alcoholic beverages are "experience goods" for which demand changes only slowly as consumers become gradually more familiar with new products.[394] We also think that the estimated

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[392] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 117.

[393] Panel Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 45, para. 6.28, citing Panel Report on *Japan - Taxes on Alcoholic Beverages I, supra*., para. 5.9.

[394] Appellate Body Report on *Korea - Taxes on Alcoholic Beverages*, *supra*, footnote 353, para. 123 citing the Panel Report on *Korea on Alcoholic Beverages*, supra, footnote 56, paras. 10.44, 10.50 and 10.73.

elasticity would have been higher, had whisky been less expensive and we note that the whisky imported into Chile tends to be at the higher end of the price range for distilled spirits generally. Whisky is taxed at a much higher rate than pisco and we also note that tariffs on imported spirits were high for a long period of time. These factors, which include the very measures at issue here, can have a noticeable impact on the price of the imports, both directly and indirectly. For instance, the tax and tariff structure can change product offerings towards more expensive items and partly as a result, increase other costs such as distribution. If the retail price of whisky were lower than what it is now, or other normally lower priced products were readily available in a neutral tax setting, it is not unreasonable to expect based on the information before the panel that new customer groups could be attracted and the actual cross-price elasticity would be higher than the current estimates.[395]

7.73 All these factors point to the logic in the Appellate Body's reasoning in the *Japan - Taxes on Alcoholic Beverages II* case, that undue weight should not be placed on estimated price-elasticity, demand-elasticity or cross-price elasticity. Studies that attempt to measure the relationship between dependent and independent variables and are only part of the totality of factors a panel should take into account in determining the question of direct competitiveness or substitutability.[396]

7.74 As we have already noted, Chileans consider pisco as a traditional or national drink. We further noted that this does not mean that pisco cannot be substituted for at any time and at any occasion. In this regard, we note that Chile submitted that pisco, in any of its categories, has a pre-tax price that is substantially lower than whisky, and that consequently taxation has no real effect on retail prices.[397] We also note the EC response that Chile is comparing the price of a relatively expensive brand of whisky such as Johnnie Walker, with an inexpensive brand of pisco. The European Communities also points out that the differences in prices between different varieties of pisco can be as large as differences between prices of a particular variety of pisco and say, whisky.

7.75 We agree with the European Communities on the question of price differences between pisco and imported distilled spirits. From the evidence before us, it is clear that one cannot speak of a price difference between pisco and *all* imported distilled spirits. The price differences are only relative, depending on which variety of pisco is being compared with which imported distilled spirit. To assert that all pisco is within a certain price range and all imported spirits in another price range is to go against the weight of evidence.[398] What is important is the effect of relative

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[395] The Panel in *Japan - Taxes on Alcoholic Beverages II* specifically noted that calculated cross-price elasticities in cases such as these will generally underestimate the actual degree of substitutability. Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra*, footnote 45, paras. 6.28 and 6.31. This was expressly approved by the Appellate Body in that case and reiterated in the Appellate Body decision in *Korea - Taxes on Alcoholic Beverages*. Appellate Body Report on *Korea - Taxes on Alcoholic Beverages, supra,* footnote 353, para. 120.

[396] *See* Appellate Body Report in *Japan - Taxes on Alcoholic Beverages II*, *supra*, footnote 41, at 117 and Appellate Body Report on *Korea - Taxes on Alcoholic Beverages*, *supra*, footnote 353, paras. 120-123 and 134.

[397] Table I, Annex I, Chile First Submission.

[398] We also note that there are other distilled spirits imported into Chile in relatively smaller quantities that are often sold at lower prices than many brands of whisky. We also note the EC's

price movements, since it is relative prices and their changes that influence consumer behaviour in the dynamic situation of changes in the demand for directly competitive or substitutable products.[399]

7.76 It is, therefore, arguable that the retail price levels of imported distilled spirits, such as whisky, could have been influenced by the taxes at issue in this dispute. Despite this, as we have noted, there is some degree of cross-price elasticity between pisco and the imported distilled spirits including whisky (which as we have earlier noted, Chile finds most difficult to envisage being substitutable with pisco).

7.77 As we noted, earlier cases have stated that the *concept* of cross-price elasticity is a strong indicator of substitutability. As we also observed above, a low *estimated* coefficient, as determined in the study submitted by the European Communities and the data from Chile, is not in itself conclusive that substitutability does not exist. We further note that studies that measure elasticity applied to historical data may reveal little about the *potential* for substitution and competition.

7.78 In the case before us, we find it significant that the studies indicate some degree of cross-price elasticity, indicating a potential for substitutability. The level of the elasticity may be a function of actual retail price levels, which could be influenced by taxation and other factors such as past measures, including tariffs, as well as higher distribution costs and other factors resulting from lower volumes.[400] In our view, therefore, the evidence presented by the data in the various studies and surveys is supportive of the other factors in arriving at a determination that pisco and the imported distilled spirits are directly competitive or substitutable. In this regard, we agree with the panel in *Korea - Taxes on Alcoholic Beverages* when it stated that:

> [T]he question is not of the degree of competitive overlap, but its nature. Is there a competitive relationship and is it direct? It is for this reason, among others, that quantitative studies of cross-price elasticity are relevant, but not exclusive or even decisive in nature.[401]

7.79 We find, therefore, that the existence of cross-price elasticity between pisco and the imported distilled spirits, although at a low level in the studies, is further indication of a directly competitive and substitutable relationship between the two.

4. Conclusions with Respect to "Directly Competitive or Substitutable"

7.80 Substitutability and competitiveness refer to the ability of products that may be dissimilar in some respects to satisfy a particular consumer want. This definition would suggest that "end-use" is a very important indicator of substitution.

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argument that small import volumes, due in part to the tax differentials, can lead to a concentration of imports in higher price categories.

[399] *See* Panel Report on *Korea - Taxes on Alcoholic Beverages, supra*, footnote 56, para. 10.94.

[400] *See* Appellate Body Report on *Korea - Taxes on Alcoholic Beverages*, *supra*, footnote 353, paras. 122-123.

[401] Panel Report on *Korea - Taxes on Alcoholic Beverages, supra*., para. 10.44. *See* also Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*., footnote 41, at 117, and Appellate Body Report on *Korea - Taxes on Alcoholic Beverages, supra*, footnote 353, paras. 120-123 and 134.

7.81 In our view, studies or surveys that reveal the following all serve as evidence of substitutability in end-uses:

(i) a tendency among consumers to regard products as substitutes in satisfying a particular need;

(ii) that the nature and content of marketing strategies of producers indicate that they are competing for the expenditure of potential consumers in a particular market segment; and

(iii) that distribution channels are shared with other goods;

7.82 In evaluating substitutability in end-use, it may be useful in this regard, to refer to an approach in consumer theory which has been gaining ground.[402] According to the theory, goods are, in the eyes of consumers, never really perceived as commodities that are in themselves direct objects of utility; rather, it is the properties or characteristics of the goods from which utility is derived that are the relevant considerations. It is these characteristics or attributes that yield satisfaction and not the goods as such. Goods may share a common characteristic but may have other characteristics that are qualitatively different, or they may have the same characteristics but in quantitatively different combinations. Substitution possibilities arise because of these shared characteristics. The oft-cited hypothetical textbook example of butter and margarine may be instructive. Butter and milk are both dairy products that share important characteristics that margarine does not have. However, butter and margarine each have combinations of characteristics that make them good substitutes as compliments for bread, which is not the case with milk. The characteristics of butter and margarine can be expressed as physical properties such as spreadability, taste, colour and consistency. These physical characteristics combine to render both products good substitutes as bread complements. The latter represents the end-use of the commodities as determined by their combination of characteristics derived from certain physical characteristics.

7.83 In our view, the same type of reasoning can be applied to the substitutability of pisco and other spirits such as whisky, brandy, cognac, etc. With respect to whisky and pisco, although the two spirits are distilled from different substances, namely barley and grapes respectively, they share the characteristics of being potable liquids with high alcohol content, which is the product of distillation, as well as being receptive to mixing with non-alcoholic beverages. In any event, even the differences in ingredients between whisky and pisco is not sufficient to render these two distilled alcoholic spirits, both of which have a high alcohol content and more or less satisfy a similar need, incapable of being substituted with each other. As for brandy, cognac and some other spirits, we have already noted that the differences in physical characteristics are only post-distillation differences such as colour and smell which are not sufficiently significant to change the basic character of spirits essentially made from grapes or other fruits.

7.84 We should stress that the complainants did not have to prove that there is a complete overlap in their analysis of substitutability. We take note in this regard, as discussed above, that the negotiators of what became Article III:2, second sentence,

[402] *See* Kelvin J. Lancaster, "A New Approach to Consumer Theory", in *Journal of Political Economy*, Vol. LXXIV (April 1966), pp. 132-157.

considered, *inter alia*, that apples and oranges were directly competitive or substitutable products. Moreover, we take guidance from the earlier panel findings which found that current market conditions may be distorted by government tax and regulatory policies which tend to freeze consumer preferences in favour of the domestic products. We do not agree that there are pre-tax price differences in the present case of such a level as to establish that the products in question are not even potentially competitive. In addition, after-tax price differences are partly a function of the tax system both in direct impact and indirectly through other factors such as product availability and distribution costs.

7.85 The complainants have established that, as between pisco and the imported distilled spirits, there is certainly a degree of current competition and the likelihood of greater competition in future. We also note that the production and marketing decisions of the pisco producers also reflect such a realization. The evidence submitted[403] clearly shows their desire to convey an image of pisco as a drink that competes with the best imported distilled spirits. We believe that when a product is being marketed in ways that suggest that it is in competition with the most up-market imported distilled spirits, this is evidence of at least potential competition with those imports. In addition, evidence of actual or potential competition must be viewed in the context of the fact that consumer habits on consumption of distilled spirits only change gradually over time.[404] We are of the view that the totality of the evidence presented supports a finding that the imported distilled spirits, and pisco are directly competitive or substitutable.

7.86 We also note that our findings are consistent with a recent opinion of the Chilean Central Preventive Commission[405] ("the Commission") which, in deciding on a merger between two major pisco producers, stated that:

> [T]here are two conditions that must be met for a monopoly to exist:
>
> (i) Non-availability of substitute products for pisco; and
>
> (ii) Existence of barriers to entry preventing new pisco growers from entering the market.

[403] *See* EC Exhibits 50-54.

[404] Some of the imported products have an extensive history in the marketplace. Whisky, for example, has long been present in the Chilean market and subject to high duties and/or taxes. However, we note that the taxes and duties on whisky were increased substantially in the 1980's, which appeared to result in a substantial and sustained loss of market share.

[405] In its submission dated 23 November 1998, the European Communities provided some commentary on the Commission paper. Subsequently, Chile argued that the EC had not requested nor been granted permission to file such comments. Chile requested permission to file further comments itself or, in the alternative requested the Panel disregard the EC's comments. The Panel decided not to grant Chile's request for further time for commentary, given that the Commission paper was a document of the Chilean government that was issued 11 days prior to the second substantive meeting of the Panel with the parties. Chile, in fact, did make some comments on the Commission paper at that meeting. We agreed to take into further consideration Chile's alternative request and have decided to grant it. The European Communities did not ask for time to make further comments on the Commission paper and chose to submit its comments in a submission that was explicitly limited by the Panel to commentary on other documents. Accordingly, we will disregard the EC's comments on the Commission paper.

With respect to the first condition, the Commission was satisfied that this was not the position in the Chilean market because:

> The broad range of substitute products for pisco available in the liquor segment of the alcoholic beverages market should allow a full substitution in view of the "premium" that consumers are willing to pay for the specific features offered by pisco.[406]

The Commission also observed that:

> [T]he market for alcoholic beverages is the pertinent market for pisco. This market includes beer, wine and liquor. Specifically, pisco participates in the segment formed by liquor, brandies and distilled liquor, in a particular niche covered by appellation regulations.[407]

Ultimately, the Commission concluded that:

> [P]isco faces major competition from other alcoholic beverages, such as wine, beer and whisky, due to the usual practice of drinking pisco diluted with non-alcoholic beverages. *Therefore, in the market for alcoholic beverages,…….there are alternative products which consumers of alcoholic beverages can choose to drink* (emphasis supplied*).*[408]

7.87 We note that the Commission was dealing with the question of competition from an anti-trust perspective, which generally utilizes narrower market definitions than used when analyzing markets pursuant to Article III:2, second sentence.[409] Consequently, it seems logical that competitive conditions sufficient for defining an appropriate market with respect to anti-trust analysis would *a fortiori* suffice for an Article III analysis. We would, therefore, regard the findings of the Commission as tending to confirm the finding that in the Chilean market, pisco and imported distilled spirits are directly competitive or substitutable products.

7.88 In summary, we are of the view that there is sufficient unrebutted evidence in this case to show both present and potential direct competition between the two categories of products. Accordingly, we find that the evidence concerning physical characteristics, end-uses, channels of distribution and pricing (including cross-price

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[406] Legal Opinion adopted by the Central Preventive Commission, Merger of Pisco-Manufacturing Cooperative Societies CAPEL and Control, Case Record No. 107-97, pp. 4-5.

[407] Legal Opinion adopted by the Central Preventive Commission, Merger of Pisco-Manufacturing Cooperative Societies CAPEL and Control, Case Record No. 107-97, p. 2.

[408] *Ibid*., p. 8.

[409] The panel in *Korea - Taxes on Alcoholic Beverages* was of the view that the definition of a market in anti-trust is not the same as under Article III. The panel felt that because the two concepts (anti-trust and competitive opportunities under Article III) are designed to address different concerns their definitions of the market need not be the same. According to the panel, since Article III is primarily concerned with competitive opportunities it defines markets more broadly than anti-trust which is designed to protect the actual mechanisms of competition. *See* Panel Report on *Korea - Taxes on Alcoholic Beverages*, *supra*, footnote 56, para. 10.81. We agree with that panel's conclusions on the general relationship of the definition of markets in anti-trust cases and under Article III.

elasticity),[410] leads us to conclude that the imported and domestic products at issue in this case are directly competitive or substitutable.

D. "Not Similarly Taxed"

1. General

7.89 The Appellate Body in *Japan - Taxes on Alcoholic Beverages II* stated that "to be 'not similarly taxed', the tax burden on imported products must be heavier than on 'directly competitive or substitutable' domestic products and that burden must be more than *de minimis* in any given case".[411] The Appellate Body noted that this determination must be made on a case-by-case basis.

7.90 In our view this means that panels should look at the particular market in question and the products themselves. That is, there is no set level of tax differential which can be considered *de minimis* in all cases. This follows from the Appellate Body's observation that with respect to "like products" the similarities between the products are so strong that it can be presumed that any differential in taxation will have an impact on the market. However, when products are somewhat different, but are still directly competitive or substitutable, then *de minimis* differences in taxation are permissible because it is not necessarily true that small differences in tax levels will have an effect in the market.

7.91 For some products a very small difference in tax levels could be *de minimis*, a difference that would be too large to be considered *de minimis* for other products. As always in cases such as these, the determination must be based on examination of the market in question, the market of the respondent Member. However, caution must be used because the very taxes in question, as well as other governmental policies, may have had an impact on the market resulting in difficulty determining whether a relatively small level of differentiation is *de minimis* or does indeed have a discernable effect on the market.

7.92 We must also note that this examination of whether products are similarly taxed or not involves no evaluation of the purpose or effect of the differences. Dissimilar taxation is not in itself inconsistent with Article III:2, second sentence. It

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[410] The European Communities argued that tariff classification can be important in determining whether products are directly competitive or substitutable. In this case, the European Communities referred to the 4-digit Harmonized System category 2208 as such evidence. Chile responded that 4-digit classifications are too general to be of much analytical use and in some cases contained products which Chile maintained clearly were not substitutable. We note that the Appellate Body and previous panels have referred to the tariff classifications of products in making determinations. However, two issues must be taken into account. First, is the classification sufficiently narrow to be of much probative value? Chile has a valid point in urging caution in this regard. Second, is relying on tariff classifications merely duplicative of examinations made in greater detail for the specific market in question in regard to such factors as physical characteristics and similar end-uses? In our view, with respect to the Chilean market, there is not a great amount of probative value in referring to HS 2208 in light of other evidence available, but we note that the classification is consistent with our conclusions.

[411] Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra*, footnote 41, at 119. *See also* Appellate Body Report on *Canada - Periodicals*, *supra*, footnote 41, at 474.

is only inconsistent if such tax differentials are applied in a manner so as to afford protection.

2. Transitional System

7.93 The Transitional System took effect on 1 December 1997 and lasts until 1 December 2000. The Transitional System continues the pre-existing system of differentiation based on three categories of distilled beverages: pisco, whisky and "other spirits." Prior to the beginning of the implementation of the Transitional System, whisky was taxed at 70% *ad valorem*, while other spirits were taxed at 30% and pisco at 25%. The rates for pisco and other spirits remain the same throughout the period of the Transitional System. For the 12 months beginning on 1 December 1997 the rate on whisky dropped to 65%, falling to 59% for the 12 months beginning on 1 December 1998, to be reduced further to 53% for the final twelve month period the Transitional System is in effect.

7.94 The European Communities argues that these tax differentials are quite large and, even at the lowest differential in the final period of the Transitional System, the rate for whisky (53%) is more than double the rate for pisco (25%). The EC argues that this is more than *de minimis*. The European Communities also argues that pisco will be taxed at a lower rate than the category of "other spirits". The European Communities states that, while the differential is lower than with respect to whisky, it is still large enough to be capable of affecting the competitive relationship between the products, citing the 1998 SM survey.

7.95 Chile does not contest the EC's arguments with respect to the Transitional System, relying instead on its arguments that the domestic and imported products are not directly competitive or substitutable.

7.96 It is obvious that the level of difference in taxation between the imported and domestic products is greater than *de minimis*. We note that there is Chilean production of both whisky and other spirits, but by definition there are no imports of pisco. Whisky (imported and domestic) currently is taxed at more than twice the rate of pisco. While this difference will narrow somewhat next year, it clearly will remain more than *de minimis*. With respect to other spirits (again, including both domestic and imported) the difference is five percentage points *ad valorem*. The 1998 SM Survey indicates that such a difference has an impact and is greater than *de minimis*. Chile does not contest the EC's arguments and evidence to the effect that this is greater than *de minimis* in the context of distilled alcoholic beverages in Chile.

7.97 We are of the view that under the Transitional System imported and domestic distilled alcoholic beverages are not similarly taxed. The fact that some of the domestic production (e.g., products such as Chilean whisky) is similarly taxed is irrelevant to this step of the analysis. That is, it is sufficient to find that certain of the imports are taxed dissimilarly compared to certain of the domestic substitutable products. It is not necessary to show that all of the imports are taxed dissimilarly to all of the domestic products.[412]

[412] *See* Appellate Body Report on *Canada - Periodicals*, *supra*, footnote 41, at 474; Panel Report on *Korea - Taxes on Alcoholic Beverages*, *supra*, footnote 56, para. 10.100 (fn. 412).

3. New Chilean System

7.98 The New Chilean system becomes effective on 1 December 2000.[413] The distinction between types of distilled alcoholic beverages utilized in the Transitional System is eliminated. Instead, the New Chilean System assesses taxes on an *ad valorem* basis that varies according to alcohol content. All distilled alcoholic beverages of 35° of alcohol or less are taxed at the rate of 27% *ad valorem*. The rate increases by four percentage points *ad valorem* per degree of alcohol content through 39°, topping out at a rate of 47% *ad valorem* for alcoholic beverages of higher than 39°.

7.99 The European Communities argues that this system still taxes the domestic and imported products dissimilarly. They claim that 90% of pisco sales will be taxed at the lowest rate of 27% while imports such as whisky, vodka, rum, gin and tequila will be taxed at 47% while brandy will be taxed at no less than 39 %. The European Communities notes that under Chilean law, whisky, vodka, rum, gin and tequila *must* contain at least 40° of alcohol.

7.100 According to the European Communities, the New Chilean System cannot be considered as a tax on alcohol content, because it is applied on the value of the beverage as a whole and not on the value of the alcohol content. Moreover, the European Communities argues that the value of distilled spirits is not directly related to alcohol content. For those reasons the European Communities considers that, in order to determine whether pisco and the other spirits are "similarly taxed", we should compare the rates per bottle of each spirit. Such *ad valorem* rates are manifestly different varying between 27% and 47% in steps of four percentage points and such differences are clearly not *de minimis*. In the alternative, the European Communities argues that, at any rate, pisco and the other spirits are also "not similarly" taxed when one compares the rates per degree of alcohol. The rates vary from 0.771% per degree of alcohol at the level of 35° of alcohol to 1.175% per degree of alcohol for beverages at 40°, which is a rate of taxation more than 50% higher per degree of alcohol.[414] According to the European Communities, this difference also is more than *de minimis*.

7.101 Chile responds that the New Chilean System is based on objective and neutral factors. In Chile's view, the criterion of alcohol content was recognized by the panel in *Japan - Taxes on Alcoholic Beverages I* as a permissible objective means of taxation. Chile notes that that case involved non-taxable thresholds and taxes applied in a manner not directly proportional to alcohol content and that the panel did not object to either characteristic. In Chile's view, there is no requirement in GATT/WTO jurisprudence for the proposition that tax systems must be directly proportional.

7.102 Chile argued that it has many products in the higher tax ranges of the New Chilean System, including gran pisco and pisco reserve, as well as locally produced

[413] The new Chilean System has been enacted but not implemented. There appears to be no discretion allowed in its enforcement. The law is certain and definitive. We consider it appropriate to examine the law to determine its consistency with Article III:2, second sentence. Neither party has argued to the contrary.

[414] The European Communities suggests that there is a third typical method of taxation which is based on volume without reference to value or alcohol content. However, this type of taxation is not used in whole or part in the New Chilean System.

brandy, rum, gin, vodka and whisky. Chile also notes that the European Communities produces many spirits that contain 35° alcohol or less. Chile states that according to the EC's arguments, the EC tax structures would also produce dissimilar taxation. According to Chile, it all depends on how one looks at the issue. Specific tax systems are preferential to high priced products, while *ad valorem* tax systems are preferential to low priced products. Chile made extensive arguments with respect to the taxation system of EC member states to show that such systems were not proportional or could be considered discriminatory depending on how they were viewed.

7.103 In our view the question of dissimilar taxation is relatively straightforward. It does not involve judgements about the objectivity of the laws or regulations involved. It does not involve an assessment of who benefits from the tax system. It does not involve an examination of the design, structure or architecture of the law in question. Such inquiries are relevant only to the next step of our analysis; namely, whether any system of dissimilar taxation has been applied so as to afford protection to domestic production. All we are doing at this point is determining whether there is dissimilar taxation of directly competitive or substitutable imported and domestic products. Even if it were to turn out that the large majority of imported products benefited from a particular tax, that would be irrelevant to this stage of the analysis. Our only issue here is to identify whether there is dissimilar taxation.

7.104 We note Chile's references to the panel report in *Japan -Taxes on Alcoholic Beverages I*, but we also note that the method of analysis in that case, as well as in the panel finding in *Japan - Taxes on Alcoholic Beverages II,* was somewhat different from the test utilized now. In those panel reports there was not clear demarcation between the analysis of "dissimilar taxation" and "so as to afford protection". The Appellate Body in *Japan - Taxes on Alcoholic Beverages II* made it clear that panels should review the matter in two distinct steps.[415] Some of the Chilean argumentation with respect to the question of dissimilar taxation is more appropriately considered in the next step of our analysis.

7.105 We do agree with the Chilean observation that tax systems can appear dissimilar depending on how one looks at them. However, we do not think that observation is relevant to our consideration.[416] A tax system based on taxing value is generally considered not to be applying dissimilar taxation if done on a purely *ad valorem* basis (i.e., a single *ad valorem* rate applied uniformly to all products). The difficulty in evaluating the New Chilean System is that it is not strictly an *ad valorem* system. It applies *ad valorem* rates that vary not just by the value but qualifies the rate by alcohol content.

7.106 With respect to Chile's argument that it is permitted to choose any objective criteria it wishes in formulating its tax system, we make the following observations. First, we note that the justification of "objective criteria" is troublesome in this regard. Some of the arguments on objectivity are, as we stated, relevant to the third step of the analysis, if at all. Second, it is unclear whether any "objective criteria"

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[415] *See also* Appellate Body Report on *Korea - Taxes on Alcoholic Beverages, supra*, footnote 353, para. 107.

[416] If taken further, one could argue that an overall system of indirect taxation provides dissimilar taxation if viewed from the perspective of direct income taxation. Such an observation may not be inaccurate, but it also is largely devoid of meaning.

would suffice even in Chile's proposal. Would it be permissible, for instance, to tax white spirits differently from brown spirits? The color of spirits is a major dividing line in consumer perception of distilled alcoholic beverages and is certainly "objective" in that it is fairly clear into which category a particular beverage would fall. However, use of such "objective criteria" could result in different taxation of, for example, white rum and dark rum, which would be completely arbitrary. Thus it is clear that Chile's reliance on the argument that its system is based on "objective criteria" is not sufficient.

7.107 To argue as Chile does that there is no rule requiring proportionality is rather beside the point. Even utilizing the EC's system of expressing the difference of percentage points per degree of alcohol, an evaluation of the nature of the system still involves mixing together two types of criteria. It is not clear that, even if proportional with respect to *some* particular products, assessing an *ad valorem* tax qualified by the additional criterion of alcohol content would result in a *system* of taxation that would survive examination under this step of the analysis. In this case, a statement that the New Chilean System does not assess taxes in a proportional manner is merely another way of stating that it is not really an *ad valorem* system strictly speaking (and certainly is not a specific system).[417]

7.108 We reiterate our observation in the section above that a system of taxation which results in non-*de minimis* dissimilar taxation of directly competitive or substitutable products is not in itself inconsistent with Article III:2, second sentence. It is only inconsistent if such a dissimilar system of taxation is applied so as to afford protection to domestic production. We, in fact, agree that a system which mixes criteria, and possibly even one that explicitly treats imported and domestic directly competitive or substitutable (but not "like") products differently, is not necessarily GATT-inconsistent. However, such a system could be found to involve dissimilar taxation and, therefore, require further analysis under the third step.

7.109 Chile has suggested that saying that the New Chilean System involves dissimilar taxation would be condemning luxury tax systems. However, in the context of the products involved in this case, a luxury tax system would be an *ad valorem* tax system that increased rates as the *value* of the products increased, not as

[417] Chile offered as an analogy the example of automobile taxation in Europe. According to Chile, such automobile taxes increase depending on the size or horsepower of the engines. Chile states that this could discriminate against high horsepower imports. Therefore, Chile concludes, the logic of the EC's argument implies that such a system would be inconsistent with the EC's WTO obligations if Chile's system is found to be so. Analogies can be useful analytical tools if they provide relatively simple illustrations of a problem. However, analogies lose their utility to the extent more and more facts need to be provided about the purportedly analogous situation to determine its relevance. With respect to engine power or size based systems of taxing automobiles, we would need to find out more about the competitive relationship of the products in question and structure of the tax system, as well as how it is applied. Again, we note, mere dissimilar taxation alone is not enough to render a tax system inconsistent with the obligations of Article III:2, second sentence. It is also necessary to determine if such a system of dissimilar taxation is applied in a manner so as to afford protection to domestic production. Even then, there may be questions regarding the potential applicability of exceptions pursuant to Article XX. Chile's analogy might or might not be correct, but it would require a whole new fact finding exercise to make such a determination and that clearly is beyond the scope of our terms of reference.

some specific characteristic changed. Thus, for example, a system that assessed taxes at a rate of 20% for products valued between 1000 and 5000 pesos, 30% for products valued between 5,000 and 10,000 pesos, and 40% for products valued above 10,000 pesos and so on might arguably constitute a luxury tax. However, varying the *ad valorem* rate based on alcohol content does not necessarily tax high priced goods at a higher rate because the additional criterion of alcohol content is not necessarily related to value. Therefore, we need not reach the issue of whether luxury tax systems are consistent with the requirements of Article III:2, second sentence.[418]

7.110 The difference in taxation between the top (47%) and bottom (27%) levels of *ad valorem* rates of taxation of distilled alcoholic beverages is clearly more than *de minimis* and is so by a very large margin. Indeed, it is obvious that the difference of four percentage points between the various levels of alcohol content also constitutes a greater than *de minimis* level of dissimilar taxation.[419]

7.111 Furthermore, if viewed from the perspective of specific taxation the difference of over 50% per degree of alcohol between pisco of 35° (0.771 percentage points per degree of alcohol) and whisky and other imports of 40° (1.175 percentage points per degree of alcohol) is much greater than *de minimis*. We also are of the view that the differential between the individual degrees of alcohol are more than *de minimis*. For instance, spirits of 35° are assessed taxes at 0.771 percentage points per degree of alcohol; spirits of 36° are assessed at 0.861 percentage points per degree of alcohol; and spirits of 37° are assessed at 0.946 percentage points per degree of alcohol. These are significant percentage differences.[420]

7.112 We also wish to be clear that we are not concluding that any "hybrid" system must result in dissimilar taxation. For one thing, such a broad conclusion would require further examination of the definition of the term "hybrid." For another, it would be beyond our terms of reference. Rather, our finding is that *this* particular system utilized by Chile results in dissimilar taxation that is not *de minimis*.

7.113 As with our finding above with respect to the Transitional System, the fact that some imported and domestic distilled alcoholic beverages could in particular factual circumstances be assessed identical taxes, or different taxes at less than *de minimis* levels, does not change our conclusion.[421] It is sufficient for this step of the analysis to find that some of the imports are being taxed dissimilarly from some of the domestic production and the difference is more than *de minimis*.

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[418] We also note, that a luxury tax system could be found to result in dissimilar taxation, but still not result in a violation of Article III:2, second sentence, as long as such a system was not applied so as to afford protection to domestic production.

[419] *See* discussion with respect to Transitional System, above, and results of the 1998 SM Marketing Survey.

[420] We also note because of the particular structure of the New Chilean System, the rates decrease from 15° to 35°, increase substantially from 35° to 39° and then begin to decrease above 40°.

[421] *See* Appellate Body Report on *Canada - Periodicals, supra*, footnote 41, at 474. *See* also Panel Report on *Korea - Taxes on Alcoholic Beverages, supra*, footnote 56, para. 10.100, fn. 412; and Panel Report on *United States - Section 337 of the Tariff Act of 1930*, BISD 36S/345, para. 5.14.

E. "So as to Afford Protection to Domestic Production"

1. General

7.114 In its report on *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body stated that:

> [The] third inquiry under Article III:2, second sentence, must determine whether "directly competitive or substitutable products" are "not similarly taxed" in a way that affords protection. This is not an issue of intent. It is not necessary for a panel to sort through the many reasons legislators and regulators often have for what they do and weigh the relative significance of those reasons to establish regulatory intent.[422]

7.115 The Appellate Body further noted that rather than review the intent of legislators to see whether there was protectionist intent, the real issue was one of "how the measure in question is *applied*".[423] The Appellate Body went on to explain that the question of application of a measure can be discerned from an examination of the "design, architecture and revealing structure of a measure".[424] The Appellate Body further observed that the very magnitude of dissimilar taxation could be evidence of protective application, but there often will be other factors and that panels should give full consideration to all the relevant facts on a case-by-case basis.

7.116 In its report on *Canada - Periodicals*, the Appellate Body provided extensive quotations from a Canadian Minister Designate concerning a Task Force Report which preceded the legislation under examination. There was also a quotation from the Minister of Canadian Heritage during the debate on the legislation to the effect that:

> [T]he reality of the situation is that we must protect ourselves against split-runs coming from foreign countries and, in particular, from the United States.[425]

7.117 The Appellate Body also noted the effect in the market-place that one split-run magazine had pulled out of the Canadian market and that a Canadian-owned split-run magazine had ceased production of its US edition. In light of these various facts, as well as the magnitude of the dissimilar taxation, the Appellate Body concluded that the system of dissimilar taxation was applied in a way that afforded protection to domestic production.

7.118 To a certain extent, this may appear as a change by the Appellate Body in their approach to this part of the analysis of Article III:2, second sentence. However, in its report in *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body stated that the central issue was the design, architecture and revealing structure of the measure. It goes without saying that the stated objectives by the *government* of the Member concerned may be relevant in evaluating the *design* of a measure. However, caution must be exercised in doing this for many views can be expressed in open

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422 Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra*, footnote 41, at 119.
423 Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II, supra,* footnote 41, at 119 (emphasis in the original).
424 *Ibid*., at 120.
425 Appellate Body Reports on *Canada - Periodicals*, *supra*, footnote 41, at 476.

parliamentary debates and this was why the Appellate Body stated that delving into individual legislators' intent is not a useful exercise. Thus, presumably, the Appellate Body was distinguishing between statements by a government and statements by individual legislators.

7.119 Also, it is worth noting the nature of the quotations used in *Canada - Periodicals*. The statements were supportive of a finding of a protective objective and structure of the provision. Statements by a government against WTO interests (e.g., indicating a protective purpose or design) are most probative. Correspondingly, it is less likely that self-serving comments by a government attempting to justify its measure would be particularly probative. To put it another way, dissimilar taxation applied so as to afford protection to domestic production cannot be justified as WTO-consistent because of good intentions. There is no basis for such a justification in the text of GATT 1994.

7.120 Finally in this regard, such statements as referred to by the Appellate Body in *Canada - Periodicals* are really only useful as a factor confirming other evidence. The Appellate Body did not rely just on the statements; rather, account also was taken of the results in the marketplace and the fact of the high level of differential in tax rates between the domestic and imported products.

7.121 The European Communities submitted evidence concerning the Chilean legislative process that led to the adoption of the Transitional System and the New Chilean System. Among other things, the European Communities has alleged that the taxation systems were arrived at as part of an agreement between the Chilean domestic industry and the government. As part of this, the European Communities argues that the pisco industry agreed to sacrifice the high alcohol content versions of pisco in order to preserve the preferential tax treatment of the large majority of pisco production under 35° alcohol content. According to the European Communities, there is no other logical reason why the pisco industry would agree to this increase in taxation of some of its products.

7.122 We do not think it fruitful or appropriate to try to evaluate the Chilean legislative process. As noted above, all sorts of agreements can be made in order to obtain support from a domestic constituent for changes in tax rates. Some may not even have anything to do with the legislation at hand. Furthermore, it is normal for one constituent to wish to push a tax burden onto another even if the products made by both constituents are not directly competitive. The competition in spreading tax burdens may be very different from the competition in the marketplace. We do not find the evidence of legislative purpose offered by the European Communities to be particularly probative in this instance.

7.123 In our view, an important question is who receives the benefit of the dissimilar taxation. This is implicit in the reference of the Appellate Body and previous panels to the magnitude of the tax differentials. For example, the magnitude of the differentials would not be particularly relevant if the products realizing the resulting benefits were imports. Furthermore, the Appellate Body's review of the results of the application of dissimilar taxation in the marketplace in *Canada - Periodicals* shows that the Appellate Body was reviewing *who* had benefitted from the tax rate differentials. This is only logical given the language of Article III itself.

7.124 We must consider in this regard that Article III is to protect competitive opportunities. If there have been significant governmental restrictions in the market-place (which can include completely WTO consistent measures such as

tariffs) it may be that there are relatively few, if any, imports and the distribution of the current benefits of the dissimilar taxation may be reflective of this fact. In such a situation, it would be necessary to consider if the large differentials could be having the effect of inhibiting potential imports.

2. Transitional System

7.125 The European Communities has argued that there are a number of factors that support a conclusion that the dissimilar taxation under the Transitional System is applied in a way so as to afford protection to domestic production. The European Communities refers to the following factors:

- the magnitude of the tax differentials;
- the absence of legitimate policy purposes for applying a lower rate to pisco;
- the fact that the beneficiary of the differentials (pisco) is by Chilean law a domestic product;
- the fact that the vast majority of Chilean production of distilled spirits is pisco;
- the fact that the majority of whisky (the highest taxed product) is imported; and,
- the alleged admission by the Chilean government that the reason for enacting the New Chilean System is that the prior and existing systems were discriminatory.

7.126 Chile responds that the purpose of the Transitional System is to allow time for the domestic and foreign producers and distributors to prepare for the changes under the New Chilean System and also to begin phasing in immediate benefits for whisky producers. In effect, Chile argues that the Transitional System should not be condemned as being a measure applied so as to afford protection when the primary result is the lessening of taxes on importers.

7.127 We take note of this point made by Chile that the primary beneficiary of the changes under the Transitional System are some of the imported products, specifically whisky. However, it is not for the Panel to inquire into such issues as whether political deference should be accorded for these efforts. The fact that the Transitional System lessens the protective effect does not vitiate the conclusion that, even at its least discriminatory, it is a system that does and will afford protection to domestic production.

7.128 The Transitional System assesses tax rates by type of spirits. The lowest tax rate is on pisco which under Chilean law is exclusively a domestic product. There could be an import physically *identical* to pisco and it would be assessed a tax rate five percentage points higher. This illustrates the protective nature of the structure of the tax system.

7.129 The largest category of imports by far at the present time is whisky and that is presently taxed at a rate of 53% (at its least discriminatory level beginning 1 December 1999) compared to pisco's 25% and pisco accounts for almost 75% of domestic production of distilled spirits. It is clear that the beneficiary of this structure is the domestic industry.

7.130 In our view, the design, architecture and structure of the Transitional System is to apply dissimilar taxation in a manner so as to afford protection to domestic production. The fact that the level of protection is lessened during the period of applicability of the law does not obviate the fact that its objective is to maintain such protection during the period.

3. New Chilean System

(a) Arguments

7.131 The European Communities argues that under the New Chilean System taxes are assessed in a dissimilar manner so as to afford protection to domestic production based on the following arguments:

(i) the European Communities argues that the magnitude of the tax differentials is large with a range from 27% for most pisco to 47% for most imports.

(ii) the European Communities notes that these large differentials in the rates do not serve any legitimate policy purpose. It cannot be for health reasons, because there is no correlation between alcohol content and heath factors related to distilled beverages. It cannot be for income redistribution, because the taxes are not just ad valorem and there is no necessary correlation between alcohol strength and value.

(iii) the European Communities claims that the large majority of Chile's distilled beverage production (between 70 and 80 percent, according to the European Communities) will enjoy the lowest rate of taxation, while over 95% of imports will be taxed at the highest rate.

(iv) according to the European Communities, the New Chilean System was the product of negotiations between the pisco industry and the Chilean government and reflects the desire of the pisco producers for protection from imports. The European Communities also points to statements made by various sectors of Chilean industry and Chilean legislators to the effect that the New Chilean System was crafted to provide protection for Chilean producers.

7.132 Chile responds that their system is based on completely objective factors and therefore cannot be considered to be applied in a manner so as to afford protection. According to Chile, any producer whether foreign or domestic can produce spirits at lower levels and benefit from the tax structure. Chile noted that there are a great deal of spirits produced in the European Communities at 35° of alcohol or less that could easily be exported to Chile and enjoy a lower level of taxation. Chile also noted that there is more absolute production of domestic spirits in Chile at the higher levels of taxation than there are imports.

7.133 Chile also states that the structure was arrived at as part of a series of compromises between various government ministries. Specifically, Chile notes that there were compromises between the desire of the Finance Ministry to maintain

pre-existing levels of taxation and other elements of the government that wanted higher taxes on higher alcohol content beverages. Chile notes that such compromises are normal in a democracy and do not constitute WTO-illegal discrimination.[426]

7.134 Chile argues that the Appellate Body has made it clear that statements made by legislators are irrelevant to the analysis because the subjective intent of individual legislators is impossible to discern. Chile notes that individuals may make arguments in support of their domestic industry in order to obtain better treatment and such comments may not be accurate reflections of the actual policy concerns of the government. Chile also notes that it is not surprising that the domestic industry argues for lower taxes for itself. Such lobbying of the government is perfectly normal and is found in the EC and elsewhere, too. It is also completely irrelevant, according to Chile.

7.135 Chile also argues that there is nothing in the GATT which requires a particular type of taxation or constrains the sovereign right of Member governments to structure their tax systems in a particular way. All that is required is that the tax system be based on objective factors and applied in a manner that allows any product, be it imported or domestic, to take advantage of the structure.

7.136 The European Community responds that under Chilean law, virtually all the categories of imported spirits (whisky, gin, rum, vodka and tequila) must have 40° or higher levels of alcohol. It would be impossible as a matter of law to sell whisky and these other beverages at anything other than the highest levels of taxation. Chile argued that they certainly could. Even if they had to change the product name somewhat, they could easily sell a diluted version. Adding water is the last step of the production process anyway and it would be a simple matter to add more water and sell, for example, "Johnnie Walker Light" or "Beef Eaters Lean". The European Community, as well as the third parties, objected that such a notion was absurd. Consumers wanted to buy whisky or vodka or gin. They didn't want to buy some diluted version that would taste different and be different.

7.137 Chile argues that if protection was what it wanted, it could raise the tariffs on spirits. Chile's binding is at 25% while the applied rate is 11%. This is evidence that the purpose of the tax structure was not protective. The European Communities responded that since the 1970's Chile has applied a single flat rate to imports of all products. According to the European Communities, this is considered as one of the basic principles of Chile's trade policy and, if the Chilean authorities were to make now an exception to that principle, it would be difficult for them to resist similar requests from other industries.

[426] We note that when we use the term "discrimination" in this discussion, we recognize that there are different nuances to the term depending on whether one is referring to the first or second sentence of Article III:2. Any difference in tax level for like products would be discrimination under the first sentence, while for directly competitive or substitutable products there is only discrimination when greater than *de minimis* dissimilar taxation is applied so as to afford protection to domestic production. Thus, we use the term "discrimination" here in a broad sense to encompass the latter meaning, recognizing that it would necessarily include the former, too.

(b) Discussion

7.138 In light of all the evidence and arguments offered by the parties, we now proceed to examine whether the New Chilean System applies dissimilar taxes in a manner so as to afford protection to domestic production.[427]

7.139 First, we address a question of interpretation important to our examination of the New Chilean System. Chile cites some of the drafting history of the provision which eventually became Article III:2 of the GATT. Chile notes that the Sub-Committee responsible for the Article reported that:

> The Sub-Committee was in agreement that under the provisions of Article 18 [Article III of the GATT], regulations and taxes would be permitted which, while perhaps having the effect of assisting the production of a particular domestic product (say, butter) are directed as much against the domestic production of another product (say, oleomargerine) of which there was substantial domestic production as they are against imports (say, imported oleomargerine).[428]

7.140 Chile draws from this the conclusion that it is permissible to have taxation systems that may have differential impact on some products including imports and domestic products as long as the distinctions are "objective and neutral".[429] We agree that there may be differences between taxation of directly competitive products, but we see no basis for extending the statement of the sub-committee to mean that something described as "objective and neutral" can be used to justify dissimilar taxation. We recall the precepts of Articles 31 and 32 of the Vienna Convention, that our decisions should be guided by the treaty language itself and that resort to the negotiating history is useful either to confirm an understanding of the language of the treaty or to clarify the meaning in the case of ambiguity. In this case, the treaty language appears to be clear. Dissimilar taxation, as we have noted before, is not in and of itself, inconsistent with the requirements of Article III:2, second sentence. It is only if such system of dissimilar taxation is applied in a way so as to afford protection to domestic production that there is a violation of the GATT. In our view, this language of the Sub-Committee merely confirms that. There is no violation *per se* due to dissimilar taxation. It depends, in that example, on who benefits from such a taxation system and, as a corollary, who has a disadvantage. Is it the imports or some portion of the domestic industry? We see no basis for reading into this Sub-Committee report an interpretation that a system of dissimilar taxation is permissible if the criteria used to distinguish products are "objective and neutral." It says no such thing and such an interpretation would be inconsistent with the treaty language that any system which imposes dissimilar taxation in a manner so as to afford protection to domestic production is inconsistent with a Member's obligations under the GATT 1994 regardless of the alleged objectivity of the criteria chosen.

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[427] Chile has repeatedly urged us to take into consideration the tax systems of other Members when evaluating the New Chilean System. It is a well settled point of GATT/WTO jurisprudence that such other systems are irrelevant to an evaluation of the Member's measure which is the subject of the specific dispute.

[428] Reports of the Committees and Principal Sub-Committees, ICITO 1/8, 64 (Geneva, Sept. 1948).

[429] *See* First Submission of Chile, paras. 34-35.

7.141 Chile says it agrees that Article III:2 applies beyond mere *de jure* discrimination to also cover *de facto* discrimination. However, when examined further, it seems that Chile actually is willing to extend Article III:2 beyond *de jure* discrimination in only the most minimal manner. According to Chile, the findings in *Japan - Taxes on Alcoholic Beverages I and II* and *Korea - Taxes on Alcoholic Beverages* are that tax systems based on "subjective" criteria such as product type names are impermissible. Chile then takes a further analytical step by asserting, therefore, that systems based on "objective" criteria are permissible.[430] This step is a non-sequitur. It is the case that Japan and Korea made distinctions based on types of beverages. However, the findings with respect to the second and third analytical steps under Article III:2, second sentence, were not dependent on that fact alone. As the panel stated in *Korea - Taxes on Alcoholic Beverages*:

> The structure of the Liquor Tax Law itself is discriminatory. It is based on a very broad generic definition which is defined as soju and then there are specific exceptions corresponding very closely to one or more characteristics of imported beverages that are used to identify products which receive higher tax rates. There is virtually no imported soju *so the beneficiaries of this structure are almost exclusively domestic producers.*[431]

7.142 Thus, the panel rested its conclusion in part on the factual finding that the primary beneficiaries of the particular structure in that case were the domestic producers. At no point did the panel in that case or the panels and Appellate Body in the cases of *Japan - Taxes on Alcoholic Beverages I and II* state or imply that any system based on so-called "objective" factors would necessarily survive scrutiny under Article III:2.

7.143 Chile also contends that there is not even *de facto* discrimination here because the imported product could easily be diluted to take advantage of the lower available tax rates. We do not find this persuasive. Exporters should not be required to alter important characteristics of their products and, indeed, change their generic name in order to compete equally with the domestic product.[432] To state it that way clearly demonstrates the flaw in the Chilean argument. It is evident that there will not be equal competitive conditions unless the foreign producers make certain important changes in their products, changes that Chile has not attempted to justify by any exception or rule of the WTO Agreements.[433] The only reason Chile offers for the

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[430] *See* Report, para. 4.399, Chile Second Submission, para. 28 and Chile's Statement at the Second Meeting, paras. 26-31.

[431] Panel Report on *Korea - Taxes on Alcoholic Bever*ages, *supra*, footnote 56, para. 10.102 (emphasis added).

[432] Chile argues that there is an inconsistency between arguing that products are directly competitive and substitutable and arguing that they should not be forced to change distinctive physical characteristics and names. We do not agree. Products which are directly competitive or substitutable have differences between them or they would be "like." Indeed, even like products do not need to be identical. It is perfectly logical for marketers to emphasize one product's distinctive qualities *in order to compete* effectively with other directly competitive products. We are not dealing with commodities here.

[433] For instance, as justified by legitimate technical requirements or for health and safety reasons excepted under Article XX.

foreign producers to change their products is to take advantage of preferential tax rates. A measure which imposes such requirements obviously does not provide the equal competitive conditions required by Article III.

7.144 Chile argues that this is a matter of intellectual property protection irrelevant to this case. According to Chile, the EC's arguments that it should not have to change it's products names in order to sell in Chile is akin to arguing that the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) is being extended to put an affirmative obligation on Chile to support the use of names such as whisky, vodka, gin and rum. We do not share Chile's view that there is such a necessary legal connection here between the concept of protected names, such as trademarks, and generic product names. The two types of names simply are not the same. The European Communities is not here asserting a trademark in the word "whisky." There is, in fact, Chilean whisky, as there is whisky produced in many countries. The issue here is whether a producer can be forced to give up its generic name and be compelled to sell its product as something different in order to enjoy equal tax treatment.

7.145 Furthermore, Chile is correct that it is under no obligation to assist the European Communities or any other Member in marketing its products under particular names. However, Chile is under an obligation not to apply a discriminatory tax regime to directly competitive or substitutable imports simply *because* they carry particular names. Indeed, Chile's earlier arguments concerning the decisions in *Japan -Taxes on Alcoholic Beverages I and II* and *Korea - Taxes on Alcoholic Beverages* makes Chile's position on this issue untenable. According to Chile, in those cases there was protective application of tax systems based on definitions of a favoured *type* of spirit that was overwhelmingly produced domestically. Surely it must follow that there is impermissible discrimination if a type of spirit which is mainly imported is, by definition of generic name *or type,* taxed at a higher rate.[434] The difference is very small between a law offering favorable treatment as long as a product is called "X" and a regulation discriminating against a product if it is called "Y".[435]

7.146 Related to the question of "objective" criteria is the argument concerning the policy objectives of the taxation system. Chile states that the European Communities has no right to question its policy objectives in structuring the New Chilean System as long as its system is based on objective criteria. The European Communities replies that it is evidence of the protective application of a measure if the measure is inconsistent with the stated policy objectives. To a certain extent, both parties are correct in their arguments.

7.147 We agree with Chile that it is not for the Panel to question their policy objectives. Chile lists these objectives as: (1) maintaining revenue collection; (2)

[434] We note that the Chilean regulation regarding alcohol content (Decree 78/1986 implementing Law No. 18,455) is not at issue in this dispute. We make no findings with respect to the consistency of this measure.with Chile's WTO obligations. Rather, what we are reviewing, in part, are the results of the interaction of that Decree with the Chilean spirits taxes which are the measures at issue. Decree 78/1986 constitutes one of the relevant facts of this case.

[435] We note that in making its projections of the fiscal impact of the New Chilean System, the Chilean Finance Ministry assumed that whisky, vodka, gin, rum and tequila would continue to be sold using their generic names.

eliminating type distinctions as were found in Japan and Korea; (3) discouraging alcohol consumption; and, (4) minimizing the potentially regressive aspects of the reform of the tax system. We offer no comment on whether these are appropriate goals and objectives of tax policy. It is not for us to evaluate the measure in these terms, either to condemn it or condone it.

7.148 In our view, the failure of a measure to conform to its stated objectives may be indicative of certain aspects of its design structure and architecture. That is, while we will not examine the stated objective itself to determine its legitimacy, it is a relevant inquiry to examine the *relationship* between the stated objective and the measure in question. If a rational relationship between the stated objective and the measure is lacking, this may provide evidence of protective application, which we will take into consideration along with other factors.

7.149 With respect to the question of maintaining revenue neutrality, we note that there is no rational reason why such a structure as devised by Chile is necessary for this purpose. Chile has acknowledged that the same revenue result could be achieved with a single *ad valorem* rate at some point between 27% and 47%.

7.150 With respect to eliminating type distinctions, the New Chilean System does not achieve this. As discussed above, the favorable tax treatment accorded to products called "pisco" was removed. However, the system was replaced with one providing unfavourable tax treatment for any products called "whisky", "gin," "vodka" or "rum," which happen to be primarily imports.

7.151 With respect to discouraging alcohol consumption, the gradations based on degree of alcohol content arguably may achieve such a result, although the evidence seems to be more persuasive to the contrary.[436] Moreover, if there were a direct correlation such as Chile proposes then the tax differential between products with 35° of alcohol and 39° degrees of alcohol should be the same as the differential between products with, for instance, 40° and 44° of alcohol unless there is an adequate rational explanation for the difference. However, the tax rate almost doubles between 35° and 39° but is the same between 40° and 44° and such an explanation is lacking.

7.152 Even then, the Chilean response is somewhat beside the point, for this is a system based not just on alcohol content, but on *ad valorem* rates qualified by the additional criterion of alcohol content, and there appears to be no correlation between value and alcohol consumption. Or, if there is a correlation, it is more likely to be an inverse relationship. If money a consumer might set aside to purchase distilled alcoholic beverages is spent on high value products, it follows that it will result in lower absolute levels of alcohol consumption than if spent on low value products.

7.153 With respect to minimizing the regressive aspects of the tax reform, this is only true if the factual situation were to remain static. As it currently stands in the Chilean market, the lower priced spirits generally are also the lower alcohol content products, thereby reinforcing the progressive nature of the tax system if the market shares do not change prior to implementation. However, this is a coincidence of factors, not anything inherent in alcoholic beverages. For instance, in many markets

[436] *See* EC Answers to Question C. 4 and EC Exhibit 62.

there are quite low priced whiskies sold at the same alcohol content as high priced whisky. Expensive cognac sold in Chile will have a lower alcohol content than a relatively inexpensive vodka or rum, etc. As Article III is meant to protect competitive opportunities, not market shares, Chile cannot base its justification of the system on currently existing facts, (e.g., distribution of market shares across the tax rates) which may exist partially, or even primarily, due to the tax system itself.

7.154 Chile argued that the New Chilean System was a result of a series of compromises between these competing objectives so it is not totally linked to any one objective. We recognize that legislation is generally the result of compromises. However, the mere fact that compromises are necessary cannot justify the resulting legislation if it is otherwise inconsistent with WTO obligations. Furthermore, it is difficult for Chile to, on the one hand, justify its tax system based on the stated objectives, but then, on the other hand, argue that the objectives are not reached due to legislative compromises. As we noted above, if the stated objectives and the measure are inconsistent, it may provide evidence confirming the discriminatory design, structure and architecture of a measure. We find that to be the case here.

7.155 To assist in evaluating the overall design, structure and architecture, we review the New Chilean System in the context of its predecessor systems. The prior systems through the Transitional System have imposed dissimilar taxation to all products not called "pisco." Pisco is a term limited to certain Chilean production according to Chilean law. As we have concluded above, this dissimilar taxation is greater than *de minimis* and was, and will continue to be, applied so as to afford protection to domestic production. The New Chilean System eliminated the *de jure* discrimination in these systems and moved to taxation on the basis of a combination of alcohol content and value. These levels were not arbitrarily chosen and applied. Between 70 and 80 percent of Chilean production consists of products with less than 35° alcohol content and, therefore, enjoy the lowest tax rate of 27%. Over 90% of pisco is in this category, pisco being the spirit enjoying *de jure* discrimination in its favor until 1 December 2000. However, under Chilean regulations, most of the imported beverages have generic names that require them to contain at least 40° of alcohol. Thus, almost 95% of current imports will be taxed at the highest rate of 47% or lose their ability to retain their name (their generic name, not their brand names) The beverages would also require a change of an important physical characteristic, namely their water/alcohol ratio. This is a clear case of a *de jure* discriminatory system being replaced by an at least equally *de facto* discriminatory system.[437]

7.156 As a last matter relating to the objective of the New Chilean System, Chile argues that it cannot have intended the system to be protective, for if protection was the goal Chile could have raised tariffs which are currently at 11%, but bound at 25%. Once again, we note that a lack of protective actions with respect to tariff rates is irrelevant to an examination to the completely different issue of whether a system of taxation is applied in a manner so as to afford protection to domestic production. Therefore, the fact that Chile could take protective actions that would be permissible

[437] We note that, for most types of spirits, the New Chilean System will actually increase the discrimination against them compared to pisco.

under Article II, but chooses not to, is simply irrelevant to a finding that the New Chilean System is inconsistent with Chile's obligations under Article III.

7.157 Chile has also argued that the New Chilean System cannot be found to be applied in a manner so as to afford protection to domestic production because there actually are more domestic products at the highest level of taxation than imports. Most of this domestic production consists of high alcohol content versions of pisco.

7.158 It is important at this juncture to recall that Article III is meant to protect competitive opportunities. There is no question that the structure of the New Chilean System will distort competition between directly competitive domestic products and products which are now imported and ones that might reasonably be considered potential imports. First of all, it does not save a measure from running afoul of Article III:2, second sentence, merely because there are domestic products taxed at the same level as the imported products, as we noted in the previous section.[438] Second, as Chile itself has noted, there is considerable world-wide supply capacity of potential imports, the majority of which would be taxed at the highest level. The potential imports have the right to equal competitive opportunities to the Chilean market which they cannot receive under the New Chilean System. Were all distilled alcoholic beverages taxed at the same level, or at a level reflecting no more than *de minimis* differences, then it is entirely possible that the percentages of domestic versus imports at 40° alcohol content or above would change dramatically. That is, lower value, high alcohol content imports could become more viable in the marketplace, particularly as consumers become more familiar with the products. In effect, Chile offers the result of its discrimination over a long period of time as a justification for perpetuating it. On balance, we find the most persuasive evidence to be that roughly 75% of domestic production will enjoy the lowest tax rate and that over 95% of current (and potential) imports will be taxed at the highest rate unless the imported products change their alcohol content and abandon their generic, familiar product names.

7.159 In sum, considering: (1) the structure of the New Chilean System (with its lowest rate at the level of alcohol content of the large majority of domestic production and its highest rate at the level of the overwhelming majority of imports); (2) the large magnitude of the differentials over a short range of physical difference (35° versus 39° of alcohol content); (3) the interaction of the New Chilean System with the Chilean regulation which requires most of the imports to remain at the highest tax level without losing their generic name and changing their physical characteristics; (4) the lack of any connection between the stated objectives and the results of such measures (recognizing that "good" objectives cannot rescue an otherwise inconsistent measure); and, (5) the way this new measure fits in a logical connection with existing and previous systems of *de jure* discrimination against imports, we find that the dissimilar taxation assessed on directly competitive or substitutable imports and domestic products is applied in a way that affords protection to domestic production.

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[438] *See* Appellate Body Report on *Canada - Periodicals*, *supra*, footnote 41, at 474. *See also* Panel Report on *Korea - Taxes on Alcoholic Beverages*, *supra*, footnote 56, para. 10.100, fn. 412; and Panel Report on *United States - Section 337, supra.*, para. 5.14.

VIII. CONCLUSIONS

8.1 In light of the findings above, we reach the conclusion that the domestic distilled alcoholic beverages produced in Chile, including pisco, and the imported products presently identified by HS classification 2208, are directly competitive or substitutable products. Chile's Transitional System and New Chilean System provide for dissimilar taxation of the imports in an amount that is greater than *de minimis* levels. Finally, the dissimilar taxation in both systems is applied in a manner so as to afford protection to Chile's domestic production. We therefore conclude that there is nullification or impairment of the benefits accruing to the complainant under GATT 1994 within the meaning of Article 3.8 of the Dispute Settlement Understanding.

8.2 We recommend that the Dispute Settlement Body request Chile to bring its taxes on distilled alcoholic beverages into conformity with its obligations under the GATT 1994.

ARGENTINA - SAFEGUARD MEASURES ON IMPORTS OF FOOTWEAR

Report of the Appellate Body
WT/DS121/AB/R

Adopted by the Dispute Settlement Body
on 12 January 2000

Argentina, *Appellant/Appellee*
European Communities,
Appellant/Appellee
Indonesia, *Third Participant*
United States, *Third Participant*

Present:
Bacchus, Presiding Member
Beeby, Member
Matsushita, Member

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I. INTRODUCTION

1. Argentina and the European Communities appeal certain issues of law and legal interpretation in the Panel Report, *Argentina - Safeguard Measures on Imports of Footwear* (the "Panel Report").[1] The Panel was established to consider a complaint by the European Communities with respect to the application by Argentina of certain safeguard measures on imports of footwear.

2. On 14 February 1997, Argentina initiated a safeguard investigation and adopted Resolution 226/97, which imposed provisional measures in the form of minimum specific duties on imports of certain footwear.[2] On the same day, the Argentine Ministry of Economy and Public Works repealed the minimum specific duties on imports of footwear ("DIEMs") that had been maintained by Argentina since 31 December 1993.[3] The opening of the safeguard investigation and the implementation of a provisional safeguard measure were notified to the Committee on Safeguards by Argentina in a communication dated 21 February 1997 [4] and, by further communication dated 5 March 1997, Argentina transmitted a copy of the provisional duty resolution to the Committee on Safeguards. [5]

3. On 25 July 1997, Argentina notified the Committee on Safeguards of the determination of serious injury made by its competent authorities, the Comisión

1 WT/DS121/R, 25 June 1999.
2 Panel Report, para. 2.1. The Resolution became effective on 25 February 1997.
3 *Ibid*., para. 8.2.
4 G/SG/N/6/ARG/1, G/SG/N/7/ARG/1, 25 February 1997.
5 G/SG/N/6/ARG/1Suppl.1 and G/SG/N/7/ARG/1/Suppl.1, 18 March 1997.

Nacional de Comercio Exterior ("CNCE").[6] Attached to this notification was Act 338, the report of the CNCE on serious injury. Act 338 incorporates by reference the Technical Report, a summary by CNCE staff of the factual data gathered during the safeguard investigation.[7] On 1 September 1997, Argentina notified the Committee on Safeguards of its intention to impose a definitive safeguard measure.[8] On 12 September 1997, Argentina adopted Resolution 987/97, which imposed, effective 13 September 1997, a definitive safeguard measure in the form of minimum specific duties on certain imports of footwear. On 26 September 1997, Argentina transmitted a copy of this Resolution to the Committee on Safeguards [9], and Uruguay, as Pro Tempore President of the Mercado Común del Sur ("MERCOSUR")[10] notified the definitive safeguard measure imposed by that Resolution.[11] On 28 April 1998, Argentina published Resolution 512/98 modifying Resolution 987/97.[12] On 26 November 1998, Argentina published Resolution 1506/98, further modifying Resolution 987/97, and, on 7 December 1998, the Argentine Secretariat of Industry, Commerce and Mines published Resolution 837/98 implementing Resolution 1506/98.[13] The relevant factual aspects of this dispute are set out in further detail at paragraphs 2.1-2.6 and 8.1-8.20 of the Panel Report.

4. The Panel considered claims made by the European Communities that Argentina's safeguard measures are inconsistent with Articles 2, 4, 5, 6 and 12 of the *Agreement on Safeguards*, and with Article XIX:1(a) of the *General Agreement on Tariffs and Trade 1994* (the "GATT 1994"). The Panel Report was circulated to the Members of the World Trade Organization (the "WTO") on 25 June 1999.

5. The Panel concluded that "the definitive safeguard measure on footwear based on Argentina's investigation and determination is inconsistent with Articles 2 and 4 of the Agreement on Safeguards" and, therefore, "that there is nullification or impairment of the benefits accruing to the European Communities under the Agreement on Safeguards within the meaning of Article 3.8 of the DSU."[14] The Panel found "no basis to address the [European Communities'] claims under Article XIX of GATT separately and in isolation from those under the Safeguards Agreement."[15] The Panel rejected the claims of the European Communities under Article 12 of the *Agreement on Safeguards*[16] and, in light of its determination that the

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6 G/SG/N/8/ARG/1, 21 August 1997.

7 Panel Report, paras. 5.250-5.251 and 8.127-8.128.

8 G/SG/N/10/ARG/1, G/SG/N/11/ARG/1, 15 September 1997; corrigendum 18 September 1997.

9 G/SG/N/10/ARG/1/Suppl.1, G/SG/N/11/ARG/1/Suppl.1, 10 October 1997.

10 MERCOSUR was established on 26 March 1991, when Argentina, Brazil, Paraguay and Uruguay signed the Treaty of Asunción, which provides for the creation of a common market among its four State Parties.

11 G/SG/N/10/ARG/1/Suppl.2, G/SG/N/11/ARG/1/Supp.2, G/SG/14/Suppl.1 and G/L/195/Suppl.1, 22 October 1997.

12 Panel Report, para. 2.5.

13 *Ibid*., para. 2.6.

14 Panel Report, para. 9.1. The Panel's conclusions applied to "the definitive safeguard measure in its original legal form (i.e., Resolution 987/97) as well as in its subsequently modified form (i.e., Resolutions 512/98, 1506/98 and 837/98)." (Panel Report, para. 8.305) This finding has not been appealed and, therefore, stands.

15 Panel Report, para. 8.69.

16 *Ibid*., paras. 8.301 and 8.304.

definitive safeguard measure is inconsistent with Articles 2 and 4 of the *Agreement on Safeguards*, the Panel did not consider it necessary to make findings with respect to the claims of the European Communities under Articles 5 and 6 of that Agreement.[17]

6. On 15 September 1999, Argentina notified the Dispute Settlement Body (the "DSB") of its intention to appeal certain issues of law covered in the Panel Report and certain legal interpretations developed by the Panel, pursuant to paragraph 4 of Article 16 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "DSU"), and filed a Notice of Appeal pursuant to Rule 20 of the *Working Procedures for Appellate Review* (the "*Working Procedures*"). On 27 September 1999, Argentina filed its appellant's submission.[18] On 30 September 1999, the European Communities filed its own appellant's submission.[19] On 11 October 1999, Argentina[20] and the European Communities[21] each filed an appellee's submission. On the same day, Indonesia and the United States each filed a third participant's submission.[22]

7. On 19 October 1999, the Appellate Body received a letter from the Government of Paraguay indicating its interest "in attending" the oral hearing in this appeal. On 25 October 1999, the Appellate Body received a second letter from Paraguay clarifying that it was not requesting an opportunity to "make oral arguments or presentations at the oral hearing" as set forth in Rule 27.3 of the *Working Procedures*. Rather, Paraguay maintained that, as a third party which had notified its interest to the Dispute Settlement Body under Article 10.2 of the DSU, it had the right to "participate passively" in the oral hearing before the Appellate Body in the present dispute. No participant or third participant objected to the participation of Paraguay on a "passive" basis. On 26 October 1999, the Members of the Division hearing this appeal informed Paraguay, the participants and third participants that, having regard to the provisions of Articles 10.2 and 17.4 of the DSU as well as the provisions of Rules 24 and 27 of the *Working Procedures*, Paraguay would be allowed to attend the oral hearing as a "passive observer".

8. The oral hearing in the appeal was held on 29 October 1999. The participants and third participants presented oral arguments and responded to questions put to them by the Members of the Division hearing the appeal.

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17 Panel Report, paras. 8.289 and 8.292.
18 Pursuant to Rule 21(1) of the *Working Procedures*.
19 Pursuant to Rule 23(1) of the *Working Procedures*.
20 Pursuant to Rule 23(3) of the *Working Procedures*.
21 Pursuant to Rule 22 of the *Working Procedures*.
22 Pursuant to Rule 24 of the *Working Procedures*.

II. ARGUMENTS OF THE PARTICIPANTS

A. Claims of Error by Argentina - Appellant

1. Terms of Reference

9. Argentina argues that the Panel violated Article 7.2 of the DSU and exceeded its jurisdiction because the Panel not only considered, but relied on[23], alleged violations of Article 3 of the *Agreement on Safeguards* even though the European Communities' request for the establishment of a panel and the Panel's terms of reference mentioned alleged violations of only Articles 2 and 4 of the *Agreement on Safeguards*.

10. Argentina notes that Articles 3 and 4 of the *Agreement on Safeguards* are separate provisions, each of which sets out distinct requirements. In Argentina's view, Members intended with these provisions to allow national authorities to separate the Article 3 "*findings and conclusions*" requirement from the Article 4 requirement of a "*detailed analysis*", as is done in practice in Argentina. In this case, the "findings and conclusions" to which Article 3 refers are contained exclusively in Act 338 (on which the Panel relied), but no claim of a violation of Article 3 was before the Panel.

11. Argentina emphasizes that due process concerns underlie the rule that a Panel's jurisdiction is limited by its terms of reference, as recognized in the Appellate Body Reports in *Brazil - Measures Affecting Desiccated Coconut* ("*Brazil - Desiccated Coconut*")[24] and *India - Patent Protection for Pharmaceutical and Agricultural Chemical Products* ("*India - Patents*").[25] Argentina concludes that, by excluding Article 3 from its panel request, the European Communities essentially notified Argentina that it would not have to defend itself against Article 3 allegations. Argentina adds that since Article 3 is central to the Panel's decision-making, the Panel's statements about Article 3 cannot be considered harmless error, "*purely gratuitous comment*" or not "*a legal finding or conclusion.*"[26]

2. Imposition of Safeguard Measures by a Member of a Customs Union

12. Argentina argues that the Panel erred in its legal reasoning and interpretation of the *Agreement on Safeguards* with respect to Argentina's right to exclude its partners in MERCOSUR from the application of safeguard measures. In Argentina's view, the Panel misinterpreted footnote 1 to Article 2.1 of the *Agreement on Safeguards*, and imposed an obligation to apply safeguard measures to customs union members when imports from all sources are taken into account for the injury determination, as well as a "parallelism requirement". Argentina maintains that neither of these supposed obligations has any basis in the *Agreement on Safeguards*.

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[23] In paras. 8.126, 8.127, 8.205, 8.207, 8.218 and 8.238 of the Panel Report.

[24] Appellate Body Report, WT/DS22/AB/R, adopted 20 March 1997, DSR 1997:I, 157, at 186.

[25] Appellate Body Report, WT/DS50/AB/R, adopted 16 January 1998, DSR 1998:I, 9, para. 92.

[26] Appellate Body Report, *Australia - Measures Affecting Importation of Salmon* ("*Australia - Salmon*"), WT/DS18/AB/R, adopted 6 November 1998, DSR 1998:VIII, 3327, para. 110.

13. Argentina contends that the footnote to Article 2.1 addresses comprehensively the conditions applicable to a safeguard investigation when a Member is part of a customs union. The fourth sentence of the footnote reflects the fact that Members could not agree on how to reconcile the requirements of Article XXIV:8 of the GATT 1994 with the most-favoured-nation requirement in Article 2.2 of the *Agreement on Safeguards*. Thus, in the last sentence of the footnote, Members specifically acknowledged that there was no resolution of this conflict in the *Agreement on Safeguards*. Argentina notes that the drafting history of footnote 1 shows that the Members deleted the very provisions that the Panel has attempted to "read in" to the existing text of the footnote.[27]

14. Argentina alleges as well that the Panel erred in law by imposing a "parallelism requirement" between the determination of injury and the application of the safeguard measure that is not found in the *Agreement on Safeguards*. Article 5, which sets out the requirements for the *application* of safeguard measures, makes no reference to any requirement of "parallelism", except to the extent that a measure may not exceed what is necessary to remedy the injury. Similarly, Article 9, which exempts developing countries from the *application* of safeguard measures in certain circumstances, does not impose a requirement that parallel modifications be made as part of the injury determination. In Argentina's view, the only "parallelism" on which the Members agreed is that only the market where injury is found can apply safeguard measures.

3. Claims under Articles 2 and 4 of the Agreement on Safeguards

15. Argentina argues that, despite articulating a standard of review which essentially requires that a decision be "reasoned" and the decision-making process "explained", the Panel committed "significant legal error" by engaging in a "wholesale exercise of *de novo* review".[28] In its appellant's submission, Argentina referred to the standard of review applied by the panel in *United States - Imposition of Antidumping Duties on Imports of Fresh and Chilled Atlantic Salmon from Norway* ("*United States - Salmon*")[29] , as well as certain national rules of judicial review, for example, in the United States Court of Appeals for the Federal Circuit. Argentina clarified during the oral hearing that it accepts that the appropriate standard of review is found in Article 11 of the DSU, and that the Panel correctly identified this standard of review. Argentina's position is, rather, that having

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[27] Argentina cites a text tabled on 31 October 1990 by the Chairman of the Negotiating Group on Safeguards (MTN.GNG/NG9/W/25/Rev.3), which included the following proposal for the last sentence of the footnote:

> It is understood that when a safeguard measure is applied by a customs union on behalf of a member state, *[any injury attributable to competition from producers established in other member states in the customs union shall not be attributed to increased imports, in conformity with the provisions of sub-paragraph 7(b)] [such a measure shall be applied to imports from other member states of the customs union].* (emphasis added by Argentina)

[28] Argentina's appellant's submission, p. 25.

[29] Panel Report, ADP/87, adopted 27 April 1994, BISD 41S/229, para. 406.

identified the proper standard of review, the Panel did not apply it correctly. Instead, Argentina contends, the Panel erred in conducting a "*de facto de novo*" review of the findings and conclusions of the Argentine investigating authority.

16. In Argentina's view, the Panel's approach demonstrates confusion about the meaning of *de novo* review.[30] The Panel repeatedly substituted its judgment for that of the Argentine authorities and set out its own view of the correct analysis to be made and the conclusions to be drawn. The Panel's analysis went far beyond the approach used in the cases to which to the Panel referred.[31] The Panel read methodologies into the *Agreement on Safeguards* where that Agreement itself is silent, and it did so despite the fact that the Members have reached no agreement on such methodologies. Argentina also contests the Panel's characterization of the object and purpose of the *Agreement on Safeguards* as focused on limiting trade restrictions, and its reliance on this characterization in its reasoning and decision making. Argentina argues that the *Agreement on Safeguards* was in fact intended *both* to increase discipline and transparency in safeguards cases *and* to liberalize some of the rules relating to Article XIX in order to encourage Members to eliminate grey-area measures.

17. With respect to the Panel's analysis of Argentina's determination that imports had increased, Argentina argues that the Panel collapsed the "increased imports" requirement with other requirements of Article 2, and wrongly treated it as a qualitative, rather than a quantitative requirement. In Argentina's view, the ordinary meaning of increased imports is that imports have become greater, and, contrary to the position of the European Communities, there is no factual or contextual support for any additional requirements in the *Agreement on Safeguards*.

18. Argentina emphasizes that the Panel took a very specific view of how the "increase" in imports must be calculated and compared. Even though the Panel recognized that the five-year base period selected was not inappropriate and that, on the basis of such review period, imports increased, the Panel nevertheless continued its inquiry and imposed a number of methodological hurdles which must be overcome before a finding of "increased imports" can be justified. The Panel misdefined the word "rate" in Article 4 to include "direction", and found that there could only be "increased imports" in this case if: (i) a change in the base year from 1991 to 1992 would still result in an increase; (ii) the analysis of end points and interim periods were mutually reinforcing; and (iii) it was found that the decrease in imports in 1994 and 1995 was temporary.

19. Argentina argues that, in its attempt to arrive at the "correct" result, the Panel ignored the following: (i) 1991 was an appropriate starting point to measure any increase because 1991 was the year in which market reforms were completed in

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[30] Argentina notes that "*de novo* review" has been defined as "trying the matter anew - as if it had not been heard before." *Black's Law Dictionary* (West Publishing Co., 5th ed., 1979) p. 392.

[31] Panel Report, *United States - Restrictions on Imports of Cotton and Man-made Fibre Underwear* ("*United States - Underwear*"), WT/DS24/R, adopted 25 February 1997, as modified by the Appellate Body Report WT/DS24/AB/R, DSR 1997:I, 31; Panel Report, *United States - Measure Affecting Imports of Woven Wool Shirts and Blouses* ("*United States - Shirts and Blouses*"), WT/DS33/R, adopted 23 May 1997, as upheld by the Appellate Body Report WT/DS33/AB/R, DSR 1997:I, 343.

Argentina; (ii) the "mutually reinforcing" requirement means that virtually any decrease in imports during a review period could prevent a finding of increased imports; and (iii) the Argentine decision in Act 338 specifically notes that the decline in imports was due to the specific duties that had been placed on footwear imports.

20. Argentina contends that, in effect, the Panel did not object to the *analysis* made by the Argentine authorities, but to their *conclusion* that imports increased absolutely. The Panel erred because the effect of its approach was to redetermine the weight to be assigned to each fact. Such an approach does not meet the requirement of Article 11 of the DSU that an objective assessment be provided. The Panel also violated Article 11 of the DSU by referring to the *preliminary*, rather than the *final* determination of the Argentine authorities, in support of its findings. In addition, the Panel violated Article 3.2 of the DSU by imposing obligations on Argentina that are not found in the *Agreement on Safeguards*.

21. Argentina submits also that the Panel erred in its analysis of Argentina's determination of "serious injury". In Argentina's view, Article 4.2(c) of the *Agreement on Safeguards* only requires a demonstration of the relevance of the factors examined, and not an examination of whether all factors are relevant. The Panel wrongly found that Argentina had not properly considered the factors of capacity utilization and productivity, despite the fact that productivity is explicitly mentioned in Act 338 and the data to calculate capacity utilization was available to the Argentine authorities.

22. Argentina argues further that the Panel misinterpreted the evidence on "serious injury" and then found it to be legally deficient. The Panel improperly "required" Argentina to consider 1996 data as part of its injury determination, and erred in dismissing Argentina's argument that it could not have relied on 1996 data, as the record clearly shows that the data for 1996 was incomplete. Argentina submits that it was appropriate and reasonable to use a single review period for which all data was available as the basis for its consideration of all injury factors.

23. Despite certain statements made by the Panel, Argentina argues that the record is clear about the data used for each injury factor. Accordingly, the Panel erred in: (i) finding that Argentina violated the *Agreement on Safeguards* because the questionnaire results did not match such public industry-wide data; (ii) criticizing the Argentine authorities' treatment of interested party data which differed from questionnaire results; (iii) criticizing as inconsistent the data on overall firm profitability and its break-even point analysis; and (iv) finding that Argentina did not explain how a shift to higher-value production was a sign of injury.

24. Argentina argues that the Panel further erred in its findings with respect to causation. The Argentine authorities concluded that imports took market share from the domestic industry, and that this led to a fall in domestic production that caused financial and economic indicators to fall for the companies investigated. The Panel criticized this analysis and set out three of its own "standards". First, the Panel required that an upward trend in imports *coincide* with a *downward* trend in the injury factors. Argentina notes that Article 4.2(c) of the *Agreement on Safeguards* refers to "changes", not "downward trends", so there is no requirement that there be a *downward* trend in each year of the period of review. Moreover, the Panel's requirement of "coincidence" in time is not implied by the term "cause". Second, the Panel used the phrase "under such conditions" to develop a requirement that the "conditions of competition" between imported and domestic footwear in the

Argentine footwear market demonstrate a "causal link" between increased imports and injury. Argentina asserts that there is no basis in the *Agreement on Safeguards* for this requirement. Third, the Panel required the Argentine authorities to establish that other relevant factors have been analyzed, and that injury caused by factors other than imports has not been attributed to imports. Argentina maintains that this requirement goes far beyond those actually contained in the *Agreement on Safeguards*, and fails to acknowledge the approach of the Argentine authorities, which ensured that general macroeconomic factors were not attributed to imports.

25. Finally, Argentina believes that the Panel violated Article 12.7 of the DSU, which requires that a panel report include the "basic rationale" behind any findings and recommendations that a panel makes. For example, Act 338 specifically notes that the decline in imports was due to the specific duties placed on footwear imports in 1993. Argentina contends that the Panel ignored this in its insistence that the *Agreement on Safeguards* requires an analysis of intervening trends and its criticism of Argentina for failing to take such trends into account. Argentina contends also that the Panel misinterpreted the evidence before it on "serious injury" and then found that evidence to be legally deficient. In Argentina's opinion, therefore, the Panel's conclusions "are not rational and do not follow logically from the evidence".[32]

B. Arguments by the European Communities - Appellee

1. Terms of Reference

26. The European Communities does not agree with Argentina that the Panel erred in considering or relying, in its reasoning, on Article 3 of the *Agreement on Safeguards* and, accordingly asks the Appellate Body to affirm the Panel's conclusions in that respect. The European Communities notes that the Panel has not found a violation of Article 3 of the *Agreement on Safeguards as such*. Instead the Panel legitimately referred to the requirements contained in Article 3.1 when considering the violation of Article 4.2(c) (which the European Communities did invoke), because Article 4.2(c) contains a cross-reference to Article 3. Moreover, the European Communities argues that, even in the absence of a specific cross-reference, panels and the Appellate Body may, in their reasoning, legitimately rely on a provision that was not mentioned in the request for the establishment of a panel. The European Communities notes also that it made no claim of a violation of Article 3.

2. Imposition of Safeguard Measures by a Member of a Customs Union

27. The European Communities agrees with the Panel that the *Agreement on Safeguards* contains a "parallelism" requirement. By taking into consideration imports from MERCOSUR countries for the purposes of making its injury determination, even though it never intended to impose measures on those imports, Argentina violated its obligations under the *Agreement on Safeguards* and Article XIX of the GATT 1994. During the oral hearing, the European Communities

[32] Argentina's appellant's submission, p. 61.

emphasized, however, that the Panel's interpretation of Article XXIV of the GATT 1994 and Article 2.2 of the *Agreement on Safeguards* was not necessary to support its conclusion that a parallelism requirement exists, that no claim relating to the legal status of MERCOSUR was made before the Panel, and that neither party to this dispute has appealed the Panel's apparent assumption that Article XXIV is applicable.

28. The European Communities points out that the text of Article 2.1 of the *Agreement on Safeguards* sets out the *requirements* which should be fulfilled before a Member may apply a *safeguard measure*. This provision therefore underscores the inherent link between the *requirements* and the *measure*. Article 5 of the *Agreement on Safeguards* reinforces such a link by providing that "[a] Member shall apply safeguard measures only *to the extent necessary* to prevent or remedy serious injury" and that "Members should choose measures *most suitable* for the achievement of these objectives." In the view of the European Communities, Article 9 of the *Agreement on Safeguards* does not support Argentina's position that there is no "parallelism requirement" in the *Agreement on Safeguards*. Article 9 contains an express exception to the concept of "parallelism", but no similar express exception is foreseen for members of customs unions.

29. The European Communities argues that Article XIX of the GATT 1994 also requires parallelism. A liberalization obligation must give rise to increased imports, which in turn must cause serious injury. Under Article XIX, the authorized remedy for that serious injury can only be the suspension of the relevant GATT or WTO liberalization obligation. Accordingly, obligations incurred by Argentina *within the framework of its customs union* cannot justify a safeguard measure, and imports subject to such obligations must be excluded from the analysis. The European Communities notes in this context that there is no WTO obligation on Argentina not to impose safeguard measures on its MERCOSUR partners, only an internal MERCOSUR commitment.

3. Claims under Articles 2 and 4 of the Agreement on Safeguards

30. The European Communities maintains that the Panel correctly interpreted and applied the standard of review contained in Article 11 of the DSU, and did not engage in a *de novo* review.

31. The European Communities requests the Appellate Body to uphold the Panel's findings on "increased imports". The European Communities submits that the requirement of "increased imports" in Article 2.1 of the *Agreement on Safeguards* "should now be read in the light of the new package of rights and obligations,"[33] including Article XIX of the GATT 1994, and the *Agreement on Safeguards*, as well as on the basis of the object and purpose of these agreements. Given the content of the new "package", the determination of "increased imports" necessarily contains more than it did under the safeguard regime governed by Article XIX of the GATT 1947. The European Communities concludes that a strictly quantitative interpretation of the "increased imports" requirement (assuming *arguendo* that such an

[33] European Communities' appellee's submission, para. 71.

interpretation existed under Article XIX of the GATT 1947) can no longer be reconciled with the functioning of the safeguard mechanism under the WTO.

32. In the view of the European Communities, the Panel did not, as Argentina claims, require that both the end point to end point analysis and the intervening periods *must be* mutually reinforcing. Rather, the Panel concluded that the Member taking a safeguard measure should determine whether or not imports increased by examining the issue from more than just one angle. If one analysis goes in a different direction from the other, then, as the Panel says, this "raises doubts" as to whether the conclusion that "imports increased" is justified, and a proper explanation is required. The European Communities also highlights the fact that the Panel has based its reasoning on the "increased imports" requirement on the import figures for *all* countries, that is, *including* MERCOSUR countries. The European Communities argues that Argentina's non-fulfilment of the requirement of "increased imports" is even more striking when third-country imports are separated out.

33. The European Communities submits that the Panel correctly analyzed Argentina's serious injury determination as required by Article 11 of the DSU and was justified in concluding that this determination did not comply with the *Agreement on Safeguards*. In the view of the European Communities, the ordinary meaning of the requirement contained in Article 4.2(a) of the *Agreement on Safeguards* that "the competent authorities shall evaluate all relevant factors" is that such authorities are required to: (i) evaluate *at least* all of the factors mentioned in Article 4.2(a), and possibly more, if necessary; and (ii) on the basis of this examination demonstrate - and publish - the relevance of the factors considered. The European Communities submits that the Panel correctly concluded that Argentina failed to undertake these legally required steps with regard to capacity utilization and productivity.

34. The European Communities also requests the Appellate Body to uphold the Panel's analysis of Argentina's treatment of 1996 data. Article 4.2(a) of the *Agreement on Safeguards* requires "*all relevant factors*" to be considered, and the most *relevant* information is the most *recent*. The European Communities rejects Argentina's claim that, since it could consider 1996 data for some but not for all factors, it was reasonable to use a single review period for which all data are available. The *Agreement on Safeguards* does not oblige Members to base their determinations on a complete set of data for *all* factors for a *fixed* time-frame. By deliberately ignoring the 1996 information for those factors for which it *had* collected the information, Argentina made conclusions which were not reasonably supported by the facts.

35. The European Communities submits that the Panel correctly analyzed Argentina's causation determination, as required by Article 11 of the DSU, and was justified in concluding that this determination did not meet the requirements set out in Article 4 of the *Agreement on Safeguards.* In the view of the European Communities, the ordinary meaning of the term causation is "the act of causing or producing an effect".[34] One event (the increase in imports) must *produce* the other event (serious injury). If the two events take place simultaneously, then the

[34] European Communities' appellee's submission, para. 121.

probability that the events are linked is greater than if they happen many years apart. The longer the time between the two events, the more a compelling analysis is required of why causation is still present.

36. The European Communities considers that the Panel correctly interpreted the "under such conditions" requirement in Article 2.1 of the *Agreement on Safeguards* as indicating the need to analyze the conditions of competition between the imported product and the domestic like or directly competitive products as part of the causation analysis required by Article 4.2(a) and (b).[35] The European Communities disputes Argentina's claim that Article 4.2(b) of the *Agreement on Safeguards* does not require a separate analysis of possible "other" factors. In order to conclude that no "other" factor had caused the serious injury, the European Communities submits that it is necessary to examine whether there were such other factors present and to examine their impact on the domestic industry. In the view of the European Communities, by not providing such an analysis, in particular of the "tequila effect", Argentina violated Article 4.2(b) and (c) of the *Agreement on Safeguards*.

37. With respect to Argentina's claim of a violation of Article 12.7 of the DSU, the European Communities submits that, as the Appellate Body found in *Korea - Taxes on Alcoholic Beverages* ("*Korea - Alcoholic Beverages*")[36], the Panel has set out a detailed and thorough rationale for its findings and recommendations in this case, as required by Article 12.7 of the DSU, and, therefore, there is no violation.

C. Claims of Error by the European Communities - Appellant

1. Relationship Between Article XIX of the GATT 1994 and the Agreement on Safeguards

38. The European Communities appeals and requests the Appellate Body to reverse the Panel's conclusion that safeguard measures imposed after the entry into force of the WTO agreements which meet the requirements of the new *Agreement on Safeguards* also thereby satisfy the requirements of Article XIX of the GATT 1994, as well as the Panel's consequent refusal to rule on the European Communities' Article XIX claim. The European Communities further requests the Appellate Body to reverse the legal interpretations and findings made in support of this conclusion, notably the Panel's erroneous reference to the "*express omission* of the criterion of unforeseen developments" in the *Agreement on Safeguards.* The European Communities requests the Appellate Body to complete the Panel's reasoning and find, on the basis of the uncontested facts, that Argentina did not comply with the requirement contained in Article XIX:1(a) of the GATT 1994 to take safeguard measures only where the alleged increase in imports is "*as a result of unforeseen developments*".

39. The European Communities asserts that the requirement that increased imports result from "unforeseen developments" is a fundamental characteristic of safeguard measures, and lies at the beginning of the "logical " of events justifying the

[35] Panel Report, para. 8.250.

[36] Appellate Body Report, WT/DS75/AB/R, WT/DS84/AB/R, adopted 17 February 1999, DSR 1999:I, 3, para. 168.

invocation of the safeguard mechanism. This starts with a WTO Member incurring an obligation under the GATT 1994. After this obligation is implemented, an unforeseen development occurs, resulting in increased imports, which occur under conditions such that serious injury (or a threat thereof) is caused. In the view of the European Communities, if this chain of events has occurred, then a WTO Member may take a safeguard measure.

40. The European Communities is convinced that the WTO agreements are a "single undertaking" which constitutes an "integrated system". The requirement that increased imports must result from "unforeseen developments" and the other fundamental characteristics of safeguard measures were not expressly repeated in the *Agreement on Safeguards* because they did not need to be clarified, added to or modified.

41. The European Communities submits that there are four possible relationships between a provision of the GATT 1994 and an Agreement in Annex 1A of the *Marrakesh Agreement Establishing the World Trade Organization* (the "*WTO Agreement*"), namely: a *conflict* between provisions of the two texts; an *overlap* of provisions of the two texts[37]; *an express derogation* in an Agreement in Annex 1A of the *WTO Agreement* that allows for a violation of the GATT 1994; and provisions that are *complementary*. The European Communities argues that the fourth option, i.e, *complementary* provisions, describes the relationship between Article XIX:1(a) and Article 2.1 of the *Agreement on Safeguards*, and should have formed the basis for the Panel's reasoning. The Appellate Body has confirmed in *Brazil - Desiccated Coconut*[38] and *Guatemala - Antidumping Investigation Regarding Grey Portland Cement from Mexico* ("*Guatemala - Cement*")[39] that provisions of the GATT 1994 and the relevant Agreement in Annex 1A of the *WTO Agreement* represent a package of rights and disciplines that must be considered in conjunction. Applying this to the present case, the European Communities argues that the *Agreement on Safeguards* does not supersede or replace the GATT 1994, and that it is possible to apply the conditions in the GATT 1994 and the *Agreement on Safeguards* together, because there is no formal *conflict* between them.

42. The European Communities argues that the ordinary meaning of the term "*as a result of unforeseen developments*" is "as a consequence of a sudden change in a course of action or events or in conditions that has not been foreseen".[40] The European Communities agrees that the opening phrase of Article XIX:1(a) of the GATT 1994 is relevant context for the "*as a result of unforeseen developments*" requirement, but comes to a conclusion opposite to that reached by the Panel. This phrase makes clear that there are two pre-conditions which need to be present before a safeguard action can be taken. Imports should increase *as a result of* unforeseen

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[37] *See* e.g., Panel Report, *European Communities - Regime for the Importation, Sale and Distribution of Bananas* ("*European Communities - Bananas*"), WT/DS27/R/USA, adopted 25 September 1997, as modified by the Appellate Body Report, WT/DS27/AB/R, DSR 1997:II, 943, para. 203.

[38] *Supra,* footnote 24.

[39] Appellate Body Report, WT/DS60/AB/R, adopted 25 November 1998, DSR 1998:IX, 3763.

[40] European Communities' appellant's submission, para. 24.

developments, and also *as a result of* the effect of tariff concessions or any other obligations under the GATT 1994.

43. The European Communities rejects the reasoning of the Panel on the object and purpose of the *Agreement on Safeguards*. In the view of the European Communities, the object and purpose of the *Agreement on Safeguards* is inherently linked with Article XIX of the GATT 1994, entitled "*Emergency Action* on Imports of Particular Products". (emphasis added) Therefore, safeguard measures are by definition a mechanism based on "emergencies": the very nature of a safeguard measure is to tackle an *urgent* situation which was *not expected*.

44. The European Communities is of the view also that the Panel mis-interpreted the 1951 *Hatters' Fur* case[41] by stating that it "made it easier" to meet the "*unforeseen developments*" condition, and that the Panel wrongly gave credit to the view of one legal scholar that this case "essentially read the unforeseen developments condition out of the text of Article XIX:1(a) of GATT 1947".[42] In fact, the *Hatters' Fur* Working Party confirmed the validity and relevance of the "*as a result of unforeseen developments*" requirement. The European Communities adds that further support for the continuing validity of the "*as a result of unforeseen developments*" requirement is found in recent texts of national legislation notified by WTO Members. Korea, Costa Rica, Norway, Panama and Japan have all incorporated the phrase in their national laws.

D. Arguments by Argentina - Appellee

1. Relationship Between Article XIX of the GATT 1994 and the Agreement on Safeguards

45. Argentina requests the Appellate Body to affirm the Panel's finding that "safeguard measures imposed after the entry into force of the WTO agreements which meet the requirements of the new Safeguards Agreement satisfy the requirements of Article XIX of GATT"[43] and to decline to consider the claims of the European Communities under Article XIX separately. Argentina maintains that the "unforeseen developments" requirement in Article XIX has not been included in the *Agreement on Safeguards*, and that this significant omission can only be attributed to the intention of Members to eliminate that requirement *as a condition separate from and independent of the provisions of the Agreement on Safeguards*.

46. Argentina finds no legal text or other element that supports the reasoning of the European Communities that there is a "logical continuum of events" that conditions the application of a safeguard measure and that begins with the condition that "unforeseen developments" must occur. To Argentina, it is clear that the Uruguay Round undertook to recast the disciplines governing the application of safeguard measures by clarifying, developing and, where appropriate, modifying some aspects of those disciplines. If the entire content of Article XIX were perfectly

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[41] *Report of the Intersessional Working Party on the Complaint of Czechoslovakia Concerning the Withdrawal by the United States of a Tariff Concession under the Terms of Article XIX, ("Hatters' Fur")*, GATT/CP/106, adopted 22 October 1951.

[42] Panel Report, para. 8.65, footnote 470.

[43] Panel Report, para. 8.69.

consistent with the *Agreement on Safeguards*, there would have been no need to include in Article 11.1(a) the reference to "provisions of that Article applied in accordance with this Agreement".

47. In Argentina's view, the fact that certain Article XIX provisions are not expressly incorporated in the *Agreement on Safeguards* does not support the position of the European Communities. For example, the concept of "emergency action" is incorporated *by reference* in Article 11.1(a), with the clarification that any measure of this kind must be applied in conformity both with the *Agreement on Safeguards* and with Article XIX, and the provision that safeguard measures consist of the suspension of the relevant GATT obligation or the withdrawal or modification of the relevant concession appears in Article 8 of the *Agreement on Safeguards*. Similarly, the concept of "unforeseen developments" is now fully met once the conditions under Article 2 of the *Agreement on Safeguards* have been satisfied. Consequently, Argentina submits that it is clear that a situation in which a product is being imported "in such increased quantities" and "under such conditions" as to cause or threaten serious injury is now, by definition, an instance of "unforeseen developments" within the meaning of Article XIX and Article 2 of the *Agreement on Safeguards*.

48. Argentina argues that none of the four possible interpretations put forward by the European Communities constitutes the proper analytical approach based on *Brazil - Desiccated Coconut*. The panel in *Brazil - Desiccated Coconut* specifically rejected the notion that the *Agreement on Subsidies and Countervailing Measures* (the "*SCM Agreement*") merely imposed *additional* substantive and procedural obligations[44] or that a measure imposed under that Agreement and under Article VI of the GATT 1994 would necessarily be consistent with Article VI in isolation.[45] Argentina interprets this case to mean that Article VI in and of itself can no longer have an independent, separate meaning, and that both agreements must be considered in conjunction.[46]

49. Argentina refers to the negotiating history of the *Agreement on Safeguards* in support of its position, noting that the June 1989 draft of that Agreement contained the concept of an "unforeseen increase … " in imports.[47] By mid-1990, though, all references to measures taken as a result of unforeseen or emergency situations had disappeared from the drafts of the *Agreement on Safeguards*.[48] Thus, in Argentina's view, the requirement that the increase in imports should result from unforeseen circumstances was expressly considered during the negotiation and intentionally left out of the text.

50. Argentina highlights the fact that the European Communities eliminated the "unforeseen developments" requirements from its domestic legislation on safeguards.[49] Argentina considers this to be proof that the European Communities

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[44] Panel Report, WT/DS22/R, adopted 20 March 1997, as upheld by the Appellate Body Report, WT/DS22/AB/R, DSR 1997:I, 189, para. 246.

[45] *Ibid*., para. 247.

[46] Appellate Body Report, *Brazil - Desiccated Coconut*, *supra*, footnote 24, at 181.

[47] MTN.GNG/NG9/W/25, 27 June 1989.

[48] MTN.GNG/NG9/W/25/Rev.2, 13 July 1990.

[49] EC Regulation 3285/94, OJ 1994 L349/53.

did not itself consider that the requirement existed in the context of the new rights and obligations defined and interpreted in the *Agreement on Safeguards*.

51. Argentina requests that if the Appellate Body does not accept the Panel's interpretation, then, in the alternative, the Appellate Body should find that there is a "conflict" between the *Agreement on Safeguards* and Article XIX, and confirm that the *Agreement on Safeguards* takes precedence over Article XIX in accordance with the General Interpretative Note to Annex 1A. Finally, in the event that the Appellate Body finds that there is a separate obligation to verify the existence of unforeseen developments, Argentina requests, in the further alternative, that the Appellate Body find that Argentina did verify such unforeseen developments in its investigation. Argentina stated in its decision that "the pressure of imports was unforeseen on account of its rapid pace of increase at a time when the national economy was facing macroeconomic problems".[50]

E. Arguments by the Third Participants

1. Indonesia

52. Indonesia agrees with the European Communities that Argentina's safeguard measure was "fatally flawed" because it was not imposed in response to "unforeseen developments" as required by Article XIX of the GATT 1994. Indonesia also joins the European Communities in its request that the Appellate Body complete the Panel's analysis and hold that Argentina acted in violation of Article XIX. In Indonesia's view, the Panel's treatment of Article XIX and the *Agreement on Safeguards* is in direct conflict with the construction of the relationship between the GATT 1994 and the Annex 1A Agreements by previous panels and by the Appellate Body. Referring to the panel report in *European Communities - Bananas*[51], as well as to the Appellate Body reports in *Brazil - Desiccated Coconut*[52] and *Guatemala - Cement*[53], Indonesia submits that the Panel erred in law when it refused to apply Article XIX and the *Agreement on Safeguards* together, giving meaning to *all* terms in *both* agreements. Indonesia adds that, by reading the "unforeseen developments" requirement out of the WTO system altogether, the Panel removed an important protection against abuse of the safeguard mechanism.

53. Indonesia submits that Argentina's interpretation of footnote 1 to Article 2.1 of the *Agreement on Safeguards* is incorrect. Footnote 1 relates to the imposition of a safeguard measure by a customs union. Here, however, no action was taken *by a customs union*. Rather, Argentina independently investigated and imposed the safeguard measure on its own behalf. Footnote 1 says *nothing* about the obligations of, or any conditions affecting, a member of a customs union *acting individually*. For the same reason, even assuming *arguendo* that Argentina's interpretation of the negotiating history of footnote 1 is correct, it does not support Argentina's argument, because the language on which the parties allegedly could not reach agreement would not have applied to Argentina's actions in this case, i.e., to where a safeguard

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50 Act 338, folio 5350.
51 *Supra*, footnote 37, para. 7.160.
52 *See Brazil - Desiccated Coconut, supra*, footnote 24, at 178-179.
53 *Supra*, footnote 39, para. 65.

measure is applied *by a state acting independently*. Indonesia also questions whether Article XXIV is applicable to MERCOSUR, as the members of MERCOSUR did not notify the customs union under Article XXIV of either the GATT 1947 or the GATT 1994.

54. Indonesia adds that even if footnote 1 were somehow applicable to Argentina's action by virtue of its MERCOSUR membership, that footnote would only permit a derogation from the obligations contained in *Article 2.1* of the *Agreement on Safeguards*. However, Argentina's independent imposition of a safeguard against only non-MERCOSUR countries violates *Article 2.2*, which obliges Members to apply safeguard measures in a nondiscriminatory fashion.

55. Indonesia maintains that the Panel's analysis of the "parallelism requirement" is best understood, not as an interpretation of the terms of the *Agreement on Safeguards* as such, but as an explanation of how - in practical terms - a Member can reconcile its WTO obligations under the *Agreement* with commitments that it may have made separately to members of its customs union. Argentina agreed with its fellow MERCOSUR members to refrain from applying safeguard measures against one another. That "extra-WTO" agreement, however, cannot exempt Argentina from its obligations *vis-à-vis* all other WTO Members under the *Agreement on Safeguards*.

56. Indonesia submits that the Panel properly refrained from conducting a *de novo* review of the determinations by Argentine authorities. In Indonesia's view, it was well within the scope of the Panel's authority to assess whether those determinations were reasonably supported by the results of the investigation. Moreover, Indonesia believes that, because Argentina failed to demonstrate "increased imports", failed to demonstrate "serious injury", and failed to demonstrate causation, the Panel correctly concluded that Argentina violated Articles 2 and 4 of the *Agreement on Safeguards*.

57. With respect to "increased imports", Indonesia characterizes Argentina's principal complaint as a belief that the Panel imposed new obligations on Members to use specific methodologies. In Indonesia's view, however, the Panel Report merely points out analytical flaws in Argentina's analysis; it is *not* fairly read as imposing specific requirements. Indonesia contends that Argentina ignored the "tense" of Article 2 of the *Agreement on Safeguards* - its focus on present and future rather than past events. In this respect, Indonesia points out that Argentina's failure to consult 1996 data did not itself constitute a violation of Article 2 and also that the Panel did not characterize it as such. The Panel simply found fault with Argentina's failure to weigh *all* the available data, particularly where the missing data would tend to contradict Argentina's finding of an "increase."

58. With respect to "serious injury", Indonesia underlines that Argentina failed to consider two factors that it was specifically required to evaluate under Article 4.2(a) - productivity and capacity utilization. Indonesia rejects Argentina's claim that it may pick and choose *a priori* the factors that it wishes to examine, and explain the relevance of those selected factors after the fact. Indonesia is also of the view that the Panel correctly held that Argentina relied on inadequate evidence even for those "serious injury" factors that it did choose to consider.

59. Indonesia submits that the Panel's conclusion that Argentina had not identified evidence or analysis on which it could reasonably base a determination of causation should also be upheld. Argentina failed to separate out the effects of other economic factors - such as the "tequila effect" - from the effects of footwear imports

on the domestic industry. Indonesia agrees with the Panel that it is not enough simply to juxtapose the imports and the injury, and then to assert that there must be a link between them. If Argentina did not or cannot explain *how* the alleged increase in imports caused the alleged harm to its domestic manufacturers, then, Indonesia submits, the mere correspondence of these events in time will not support the imposition of a safeguard measure.

2. United States

60. The United States submits that the Panel correctly found that safeguard investigations conducted and safeguard measures imposed since the entry into force of the WTO agreements which meet the requirements of the *Agreement on Safeguards* also thereby satisfy the requirements of Article XIX of the GATT 1994. The United States requests the Appellate Body to uphold this ruling, as well as the Panel's consequent decision to decline to rule on the Article XIX claim by the European Communities.

61. The United States notes that while the *Agreement on Safeguards* defines "safeguard measures" as "those measures provided for in Article XIX", a number of the provisions of the Agreement, including Articles 2, 3, 4, 5, 7, 8.3, 9 and 10, either limit the rights provided in Article XIX or provide rights ruled out by Article XIX. In addition, the United States observes that the preamble of the Agreement refers to a "comprehensive agreement, applicable to all Members", and notes the need to re-establish control over safeguards measures and to eliminate grey-area measures. These objectives were achieved through an agreement that imposed new procedural requirements, enhanced transparency and consultation requirements, but loosened in some respects the strict requirements of Article XIX, while explicitly prohibiting grey-area measures. If it were possible for Members to pick and choose between the rights and obligations in the original package of Article XIX, and the rights and obligations in the *Agreement on Safeguards*, then the entire project represented by that Agreement would be revised *post hoc*, and the negotiated balance would be fundamentally upset.

62. The United States argues that the rebalancing of Article XIX was a fundamental premise of the negotiations on safeguards. Because of the problem of grey-area measures, the agreement had to be comprehensive and had to apply to all contracting parties. That rebalancing included the removal of the "unforeseen developments" condition for safeguard measures. Therefore, the text of Article XIX now cannot be read outside the context of the *Agreement on Safeguards*, and that Agreement now completely occupies the field of regulation of safeguard measures in the WTO system. The United States concludes that the omission of "unforeseen developments" from the Agreement was intentional, and that this express omission must be given meaning.

63. The United States notes that legal scholars agree that under the *Agreement on Safeguards*, "unforeseen developments" are no longer a prerequisite for a safeguard action[54], and that state practice has also treated the question of "unforeseen

[54] M.C.E.J. Bronckers, "Voluntary Export Restraints and the GATT 1994 Agreement on Safeguards," in J.H.J. Bourgeois, F. Berrod and E.Fournier (eds.), *The Uruguay Round Results: A*

developments" as "marginal, legally nonbinding or subsumed by other aspects of the safeguards process".[55] The United States underlines that the great majority of safeguards legislation notified to the WTO (including that of the European Communities) does not even refer to "unforeseen developments". With respect to the *Hatters' Fur* case of 1951[56], the United States considers that, while this case cannot contradict the substantive rebalancing that took place in the Uruguay Round, it does help to clarify the legal interpretation of "unforeseen developments" under the GATT 1947, the reasons why negotiators were willing to omit this concept from the Uruguay Round results, and how a determination which fully satisfies the requirements of Article 2.1 may also satisfy the "unforeseen developments" requirement.

64. With respect to the Panel's interpretation of footnote 1 to Article 2.1 of the *Agreement on Safeguards*, the United States refers to its view of the negotiating history of the footnote, as set out *in extenso* in paragraph 6.32 of the Panel Report and in footnote 396 to that paragraph. The United States emphasizes the reason why this footnote follows the word "Member": due to the unique status of the European Communities in the GATT, and to the fact that the European Communities did take safeguards measures, a special provision was needed to deal with the application of safeguards by the European Communities.

65. The United States also notes that Argentina and the Panel have wrongly referred to Article XXIV of the GATT 1994. In the view of the United States, MERCOSUR has never been notified under Article XXIV. The parties to MERCOSUR have chosen to notify it instead exclusively under the Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries[57] (the "Enabling Clause"). The United States contends that, having made this legal choice, Argentina is now precluded from basing its arguments on the assumption that MERCOSUR is an Article XXIV agreement, and that, therefore, the fourth sentence of footnote 1 to Article 2.1 of the *Agreement on Safeguards* is legally irrelevant in this case.

66. The United States submits that the Panel identified and applied the proper standard of review. A fair reading of the Panel Report demonstrates that the Panel did not, as Argentina alleges, engage in *de novo* review or construct alternate methodologies that it then concluded Argentina had failed to satisfy. Rather, the Panel properly examined whether Argentina had evaluated the relevant evidence, reached conclusions that were reasonably supported by the evidence, and adequately explained the reasoning set forth in its findings and conclusions. On this basis, and in keeping with the applicable standard of review, the Panel properly concluded that Argentina's actions were inconsistent with Articles 2 and 4 of the *Agreement on Safeguards*.

67. With respect to "increased imports", the United States emphasizes that the Panel *did not* re-evaluate the facts or impose a specific methodology for collecting or

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European Lawyers' Perspective" (European University Press, 1995), p. 275; M. Trebilcock and R. Howse, *The Regulation of International Trade* (2nd ed., 1999), p. 228.

55 United States' third participant's submission, para. 22.

56 *Supra*, footnote 41.

57 L/4903, adopted 28 November 1979, BISD 26S/203.

evaluating the evidence. The Panel did not conclude that an end point analysis is *per se* inconsistent with the *Agreement on Safeguards*. Rather, the United States believes, the contrary evidence on interim periods was so significant that, in the absence of an explanation in Argentina's determination concerning how it had evaluated that contrary evidence, the Panel could not conclude that Argentina's determination that imports had increased constituted an objective evaluation of the record as a whole.

68. The United States argues also that the Panel properly found that Argentina's conclusions with respect to "serious injury" were not adequately supported by the evidence. The Panel's determination that, under Article 4.2(a), a Member must evaluate *all* relevant factors is consistent with past panel practice, including *United States - Underwear* and *United States - Shirts and Blouses*.[58] The United States also rejects as without merit Argentina's attacks on the Panel's determination that Argentina's findings and conclusions were not adequately explained and supported by the evidence.

69. On the question of causation, the United States notes that Argentina alleges *inter alia* that the Panel articulated a series of "new standards" that Argentina had to satisfy, rather than analyzing the adequacy of Argentina's actual decision. However, the United States asserts that the Panel's determination makes clear that what is at issue is Argentina's failure to provide sufficient evidence to justify its decision. The United States concludes that the Panel correctly found that Argentina's measure cannot be sustained where the underlying decision does not demonstrate that Argentina considered the relevant evidence and provided a reasoned explanation of its conclusions.

III. ISSUES RAISED IN THIS APPEAL

70. This appeal raises the following issues:

(a) whether the Panel exceeded its terms of reference in its consideration of Article 3 of the *Agreement on Safeguards*;

(b) whether the Panel erred: in concluding that "safeguard investigations conducted and safeguard measures imposed after the entry into force of the WTO agreements which meet the requirements of the new Safeguards Agreement satisfy the requirements of Article XIX of GATT"; in its consequent refusal to consider the EC's claims under Article XIX of the GATT 1994; and in its conclusion that the phrase "as a result of unforeseen developments" in Article XIX:1(a) of the GATT 1994 was "*expressly omitted*" from the *Agreement on Safeguards* and, therefore, has no relevance for a safeguard measure imposed under the *Agreement on Safeguards*;

(c) whether the Panel erred in its interpretation and application of Article 2 of the *Agreement on Safeguards* and Article XXIV of the GATT 1994 as these provisions relate to the application of the safeguard measure at issue in this case;

[58] *Supra*, footnote 31.

(d) whether the Panel: enunciated and applied the correct standard of review in this case; erred in its interpretation and application of the conditions for imposing a safeguard measure set forth in Articles 2 and 4 of the *Agreement on Safeguards*, in particular, increased imports, serious injury and causation; and set out a "basic rationale" for its findings as required by Article 12.7 of the DSU.

IV. TERMS OF REFERENCE

71. Argentina argues, on appeal, that the Panel violated Article 7.2 of the DSU and exceeded its terms of reference, because the Panel not only considered, but also relied on, alleged violations of Article 3 of the *Agreement on Safeguards* even though the request for the establishment of a Panel submitted by the European Communities only alleged violations of Articles 2 and 4 of the *Agreement on Safeguards*. Argentina maintains, in particular, that the Panel's references to Article 3 contained in paragraphs 8.205, 8.207, 8.218 and 8.238 of the Panel Report [59] demonstrate that the Panel relied on obligations contained in Article 3 in reaching its conclusion that Argentina did not act in compliance with its obligations under Article 4.2(c) of the *Agreement on Safeguards*.

72. Article 4.2(c) of the *Agreement on Safeguards* provides as follows:

> The competent authorities shall publish promptly, *in accordance with the provisions of Article 3*, a detailed analysis of the case under investigation as well as a demonstration of the relevance of the factors examined. (emphasis added)

Article 3 provides, in relevant part:

> 1. … The competent authorities shall publish a report setting forth their findings and reasoned conclusions reached on all pertinent issues of fact and law.

73. We have examined the specific paragraphs in the Panel Report cited by Argentina, and we see no *finding* by the Panel that Argentina acted inconsistently with Article 3 of the *Agreement on Safeguards*. In one instance[60], the Panel referred to Article 3 parenthetically in support of its reasoning on Article 4.2(a) of the *Agreement on Safeguards*. Every other reference to Article 3 cited by Argentina was made by the Panel in conjunction with the Panel's reasoning and findings relating to Article 4.2(c) of the *Agreement on Safeguards*. None of these references constitutes a legal finding or conclusion by the Panel regarding Article 3 itself.

74. We note that the very terms of Article 4.2(c) of the *Agreement on Safeguards* expressly incorporate the provisions of Article 3. Thus, we find it difficult to see how a panel could examine whether a Member had complied with Article 4.2(c) without also referring to the provisions of Article 3 of the *Agreement on Safeguards*. More particularly, given the express language of Article 4.2(c), we do not see how a panel

[59] At page 1 of its appellant's submission, Argentina also referred to the Panel's reasoning in paragraphs 8.126 and 8.127 of the Panel Report. During the oral hearing, however, Argentina limited its arguments to paragraphs 8.205, 8.207, 8.218 and 8.238 of the Panel Report.

[60] Panel Report, para. 8.238.

could ignore the publication requirement set out in Article 3.1 when examining the publication requirement in Article 4.2(c) of the *Agreement on Safeguards*. And, generally, we fail to see how the Panel could have interpreted the requirements of Article 4.2(c) *without* taking into account in some way the provisions of Article 3. What is more, we fail to see how any panel could be expected to make an "objective assessment of the matter", as required by Article 11 of the DSU, if it could only refer in its reasoning to the specific provisions cited by the parties in their claims.

75. Consequently, we conclude that the Panel did not exceed its terms of reference by referring in its reasoning to the provisions of Article 3 of the *Agreement on Safeguards*. On the contrary, we find that the Panel was *obliged* by the terms of Article 4.2(c) to take the provisions of Article 3 into account. Thus, we do not believe that the Panel erred in its reasoning relating to the provisions of Article 3 of the *Agreement on Safeguards* in making its findings under Article 4.2(c) of that Agreement.

V. ARTICLE XIX OF THE GATT 1994 AND "UNFORESEEN DEVELOPMENTS"

76. The European Communities appeals the Panel's conclusion "that safeguard investigations conducted and safeguard measures imposed after the entry into force of the WTO agreements which meet the requirements of the new Safeguards Agreement satisfy the requirements of Article XIX of GATT." [61] The European Communities appeals as well the Panel's consequent refusal to rule on the European Communities' Article XIX claim, and asks the Appellate Body to reverse the legal interpretations and findings of the Panel made in support of this conclusion, notably the "fundamental error" made by the Panel when it referred to the "*express omission* of the criterion of unforeseen developments" in the *Agreement on Safeguards*.[62] The European Communities argues that the requirement of increased imports resulting from "unforeseen developments" is a fundamental characteristic of a safeguard measure because it lies at the beginning of a "logical " of events justifying the invocation of a safeguard measure.[63] The European Communities requests the Appellate Body to find, on the basis of uncontested facts in the Panel Report, that Argentina did not comply with the requirement in Article XIX:1(a) of the GATT 1994 that safeguard measures may only be taken when the alleged increase in imports is "a result of unforeseen developments".[64]

77. In concluding that safeguard investigations and safeguard measures imposed after the entry into force of the *Agreement on Safeguards* which meet the requirements of that Agreement also thereby "*satisfy*" the requirements of Article XIX of the GATT 1994, the Panel made the following observations about the relationship between Article XIX of the GATT 1994 and the *Agreement on Safeguards*:

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61 Panel Report, para. 8.69.
62 European Communities' appellant's submission, para. 5.
63 *Ibid*., para. 17.
64 *Ibid*., para. 138.

> … the application of safeguard measures in the meaning of Article XIX requires - since the entry into force of the Safeguards Agreement - conformity with the requirements and conditions of the latter agreement. Although all the provisions of Article XIX of GATT continue to legally co-exist with the Safeguards Agreement in the framework of the single undertaking of the Uruguay Round agreements, any implementation of safeguard measures in the meaning of Article XIX presupposes the application of and thus compliance with the provisions of the Safeguards Agreement.[65]
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> …
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> … While the Safeguards Agreement does not supersede or replace Article XIX, which continues to remain in force as part of the GATT, the original conditions contained in Article XIX have to be read in the light of the subsequently negotiated and much more specific provisions of the Safeguards Agreement. Those provisions of the Safeguards Agreement place the original rule of Article XIX within the entire package of the new WTO legal system and make it operational in practice.[66]
>
> …
>
> … Given the reasoning developed by the panel and the Appellate Body in the *Brazil - Desiccated Coconut* case, it is our view that Article XIX of GATT and the Safeguards Agreement must *a fortiori* be read as representing an *inseparable package* of rights and disciplines which have to be considered in conjunction. Therefore, we conclude that Article XIX of GATT cannot be understood to represent the total rights and obligations of WTO Members, but that rather the Safeguards Agreement as applying the disciplines of Article XIX of GATT, reflects the latest statement of WTO Members concerning their rights and obligations concerning safeguards. Thus the Safeguards Agreement should be understood as *defining, clarifying, and in some cases modifying* the whole package of rights and obligations of Members with respect to safeguard measures as they currently exist. By the same token, and in the light of the principle of effective treaty interpretation, the *express omission* of the criterion of unforeseen developments in the new agreement (which otherwise transposes, reflects and refines in great detail the essential conditions for the imposition of safeguard measures

[65] Panel Report, para. 8.55.
[66] *Ibid*., para. 8.56.

> provided for in Article XIX of GATT) must, in our view, have meaning.[67]
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> …
>
> … it is our conclusion that safeguard investigations conducted and safeguard measures imposed after the entry into force of the WTO agreements which meet the requirements of the new Safeguards Agreement satisfy the requirements of Article XIX of GATT. Therefore, we see no basis to address the EC's claims under Article XIX of GATT separately and in isolation from those under the Safeguards Agreement.[68]

78. In addressing this issue, we will examine, first, whether the Panel is correct in its conclusion about the relationship between the *Agreement on Safeguards* and Article XIX of the GATT 1994, and, second, whether the clause - "as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions … " in Article XIX:1(a) of the GATT 1994 continues to have any meaning and legal effect.

79. With respect to the relationship between the *Agreement on Safeguards* and Article XIX of the GATT 1994, we begin with Article II of the *WTO Agreement*. Paragraph 2 of that Article stipulates:

> The agreements and associated legal instruments included in Annexes 1, 2 and 3 (hereinafter referred to as "Multilateral Trade Agreements") are *integral parts* of this Agreement, *binding on all Members*. (emphasis added)

Paragraph 4 of that Article provides:

> The General Agreement on Tariffs and Trade 1994 as specified in Annex 1A (hereinafter referred to as "GATT 1994") is *legally distinct* from the General Agreement on Tariffs and Trade, dated 30 October 1947 … (hereinafter referred to as "GATT 1947"). (emphasis added)

80. We note that the GATT 1994 is the first agreement that appears in Annex 1A to the *WTO Agreement*, and that it consists of: the provisions of the GATT 1947, as rectified, amended or modified by the terms of legal instruments that entered into force before the entry into force of the *WTO Agreement*; the provisions of certain legal instruments, such as protocols and certifications, decisions on waivers and other decisions of the CONTRACTING PARTIES to the GATT 1947, that entered into force under the GATT 1947 before the entry into force of the *WTO Agreement*; certain Uruguay Round Understandings relating to specific GATT articles; and the Marrakesh Protocol to the GATT 1994 containing Members' Schedules of Concessions.[69]

81. Thus, the GATT 1994 is *not* the GATT 1947. It is "legally distinct" from the GATT 1947. The GATT 1994 and the *Agreement on Safeguards* are *both*

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[67] Panel Report, para. 8.58.

[68] Panel Report, para. 8.69.

[69] *See* paragraph 1 of the language incorporating the GATT 1994 into Annex 1A of the *WTO Agreement*.

Multilateral Agreements on Trade in Goods contained in Annex 1A of the *WTO Agreement*, and, as such, are *both* "integral parts" of the same treaty, the *WTO Agreement*, that are "binding on all Members".[70] Therefore, the provisions of Article XIX of the GATT 1994 *and* the provisions of the *Agreement on Safeguards* are *all* provisions of one treaty, the *WTO Agreement*. They entered into force as part of that treaty at the same time. They apply equally and are equally binding on all WTO Members. And, as these provisions relate to the same thing, namely the application by Members of safeguard measures, the Panel was correct in saying that "Article XIX of GATT and the Safeguards Agreement must *a fortiori* be read as representing an *inseparable package* of rights and disciplines which have to be considered in conjunction."[71] Yet a treaty interpreter must read all applicable provisions of a treaty in a way that gives meaning to *all* of them, harmoniously.[72] And, an appropriate reading of this "inseparable package of rights and disciplines" must, accordingly, be one that gives meaning to *all* the relevant provisions of these two equally binding agreements.

82. The drafters of the *WTO Agreement* addressed this issue specifically. The precise nature of the relationship between Article XIX of the GATT 1994 and the *Agreement on Safeguards* within the *WTO Agreement* is described in Articles 1 and 11.1(a) of the *Agreement on Safeguards* as follows:

> Article 1
>
> *General Provision*
>
> This Agreement establishes rules for the application of safeguard measures which shall be understood to mean *those measures provided for in Article XIX of GATT 1994*. (emphasis added)

> Article 11
>
> *Prohibition and Elimination of Certain Measures*
>
> 1. (a) A Member shall not take or seek any *emergency action* on imports of particular products *as set forth in Article XIX of GATT 1994 unless such action conforms with the provisions of that Article applied in accordance with this Agreement*. (emphasis added)

83. We see nothing in the language of either Article 1 or Article 11.1(a) of the *Agreement on Safeguards* that suggests an intention by the Uruguay Round

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[70] *WTO Agreement*, Article II:2.

[71] Panel Report, para. 8.58.

[72] We have recently confirmed this principle in our Report in *Korea - Definitive Safeguard Measure on Imports of Certain Dairy Products*, WT/DS98/AB/R, circulated 14 December 1999, para. 81. *See* also Appellate Body Report, *United States - Standards for Reformulated and Conventional Gasoline* ("*United States - Gasoline*"), WT/DS2/AB/R, adopted 20 May 1996, DSR 1996:I, 3, at 21; Appellate Body Report, *Japan - Taxes on Alcoholic Beverages* ("*Japan - Alcoholic Beverages*"), WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, adopted 1 November 1996, DSR 1996:I, 97, at 106; Appellate Body Report, *India - Patents*, *supra*, footnote 25, para. 45.

negotiators to *subsume* the requirements of Article XIX of the GATT 1994 within the *Agreement on Safeguards* and thus to render those requirements no longer applicable. Article 1 states that the purpose of the *Agreement on Safeguards* is to establish "rules for the application of safeguard measures which shall be understood to mean *those measures provided for* in Article XIX of GATT 1994." (emphasis added) This suggests that Article XIX continues in full force and effect, and, in fact, establishes certain prerequisites for the imposition of safeguard measures. Furthermore, in Article 11.1(a), the ordinary meaning of the language "unless such action *conforms with the provisions of that Article applied in accordance with this Agreement*" (emphasis added) clearly is that any safeguard action must *conform with* the provisions of Article XIX of the GATT 1994 *as well as* with the provisions of the *Agreement on Safeguards*. Neither of these provisions states that any safeguard action taken after the entry into force of the *WTO Agreement* need only conform with the provisions of the *Agreement on Safeguards*.[73]

84. Thus, we conclude that any safeguard measure[74] imposed after the entry into force of the *WTO Agreement* must comply with the provisions of *both* the *Agreement on Safeguards and* Article XIX of the GATT 1994.

85. As a consequence, we must examine the claims of the European Communities under Article XIX of the GATT 1994, and, specifically, its claim on appeal that the clause - "as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions … " - in Article XIX:1(a) of the GATT 1994 is a requirement that must be satisfied in order for a safeguard measure to be imposed.

86. The provisions of Article XIX:1(a) of the GATT 1994 and Article 2.1 of the *Agreement on Safeguards*, which together set out the conditions for applying a safeguard measure under the *WTO Agreement*, read as follows:

GATT 1994

Article XIX

Emergency Action on Imports of Particular Products

> 1. *(a)* If, *as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions*, any product is

[73] We note that the provisions of Article 11.1(a) of the *Agreement on Safeguards* are significantly different from the provisions of Article 2.4 of the *Agreement on the Application of Sanitary and Phytosanitary Measures*, which state:

> Sanitary or phytosanitary measures *which conform to* the relevant provisions of this Agreement *shall be presumed to be in accordance with* the obligations of the Members under the provisions of GATT 1994 which relate to the use of sanitary or phytosanitary measures, in particular the provisions of Article XX(b). (emphasis added)

[74] With the exception of special safeguard measures taken pursuant to Article 5 of the *Agreement on Agriculture* or Article 6 of the *Agreement on Textiles and Clothing*.

> being imported into the territory of that Member in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers in that territory of like or directly competitive products, the Member shall be free, in respect of such product, and to the extent and for such time as may be necessary to prevent or remedy such injury, to suspend the obligation in whole or in part or to withdraw or modify the concession. (emphasis added)

Agreement on Safeguards

Article 2

Conditions

> 1. A Member may apply a safeguard measure to a product only if that Member has determined, pursuant to the provisions set out below, that such product is being imported into its territory in such increased quantities, absolute or relative to domestic production, and under such conditions as to cause or threaten to cause serious injury to the domestic industry that produces like or directly competitive products. (footnote omitted)

87. In comparing the language of Article XIX:1(a) of the GATT 1994 and Article 2.1 of the *Agreement on Safeguards*, we observe that although much of the language in the two provisions is very similar, and, in fact, identical, the initial clause in Article XIX:1(a) - "as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions … " - does not appear in Article 2.1 of the *Agreement on Safeguards*. After making this same observation, the Panel concluded that the "unforeseen developments" clause was "expressly omitted" by the Uruguay Round negotiators. And, although the Panel conceded at one point in its reasoning that Article XIX and the *Agreement on Safeguards* "legally co-exist"[75] as part of the *WTO Agreement*, the Panel concluded from this supposedly "*express omission*" that the "omitted" phrase has no meaning.

88. We believe that, with this conclusion, the Panel failed to give meaning and legal effect to *all* the relevant terms of the *WTO Agreement*, contrary to the principle of effectiveness (*ut res magis valeat quam pereat*) in the interpretation of treaties.[76]

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[75] Panel Report, para. 8.55.

[76] We note that in our Report *United States - Gasoline*, (*supra,* footnote 72, at 21), we emphasized that:

> … One of the corollaries of the "general rule of interpretation" in the *Vienna Convention* is that interpretation must give meaning and effect to all the terms of a treaty. An interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility.

See also Appellate Body Report, *Japan - Alcoholic Beverages*, *supra,* footnote 72, at 106; and Appellate Body Report, *Canada - Measures Affecting the Importation of Milk and the Exportation*

The Panel states that the "*express omission* of the criterion of unforeseen developments" in Article XIX:1(a) from the *Agreement on Safeguards* "must, in our view, have meaning."[77] On the contrary, in our view, if they had intended to *expressly omit* this clause, the Uruguay Round negotiators would and could have said so in the *Agreement on Safeguards*. They did not.

89. Furthermore, it is clear from Articles 1 and 11.1(a) of the *Agreement on Safeguards* that the Uruguay Round negotiators did not intend that the *Agreement on Safeguards* would entirely replace Article XIX. Instead, the ordinary meaning of Articles 1 and 11.1(a) of the *Agreement on Safeguards* confirms that the intention of the negotiators was that the provisions of Article XIX of the GATT 1994 and of the *Agreement on Safeguards* would apply *cumulatively*, except to the extent of a conflict between specific provisions.[78] We do not see this as an issue involving a conflict between specific provisions of two Multilateral Agreements on Trade in Goods. Thus, we are obliged to apply the provisions of Article 2.1 of the *Agreement on Safeguards* and Article XIX:1(a) of the GATT 1994 *cumulatively*, in order to give meaning, by giving legal effect, to all the applicable provisions relating to safeguard measures.

90. Having concluded that the clause - "as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions … " - in Article XIX:1(a) of the GATT 1994 does have meaning, we are obliged by virtue of that conclusion to consider what that meaning *is*. Toward this end, we refer again to the language of Article XIX:1(a), in its entirety:

> If, *as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions, any product is being imported* into the territory of that Member in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers in that territory of like or directly competitive products, the Member shall be free, in respect of such product, and to the extent and for such time as may be necessary to prevent or remedy such injury, to suspend the obligation in whole or in part or to withdraw or modify the concession. (emphasis added)

91. To determine the meaning of the clause - "as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions … " - in sub-paragraph (a) of Article XIX:1, we must examine these words in their ordinary meaning, in their context and in light of the object and purpose of Article XIX.[79] We look first to the ordinary meaning of

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of Dairy Products, WT/DS103/AB/R, WT/DS113/AB/R, adopted 27 October 1999, DSR 1999:V, 2057, para. 133.

[77] Panel Report, para. 8.58.

[78] As set out in the General Interpretative Note to Annex 1A of the *WTO Agreement*.

[79] As we have said in Appellate Body Report, *United States - Gasoline*, *supra*, footnote 72, at 16; Appellate Body Report, *Japan - Alcoholic Beverages*, *supra*, footnote 72, at 105; Appellate Body Report, *India - Patents*, *supra*, footnote 25, para. 46; Appellate Body Report, *Argentina - Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items*, WT/DS56/AB/R, adopted 22

these words. As to the meaning of "unforeseen developments", we note that the dictionary definition of "unforeseen", particularly as it relates to the word "developments", is synonymous with "unexpected".[80] "Unforeseeable", on the other hand, is defined in the dictionaries as meaning "unpredictable" or "incapable of being foreseen, foretold or anticipated".[81] Thus, it seems to us that the ordinary meaning of the phrase "as a result of unforeseen developments" requires that the developments which led to a product being imported in such increased quantities and under such conditions as to cause or threaten to cause serious injury to domestic producers must have been "unexpected". With respect to the phrase "of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions … ", we believe that this phrase simply means that it must be demonstrated, as a matter of fact, that the importing Member has incurred obligations under the GATT 1994, including tariff concessions. Here, we note that the Schedules annexed to the GATT 1994 are made an integral part of Part I of that Agreement, pursuant to paragraph 7 of Article II of the GATT 1994. Therefore, any concession or commitment in a Member's Schedule is subject to the obligations contained in Article II of the GATT 1994.

92. When we examine this clause - "as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions … " - in its immediate context in Article XIX:1(a), we see that it relates directly to the second clause in that paragraph - "If, … , any product is being imported into the territory of that Member in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers in that territory of like or directly competitive products …". The latter, or second, clause in Article XIX:1(a) contains the three *conditions* for the application of safeguard measures. These *conditions*, which are reiterated in Article 2.1 of the *Agreement on Safeguards*[82], are that: (1) a product is being imported "in such quantities and under such conditions"; (2) "as to cause"; (3) serious injury or the threat of serious injury to domestic producers. The first clause in Article XIX:1(a) - "as a result of unforeseen developments and of the obligations incurred by a Member under the Agreement, including tariff concessions … " - is a dependent clause which, in our view, is linked grammatically to the verb phrase "is being imported" in the second clause of that paragraph. Although we do not view the first clause in Article XIX:1(a) as establishing independent *conditions* for the application of a safeguard measure, additional to the *conditions* set forth in the second clause of that paragraph, we do believe that the first clause describes certain *circumstances* which must be demonstrated as a matter of fact in order for a safeguard measure to be applied

April 1998, DSR 1998:III, 1003, para. 47; Appellate Body Report, *European Communities - Customs Classification of Certain Computer Equipment*, WT/DS62/AB/R, adopted 22 June 1998, DSR 1998:V, 1851, para. 84; Appellate Body Report, *United States - Import Prohibition of Certain Shrimp and Shrimp Products*, WT/DS58/AB/R, adopted 6 November 1998, DSR 1998:VII, 2755, para. 114.

[80] *See Webster's Third New International Dictionary*, (Encyclopaedia Britannica Inc., 1966) Vol. 3, p. 2496; and *Black's Law Dictionary*, 6th ed., (West Publishing Company, 1990) p. 1530.

[81] *Ibid*.

[82] We note that the title of Article 2 of the *Agreement on Safeguards* is: "*Conditions*".

consistently with the provisions of Article XIX of the GATT 1994. In this sense, we believe that there is a logical connection between the circumstances described in the first clause - "as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions … " - and the conditions set forth in the second clause of Article XIX:1(a) for the imposition of a safeguard measure.

93. Our reading is supported by the context of these provisions. As part of the context of paragraph 1(a) of Article XIX, we note that the title of Article XIX is: "*Emergency Action on Imports of Particular Products*". The words "emergency action" also appear in Article 11.1(a) of the *Agreement on Safeguards*. We note once again, that Article XIX:1(a) requires that a product be imported "*in such increased quantities* and *under such conditions* as *to cause or threaten serious injury* to domestic producers". (emphasis added) Clearly, this is not the language of ordinary events in routine commerce. In our view, the text of Article XIX:1(a) of the GATT 1994, read in its ordinary meaning and in its context, demonstrates that safeguard measures were intended by the drafters of the GATT to be matters out of the ordinary, to be matters of urgency, to be, in short, "emergency actions." And, such "emergency actions" are to be invoked only in situations when, as a result of obligations incurred under the GATT 1994, a Member finds itself confronted with developments it had not "foreseen" or "expected" when it incurred that obligation. The remedy that Article XIX:1(a) allows in this situation is temporarily to "suspend the obligation in whole or in part or to withdraw or modify the concession". Thus, Article XIX is clearly, and in every way, an extraordinary remedy.

94. This reading of these phrases is also confirmed by the object and purpose of Article XIX of the GATT 1994. The object and purpose of Article XIX is, quite simply, to allow a Member to re-adjust temporarily the balance in the level of concessions between that Member and other exporting Members when it is faced with "unexpected" and, thus, "unforeseen" circumstances which lead to the product "being imported" in "such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers of like or directly competitive products". In perceiving and applying this object and purpose to the interpretation of this provision of the *WTO Agreement*, it is essential to keep in mind that a safeguard action is a "fair" trade remedy. The application of a safeguard measure does not depend upon "unfair" trade actions, as is the case with anti-dumping or countervailing measures. Thus, the import restrictions that are imposed on products of exporting Members when a safeguard action is taken must be seen, as we have said, as extraordinary. And, when construing the prerequisites for taking such actions, their extraordinary nature must be taken into account.

95. Our reading of these prerequisites does precisely this, by making certain that *all* the relevant provisions of the *Agreement on Safeguards* and Article XIX of the GATT 1994 relating to safeguard measures are given their full meaning and their full legal effect. Our reading, too, is consistent with the desire expressed by the Uruguay Round negotiators in the Preamble to the *Agreement on Safeguards* "to clarify and *reinforce* the disciplines of GATT 1994, and *specifically those of its Article XIX* …, to re-establish *multilateral control* over safeguards and eliminate measures that

escape such control …".[83] In furthering this statement of the object and purpose of the *Agreement on Safeguards*, it must always be remembered that safeguard measures result in the temporary suspension of concessions or withdrawal of obligations, such as those in Article II and Article XI of the GATT 1994, which are fundamental to the *WTO Agreement*. As such, safeguard measures may be applied only when *all* the provisions of the *Agreement on Safeguards* and Article XIX of the GATT 1994 are clearly demonstrated.

96. In addition, we note that our reading of the clause - "as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions … " - in Article XIX:1(a) is also consistent with the one GATT 1947 case that involved Article XIX, the so-called "*Hatters' Fur*" case.[84] Members of the Working Party in that case, in 1951, stated:

> … "unforeseen developments" should be interpreted to mean developments occurring after the negotiation of the relevant tariff concession which it would not be reasonable to expect that the negotiators of the country making the concession could and should have foreseen at the time when the concession was negotiated.[85]

97. In the light of all of this, we do not agree with the Panel that any safeguard investigations conducted or safeguard measures imposed after the entry into force of the *WTO Agreement* "which meet the requirements of the new Safeguards Agreement *satisfy* the requirements of Article XIX of GATT." (emphasis added) Therefore, we reverse the Panel's conclusion in paragraph 8.69 of the Panel Report that safeguard measures imposed after entry into force of the *WTO Agreement* which meet the requirements of the *Agreement on Safeguards* necessarily "satisfy" the requirements of Article XIX of the GATT 1994, as well as the Panel's finding that the Uruguay Round negotiators "expressly omitted" the clause - "as a result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions … " - from Article 2 of the *Agreement on Safeguards*.

98. As will be seen, in the final section of this Report, we uphold the conclusions of the Panel that Argentina's investigation in this case was inconsistent with the requirements of Articles 2 and 4 of the *Agreement on Safeguards*. As a consequence, there is *no legal basis* for the safeguard measures imposed by Argentina. For this reason, we do not believe that it is necessary to complete the analysis of the Panel relating to the claim made by the European Communities under Article XIX of the GATT 1994 by ruling on whether the Argentine authorities have, in their investigation, demonstrated that the increased imports in this case occurred "as a

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[83] *Agreement on Safeguards,* Preamble.

[84] *Report of the Intersessional Working Party on the Complaint of Czechoslovakia Concerning the Withdrawal by the United States of a Tariff Concession under the Terms of Article XIX, ("Hatters' Fur")*, GATT/CP/106, adopted 22 October 1951.

[85] *Supra*, footnote 84, para. 9. This interpretation was proposed by the representative of Czechoslovakia, and was accepted by the majority of the Working Party with the exception of the United States.

result of unforeseen developments and of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions … ".

VI. IMPOSITION OF SAFEGUARD MEASURES BY A MEMBER OF A CUSTOMS UNION

99. Argentina claims on appeal that the Panel misinterpreted footnote 1 to Article 2.1 of the *Agreement on Safeguards* and erred by "imposing an obligation" on a member of a customs union to apply any safeguard measure on other members of that customs union whenever imports from all sources are taken into account in a safeguards investigation.

100. The Panel described the issue before it as follows:

> … the essential question is whether Argentina was permitted under the Safeguards Agreement to take MERCOSUR imports into account in the analysis of injury factors and of a causal link between increased imports and the alleged (threat of) serious injury, and was at the same time permitted to exclude MERCOSUR countries from the application of the safeguard measure imposed.[86]

101. Article 2 of the *Agreement on Safeguards* provides as follows:

> *Conditions*
>
> 1. A Member[1] may apply a safeguard measure to a product only if that Member has determined, pursuant to the provisions set out below, that such product is being imported into its territory in such increased quantities, absolute or relative to domestic production, and under such conditions as to cause or threaten to cause serious injury to the domestic industry that produces like or directly competitive products.
>
> 2. Safeguard measures shall be applied to a product being imported irrespective of its source.
>
> ---
>
> [1]A customs union may apply a safeguard measure as a single unit or on behalf of a member State. When a customs union applies a safeguard measure as a single unit, all the requirements for the determination of serious injury or threat thereof under this Agreement shall be based on the conditions existing in the customs union as a whole. When a safeguard measure is applied on behalf of a member State, all the requirements for the determination of serious injury or threat thereof shall be based on the conditions existing in that member State and the measure shall be limited to that member State. Nothing in this Agreement prejudges the interpretation of the relationship between Article XIX and paragraph 8 of Article XXIV of GATT 1994.

[86] Panel Report, para. 8.75.

102. The Panel examined the ordinary meaning of footnote 1 to Article 2.1, and stated that "*in the case of measures imposed by a customs union* there are two options for imposing safeguard measures, i.e., (i) as a single unit or (ii) on behalf of a member State."[87] (emphasis added) The Panel assumed that it was dealing with a safeguard measure imposed by a customs union "on behalf of a member State" within the meaning of the first and third sentences of footnote 1, and concluded that the "footnote does not concern *to whom* but rather *by whom* a safeguard measure may be applied."[88] The Panel then proceeded to examine the context of Article 2.1 and the footnote thereto. The Panel declared this context to be Article 2.2, which provides that "[s]afeguard measures shall be applied to a product being imported irrespective of its source."[89] The Panel then stated that:

> The ordinary meaning of Article 2.2 would appear to imply that, as a result of a member-State-specific investigation, safeguard measures have to be imposed on a non-discriminatory basis against products from all sources of supply, regardless of whether they originate from within or from outside of the customs union.[90]

103. On the basis of this reasoning, the Panel stated its interpretation that:

> … the two options offered by the footnote to Article 2.1 read in conjunction with Article 2.2 imply a *parallelism* between the scope of a safeguard *investigation* and the scope of the *application* of safeguard measures. Thus, in the light of the context of the footnote to Article 2.1, a member-state-specific investigation in which serious injury or threat thereof is found based on imports from all sources could only lead to the imposition of safeguard measures on a MFN-basis against all sources of intra-regional as well as extra-regional supply of a customs union.[91]

The Panel concluded, on the basis of its reasoning relating to Article 2, that "a member-state-specific investigation that finds serious injury or threat thereof caused by imports from all sources cannot serve as a basis for imposing a safeguard measure on imports only from third-country sources of supply."[92]

104. The Panel then turned its attention to Article XXIV of the GATT 1994, in response to an argument by Argentina that Article XXIV of the GATT 1994 and certain MERCOSUR regulations prohibited Argentina from imposing safeguard measures on other MERCOSUR countries. After a lengthy analysis of Article XXIV:8 of the GATT 1994, the Panel stated:

> … we do not agree with the argument that in the case before us Argentina is prevented by Article XXIV:8 of GATT from

87 Panel Report, para. 8.78.
88 *Ibid*., para. 8.83.
89 *Ibid*., para. 8.84.
90 Panel Report, para. 8.84.
91 *Ibid*., para. 8.87.
92 *Ibid*., para. 8.91.

> applying safeguard measures to all sources of supply, i.e., third countries as well as other member States of MERCOSUR.[93]

105. Finally, the Panel concluded as follows:

> … in the light of Article 2 of the Safeguards Agreement and Article XXIV of GATT, we conclude that in the case of a customs union the imposition of a safeguard measure only on third-country sources of supply cannot be justified on the basis of a member-state-specific investigation that finds serious injury or threat thereof caused by imports from all sources of supply from within and outside a customs union.[94]

106. We question the Panel's implicit assumption that footnote 1 to Article 2.1 of the *Agreement on Safeguards* applies to the facts of this case. The ordinary meaning of the first sentence of footnote 1 appears to us to be that the footnote only applies when a customs union applies a safeguard measure "as a single unit or on behalf of a member State".[95] On the facts of this case, Argentina applied the safeguard measures at issue after an investigation by Argentine authorities of the effects of imports from all sources on the Argentine domestic industry.

107. MERCOSUR did not apply these safeguard measures, either as a single unit or on behalf of Argentina.[96] When the safeguard measures at issue in this case were adopted by the government of Argentina, the transitional provisions in Chapter XII of the Regulation on the Application of Safeguard Measures to Imports from Non-Members of MERCOSUR (the "Regulation"), approved by Common Market Decision No. 17/96, were in effect among the State Parties of MERCOSUR.[97] According to these transitional provisions, the investigation procedure for the adoption of safeguard measures was to be conducted by the competent authorities of the State Party in question, applying relevant national legislation.[98]

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[93] *Ibid*., para. 8.101.

[94] Panel Report, para. 8.102.

[95] We also note that footnote 1 relates to the word "Member" in Article 2.1, which is commonly understood to mean a Member of the WTO.

[96] It is true that on 26 September 1997, Uruguay, as Pro Tempore President of MERCOSUR and on behalf of Argentina, notified the definitive safeguard measure imposed by Argentina. (G/SG/N/10/ARG/1/Suppl.2, G/SG/N/11/ARG/1/Supp.2, G/SG/14/Suppl.1 and G/L/195/Suppl.1, 22 October 1997). However, all relevant resolutions were adopted by Argentina alone, pursuant to Argentine national laws. We further note that that all other notifications relating to the measures at issue in this case were made by Argentina acting on its own behalf. In particular, on 26 September 1997 - the same day as Uruguay notified the measure on behalf of Argentina - Argentina itself transmitted a copy of Resolution 987/87 to the Committee on Safeguards (G/SG/N/10/ARG/1/Suppl.1, G/SG/N/11/ARG/1/Suppl.1, 10 October 1997).

[97] Adopted by the Council of Ministers of MERCOSUR in December 1996. *See* Panel Report, para. 5.103.

[98] In response to questions during the oral hearing, Argentina confirmed that:

> … until 31 December 1998, the common safeguards regime of MERCOSUR provided for this modality of application of a measure which would permit a state member of the customs union to apply the measure uniquely and that it would be notified by MERCOSUR. That is why the measure was applied by Argentina within its regulatory framework.

108. Therefore, at the time the safeguard measures at issue in this case were imposed by the Government of Argentina, these measures were not applied by MERCOSUR "on behalf of" Argentina, but rather, they were applied by Argentina. It is Argentina that is a Member of the WTO for the purposes of Article 2 of the *Agreement on Safeguards*, and it is Argentina that applied the safeguard measures after conducting an investigation of products being imported into *its* territory and the effects of those imports on *its* domestic industry. For these reasons, we do not believe that footnote 1 to Article 2.1 applies to the safeguard measures imposed by Argentina in this case. As a result, we find that the Panel erred in assuming that footnote 1 applied, and we, therefore, reverse the legal reasoning and findings of the Panel relating to footnote 1 to Article 2.1 of the *Agreement on Safeguards*.

109. Having found that footnote 1 to Article 2.1 is not applicable in this case, we also are not persuaded that an analysis of Article XXIV of the GATT 1994 was relevant to the specific issue that was before the Panel. This issue, as the Panel itself observed, is whether Argentina, after including imports from all sources in its investigation of "increased imports" of footwear products into its territory and the consequent effects of such imports on its domestic footwear industry, was justified in excluding other MERCOSUR member States from the application of the safeguard measures. In our Report in *Turkey - Restrictions on Imports of Textile and Clothing Products*, we stated that under certain conditions, "Article XXIV may justify a measure which is inconsistent with certain other GATT provisions."[99] We indicated, however, that this defence is available only when it is demonstrated by the Member imposing the measure that "the measure at issue is introduced upon the formation of a customs union that fully meets the requirements of sub-paragraphs 8(a) and 5(a) of Article XXIV" and "that the formation of that customs union would be prevented if it were not allowed to introduce the measure at issue."[100]

110. In this case, we note that Argentina did not argue before the Panel that Article XXIV of the GATT 1994 provided it with a defence to a finding of violation of a provision of the GATT 1994. As Argentina did not argue that Article XXIV provided it with a defence against a finding of violation of a provision of the GATT 1994, and as the Panel did not consider whether the safeguard measures at issue were introduced upon the formation of a customs union that fully meets the requirements of sub-paragraphs 8(a) and 5(a) of Article XXIV, we believe that the Panel erred in deciding that an examination of Article XXIV:8 of the GATT 1994 was relevant to its analysis of whether the safeguard measures at issue in this case were consistent with the provisions of Articles 2 and 4 of the *Agreement on Safeguards*. Accordingly, as we have found that the Panel's analysis of Article XXIV of the GATT 1994 was not relevant in this case, we reverse the Panel's legal findings and conclusions relating to Article XXIV of the GATT 1994.[101]

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[99] Appellate Body Report, WT/DS34/AB/R, adopted 19 November 1999, DSR 1999:VI, 2345, para. 58.

[100] *Ibid.*

[101] Panel Report, paras. 8.93-8.102.

111. We now turn to examine whether the Panel was correct in its interpretation that there is an implied "*parallelism* between the scope of a safeguard *investigation* and the scope of the *application* of safeguard measures."[102] Article 2.1 provides that:

> A *Member may* apply a safeguard measures … *only* if *that Member* has determined … that such product is being imported into *its territory* in such increased quantities … and under such conditions as to cause or threaten to cause serious injury to the domestic industry … (emphasis added)

Article 4.1(c) defines "domestic industry" as meaning "the producers as a whole of the like or directly competitive products operating *within the territory of a Member* …". (emphasis added) Taken together, the provisions of Articles 2.1 and 4.1(c) of the *Agreement on Safeguards* demonstrate that a Member of the WTO may only apply a safeguard measure after that Member has determined that a product is being imported *into its territory* in such increased quantities and under such conditions as to cause or threaten to cause serious injury to *its* domestic industry *within its territory*. According to Articles 2.1 and 4.1(c), therefore, all of the relevant aspects of a safeguard investigation must be conducted by the Member that ultimately applies the safeguard measure, on the basis of increased imports entering its territory and causing or threatening to cause serious injury to the domestic industry within its territory.

112. While Articles 2.1 and 4.1(c) set out the conditions for imposing a safeguard measure and the requirements for the scope of a safeguard *investigation*, these provisions do not resolve the matter of the scope of *application* of a safeguard measure. In that context, Article 2.2 of the *Agreement on Safeguards* provides:

> Safeguard measures shall be applied to a product being imported irrespective of its source.

As we have noted, in this case, Argentina applied the safeguard measures at issue after conducting an investigation of products being imported into Argentine territory and the effects of those imports on Argentina's domestic industry. In applying safeguard measures on the basis of this investigation in this case, Argentina was also required under Article 2.2 to apply those measures to imports from all sources, including from other MERCOSUR member States.

113. On the basis of this reasoning, and on the facts of this case, we find that Argentina's investigation, which evaluated whether serious injury or the threat thereof was caused by imports from *all* sources, could only lead to the imposition of safeguard measures on imports from *all* sources. Therefore, we conclude that Argentina's investigation, in this case, cannot serve as a basis for excluding imports from other MERCOSUR member States from the application of the safeguard measures.

114. For all the above reasons, we reverse the Panel's legal findings and conclusions relating to footnote 1 to Article 2.1 of the *Agreement on Safeguards* and Article XXIV of the GATT 1994. We conclude that Argentina, on the facts of this case, cannot justify the imposition of its safeguard measures only on

[102] *Ibid*., para. 8.87.

non-MERCOSUR third country sources of supply on the basis of an investigation that found serious injury or threat thereof caused by imports from all sources, including imports from other MERCOSUR member States. However, as we have stated, we do not agree that the Panel was dealing, on the facts of this case, with a safeguard measure applied by a customs union *on behalf of* a member State. And we wish to underscore that, as the issue is not raised in this appeal, we make no ruling on whether, as a general principle, a member of a customs union can exclude other members of that customs union from the application of a safeguard measure.

VII. CLAIMS UNDER ARTICLES 2 AND 4 OF THE AGREEMENT ON SAFEGUARDS

115. Although Argentina acknowledges that the Panel correctly articulated the proper standard of review based on Article 11 of the DSU, Argentina alleges that the Panel erred in *applying* that standard of review, by conducting a "*de facto de novo* review"[103] of the findings and conclusions of the Argentine authorities. As a consequence, Argentina maintains that the Panel read certain methodologies into the *Agreement on Safeguards* where that Agreement itself is silent, and thereby added to the rights and obligations of Members under that Agreement in violation of Article 3.2 of the DSU.[104] The *Agreement on Safeguards*, in Argentina's view, allows Members discretion in the way it is implemented; however, the Panel, in its reasoning, created new requirements that are not contained in the *Agreement on Safeguards*. Argentina also claims that the Panel made several legal errors in its analysis of the requirements of Articles 2 and 4 of the *Agreement on Safeguards*, in particular, relating to the conditions of increased imports, serious injury and causation that must be satisfied before a safeguard measure may be applied.[105] Finally, Argentina submits that the Panel Report was not adequately reasoned because the Panel failed to reach reasonable conclusions based on the totality of the evidence before the Argentine authorities, and that the Panel has therefore not fulfilled the requirement of Article 12.7 of the DSU that it provide a "basic rationale" for its ruling.[106]

A. Standard of Review

116. The Panel stated its approach to the standard of review as follows:

> In our view, we have no mandate to conduct a *de novo* review of the safeguard investigation conducted by the national authority. Rather, we must determine whether Argentina has abided by its multilateral obligations under the Agreement on Safeguards … in reaching its affirmative finding of injury and causation in the footwear investigation.[107]

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[103] Argentina's appellant's submission, p. 26.
[104] *Ibid*., p. 43.
[105] *Ibid*., pp. 43-66.
[106] Argentina's appellant's submission, pp. 42, 49 and 61.
[107] Panel Report, para. 8.117.

…

> … our review will be limited to an objective assessment, pursuant to Article 11 of the DSU, of whether the domestic authority has considered all relevant facts, including an examination of each factor listed in Article 4.2(a), of whether the published report on the investigation contains adequate explanation of how the facts support the determination made, and consequently of whether the determination made is consistent with Argentina's obligations under the Safeguards Agreement. We note that this was the standard of review applied by the Panel in *United States - Underwear*, with which we agree.[108]

117. Although the Panel ultimately stated the standard of review correctly, we are surprised that the Panel based its approach on several reports by previous panels reviewing domestic investigations in the context of two Tokyo Round Agreements: the Agreement on Implementation of Article VI of GATT and the Agreement on Interpretation and Application of Article VI, XVI and XXIII of GATT[109] as well as two previous WTO panels in United States - Underwear and United States - Shirts and Blouses.[110]

118. We have stated, on more than one occasion, that, for all but one of the covered agreements, Article 11 of the DSU sets forth the appropriate standard of review for panels.[111] The only exception is the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994, in which a specific provision, Article 17.6, sets out a special standard of review for disputes arising under that Agreement.

119. In our report in *European Communities - Hormones*, we stated that:

> Article 11 of the DSU bears directly on this matter and, in effect, articulates with great succinctness but with sufficient clarity the appropriate standard of review for panels in respect of both the ascertainment of facts and the legal characterization of such facts under the relevant agreements. …[112]

…

> So far as fact-finding by panels is concerned, their activities are always constrained by the mandate of Article 11 of the DSU: the applicable standard is neither *de novo* review as

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[108] Panel Report, para. 8.124.

[109] Panel Report, *New Zealand - Imports of Electrical Transformers from Finland*, adopted on 18 July 1985, BISD 32S/55; Panel Report, *United States - Salmon*, *supra*, footnote 29, para. 494.

[110] *Supra*, footnote 31.

[111] *See* e.g., Appellate Body Report, *EC Measures Concerning Meat and Meat Products* ("*European Communities - Hormones*"), WT/DS26/AB/R, WT/DS48/AB/R, adopted 13 February 1998, DSR 1998:I, 135, paras. 114-119; *Australia - Salmon*, *supra*, footnote 26, para. 2.67.

[112] Appellate Body Report, *European Communities - Hormones*, s*upra*, footnote 111, para. 116.

> such, nor "total deference", but rather the "objective assessment of the facts".[113]

120. Although that case dealt with the panel's assessment of the facts, and this case deals with the Panel's assessment of the matter, more generally, the same reasoning applies here. The *Agreement on Safeguards*, like the *Agreement on the Application of Sanitary and Phytosanitary Measures*, is silent as to the appropriate standard of review. Therefore, Article 11 of the DSU, and, in particular, its requirement that "… a panel should make an objective assessment of the matter before it, including an objective assessment of the facts of the case and the applicability of and conformity with the relevant covered agreements", sets forth the appropriate standard of review for examining the consistency of a safeguard measure with the provisions of the *Agreement on Safeguards*.

121. Based on our review of the Panel's reasoning, we find that the Panel correctly stated the appropriate standard of review, as set forth in Article 11 of the DSU. And, with respect to its *application* of the standard of review, we do not believe that the Panel conducted a *de novo* review of the evidence, or that it substituted its analysis and judgement for that of the Argentine authorities. Rather, the Panel examined whether, as required by Article 4 of the *Agreement on Safeguards*, the Argentine authorities had considered all the relevant facts and had adequately explained how the facts supported the determinations that were made. Indeed, far from departing from its responsibility, in our view, the Panel was simply fulfilling its responsibility under Article 11 of the DSU in taking the approach it did. To determine whether the safeguard investigation and the resulting safeguard measure applied by Argentina were consistent with Article 4 of the *Agreement on Safeguards*, the Panel was obliged, by the very terms of Article 4, to assess whether the Argentine authorities had examined all the relevant facts and had provided a reasoned explanation of how the facts supported their determination.

122. In addition to "an objective assessment of the facts ", we note, too, that part of the "objective assessment of the matter" required of a panel by Article 11 of the DSU is an assessment of "the applicability of and conformity with the relevant covered agreements". Consequently, we must also examine whether the Panel correctly interpreted and applied the substantive provisions of Articles 2 and 4 of the *Agreement on Safeguards*, in particular, those relating to the requirements of imports "in such increased quantities", "serious injury" to the domestic industry, and causation.

B. Interpretation and Application of Articles 2 and 4 of the Agreement on Safeguards

123. Articles 2.1 and 4.2 of the *Agreement on Safeguards* provide as follows:

[113] *Ibid*., para. 117.

> Article 2
>
> *Conditions*
>
> 1. A Member may apply a safeguard measure to a product only if that Member has determined, pursuant to the provisions set out below, that such product is being imported into its territory in such increased quantities, absolute or relative to domestic production, and under such conditions as to cause or threaten to cause serious injury to the domestic industry that produces like or directly competitive products. (footnote omitted)
>
> Article 4
>
> *Determination of Serious Injury or Threat Thereof*
>
> 2. (a) In the investigation to determine whether increased imports have caused or are threatening to cause serious injury to a domestic industry under the terms of this Agreement, the competent authorities shall evaluate all relevant factors of an objective and quantifiable nature having a bearing on the situation of that industry, in particular, the rate and amount of the increase in imports of the product concerned in absolute and relative terms, the share of the domestic market taken by increased imports, changes in the level of sales, production, productivity, capacity utilization, profits and losses, and employment.
>
> (b) The determination referred to in subparagraph (a) shall not be made unless this investigation demonstrates, on the basis of objective evidence, the existence of the causal link between increased imports of the product concerned and serious injury or threat thereof. When factors other than increased imports are causing injury to the domestic industry at the same time, such injury shall not be attributed to increased imports.
>
> (c) The competent authorities shall publish promptly, in accordance with the provisions of Article 3, a detailed analysis of the case under investigation as well as a demonstration of the relevance of the factors examined.

124. We recall the Panel's ultimate conclusions on Articles 2.1 and 4.2:

> For the foregoing reasons, we conclude that Argentina's investigation did not demonstrate that there were increased imports within the meaning of Articles 2.1 and 4.2(a); that the investigation did not evaluate all relevant factors of an objective and quantifiable nature having a bearing on the situation of the domestic industry within the meaning of Article 4.2(a); that the investigation did not demonstrate on the basis of objective evidence the existence of a causal link between increased imports and serious injury within the

> meaning of Article 2.1 and 4.2(b); that the investigation did not adequately take into account factors other than increased imports within the meaning of Article 4.2(b); and that the published report concerning the investigation did not set forth a complete analysis of the case under investigation as well as a demonstration of the relevance of the factors examined within the meaning of Article 4.2(c).
>
> Therefore, we find that Argentina's investigation and determinations of increased imports, serious injury and causation are inconsistent with Articles 2 and 4 of the Safeguards Agreement. As such, we find that Argentina's investigation provides *no* legal basis for the application of the definitive safeguard measure at issue, or any safeguard measure.[114]

1. Increased Imports

125. With respect to the requirement relating to "increased imports", the Panel stated as follows:

> The Agreement on Safeguards requires an increase in imports as a basic prerequisite for the application of a safeguard measure. The relevant provisions are in Articles 2.1 and 4.2(a).[115]
>
> …
>
> Thus, to determine whether imports have increased in "such quantities" for purposes of applying a safeguard measure, these two provisions require an analysis of the rate and amount of the increase in imports, in absolute terms and as a percentage of domestic production.[116]

126. In its evaluation of whether the investigation by the Argentine authorities demonstrated the required increase in imports under Articles 2.1 and 4.2(a), the Panel stated the following:

> *… the Agreement requires not just an increase (i.e., any increase) in imports, but an increase in "such…quantities" as to cause or threaten to cause serious injury*. The Agreement provides no numerical guidance as to how this is to be judged, nor in our view could it do so. But this does not mean that this requirement is meaningless. To the contrary, we believe that it means that the increase in imports must be judged in its full context, in particular with regard to its "rate and amount" as required by Article 4.2(a). Thus, considering the changes in import levels over the entire period of investigation, as

[114] Panel Report, paras. 8.279 and 8.280.
[115] *Ibid*., para. 8.138.
[116] *Ibid*., para. 8.141.

> discussed above, seems unavoidable when making a determination of whether there has been an increase in imports "in such quantities" in the sense of Article 2.1.[117] (emphasis added)

127. The Panel concluded that Argentina did not adequately consider the "intervening trends in imports, in particular the steady and significant declines in imports beginning in 1994, as well as the sensitivity of the analysis to the particular end points of the investigation period used."[118] For these reasons, the Panel concluded that "Argentina's investigation did not demonstrate that there were increased imports within the meaning of Articles 2.1 and 4.2(a)".[119] The Panel, though, rejected an argument made by the European Communities "that only a 'sharply increasing' trend in imports at the end of the investigation period can satisfy this requirement."[120]

128. Argentina maintains that, in its interpretation and application of the requirement of "increased imports" in Articles 2.1 and 4.2 of the *Agreement on Safeguards*, the Panel "impose[d] a variety of methodological hurdles which must be overcome before a finding of 'increased imports' can be justified."[121] In particular, Argentina argues that the Panel misinterpreted the word "rate" in Article 4.2(a) to include "direction", and found that there could only be "increased imports" if: (i) a change in the base year from 1991 to 1992 would still result in an increase; (ii) the analysis of end points and interim periods is mutually reinforcing; and (iii) it is found that the decrease in imports in 1994 and 1995 was temporary.[122] Argentina also asserts that the Panel "collapsed" the "increased imports" requirement "with the other qualitative requirements of Article 2" and wrongly treated it as a " , rather than a separate requirement."[123] The ordinary meaning of "increased imports", in Argentina's view, is that imports have become greater, and Argentina argues that there is no factual or contextual support for any additional requirements in the *Agreement on Safeguards*.[124]

129. We agree with the Panel that Articles 2.1 and 4.2(a) of the *Agreement on Safeguards* require a demonstration not merely of *any* increase in imports, but, instead, of imports "in such increased quantities … and under such conditions as to cause or threaten to cause serious injury."[125] In addition, we agree with the Panel that the specific provisions of Article 4.2(a) require that "the *rate* and *amount* of the increase in imports … in absolute and relative terms" (emphasis added) must be evaluated.[126] Thus, we do not dispute the Panel's view and ultimate conclusion that the competent authorities are required to consider the *trends* in imports over the

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117 Panel Report, para. 8.161.
118 *Ibid*., para. 8.276.
119 Panel Report, para. 8.279.
120 *Ibid*., para. 8.165.
121 Argentina's appellant's submission, p. 45.
122 *Ibid*., p. 46.
123 *Ibid*., p. 45.
124 Statement by Argentina at the oral hearing.
125 Article 2.1 of the *Agreement on Safeguards*.
126 Panel Report, paras. 8.140-8.141.

period of investigation (rather than just comparing the end points) under Article 4.2(a).[127] As a result, we agree with the Panel's conclusion that "Argentina did not adequately consider the intervening trends in imports, in particular the steady and significant declines in imports beginning in 1994, as well as the sensitivity of the analysis to the particular end points of the investigation period used."[128]

130. All the same, while we do not find that the Panel erred in its application of the requirement in Article 2.1 of the *Agreement in Safeguards* that the "product *is being imported* … in such increased quantities", we do find the Panel's interpretation of that requirement somewhat lacking. We note that the Panel characterized this condition in Article 2.1 on several occasions in the Panel Report simply as "increased imports". However, the actual requirement, and we emphasize that this requirement is found in *both* Article 2.1 of the *Agreement on Safeguards* and Article XIX:1(a) of the GATT 1994, is that "such product *is being imported* … in such increased quantities"[129], "and under such conditions as to cause or threaten to cause serious injury to the domestic industry". (emphasis added) Although we agree with the Panel that the "increased quantities" of imports cannot be just *any* increase, we do not agree with the Panel that it is reasonable to examine the trend in imports over a five-year historical period. In our view, the use of the present tense of the verb phrase "is being imported" in both Article 2.1 of the *Agreement on Safeguards* and Article XIX:1(a) of the GATT 1994 indicates that it is necessary for the competent authorities to examine recent imports, and not simply trends in imports during the past five years - or, for that matter, during any other period of several years.[130] In our view, the phrase "is being imported" implies that the increase in imports must have been sudden and recent.

131. We recall here our reasoning and conclusions above on the meaning of the phrase "as a result of unforeseen developments" in Article XIX:1(a) of the GATT 1994. We concluded there that the increased quantities of imports should have been "unforeseen" or "unexpected".[131] We also believe that the phrase "in *such* increased quantities" in Article 2.1 of the *Agreement on Safeguards* and Article XIX:1(a) of the GATT 1994 is meaningful to this determination. In our view, the determination of whether the requirement of imports "in such increased quantities" is met is not a merely mathematical or technical determination. In other words, it is not enough for an investigation to show simply that imports of the product this year were more than last year - or five years ago. Again, and it bears repeating, not just *any* increased quantities of imports will suffice. There must be "*such* increased quantities" as to cause or threaten to cause serious injury to the domestic industry in order to fulfil this requirement for applying a safeguard measure. And this language in both Article 2.1

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127 *Ibid.*, para. 8.276.

128 *Ibid.*

129 Article 2.1 of the *Agreement on Safeguards* contains the additional words "absolute or relative to domestic production".

130 The Panel, in footnote 530 to para. 8.166 of the Panel Report, recognizes that the present tense is being used, which it states "would seem to indicate that, whatever the starting-point of an investigation period, it has to *end* no later than the very recent past." (emphasis added) Here, we disagree with the Panel. We believe that the relevant investigation period should not only *end* in the very recent past, the investigation period should *be* the recent past.

131 *Supra*, paras. 91-98.

of the *Agreement on Safeguards* and Article XIX:1(a) of the GATT 1994, we believe, requires that the increase in imports must have been recent enough, sudden enough, sharp enough, and significant enough, both quantitatively and qualitatively, to cause or threaten to cause "serious injury".

2. Serious Injury

132. With respect to the requirement relating to "serious injury", Article 4.2(a) of the *Agreement on Safeguards* provides, in relevant part:

> In the investigation to determine whether increased imports have caused or are threatening to cause serious injury to a domestic industry under the terms of this Agreement, the competent authorities *shall evaluate all relevant factors* of an objective and quantifiable nature *having a bearing on the situation of that industry*, *in particular*, … the share of the domestic market taken by increased imports, changes in the level of sales, production, productivity, capacity utilization, profits and losses, and employment.

133. The Panel stated that the requirements of Article 4.2(a) obliged it to:

> … consider, first, whether all injury factors listed in the Agreement were considered by Argentina, as the text of Article 4.2(a) of the Agreement ("all relevant factors … including … changes in the level of sales, production, productivity, capacity utilization, profits and losses, and employment") is unambiguous that at a minimum each of the factors listed, in addition to all other factors that are "relevant", must be considered.[132]

The Panel also concluded that, pursuant to the provisions of Article 4.2(c) and, by reference, Article 3 of the *Agreement on Safeguards*, it was required to examine whether Argentina's findings and conclusions on "serious injury" were supported by the evidence before the Argentine authorities.

134. The Panel read Article 4.2(a) literally to mean that all the listed factors: "changes in the level of sales, production, productivity, capacity utilization, profits and losses, and employment" - must be evaluated in every investigation. In addition, the Panel stated that all other relevant factors having a bearing on the situation of the industry must also be evaluated. As the Panel found that Argentina had not evaluated two of the listed factors, capacity utilization and productivity, the Panel concluded that Argentina's investigation was not consistent with the requirements of Article 4.2(a).[133]

135. Argentina submits that the Panel erred in its analysis of Argentina's determination of "serious injury". According to Argentina, Article 4.2(c) of the *Agreement on Safeguards* requires only a demonstration of the relevance of the

[132] Panel Report, para. 8.206.
[133] *Ibid*., para. 8.277.

factors examined, rather than an examination of all the listed factors as relevant.[134] In response to the Panel's finding that Argentina had not properly evaluated the factors of capacity utilization and productivity, Argentina replies by maintaining that the factor of productivity is explicitly mentioned in Act 338 and that data sufficient to calculate capacity utilization was available to the Argentine authorities.[135] Furthermore, Argentina argues that neither capacity utilization nor productivity was a principal or a significant issue in the investigation.[136] Argentina also takes issue with the Panel's view that the available data for 1996 should have been examined by Argentina in its investigation of "serious injury". Here, Argentina responds that the record clearly shows that the data for 1996 was incomplete, and Argentina submits that it was appropriate and reasonable to use a single review period for which all the data was available as a basis for its determination of "serious injury". In addition, Argentina argues that the Panel erred in several aspects of its examination of the evidence considered by the Argentine authorities.

136. We agree with the Panel's interpretation that Article 4.2(a) of the *Agreement on Safeguards* requires a demonstration that the competent authorities evaluated, at a minimum, each of the factors listed in Article 4.2(a) as well as all other factors that are relevant to the situation of the industry concerned. Furthermore, we do not dispute the Panel's finding that Argentina did not evaluate all of the listed factors, in particular, capacity utilization and productivity. We consider the other points that Argentina has raised in this appeal, relating to the availability of data for 1996 and to the Panel's evaluation of the evidence considered by the Argentine authorities, to relate to matters of fact which are not within our mandate, under Article 17.6 of the DSU, to examine on appeal.

137. For these reasons, we uphold the Panel's conclusion that Argentina did not evaluate "all relevant factors of an objective and quantifiable nature having a bearing on the situation of that industry" as required by Article 4.2(a) of the *Agreement on Safeguards*.

138. However, although it was not necessary for the Panel to go beyond where it did in this case, as the Panel found that Argentina had *not* evaluated all of the required listed factors, we do not believe that an evaluation of the listed factors in Article 4.2(a) is all that is required to justify a determination of "serious injury" under the *Agreement on Safeguards*. We note, in this respect, that there is a definition of "serious injury" in Article 4.1(a) of the *Agreement on Safeguards*, which reads as follows:

> "serious injury" shall be understood to mean a *significant overall impairment* in the position of a domestic industry. (emphasis added)

And we note that, in its legal analysis of "serious injury" under Article 4.2(a), the Panel made no use whatsoever of this definition.

139. In our view, it is only when the *overall position* of the domestic industry is evaluated, in light of all the relevant factors having a bearing on a situation of that

[134] Argentina's appellant's submission, p. 60.
[135] *Ibid.*, p. 59.
[136] *Ibid.*, p. 60.

industry, that it can be determined whether there is "a significant overall impairment" in the position of that industry. Although Article 4.2(a) technically requires that certain listed factors must be evaluated, and that all other relevant factors must be evaluated, that provision does not specify what such an evaluation must demonstrate. Obviously, any such evaluation will be different for different industries in different cases, depending on the facts of the particular case and the situation of the industry concerned. An evaluation of each listed factor will not necessarily have to show that each such factor is "declining". In one case, for example, there may be significant declines in sales, employment and productivity that will show "significant overall impairment" in the position of the industry, and therefore will justify a finding of serious injury. In another case, a certain factor may not be declining, but the overall picture may nevertheless demonstrate "significant overall impairment" of the industry. Thus, in addition to a technical examination of whether the competent authorities in a particular case have evaluated all the listed factors and any other relevant factors, we believe that it is essential for a panel to take the definition of "serious injury" in Article 4.1(a) of the *Agreement on Safeguards* into account in its review of any determination of "serious injury".

3. Causation

140. With respect to the requirement of causation, Article 4.2(b) of the *Agreement on Safeguards* provides that a determination of serious injury:

> … shall not be made unless this investigation demonstrates, on the basis of objective evidence, the existence of the causal link between increased imports of the product concerned and serious injury or threat thereof. When factors other than increased imports are causing injury to the domestic industry at the same time, such injury shall not be attributed to increased imports.

141. The Panel interpreted the requirements of Article 4.2(b) as follows:

> … we will consider whether Argentina's causation analysis meets these requirements on the basis of (i) whether an upward trend in imports coincides with downward trends in the injury factors, and if not, whether a reasoned explanation is provided as to why nevertheless the data show causation; (ii) whether the conditions of competition in the Argentine footwear market between imported and domestic footwear as analyzed demonstrate, on the basis of objective evidence, a causal link of the imports to any injury; and (iii) whether other relevant factors have been analyzed and whether it is established that injury caused by factors other than imports has not been attributed to imports.[137]

142. On causation, the Panel stated:

[137] Panel Report, para. 8.229.

> … the *trends* - in both the injury factors and the imports - matter as much as their absolute levels. In the particular context of a causation analysis, we also believe that this provision means that it is the *relationship* between the movements in imports (volume and market share) and the movements in injury factors that must be central to a causation analysis and determination.
>
> In practical terms, we believe therefore that this provision means that if causation is present, an increase in imports normally should coincide with a decline in the relevant injury factors. While such a coincidence by itself cannot *prove* causation (because, *inter alia*, Article 3 requires an explanation - i.e., "findings and reasoned conclusions"), its absence would create serious doubts as to the existence of a causal link, and would require a *very* compelling analysis of why causation still is present.[138]

143. Argentina argues on appeal that the Panel erred in establishing and applying three "standards" in its analysis of causation. First, Argentina maintains that the Panel required that an upward trend in imports must *coincide* with a *downward* trend in the injury factors. On this point, Argentina maintains that Article 4.2(c) of the *Agreement on Safeguards* refers to "changes" and not to "downward trends", so that there is no requirement that there be a "downward trend" in each year of the period of investigation. Moreover, Argentina maintains that the Panel's requirement of "coincidence" in time is not implied by the term "cause". Second, Argentina asserts that the Panel used the phrase "under such conditions" to develop a requirement that the "conditions of competition" between imported and domestic footwear in the Argentine market demonstrate a causal link between the increased imports and injury. Argentina asserts that there is no basis in the *Agreement on Safeguards* for this requirement. Third, Argentina maintains that the Panel required the Argentine authorities to establish that other relevant factors had been analyzed, and that injury caused by factors other than imports is not evidence of serious injury caused by imports. In Argentina's opinion, this requirement goes far beyond what is actually required in Article 4.2(b) of the *Agreement on Safeguards*.

144. We note that Article 4.2(a) requires the competent authorities to evaluate "the rate and amount of the increase in imports", "the share of the domestic market taken by increased imports", as well as the "changes" in the level of factors such as sales, production, productivity, capacity utilization, and others. We see no reason to disagree with the Panel's interpretation that the words "rate and amount" and "changes" in Article 4.2(a) mean that "the *trends* - in both the injury factors and the imports - matter as much as their absolute levels."[139] We also agree with the Panel that, in an analysis of causation, "it is the *relationship* between the *movements* in imports (volume and market share) and the *movements* in injury factors that must be

[138] Panel Report, paras. 8.237 and 8.238.
[139] *Ibid*., para. 8.237.

central to a causation analysis and determination."[140] (emphasis added) Furthermore, with respect to a "coincidence" between an increase in imports and a decline in the relevant injury factors, we note that the Panel simply said that this should "normally" occur if causation is present.[141] The Panel qualified this statement, however, in the following sentence:

> While such a coincidence by itself cannot *prove* causation (because, *inter alia*, Article 3 requires an explanation - i.e., "findings and reasoned conclusions"), its absence would create serious doubts as to the existence of a causal link, and would require a *very* compelling analysis of why causation still is present.[142]

145. We are somewhat surprised that the Panel, having determined that there were no "increased imports", and having determined that there was no "serious injury", for some reason went on to make an assessment of causation. It would be difficult, indeed, to demonstrate a "causal link" between "increased imports" that did not occur and "serious injury" that did not exist. Nevertheless, we see no error in the Panel's interpretation of the causation requirements, or in its interpretation of Article 4.2(b) of the *Agreement on Safeguards*. Rather, we believe that Argentina has mischaracterized the Panel's interpretation and reasoning. Furthermore, we agree with the Panel's conclusions that "the conditions of competition between the imports and the domestic product were not analyzed or adequately explained (in particular price); and that 'other factors' identified by the CNCE in the investigation were not sufficiently evaluated, in particular, the tequila effect."[143]

146. For all these reasons, we uphold the Panel's conclusion that "Argentina's findings and conclusions regarding causation were not adequately explained and supported by the evidence."[144]

147. And, on the basis of all of the above reasoning, we uphold the Panel's findings and conclusions in paragraph 8.279 and paragraph 8.280 of the Panel Report, including the conclusions that "Argentina's investigation and determinations of increased imports, serious injury and causation are inconsistent with Articles 2 and 4 of the Safeguards Agreement."[145] We also uphold the Panel's ultimate conclusion that "Argentina's investigation provides *no* legal basis for the application of the definitive safeguard measure at issue, or any safeguard measure."[146]

C. Article 12.7 of the DSU

148. Argentina also contends that the Panel violated Article 12.7 of the DSU by failing to provide "a basic rationale" for its findings and conclusions. Article 12.7 of the DSU reads, in relevant part:

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[140] *Ibid.*
[141] Panel Report., para. 8.238.
[142] *Ibid.*
[143] Panel Report., para. 8.278.
[144] *Ibid.*
[145] *Ibid*., para. 8.280.
[146] *Ibid.*

> … the report of a panel shall set out the findings of fact, the applicability of relevant provisions and the *basic rationale* behind any findings and recommendations that it makes. (emphasis added)

149. In our reports in *Korea - Alcoholic Beverages*[147] and *Chile - Taxes on Alcoholic Beverages*[148], we found that the panels in those cases had provided sufficient reasons for their findings and recommendations, and that, therefore, the requirements of Article 12.7 of the DSU were fulfilled. In this case, the Panel conducted *extensive* factual and legal analyses of the competing claims made by the parties, set out numerous factual findings based on detailed consideration of the evidence before the Argentine authorities as well as other evidence presented to the Panel, and provided extensive explanations of how and why it reached its factual and legal conclusions. Although Argentina may not agree with the rationale provided by the Panel, and we do not ourselves agree with all of its reasoning, we have no doubt that the Panel set out, in its Report, a "basic rationale" consistent with the requirements of Article 12.7 of the DSU.

150. For these reasons, we reject Argentina's appeal under Article 12.7 of the DSU. Indeed, we cannot help but note that, in this appeal, Argentina seems to be arguing that the Panel said and did both too much and too little.

VIII. FINDINGS AND CONCLUSIONS

151. For the reasons set out in this Report, the Appellate Body:

(a) concludes that the Panel did not exceed its terms of reference by referring in its reasoning to Article 3 of the *Agreement on Safeguards*;

(b) reverses the Panel's conclusion in paragraph 8.69 of the Panel Report that "safeguard investigations conducted and safeguard measures imposed after the entry into force of the WTO agreements which meet the requirements of the new Safeguards Agreement satisfy the requirements of Article XIX of GATT", and also reverses the Panel's finding that the Uruguay Round negotiators "*expressly omitted*" the phrase "as a result of unforeseen developments" from Article 2 of the *Agreement on Safeguards*;

(c) declines to make a finding with respect to the European Communities' claim under Article XIX of the GATT 1994 since, in light of the findings in paragraph (f) below, there is, in any event, no legal basis for the safeguard measures imposed by Argentina;

(d) reverses the Panel's findings and conclusions relating to footnote 1 to Article 2.1 of the *Agreement on Safeguards* and Article XXIV of the GATT 1994, and concludes that Argentina, on the facts of this case, cannot justify the imposition of its safeguard measures only on non-MERCOSUR third country sources of supply on the basis of an

[147] *Supra*, footnote 36, para. 168.
[148] Appellate Body Report, circulated 13 December 1999, WT/DS87/AB/R, WT/DS110/AB/R, para. 78.

investigation that found serious injury or threat thereof caused by imports from all sources, including imports from other MERCOSUR member States;

(e) concludes that the Panel correctly stated and applied the appropriate standard of review, as set forth in Article 11 of the DSU;

(f) upholds the Panel's findings and conclusions that Argentina's investigation and determinations of increased imports, serious injury and causation are inconsistent with Articles 2 and 4 of the *Agreement on Safeguards*, and that, accordingly, Argentina's investigation provides no legal basis for the application of the definitive safeguard measure at issue or any safeguard measure; and

(g) concludes that the Panel did not fail to set out the "basic rationale" behind its findings and recommendations as required by Article 12.7 of the DSU.

152. The Appellate Body *recommends* that the DSB request that Argentina bring its safeguard measures found in this Report, and in the Panel Report as modified by this Report, to be inconsistent with the *Agreement on Safeguards*, into conformity with its obligations under that Agreement.

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