

CHINA – MEASURES AFFECTING IMPORTS OF AUTOMOBILE PARTS

(WT/DS340)

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TABLE OF CONTENTS

Table of Reports	iv
I. INTRODUCTION	1
II. PROCEDURAL BACKGROUND	2
III. FACTUAL BACKGROUND	4
A. Overview of Chinese Automotive Market	4
1. Vehicle Production and Sales	4
2. Auto Parts Production and Sales	8
B. Summary of Chinese Measures Favouring Domestic Content in the Automotive Industry prior to WTO Accession	9
C. China's Commitments in Relation to Auto Parts and Vehicles Upon Accession to the WTO	10
D. Introduction of New Measures	11
1. The Measures	11
2. Automotive Policy Order	12
3. Decree 125 and Announcement 4	13
E. Substantive Criteria for Determining the Imposition of Internal Charges at the "Whole Vehicle" Rate	14
1. Determining Whether Imported Parts Are Deemed Whole Vehicles ...	14
2. Determining Whether Assemblies Are Deemed Imported	16
F. Additional Administrative Burden Imposed on Vehicle and Auto Parts Manufacturers under the Measures	19
1. Registration of Vehicle Models	19
2. Customs Clearance and Bonding Requirements	20
3. Verification Procedures	22
4. Payment of Charges	23
5. Additional Procedural Requirements in Case of Changes to the Vehicle Model or Options Fitted on the Vehicle Model	24
6. Burden on Auto Parts Manufacturers	24
G. Example of Application of the Measures	25
H. Impact of the Measures	28
IV. ARGUMENT	30
A. The Disciplines of Article III of the GATT 1994 Apply to the Measures	30
B. The Charges Are Inconsistent with Article III:2, First Sentence	33
1. Imported Auto Parts and Domestic Auto Parts Are Like Products	34
2. Imported Auto Parts are Taxed in Excess of Domestic Auto Parts	35
C. The Charges and Reporting Requirements Applied to the Use of Imported Auto Parts Are Inconsistent with Article III:4 of the GATT 1994	35

1.	Imported Auto Parts and Domestic Auto Parts Are Like Products	36
2.	The Charges and Reporting Requirements Are Laws or Regulations Affecting the Internal Sale, Offering for Sale, Purchase, Distribution and Use of Imported Auto Parts	37
3.	By Establishing Thresholds on the Use of Imported Auto Parts that Trigger Additional Internal Charges and Burdensome Procedural Requirements, the Measures Accord Less Favorable Treatment to Imported Auto Parts than to Domestic Auto Parts	38
D.	China's Measures Are Inconsistent with Article 2.1 and Paragraph 1(a) of Annex 1 of the TRIMs Agreement	42
E.	China's Measures are Inconsistent with Article III:5 of the GATT 1994	43
F.	China's Measures Are Inconsistent with Part I.7.2 of the Accession Protocol	44
G.	China's Measures Are Inconsistent with Part I.7.3 of the Accession Protocol and Paragraph 203 of the Working Party Report	45
H.	In the Alternative, China's Measures Are Inconsistent with Article II of the GATT 1994 and Paragraph 93 of the Working Party Report	45
I.	China's Measures Constitute an Import Substitution Subsidy in Breach of Articles 3.1(b) and 3.2 of the SCM Agreement	48
VI.	CONCLUSION	50

Table 1

Table of Joint Exhibits

Table of Reports

Short Form	Full Citation
<i>Argentina – Hides and Leather</i>	Panel Report, <i>Argentina – Measures Affecting the Export of Bovine Hides and the Import of Finished Leather</i> , WT/DS155/R, adopted 16 February 2001
<i>Belgian Family Allowances</i>	GATT Panel Report, <i>Belgian Family Allowances</i> , BISD 1S/59, adopted 7 November 1953
<i>Canada – Autos (Panel)</i>	Panel Report, <i>Canada – Certain Measures Affecting the Automotive Industry</i> , WT/DS139/R, WT/DS142/R, adopted 19 June 2000, as modified by the Appellate Body Report, WT/DS139/AB/R, WT/DS142/AB/R
<i>Canada – Periodicals (AB)</i>	Appellate Body Report, <i>Canada – Certain Measures Concerning Periodicals</i> , WT/DS31/AB/R, adopted 30 July 1997
<i>Canada – Wheat Exports (Panel)</i>	Panel Report, <i>Canada - Measures Relating to Exports of Wheat and Treatment of Imported Grain</i> , WT/DS276/R, adopted 27 September 2004, as modified by the Appellate Body Report, WT/DS276/AB/R
<i>EC – Bananas III (Panel)</i>	Panel Report, <i>European Communities – Regime for the Importation, Sale and Distribution of Bananas</i> , WT/DS27/R, adopted 25 September 1997, as modified by the Appellate Body Report, WT/DS27/AB/R
<i>EEC – Parts and Components</i>	GATT Panel Report, <i>EEC – Regulations on Imports of Parts and Components</i> , BISD 37S/132, adopted 16 May 1990
<i>India – Autos</i>	Panel Report, <i>India – Measures Affecting the Automotive Sector</i> , WT/DS/146/R, WT/DS175/R, adopted 5 April 2002
<i>Indonesia – Autos</i>	Panel Report, <i>Indonesia – Certain Measures Affecting the Automobile Industry</i> , WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R, adopted 23 July 1998
<i>Japan – Alcoholic Beverages (AB)</i>	Appellate Body Report, <i>Japan – Taxes on Alcoholic Beverages</i> , WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, adopted 1 November, 1996

<i>Korea – Beef (AB)</i>	Appellate Body Report, <i>Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef</i> , WT/DS161/AB/R, WT/DS169/AB/R, adopted 10 January 2001
<i>Mexico – Beverage Tax (Panel)</i>	Panel Report, <i>Mexico – Tax Measures on Soft Drinks and Other Beverages</i> , WT/DS308/R, adopted 24 March 2006, as modified by the Appellate Body Report, WT/DS308/AB/R
<i>US – FSC (Article 21.5) (Panel)</i>	Panel Report, <i>United States – Tax Treatment for “Foreign Sales Corporations” – Recourse to Article 21.5 of the DSU by the European Communities</i> , WT/DS108/RW, adopted 29 January 2002, as modified by the Appellate Body Report, WT/DS108/AB/RW
<i>US – FSC (Article 21.5) (AB)</i>	Appellate Body Report, <i>United States – Tax Treatment for “Foreign Sales Corporations” – Recourse to Article 21.5 of the DSU by the European Communities</i> , WT/DS108/AB/RW, adopted 29 January 2002

I. INTRODUCTION

1. China has adopted measures that favor domestic auto parts over imported parts, so as to afford protection to the domestic production of auto parts. These measures include an internal charge of 25 percent that China imposes on imported auto parts, with no comparable charge on domestic auto parts. The measures provide that the charge only applies if domestically-produced autos include an amount (in volume or value) of imported auto parts that exceeds specified thresholds. And the measures include extensive record-keeping, reporting and verification requirements that apply if and only if domestic automobile manufacturers make use of imported auto parts.

2. These measures amount to clear and straightforward inconsistencies with China's national treatment obligations under Article III of the *General Agreement on Tariffs and Trade 1994* ("GATT 1994"). In particular, these measures impermissibly result in internal charges on imported parts in excess of those applied on domestic parts (Article III:2); the measures accord treatment less favorable to imported parts with respect to requirements affecting internal sale, purchase, distribution, and use (Article III:4); and the measures directly or indirectly require that specified amounts or proportions of auto parts used in vehicle manufacturing must be supplied from domestic sources (Article III:5).

3. Before proceeding with a detailed factual and legal analysis, the United States would emphasize the following two points. First, the measures are subject to Article III even though China has labeled them as "customs duties." China's measures are not applied at the border; rather, they are internal measures that apply charges and procedural requirements based on the specific details of the auto manufacturing processes that occur within China. It is not the label that a Member applies to its measure that determines whether an obligation under a covered

agreement applies; rather it is the substance of the measure that matters. Otherwise the GATT 1994's core national treatment obligations under Article III would be eviscerated.

4. Second, although the detailed operation of China's measures on auto parts contain considerable complexity, the analysis of those measures under Article III is neither ambiguous nor complex. Rather, despite the complexity of China's auto parts scheme, the results of an analysis under the text of Article III, as clarified by prior GATT panel and WTO panel and Appellate Body reports, is clear – namely, China's measures are inconsistent with China's obligations under Article III.

II. PROCEDURAL BACKGROUND

5. On March 30, 2006, the United States requested consultations with China pursuant to Articles 1 and 4 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (“DSU”), Article XXII:1 of the GATT 1994, Article 8 of the *Agreement on Trade-Related Investment Measures* (“TRIMs Agreement”), and Articles 4 and 30 of the *Agreement on Subsidies and Countervailing Measures* (“SCM Agreement”) with respect to China's measures affecting the import of motor vehicle parts, components, and accessories (“auto parts”) from the United States. On the same day, the European Communities (“EC”) requested consultations with China regarding the same measures. These requests were circulated to WTO Members on April 3, 2006 (WT/DS339/1, WT/DS340/1). On April 13, 2006, Canada requested consultations with China regarding the same measures. This request was circulated to WTO members on April 19, 2006 (WT/DS342/1).

6. The United States, Canada, and the EC each notified China of its desire to be joined in the consultations of the other complainants pursuant to Article 4.11 of the DSU. Three other

Members (Australia, Japan, and Mexico) notified the United States, Canada, the EC, and China of their desire to be joined in the consultations, pursuant to Article 4.11 of the DSU. China accepted these requests. The United States, Canada, the EC and China held joint consultations on May 11-12, 2006. These consultations provided helpful clarification, but failed to resolve the dispute.

7. On September 15, 2006, the United States, Canada, and the EC each requested the establishment of a panel pursuant to Article 6 of the DSU (WT/DS340/8, WT/DS342/8, WT/DS339/8, respectively). The Dispute Settlement Body (“DSB”) considered this request at its meeting on September 28, 2006, at which time China objected to the establishment of a panel.

8. On October 26, 2006, the United States, Canada, and the EC each renewed its request for the establishment of a panel. Each complainant requested that a single panel be established to examine the three complaints pursuant to Article 9.1 of the DSU. At the DSB meeting of October 26, 2006, the DSB established a single panel with standard terms of reference to examine the complaints by the United States, Canada, and the EC.¹

9. The Panel was constituted on January 29, 2007.²

¹ *Dispute Settlement Body: Minutes of the Meeting Held on 26 October 2005*, WT/DSB/M/221, para. 54;

² *Note by the Secretariat: Constitution of the Panel Established at the Requests of the European Communities, United States, and Canada*, WT/DS339/9, WT/DS340/9, WT/DS342/9, circulated 30 January 2007.

III. FACTUAL BACKGROUND³

10. The net effect of the Measures is to discriminate between imported and domestic auto parts so as to provide unfair advantage to domestic production, raising the cost of foreign inputs and reducing the competitiveness of those vehicle manufacturers that use them. The Complainants set out in detail how this discrimination occurs. We begin by considering in general terms the auto parts and vehicle manufacturing industry in China, together with the general regulatory framework applicable to the imports of vehicles and auto parts. We will then consider the Measures at issue and the WTO-inconsistent requirements that they impose.

A. Overview of Chinese Automotive Market

1. Vehicle Production and Sales

11. Vehicle production in China is, for all intents and purposes, like vehicle production anywhere else in the world. It is a highly technical process, involving a constant inflow of parts to manufacturing facilities in accordance with strict timing requirements, so as to ensure that there is no delay in production chains. The industry demands considerable logistical sophistication, particularly when production of both parts and vehicles relies on long supply chains and the integration of complex technologies across many countries and production facilities.

12. The great majority of vehicles sold in China are produced by vehicle manufacturers located in China. There are approximately 1,500 manufacturers registered in China, of which

³ The complaining Parties are submitting a common background section, which is reproduced separately in the submission of each of the complaining Parties, and common exhibits, delivered with the submissions.

fewer than 100 sell more than 10,000 vehicles a year. Many small manufacturers sell only 300 to 500 vehicles a year.⁴

13. The top three producers of passenger vehicles in 2006 consisted of Sino-foreign joint-ventures. Shanghai GM is the largest, selling 413,400 vehicles,⁵ followed by Shanghai Volkswagen and FAW-Volkswagen selling 352,000 and 350,000 vehicles respectively. Chery, a Chinese-owned manufacturer of China's top-selling domestic brand has sales of 300,000 vehicles and is in fourth place.⁶

14. China's focus on rationalisation has increased concentration in the industry, with over 13 major producers responsible for 60% of current production. The government's target for the domestic industry is to have just three or four major producers by the year 2010.⁷

15. There has been a boom in the sales of vehicles in China. In 2006, 7.22 million vehicles were sold in China,⁸ up from approximately 2.5 million in 2001.⁹ Vehicle production in China has increased along with demand to 7.28 million vehicles in 2006 (allowing China to displace

⁴ Asia Pulse, "Sino-foreign joint ventures top Chinese auto sales in 2006", January 9, 2007 (Exhibit JE-3).

⁵ *Id.*

⁶ See generally Global Insight Report (Exhibit JE-4) and Auto News 2006 for profiles of the major joint-venture and domestic vehicle manufacturers (Exhibit JE-5).

⁷ Global Insight Report, at pp. 7 and 16 (Exhibit JE-4).

⁸ *Agence France Presse*, "China auto sales seen spreading to smaller cities in 2007", January 29, 2007 (Exhibit JE-6); BBC News, "Chinese car market is world No 2", January 11, 2007, online: <http://news.bbc.co.uk/2/hi/business/6252215.stm> (Exhibit JE-7).

⁹ Global Insight Report, at p. 13 (Exhibit JE-4).

Germany as the world's third-largest vehicle producer),¹⁰ from approximately 2.4 million vehicles in 2001.¹¹

16. Chinese-owned vehicle manufacturers have been increasing their market share over joint ventures with foreign manufacturers.¹² Chinese-owned manufacturers now have a 30% market share, as compared with 25% in 2005.¹³ Joint ventures between foreign manufacturers and domestic Chinese companies account for the vast majority of the remaining market share. Imported vehicles account for less than 5% of the Chinese market.¹⁴

17. The growth in market share of Chinese-owned vehicle manufacturers is taking place in an environment of increased sales and exports. Vehicle exports hit a record high of 340,000 units in 2006, almost seven times more than 2004, with the majority of them low-priced trucks and buses bound for developing markets in Asia, Africa and Latin America. This focus on exports is part of the Chinese government's plan to increase automobile and auto parts exports to US \$120 billion, or 10% of the world's total vehicle trading volume, in the next ten years.¹⁵

¹⁰ Asia Pulse, "China becomes world's third largest auto producer in 2006", January 17, 2007 (Exhibit JE-8).

¹¹ Global Insight Report, at pp. 13-15 (Exhibit JE-4).

¹² People's Daily Online, "China stands as world's 2nd largest auto market", January 13, 2006, online: http://english.peopledaily.com.cn/200601/13/eng20060113_235259.html (Exhibit JE-9).

¹³ The Economist, "Carmaking in China: The fast and the furious", November 25, 2006 (Exhibit JE-10); Shanghai Daily, "China's car industry on fast track", December 27, 2006, "Market share of Chinese car brands such as Geely, Chery and Brilliance rose from 25 percent in 2005 to 30 percent this year, amid intensified competition from overseas giants", online: http://en.ce.cn/Industries/Auto/200612/27/t20061227_9907488.shtml (Exhibit JE-11).

¹⁴ Asia Times Online, "Chinese auto makers race to the bottom", February 8, 2007, online: <http://www.atimes.com/atimes/China/GA07Ad01.html> (Exhibit JE-12), says 4% for 2006; Embassy of the People's Republic of China in the United States, citing the People's Daily's Jan. 16, 2006 article, online <http://www.china-embassy.org/eng/gyzg/t231212.htm>), says it is 160,000 out of almost 6 million, which is about 2.6% for 2006 (Exhibit JE-13).

¹⁵ Reuters, "China to introduce permits for auto exports", January 3, 2007 (Exhibit JE-15); Industry News, November 2006, "China Plans To Up Auto Parts Exports By Ten Fold" Agence France Press, online:

18. Pressure on pricing in China is intense, with automobile prices falling on average by approximately 10,000 yuan (approximately US \$1,250) per automobile each year over the past several years.¹⁶ Heavy competition is continuing to lead to price reductions in vehicle prices in China, with both existing and new models being discounted.¹⁷ The industry's average margin on sales fell to 4% percent in 2006.¹⁸ This pressure on prices (and on profits) is expected to continue over the short term.¹⁹

19. As noted above, the top three vehicle manufacturers in China are joint ventures, and overall joint ventures account for approximately 65% of all vehicle sales in China. Foreign vehicle manufacturers are required to operate entirely through joint ventures with a variety of restrictions, including minimum investment, a maximum interest of 50% (except for joint ventures where the production is destined for export) and a maximum number of joint ventures per vehicle type.²⁰

<http://www.industryweek.com/ReadArticle.aspx?ArticleID=13111> (Exhibit JE-16).

¹⁶ Agence France Presse, "Auto defects up in China amid price war", November 20, 2006 (Exhibit JE-17).

¹⁷ Auto News 2006, at p. 5 (Exhibit JE-5); Asia Times Online, "Chinese auto makers race to the bottom", February 9, 2007, online: <http://www.atimes.com/atimes/China/GA07Ad01.html> (Exhibit JE-12).

¹⁸ Auto News 2006, at p. 30 (Exhibit JE-5).

¹⁹ However, part of this expected drop in prices is based on an assumed reduction in tariffs for imported parts, which will be limited if the Measures remain in place. See, for example, pp. 3 and 9 of the E&Y Report (Exhibit JE-14) – Page 3: "The [Economist Intelligence Unit] research suggests that fierce competition will drive down prices of Chinese-made vehicles, while the prices of imported cars will also fall sharply from 2006 as import tariffs are cut." Page 9: "Moreover, the price of these more technologically advanced cars should fall along with the phasing out of tariffs on imported components underpinning strong sales growth."

²⁰ Automotive Policy Order, Chapter X (Exhibit JE-18); KPMG China Report, at p. 6 (Exhibit JE-19); Global Insight Report, at p. 11 (Exhibit JE-4); Morgan Stanley report, "Chinese Auto Market: Reading the Tea Leaves", February 17, 2004, at p. 24 online: www.uscc.gov/hearings/2004hearings/written_testimonies/04_09_23wrts/stephen_girsky.pdf (Exhibit JE-21).

2. Auto Parts Production and Sales

20. The auto parts market is highly fragmented, with the top ten manufacturers accounting for only 20% of the total parts market in China of US \$9.1 billion. There are estimated to be 10,000 auto parts manufacturers in China,²¹ 450 of which are foreign-owned.²² Auto parts are produced in China both for use in domestic manufacturing and for export. Chinese auto parts exports are substantial, at over US \$8 billion in 2004.²³

21. Foreign auto parts manufacturers have increasingly been investing in auto parts manufacturing facilities in China, principally (but not exclusively) to supply Sino-foreign joint ventures of vehicle manufacturers.²⁴ Vehicle manufacturers in turn use both imported and domestic parts. Foreign auto parts manufacturers may invest in wholly owned manufacturing facilities, as well as enter into joint ventures.²⁵

22. Lower average prices have also led to pricing pressure on auto parts manufacturers,²⁶ particularly since parts constitute 80% of the vehicle cost in China.²⁷ This resulted in a drop in profit for parts manufacturers of 6% in 2004 compared with 2003.²⁸ Against this background,

²¹ Global Insight Report, at p. 19 (Exhibit JE-4).

²² KPMG Asia Report, at p. 21 (Exhibit JE-20).

²³ E&Y Report, at p. 11 (Exhibit JE-14).

²⁴ Global Insight Report, at pp. 19-22 (Exhibit JE-4).

²⁵ See Auto News 2006, at pp. 30-34 (Exhibit JE-5), and Global Insight Report, at pp. 19-22 (Exhibit JE-4).

²⁶ KPMG China Report, at p. 15 (Exhibit JE-19).

²⁷ Booz Allen Hamilton report, "The Road Ahead: China's Passenger Vehicle Market in 2015", March 2006, at p.4, online: <http://www.boozallen.com/publications/article/1672938> (Exhibit JE-22).

²⁸ Auto News 2005, at p. 25 (Exhibit JE-23).

China introduced the Measures challenged in these proceedings, providing advantages to its domestic auto parts industry by discriminating against imported auto parts - advantages that had existed in a similar form before China's accession to the WTO, but which were required to be removed.

B. Summary of Chinese Measures Favouring Domestic Content²⁹ in the Automotive Industry prior to WTO Accession

23. Prior to China's accession to the WTO, China imposed charges on imported auto parts under its 1994 Automotive Industry Policy³⁰ depending on the amount of domestic content in assembled vehicles to promote local production of vehicles and auto parts in China. China imposed higher charges on imported auto parts used in the domestic production of parts or vehicles if the manufacturer importing those auto parts did not meet certain domestic content in the final vehicle or auto part that it produced.

24. There were four levels of charges. The lowest tariff was charged for manufacturers that met very high levels of domestic content in their final production (more than 80% domestic

²⁹ The terms "domestic content" and "local content" are used interchangeably throughout this submission.

³⁰ Automotive Policy Order 1994, Articles 42-44 (Exhibit JE-24):

Article 42 After introduction of a manufacturing technology from overseas, an automobile enterprise must start its effort to localize the products therewith. The State takes the progress of localization of the import technology products as one of the conditions to support the enterprise to develop the second model.

Article 43 An automobile enterprise shall not engage in assembly through import of semi-knock-downs (SKD) or completely knock-downs (CKD).

Article 44 The State formulates preferential import tariff rates in accordance with the localization rate of automobile products. Those firms that reach the following localization standards may enjoy the different preferential tariff rates.

1. The localization rate reaches 40 percent, 60 percent or 80 percent in the products manufactured with the import technology for complete automobiles in Class M;
2. The localization rate reaches 50 percent, 70 percent or 90 percent in the products manufactured with the import technology for complete automobiles and motorcycles in Classes N and L; and
3. The localization rate reaches 50 percent, 70 percent or 90 percent in the products manufactured with import technology for unit assemblages or key parts and components.

content for M class vehicle, more than 90% for N and L class vehicles or auto parts (assemblies and key components)). The highest charge was imposed for manufacturers that had less than 40% domestic content (for manufacturers of M class vehicles), or less than 50% domestic content (for manufacturers of N and L class vehicles or auto parts).³¹

C. China's Commitments in Relation to Auto Parts and Vehicles Upon Accession to the WTO

25. China removed the Auto Policy 1994 as part of its Accession Protocol and commitment to removing discriminatory charges on imported vehicles by the year 2000.³² China also committed to a Schedule of Concessions that, by July 1, 2006, imposed a bound tariff rate on most auto parts at 10% or lower, and on most vehicles at 25%.³³

26. At the time it joined the WTO, China did not have a separate tariff line for auto parts that were either fully or partly unassembled and that were shipped together for assembly and further processing into a whole vehicle within China. Parts shipped in this form are generally separated into two categories:

- Completely knocked-down kits" ("CKDs"), are parts imported together in unassembled condition that provide the necessary parts in order to manufacture a whole vehicle. The kit may include not only parts, but also sub-assemblies and assemblies such as engine, transmission, axle assemblies, chassis and body assemblies.
- Semi knocked-down kits" ("SKDs") refers to partially assembled combinations of parts that can be used to manufacture a whole vehicle after manufacturing.

³¹ Accession Protocol, Annexes 5A (pp. 71-72) and 5B (p. 92) (Exhibit JE-1); Dic Lo, *Market and Institutional Regulation in Chinese Industrialization, 1978-94* (New York: St. Martin's Press, 1997), at p. 189 (Exhibit JE-25).

³² Accession Protocol, 10.1 to 10.3 (p. 7), Annexes 5A (pp. 70-72) and 5B (p. 92) (Exhibit JE-1).

³³ *Id.*, Part II, p. 11. The relevant HS codes, at the four-digit level, are: 84.09, 84.13, 84.14, 84.81, 84.82, 84.83, 85.11, 87.02, 87.03, 87.04, 87.06, 87.07, 87.08 and 90.32. A more detailed description of the Chinese tariff schedule is provided for in the submission of the EC relating to GATT Article II.

27. Prior to joining the WTO, China imposed substantially lower tariff rates on CKDs and SKDs than on imported whole vehicles.³⁴ China agreed that if it did introduce a separate tariff line for CKDs or SKDs, the tariff rate would be no more than 10%.³⁵

D. Introduction of New Measures

1. The Measures

28. In 2004-2005, China introduced a series of measures affecting imported auto parts ("the Measures"). The overall effect of the Measures is to impose additional internal charges on imported auto parts that are incorporated into vehicles for sale in the domestic Chinese market when those parts are not combined with a sufficient value or volume of domestic parts.

26. These Measures are:

a. The Policy on Development of the Automotive Industry, issued on May 21, 2004, by China's National Development and Reform Commission ("NDRC") as Order No. 8. ("Automotive Policy Order 2004").³⁶

b. "Administrative Measures on Importation of Automotive Parts Deemed Whole Vehicles", issued as Decree 125 on February 28, 2005 by China's General Administration of Customs ("Customs"), NDRC, Ministry of Finance, and Ministry of Commerce in accordance with the Automotive Policy Order ("Decree 125").³⁷

c. "Rules for Verifying whether Imported Automotive Parts are Deemed Whole Vehicles", issued as Public Announcement No. 4 by Customs on March 28, 2005, in accordance with Decree 125 ("Announcement 4").³⁸

³⁴ Dic Lo, *Market and Institutional Regulation in Chinese Industrialization, 1978-94* (New York: St. Martin's Press, 1997), at p. 189 (Exhibit JE-25).

³⁵ *See*, for commitment regarding CKDs and SKDs, the Working Party Report, at paras. 93 and 342 (Exhibit JE-26), and the Accession Protocol, Part I:1.2 (Exhibit JE-1).

³⁶ Contained in Exhibit JE-18.

³⁷ Contained in Exhibit JE-27.

³⁸ Contained in Exhibit JE-28.

2. Automotive Policy Order

29. Despite China's commitment to a reduction in the tariff for imported auto parts in its Accession Protocol, the NDRC issued the Automotive Policy Order on May 21, 2004. This returns China to its earlier practice of providing preferential treatment for vehicle and auto parts manufacturers that favour domestic over imported content in their production.

30. China issued the Automotive Policy Order with a view to achieving specific objectives. Among those objectives, it is formulated to "meet ... the new circumstances for the development of the automotive industry at home and abroad following accession to the World Trade Organization; in order to promote the structural adjustment and upgrading of the automotive industry, and comprehensively improve the international competitiveness of the automotive industry", and "... to develop [the country's automotive industry] into a pillar industry of the national economy by 2010".³⁹ The Automotive Policy Order also provides that "[b]y 2010, our country is to become a major global automotive manufacturing country, with automotive products that are able to satisfy most of the domestic market's demand and that have entered the international market in large volumes".⁴⁰

31. With respect to the development of the auto parts industry, Article 4 of the Auto Policy Order provides that an objective is to foster parts enterprises so that they can "participate in the global auto parts supply chain as well as be internationally competitive". The nature of that "fostering" is specified in Article 31, which provides that China will provide "priority support" for auto parts production and in Article 52 which confirms that "[t]he State supports the efforts

³⁹ Automotive Policy Order, Preamble (Exhibit JE-18).

⁴⁰ *Id.*, Article 2.

of vehicle manufacturers to increase their domestic production capacity, giving impetus to the technological progress of auto parts manufacturers and to the development of the automotive manufacturing industry." (emphasis added).⁴¹

32. The method that China has chosen to ensure the localization of automotive and auto parts production is set out in Chapter XI.⁴² Imported auto parts are charged internally at the imported vehicle rate (which is generally at least 2 ½ times greater than the parts rate)⁴³ if the final vehicle in which they are used does not have enough domestic content. This higher charge applies to imported auto parts provided they are "Deemed Whole Vehicles", despite China's agreement to be bound by the lower rate for auto parts in its Accession Protocol.

3. Decree 125 and Announcement 4

33. To implement and administer aspects of the Automotive Policy Order, China promulgated Decree 125 and Announcement 4.

34. Decree 125 and Announcement 4, both made effective on April 1, 2005, are legally binding instruments designed to implement and administer the Automotive Policy Order. Decree 125, issued jointly by NDRC, Customs, the Ministry of Finance and the Ministry of Commerce, governs when imported auto parts will be Deemed Whole Vehicles and therefore assessed higher internal charges. They apply directly to and affect choices of vehicle manufacturers importing

⁴¹ *Id.*, Article 52.

⁴² *Id.*, Articles 53 to 57 and 60.

⁴³ The final bound tariff rate for auto parts is generally 10%, while it is generally 25% for whole vehicles. The 25% internal charge is effectively a payment of the 10% bound parts rate plus an additional 15%. In certain cases the amount may be as much as 12 ½ times more, such as for HS code 84099991 (parts for engines with an output of greater than 180 hp), where the Schedule commits China to a bound rate of 2%, but where a 25% charge could be imposed if the Measures apply (Exhibit JE-2).

parts to produce vehicles for sale in the Chinese Market.⁴⁴ They also indirectly affect auto parts manufacturers through either Customs involvement or contractual arrangements. This is because the manufacturers must record and track the value and number of imported parts used in parts produced in China.⁴⁵

35. Decree 125 effectively regulates the criteria used to determine when imported auto parts are Deemed Whole Vehicles and are assessed an additional charge. It also regulates the administrative procedures to which vehicle manufacturers are subject under the Measures (both matters are explained below). Announcement 4 was promulgated together with Decree 125, providing additional details on the substantive criteria and administrative procedures that apply to vehicle and auto parts manufacturers. Accordingly, the Measures work in conjunction with one another.

36. There are no comparable internal charges that apply to domestic auto parts to equalize the amount charged against imported auto parts under the Measures.

E. Substantive Criteria for Determining the Imposition of Internal Charges at the "Whole Vehicle" Rate

1. Determining Whether Imported Parts Are Deemed Whole Vehicles

37. The Measures apply to imported auto parts that are used in vehicles manufactured for sale in the Chinese market.⁴⁶ Vehicle manufacturers are required to file information about the quantity or value of imported parts that they plan to use in a particular vehicle model in order for

⁴⁴ Decree 125, Articles 2, 7 (Exhibit JE-27).

⁴⁵ *Id.*, Article 2; Announcement 4, Article 20 (Exhibit JE-28).

⁴⁶ Decree 125, Article 7, first sentence (Exhibit JE-27).

Customs to determine whether the quantity or value of imported parts used to manufacture a vehicle attains or exceeds certain thresholds.⁴⁷ If a vehicle model is found to have a certain quantity or value of imported parts, as set out in detail in Decree 125 and Announcement 4, imported auto parts are considered a "Deemed Whole Vehicle" and assessed at the higher tariff rate for whole vehicles. This charge is not levied upon the importation of the goods, but at a later date, after the vehicle has been manufactured.

38. A key concept in the Measures is that of "Assemblies" - which correspond roughly to major parts of a vehicle. The Measures differentiate between two "main Assemblies" and six other "Assemblies":

Main Assemblies

- 1) the vehicle body (including driver's cabin) Assembly; and
- 2) the engine Assembly.

Other Assemblies

- 1) the transmission Assembly;
- 2) the drive-axle Assembly;
- 3) the non-drive axle Assembly;
- 4) the chassis Assembly;
- 5) the brake Assembly;
- 6) the steering Assembly.⁴⁸

39. Under the Measures, all imported parts will be Deemed Whole Vehicles and therefore subject to internal charges that are generally at least 2 ½ times greater than the bound rate for that part, if any of these three tests are met:

⁴⁷ The process of registering a model and related procedural steps under the Measures are set out in more detail under the heading "Registration of vehicle models", starting at para. 45.

⁴⁸ See Decree 125, Articles 4, 21(2) and Annexes 1 and 2 (Exhibit JE-27); Announcement 4, Article 13 and Annex 2 (Exhibit JE-28).

- a. As of April 1, 2005, when complete CKD or SKD kits are imported to assemble a vehicle.⁴⁹
 - b. As of April 1, 2005, if a sufficient number of Deemed Imported Assemblies⁵⁰ are used in manufacturing the vehicle.⁵¹ Imported parts will be Deemed Whole Vehicles if the following combinations of Assemblies are "Deemed Imported":
 - i) the two main Assemblies (the vehicle body and engine);
 - ii) either of the two main Assemblies as well as three or more other Assemblies; or
 - iii) five or more Assemblies, other than the main Assemblies.
 - c. As of July 1, 2006, when the aggregate price of imported parts reaches 60% or more of the price of the whole vehicle.⁵² However, this aspect of the Measures was suspended by Customs Joint Bulletin 38, dated July 5, 2006, until July 1, 2008.⁵³
40. Under the Measures, then, imported parts can become Deemed Whole Vehicles on the basis of the number of Assemblies built from imported parts or the value of those imported parts.

2. Determining Whether Assemblies Are Deemed Imported

41. An Assembly need not be imported in its entirety, or even manufactured in China from exclusively imported parts to be "Deemed Imported" and thus to count against the thresholds set out in the measures. Article 22 of Decree 125 specifies that if any of the following configurations of imported auto parts are used in an Assembly, it shall be Deemed Imported:
- i) a complete set of parts is imported to assemble the Assembly;

⁴⁹ Decree 125, Article 21(1) (Exhibit JE-27); Announcement 4, Article 13(1) (Exhibit JE-28).

⁵⁰ The notion of Deemed Imported Assemblies is explained in Section 2 below.

⁵¹ Decree 125, Article 21(2) (Exhibit JE-27); Announcement 4, Article 13(2) (Exhibit JE-28).

⁵² Decree 125, Article 21(3) (Exhibit JE-27), and Announcement 4, Article 13(3) (Exhibit JE-28).

⁵³ Customs Joint Bulletin 38, July 5, 2006 (Exhibit JE-29).

- ii) key parts are imported to assemble the Assembly, and these imported key parts attain and/or exceed the stipulated quantity criteria identified in Annex 1 of Decree 125.⁵⁴ Further, as of July 1, 2008, lower quantity thresholds will apply to those key parts identified as of class A in Annex 1, and if exceeded, will make the Assembly Deemed Imported;⁵⁵ or
- iii) the aggregate price of imported parts is 60% or more of the total price of the Assembly in question.

42. Accordingly, an Assembly will be Deemed Imported under the Measures if any of these three thresholds are met, which will then count towards calculating the number of imported Assemblies listed in Article 21(2) of Decree 125. For example, for a class M1 vehicle,⁵⁶ the import of five key parts of the vehicle body and six key parts of the engine will be sufficient to make both Deemed Imported Assemblies and all imported parts Deemed Whole Vehicles. Further, from July 1, 2008 and the entry into force of the class A/B distinction, the imports of, e.g., two doors, one engine block and one cylinder head will be sufficient to make the vehicle body and the engine Deemed Imported Assemblies. This means that the import of a relatively limited quantity or value of parts will be sufficient to treat those parts as Deemed Whole Vehicles.

43. The only way to avoid imported parts becoming Deemed Whole Vehicles when the import content thresholds under Articles 21 and 22 of Decree 125 are met would be to engage in

⁵⁴ See Decree 125, Article 22 and Annex 1 (Exhibit JE-27); Announcement 4, Article 19 and Annex 2 for this calculation (Exhibit JE-28). Further, Public Announcement 4, Article 20, specifies that if the price of the imported part of a key component or sub-assembly exceeds 60% of the price of the key component or sub-assembly then that key part or sub-assembly is deemed to be imported.

⁵⁵ The entry into force of the class A/B distinction was initially foreseen on July 1, 2006 (Decree 125, Note 5 to Annex 1 (Exhibit JE-27), Announcement 4, Article 19 (Exhibit JE-28), but was suspended until July 1, 2008 by Customs Joint Bulletin 38 (Exhibit JE-29).

⁵⁶ Vehicles used for transporting passengers and comprising no more than nine seats including the driver's seat, Classification of Power-Driven Vehicles and Trailers (National Standard GB/T 15089-2001) (Exhibit JE-30).

"substantial processing" in China.⁵⁷ This results in the imported parts being deemed domestic, and occurs in one of three ways:⁵⁸

- i) if there is an alteration of the tariff classification that results in a change to the four-digit tariff classification of the good pursuant to the PRC Import Tariff;
- ii) if the price of the finished part is at least 30% higher than the price of the imported parts and raw material in the finished product; and
- iii) if the manufacturing or processing performed in China is deemed to have created the basic properties of the finished product.

44. The principle of substantial processing applies to both parts directly imported by vehicle manufacturers and to imported parts purchased by a manufacturer from a domestic auto parts supplier. However, substantial processing alone of Assemblies or key parts listed in Annex 1 of Decree 125 would not allow a vehicle manufacturer to consider the imported parts or Assemblies as domestic, leaving them no other option than to limit their imports.⁵⁹

45. If the vehicle manufacturer produces a vehicle that uses imported parts which are Deemed Whole Vehicles, then the manufacturer will be required to pay a charge on all imported parts incorporated into the vehicle. That charge will be based on the whole vehicle rate of 25%, and as noted above, will (together with the appropriate tariff rate for the parts in question) result generally in internal charges at least 2 ½ times the bound tariff rate for the imported parts.⁶⁰

⁵⁷ Decree 125, Article 24 (Exhibit JE-27).

⁵⁸ Announcement 4, Article 18 (Exhibit JE-28).

⁵⁹ Decree 125, Article 24. The complainants understand that the principle of substantial processing applies to imported parts incorporated into assemblies and key parts but does not apply to the processing of the assemblies or key parts themselves (Exhibit JE-27).

⁶⁰ From 10% to 25%. In certain cases the amount may be as much as 12 ½ times more, such as for HS code 8409.99.91 (parts for engines with an output of greater than 180 hp), where China's Schedule commits it to a bound rate of 2%, but where a 25% charge could be imposed if the Measures apply (Exhibit JE-2).

F. Additional Administrative Burden Imposed on Vehicle and Auto Parts Manufacturers under the Measures

46. In addition to the increased internal charges imposed when specified thresholds of imported parts are used in automotive manufacturing, there are certain administrative requirements imposed on manufacturers that use imported auto parts. These administrative requirements are not applied with respect to domestic auto parts and are considered in turn below.

1. Registration of Vehicle Models

47. Chapter II of Decree 125 sets out the required registration procedures to which vehicle manufacturers are subject before they can obtain an automatic import licence for auto parts.

48. Vehicle manufacturers must first perform a self-verification on proposed vehicle models to determine whether the imported parts used in the vehicle models are Deemed Whole Vehicles.⁶¹ Every vehicle model containing imported parts that are Deemed Whole Vehicles after self-verification must then be reported to Customs.⁶² Customs then registers the vehicle manufacturer and the vehicle model.⁶³

49. If the self-verification of a vehicle model is negative, then the vehicle manufacturer is obliged to request a review of that model, which is carried out by the National Centre for Verifying Deemed Whole Vehicles (the "Centre") under the authority of Customs. If the review

⁶¹ Decree 125, Article 7 (Exhibit JE-27), and Announcement 4, Article 6 (Exhibit JE-28).

⁶² Decree 125, Article 9 specifies the information that a vehicle manufacturer must file, *e.g.*, annual production plans for the registered vehicle model, list of parts categories, price ratios of parts in the vehicle model being registered, item-by-item prices of domestic and imported parts, list of domestic and foreign suppliers (Exhibit JE-27).

⁶³ *Id.*, Articles 10 and 11.

shows that the vehicle model uses imported parts that are Deemed Whole Vehicles, the vehicle model must be reported to and registered with Customs (at the local Customs office).⁶⁴

50. When applying to the NDRC for an "On-Road Motor Vehicle Manufacturer and Product Announcement" and the Ministry of Commerce for a licence to import auto parts, the vehicle manufacturer must provide its self-verification and the review report from Customs if the imported auto parts are not Deemed Whole Vehicles. Licences granted for imported parts that are Deemed Whole Vehicles on self-verification or review are marked with the words "Deemed Whole Vehicle".⁶⁵

51. Prior to the importation of auto parts, a vehicle manufacturer must provide the local Customs office with a general duty guarantee (e.g., a letter of credit or guarantee issued by a Chinese bank) where a vehicle model uses parts that are Deemed Whole Vehicles. This guarantee cannot be lower than the average total monthly duties payable on the quantity of parts to be imported by the manufacturer.⁶⁶ This amount is not based on actual imports but on the manufacturer's forecasted import plans. The general duty guarantee must be adjusted if the manufacturer changes its import plans.⁶⁷

2. Customs Clearance and Bonding Requirements

52. Chapter III of Decree 125 sets out the customs procedures for importing auto parts that are Deemed Whole Vehicles. Vehicle manufacturers must handle all customs clearance

⁶⁴ *Id.*, Article 7.

⁶⁵ *Id.*, Article 7.

⁶⁶ *Id.*, Article 12.

⁶⁷ *Id.*

procedures through the local Customs office and pay internal charges to that office, even if the parts were imported through other ports of entry.⁶⁸ Auto parts imported through other ports of entry must apply to the local Customs office for a "Customs to Customs transfer".⁶⁹

53. The Measures also establish that imported auto parts are subject to supervision by Customs "as for bonded goods", in effect deeming such imports as "in bond".⁷⁰ Bonding requirements would impose significant additional difficulties on auto part and whole vehicle manufacturers, because Chinese law⁷¹ mandates that bonded areas:

- may be established only with special permission;⁷²
- have restrictions on the entry and exit, including special passes for personnel;⁷³
- have special record-keeping requirements;⁷⁴
- have a customs checking system installed, including computers connected to Customs;⁷⁵ and
- restrict the movement of products, including treating movement out of the bonded area as an import, and requiring Customs approval for movement of products out of the area.⁷⁶

54. In addition, in order for a company to operate a bonded warehouse, it must meet a variety of requirements, including having a minimum amount of registered capital.⁷⁷

⁶⁸ *Id.*, Article 13.

⁶⁹ *Id.*

⁷⁰ *Id.*, Article 27.

⁷¹ Bonding Procedures (Exhibit JE-31); Warehouses Order (Exhibit JE-32).

⁷² Warehouses Order, Articles 7-13 (Exhibit JE-32).

⁷³ Bonding Procedures, Articles 3, 25 (Exhibit JE-31); Warehouses Order (Exhibit JE-32).

⁷⁴ Bonding Procedures, Articles 5, 26 (Exhibit JE-31).

⁷⁵ *Id.*, Article 6; Warehouses Order, Articles 9(3), 15 (Exhibit JE-32).

⁷⁶ Bonding Procedures, Articles 13, 27 (Exhibit JE-31); Warehouses Order, Articles 26-27 (Exhibit JE-32).

⁷⁷ Warehouses Order, Article 8(2) (Exhibit JE-32).

55. In practice, and despite the language of the Measures, the Chinese government has not actually treated imported parts as bonded goods. Imported auto parts are used freely at the manufacturing sites of vehicle and auto parts manufacturers with no restrictions. Thus, to date, this deeming under the Measures is a fiction. However, the risk remains that the Measures could be applied so as to impose significant additional requirements, ostensibly linked to bonding requirements, and that uncertainty provides a disincentive to use imported parts.

3. Verification Procedures

56. Within ten days of the manufacture of the first batch of whole vehicles of a registered model, the manufacturer must file specified documents with Customs.⁷⁸ Then, within seven days of this filing, Customs must instruct the Centre to carry out the verification.⁷⁹ The verification must be done within one month of the Centre receiving these instructions.⁸⁰ Accordingly, a manufacturer may again incur significant administrative delay in the final assessment of a charge as it could take up to 48 days from submission of the application after the first batch of vehicles is complete until the verification is actually carried out.

57. If a vehicle manufacturer objects to the results of the verification, a meeting is held between the manufacturer, government officials and technical experts to determine whether the Centre must perform a re-verification of the registered model.⁸¹

⁷⁸ Decree 125, Article 19 (Exhibit JE-27); Announcement 4, Article 7 (Exhibit JE-28). The documents which must be provided are: 1) application form for verification; 2) report of self-verification; 3) procurement list of parts; 4) document list for verifying Deemed Whole Vehicles; and 5) other documents as required.

⁷⁹ Announcement 4, Article 8 (Exhibit JE-28).

⁸⁰ Decree 125, Article 19 (Exhibit JE-27); Announcement 4, Article 9 (Exhibit JE-28).

⁸¹ Announcement 4, Article 12 (Exhibit JE-28). The re-verification must occur within one month of instruction to the Centre to conduct it.

4. Payment of Charges

58. One month after receiving the Verification Report, the vehicle manufacturer has ten days to make a declaration for payment to the local Customs office.⁸² The local Customs office then calculates the charges payable and levies them on the parts, including any value-added tax payable, based on the Verification Report. Imported auto parts are then assessed at the bound tariff rate (an import duty of generally 10% or less) plus a 15% internal charge if they are Deemed Whole Vehicles.⁸³ If the import duty has already been paid for a part, provided proof of payment is supplied by the vehicle manufacturer, that amount will be deducted from the total amount payable.⁸⁴

59. If a subsequent verification report shows that a registered vehicle model no longer uses imported parts that are Deemed Whole Vehicles, the manufacturer will no longer be subject to the Measures' cumbersome administrative procedures for that particular model.⁸⁵ Moreover, if a subsequent verification report shows that all registered models no longer use imported parts that are Deemed Whole Vehicles, the administrative measures will not apply to any vehicles produced by that manufacturer and the general duty guarantee will be cancelled.⁸⁶

⁸² Decree 125, Article 31 (Exhibit JE-27).

⁸³ *Id.*, Article 28.

⁸⁴ *Id.*, Article 29.

⁸⁵ *Id.*, Article 32.

⁸⁶ *Id.*, Article 33.

5. Additional Procedural Requirements in Case of Changes to the Vehicle Model or Options Fitted on the Vehicle Model

60. In addition to the general registration, self-verification and review procedures, various additional procedural requirements are applicable if imported parts are used instead of domestic parts.

61. The manufacturer must inform Customs and the Centre when a basic model vehicle can be fitted with imported optional parts, and when such optional parts are actually fitted to the vehicle.⁸⁷

62. Equally, if the manufacturer wishes to introduce changes to the composition of the basic model vehicle by increasing the number or proportion of imported parts, a new verification process is due. Such changes may require the manufacturer to register a new vehicle model and go through the entire process of self-verification, review and verification by Customs.⁸⁸

63. If domestic parts are used for the changes, it may not be necessary to register a new vehicle model but only to go through a new verification, which may lead to the vehicle model falling outside the scope of the Measures.⁸⁹

6. Burden on Auto Parts Manufacturers

64. As a result of Article 22 of Decree 125 and Article 20 of Announcement 4, the level of imported content will have to be tracked down the chain of supply to determine whether individual Assemblies and key parts are to be treated as imported for purposes of the Measures.

⁸⁷ *Id.*, Article 20.

⁸⁸ Announcement 4, Article 6 (Exhibit JE-28).

⁸⁹ Decree 125, Articles 20 and 32 (Exhibit JE-27).

Such tracking will be made first at the level of the Assembly to determine if the Assembly is Deemed Imported, and subsequently at the level of "second-tier" suppliers for key parts.⁹⁰

65. As a result, parts manufacturers and suppliers that use imported parts have to maintain records of the quantity, type and cost of imported parts used in any parts incorporated into a manufactured vehicle. They do this in order to meet their contractual obligations to vehicle manufacturers and guarantee to them that they meet the domestic content requirements of the Measures. They may also be required to provide details to Customs about the purpose for which the imported product will be used. This information may be provided directly to Customs or indirectly by providing the information to the vehicle manufacturer.

66. These administrative requirements impose a significant logistical burden on all users of imported parts and add the risk of financial penalties. Those penalties could include:

- a fine for a violation of the Measures, or indirect penalties for making statements to Customs that are not properly substantiated;⁹¹
- financial loss resulting from internal charges under the Measures where records are insufficient to establish for Customs the requisite level of domestic content; and
- contractual penalties imposed by vehicle manufacturers to protect themselves from the possibility of having to pay internal charges under the Measures.

G. Example of Application of the Measures

65. We now consider how the Measures impose internal charges on identical parts based on the use of the parts in China. To do so, we describe six hypothetical imports into China of an identical product: brake master cylinders (hereafter "brake cylinders") for a light truck (HS 8708.39.40). The brake cylinders are imported after July 1, 2006 - after the first two elements of

⁹⁰ Announcement 4, Article 20 (Exhibit JE-28).

⁹¹ Decree 125, Article 36 (Exhibit JE-27); Order 63 (Exhibit JE-33).

the Measures came into place, and after China's tariff on that item dropped to 10% in accordance with its Schedule. Those six separate imports, based upon the language in Decree 125 and Announcement 4, would have different treatment and internal charges under the Measures. These hypothetical cases with additional variants are set out in Table 1 (which has been appended to this submission).

1. The first brake cylinder is destined for a retail store where it will be sold as a spare part for repairs. It is therefore not subject to the Measures and is charged the 10% tariff at the border.

2. The second brake cylinder is imported by an auto parts manufacturer, and is used in manufacturing a brake system Assembly. Also used in the manufacture of that brake system Assembly is an imported booster assembly, an imported front brake assembly and an imported rear brake assembly. Four "key parts" used in the manufacture of the brake system Assembly are imported, making it a Deemed Imported Assembly.⁹² The vehicle manufacturer performs a self-verification for a vehicle that it plans to produce, as required by the Measures. This shows that the brake system Assembly, engine Assembly and transmission Assembly would be Deemed Imported Assemblies within the meaning of the Measures.⁹³ However, other Assemblies are largely sourced domestically. Since the vehicle contains only an engine Assembly and two other Assemblies that are deemed imported, imported parts will not fulfill the criteria for imposing the whole vehicle duty.⁹⁴ Therefore, parts used in the Deemed Imported Assemblies, including the brake cylinder, are not charged additional amounts under the Measures. The brake cylinder has been charged a 10% tariff at the border, paid by the auto parts manufacturer, but the vehicle manufacturer is not required to make any additional payments.

3. The third brake cylinder is imported and incorporated into a vehicle in exactly the same situation as the second. However, as a result of sourcing difficulties, the vehicle in question is manufactured with an imported, rather than domestic, axle shaft. Another four parts of the drive-axle Assembly are imported, which, with the imported axle shaft,

⁹² See Decree 125, Article 22(2), Annex 1 (Exhibit JE-27); Announcement 4, Article 14(2) and Annex 2, items 63-67 (Exhibit JE-28).

⁹³ Decree 125, Article 7 (Exhibit JE-27).

⁹⁴ Decree 125, Article 21(2)(b) (Exhibit JE-27); Announcement No. 4, Article 13(2)(ii) (Exhibit JE-28).

puts the imported content at the threshold of five "key parts",⁹⁵ meaning that the drive-axle Assembly becomes a Deemed Imported Assembly. Since the vehicle now contains an engine and three other Deemed Imported Assemblies, the imported auto parts are considered Deemed Whole Vehicles.⁹⁶ The auto parts manufacturer therefore pays the 10% tariff for the brake cylinder at the border, but the vehicle manufacturer is then required to register a revised plan for the vehicles.⁹⁷ This results in an additional internal charge of generally 15%⁹⁸ on all imported parts used in the vehicle.⁹⁹

4. The fourth brake cylinder is imported in the reverse situation of the third: the plan registered by the vehicle manufacturer calls for the axle shaft to be imported, but a domestic supplier is found. Thus, the drive-axle Assembly, with only four key parts imported, is no longer deemed imported. The result is that the vehicle is no longer manufactured with enough Deemed Imported Assemblies to make the imported parts used in its manufacture Deemed Whole Vehicles. The vehicle manufacturer applies to Customs for re-verification of the vehicle. Assuming that the verification confirms that the drive axle is no longer a Deemed Imported Assembly,¹⁰⁰ no additional internal charges are imposed. The charge on the brake cylinder is 10% payable by the auto parts manufacturer based on presentation at the border. The additional internal charge of 15% that would have been charged to the vehicle manufacturer based upon the registered plan is no longer required.¹⁰¹

5. The fifth brake cylinder is imported by an auto parts manufacturer who assembles an entire brake Assembly. On importation, the auto parts manufacturer pays a tariff of 10% of the value of the brake cylinder. The auto parts manufacturer has a contract with a vehicle manufacturer to provide brake Assemblies, with the requirement that the Assemblies have enough domestic content to avoid classification as Deemed Imported Assemblies. The auto parts manufacturer incorporates into the brake Assembly only

⁹⁵ Decree 125, Article 22(2) and Annex 1 (Exhibit JE-27); Announcement 4, Article 14(2) and Annex 2, items 44-53 (Exhibit JE-28). Note that pursuant to the Annex of Decree 125 the number of key parts for a drive axle for M1 vehicles is six, for other vehicles (M, M2, N) it is five. Light trucks are N vehicles (see Classification of Power-Driven Vehicles and Trailers - National Standard GB/T 15089-2001 (Exhibit JE-30)), and thus the key part threshold is five.

⁹⁶ Decree 125, Article 21(2)(b) (Exhibit JE-27); Announcement 4, Article 13(2)(ii) (Exhibit JE-28).

⁹⁷ Decree 125, Article 28 (Exhibit JE-27); Announcement 4, Articles 6 and 25 (Exhibit JE-28).

⁹⁸ As noted earlier, the final rate bound in China's schedule is 10% for most auto parts, but is lower for certain parts, going as low as 2%.

⁹⁹ Decree 125, Article 28 (Exhibit JE-27). Note that it is possible that the whole 25% is paid after verification, as suggested in Article 29, which allows for the deduction of duties already paid, but suggests that it will not always have occurred.

¹⁰⁰ Decree 125, Article 20, second paragraph (Exhibit JE-27).

¹⁰¹ *Id.*, Article 28.

three imported "key parts" (including the brake cylinder). It then calculates that the value of imported parts is 58% of the total value and concludes that the Assembly is not a Deemed Imported Assembly. The brake Assembly is shipped to a vehicle manufacturer which uses it to manufacture a vehicle together with an engine, transmission and axle that are Deemed Imported Assemblies. On the strength of the information from the auto parts manufacturer, the vehicle manufacturer conducts a self-verification and determines that the vehicle is not using imported parts that are Deemed Whole Vehicles. However, on verification, the Centre determines that the value of imported parts incorporated into the brake Assembly is actually 61%.¹⁰² The vehicle manufacturer is required to pay an additional internal charge of 15% on all imported auto parts used in the vehicle (including those used in the engine, transmission, axle and brake Assemblies).¹⁰³ Depending on the wording of the contract between the auto parts manufacturer and the vehicle manufacturer, the former may be required to reimburse the latter for some or all of those internal charges.

6. The sixth brake cylinder is imported as part of a CKD. This is done because the vehicle in question has a very limited market in China, so it is not economical to have a production line established solely for that model. The parts are assembled in China at a facility that also manufactures wholly domestic vehicles. The imported parts are Deemed Whole Vehicles, and the vehicle manufacturer is required to pay a total of 25% of their value.¹⁰⁴

67. As these examples demonstrate, the key factor in determining the amount charged on an imported auto part is the use to which it is put in China.

H. Impact of the Measures

68. The Chinese vehicle and auto parts market is changing rapidly as a result of a variety of factors, including increasing vehicle sales, changing consumer preferences, concerns regarding overcapacity in vehicle production in China, and corporate strategy of foreign and domestic

¹⁰² There are myriad ways that there could be differences in calculation, but, to take one example, there could be a different interpretation about whether certain domestically sourced oils and liquids should be included in the calculation of domestic content (see Announcement 4, Article 24, which speaks of which oils and liquids can be included in the calculation (Exhibit JE-28)).

¹⁰³ Decree 125, Articles 21(2)(b) and 28 (Exhibit JE-27); Announcement 4, Article 13(2)(ii) (Exhibit JE-28).

¹⁰⁴ Decree 125, Article 21(1) (Exhibit JE-27).

manufacturers. In the context of these factors, a review of the present market situation shows that the Measures skew the choice of manufacturers towards the use of domestic auto parts.

69. On April 1, 2006, a new tax was imposed on cars with engines of 2.0-litre or larger. The new tax structure imposes charges of between 9 and 20 percent of the purchase price, while simultaneously cutting the existing tax on cars with engines smaller than 2.0 litres. This tax added further pricing pressure, forcing manufacturers to determine whether they could pass along the increased cost to consumers, or whether to suffer a further diminution in margins. This new tax particularly affects the middle segments of the market, where most foreign manufacturers are concentrated.¹⁰⁵

70. Due to the price-sensitivity of the Chinese market, vehicle and auto part manufacturers (both foreign and domestic) in many cases would be "priced out" of the Chinese marketplace in cases where the Measures force them to pass on the additional 15% internal charges on imported parts to their customers. Due to low profit margins on vehicle and parts manufacturing in the Chinese automotive market, neither vehicle nor auto parts manufacturers can absorb the additional 15% internal charge.

71. As a result of the heavy pricing pressures in the existing Chinese market, manufacturers are forced to maximize domestic content in their parts and vehicles so as to avoid a finding that a vehicle uses imported parts that are Deemed Whole Vehicles.

72. In addition, foreign vehicle manufacturers invested in the Chinese marketplace on the premise that they would be able to import parts as required at the rates to which China bound itself in its Schedule. Accordingly, the addition of an internal charge of 15% of the value of

¹⁰⁵ Auto News 2006, at p. 5 (Exhibit JE-5).

imported parts, and the consequent commercial uncertainty, significantly devalues their investment in China.

73. Even where an imported auto part is commercially superior, a vehicle manufacturer must secure a minimum amount of domestic substitutes of higher price or lower quality, in order to avoid the internal charges imposed by the Measures. If not, it risks significant losses or devaluation of its investment in the automotive industry.

74. The requirements of vehicle manufacturers imposed in order to avoid additional internal charges under the Measures introduce difficulties for the auto parts manufacturer that must locate a domestic source for such parts. These requirements also make it less attractive to use imported product otherwise equal to or better than domestic product, since use of that imported product may cause the manufacturer to exceed contractual thresholds for domestic content, resulting in financial penalty.

IV. ARGUMENT

A. The Disciplines of Article III of the GATT 1994 Apply to the Measures

75. Article III of the GATT 1994 ensures that “internal taxes and other internal charges . . . affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products” are not applied in a manner so as to afford protection to domestic production.¹⁰⁶ China’s Auto Policy, Decree No. 125, and Announcement No. 4 together establish internal charges and burdensome procedures that apply only to foreign goods and that indeed afford protection to domestic production.

¹⁰⁶ GATT 1994, Art. III.1.

76. Although China’s measures label the 25 percent charge as an “import duty,” the name assigned to the charge is not determinative in deciding whether the charge is an internal one – thus subject to the disciplines of Article III – or an import duty subject to tariff bindings under Article II of GATT 1994. Rather, it is necessary to examine whether the charge is based on the internal use and/or sale of the product, or if the charge is instead a border measure. In this dispute, China’s measures apply after importation of the product, and cannot be considered border measures.

77. The distinction between internal charges and customs duties had been addressed in prior panels under the GATT 1947. In one of the first GATT 1947 reports, *Belgian Family Allowances*, the panel examined whether a particular charge should be treated as an “internal charge” within the scope of Article III:2 of the GATT or an “import charge” within the scope of Article II. Belgium imposed the charge at issue on imported goods purchased by public bodies when the goods originated in a country whose system of family allowances failed to meet specific requirements.¹⁰⁷ The panel concluded that because the charge (a) “was collected only on products purchased by public bodies for their own use and not on imports as such” and (b) “was charged, not at the time of importation, but when the purchase price was paid by the public body,” the charge constituted an internal charge.¹⁰⁸ In other words, because the charge depended on the internal use of the product, it could not be considered a border charge.

78. The issue was again addressed in *EEC - Parts and Components*. In that dispute, the GATT 1947 panel examined whether charges imposed to allegedly prevent the circumvention of

¹⁰⁷ *Belgian Family Allowances*, para. 1.

¹⁰⁸ *Belgian Family Allowances*, para. 2.

anti-dumping duties should be analyzed as customs duties or internal charges.¹⁰⁹ In making its determination, the panel focused on “whether the charge is due on importation or at the time or point of importation or whether it is collected internally.”¹¹⁰ The panel noted that the duties were levied on finished products assembled or produced in the EEC and were not imposed “conditional upon the importation of a product or at the time or point of importation.”¹¹¹ Accordingly, the panel concluded that the EEC charges qualified as “internal charges” under Article III.¹¹²

79. As in *Belgian Family Allowances* and *EEC – Parts and Components*, China’s measures at issue in this dispute are internal ones, not border measures. China’s charges are not imposed at the time of, or as a condition to, the entry of the parts into China. Indeed, the measures at issue do not impose charges on all imported parts, but only on parts used by manufacturers in the assembly of new vehicles that exceed the thresholds established by Decree No. 125.¹¹³

80. Instead of being border measures, China’s measures at issue in this dispute are internal measures, the application of which turns on the details of the manufacturing operations conducted within China. All of the following factors lead to this conclusion:

- The determination of whether imported parts constitute “features of a complete automobile” is made at the time the parts are used in the assembly process rather than at the time the parts enter the territory to which China’s Schedule relates.¹¹⁴

¹⁰⁹ *EEC – Parts and Components*, para. 5.4.

¹¹⁰ *EEC – Parts and Components*, para. 5.6.

¹¹¹ *EEC – Parts and Components*, para. 5.5.

¹¹² *EEC – Parts and Components*, para. 5.8 - 5.10.

¹¹³ See Sections III.D to III.G *supra*.

¹¹⁴ *Decree No. 125, Article 5* (JE-27).

- Under the measures, all of the parts of a completed vehicle are combined for the determination of whether the 25 percent charge applies, regardless of where those parts originate, when or where they entered the territory of China, or who imported them. Even if a part has been imported by a supplier, and even if the supplier has already paid customs fees and duties, the part is nonetheless grouped together with parts imported by the manufacturer itself when making the determination.¹¹⁵
- The 25 percent charge is imposed not on the importer, but on the manufacturer – whether or not the manufacturer is actually the importer of the part in question.¹¹⁶
- Official verification is performed by the Chinese authorities at the manufacturer’s site, not at the border.¹¹⁷ And, this determination is not made by China Customs through normal customs procedures, but by a special administrative body pursuant to measures developed by agencies with industrial policy functions.¹¹⁸

In short, the measures are not focused on importation, but rather on the internal use of imported parts in the manufacture of new automobiles. China’s measures are thus internal ones, and are subject to the disciplines of Article III of the GATT 1994.

B. The Charges Are Inconsistent with Article III:2, First Sentence

81. The charges imposed under China’s measures are inconsistent with the first sentence of Article III:2 of the GATT 1994. The provision states:

The products of the territory of any contracting party imported into the territory of any other contracting party 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.

¹¹⁵ See Sections III.E, III.G *supra*.

¹¹⁶ *Decree No. 125, Articles 12, 28-31 (JE-27)*. When paying the charge on an imported part, the manufacturer may deduct from the 25 percent charge an amount equal to the amount of duties paid by the importer

¹¹⁷ *Decree No. 125, Articles 7 and 19 (JE-27)*.

¹¹⁸ See Section III.F *supra*.

82. As confirmed by the Appellate Body in *Japan – Alcoholic Beverages*, a determination of an internal charge’s inconsistency with Article III:2, first sentence is a two step process: First, the imported and domestic products at issue must be “like.” Second, the internal charge must be applied to imported products “in excess of” those applied to the like domestic products.¹¹⁹ “If the imported and domestic products are ‘like products’, and if the charges applied to the imported products are ‘in excess of’ those applied to the like domestic products, the measure is inconsistent with Article III:2, first sentence.”¹²⁰

1. Imported Auto Parts and Domestic Auto Parts Are Like Products

83. As described above,¹²¹ where the number or value of the imported parts used in the assembly of a vehicle in China exceeds the specified thresholds, the measures impose an internal charge of 25% on all imported parts in the vehicle. This internal charge applies only to parts of foreign origin – domestic parts are exempt.

84. Where a WTO Member draws an origin-based distinction in respect of internal charges, a case-by-case determination of “likeness” between the foreign and domestic product is unnecessary.¹²² As such, in this dispute, the requirement that the “like products” be established is readily satisfied.

¹¹⁹ *Japan – Alcoholic Beverages (AB)*, Section H.1.

¹²⁰ *Japan – Alcoholic Beverages (AB)*, Section H.1; *see also Canada – Periodicals (AB)*, Section V.

¹²¹ *See* Sections III.D to III.G *supra*.

¹²² *See Indonesia – Autos*, para. 14.113); *Argentina – Hides and Leather*, paras. 11.168-11.170).

2. Imported Auto Parts are Taxed in Excess of Domestic Auto Parts

85. As noted, when the number or value of the imported parts used in the assembly of a vehicle in China exceed the thresholds established in the measures, the measures impose an internal charge on all imported parts in the vehicle. Domestic parts are exempt.

86. This differential taxation of imported and domestic auto parts breaches Article III:2. Indeed, any taxation of imported products in excess of like domestic products, regardless of amount, is sufficient to render a charge inconsistent with Article III:2, first sentence.¹²³

87. In sum, for the reasons set out above, the measures are inconsistent with the first sentence of Article III:2.

C. The Charges and Reporting Requirements Applied to the Use of Imported Auto Parts Are Inconsistent with Article III:4 of the GATT 1994

88. The charges and reporting requirements under the measures are also inconsistent with Article III:4 of the GATT 1994. That provision states:

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

89. In examining a claim under Article III:4, the Appellate Body has identified three distinct elements required to establish a breach: (1) the imported and domestic products are "like products;" (2) the measure is a law, regulation, or requirement affecting the internal sale, offering for sale, purchase, transportation, distribution, or use of the imported and domestic like

¹²³ See *Japan – Alcoholic Beverages (AB)*, Section H.1(b); *Mexico – Beverage Tax*, paras. 8.52-8.59.

products; and (3) the imported product is accorded less favorable treatment than the domestic like product.¹²⁴

1. Imported Auto Parts and Domestic Auto Parts Are Like Products

90. As with the Article III:2 analysis above, the determination of “like products” for purposes of Article III:4 is established where the measures at issue make distinctions between products based solely on origin.¹²⁵ For instance, the *Canada – Wheat Exports* panel stated that:

Where a difference in treatment between domestic and imported products is based exclusively on the products’ origin, the complaining party need not necessarily identify specific domestic and imported products and establish their likeness in terms of the traditional criteria – that is, the physical properties, end-uses and consumers’ taste and habits. Instead, it is sufficient for the purposes of satisfying the “like product” requirement, to demonstrate that there can or will be domestic and imported products that are like.¹²⁶

Similarly, the *US – FSC (Article 21.5)* panel, noting that a measure made a distinction between foreign and imported articles solely on the basis of origin, found that “there is no need to demonstrate the existence of actually traded like products in order to establish a violation of Article III:4.”¹²⁷

91. As noted above, China’s measures at issue apply the internal charge, and the burdensome administrative requirements on car manufacturers, solely on an origin-based distinction. As such, foreign and domestic auto parts satisfy the “like products” requirement of Article III:4.

¹²⁴ *Korea – Beef (AB)*, para. 133.

¹²⁵ See *Canada Autos (Panel)*, para. 10.74; *India Autos*, paras. 7.173 - 7.176; and *US – FSC (Article 21.5) (Panel)*, paras. 8.130-8.135.

¹²⁶ *Canada – Wheat Exports (Panel)*, para. 6.164.

¹²⁷ *US – FSC (Article 21.5) (Panel)*, para. 8.133.

2. The Charges and Reporting Requirements Are Laws or Regulations Affecting the Internal Sale, Offering for Sale, Purchase, Distribution and Use of Imported Auto Parts

92. The second element of an Article III:4 analysis is that the measures “affect[] [the] internal sale, offering for sale, purchase, distribution . . . or use” of the like products.

93. The Appellate Body has noted that the term “affecting” in Article III:4 should be interpreted as having a “broad scope of application.”¹²⁸ In addition, the panels in *EC – Bananas III*¹²⁹ and *India – Autos*¹³⁰ both concluded that the word “affecting” covered more than measures which directly regulate or govern the sale of domestic and imported like products. In fact, the term “affecting” was broad enough to cover measures that might “adversely modify the conditions of competition between domestic and imported products.”¹³¹ Thus, in *India – Autos*, the panel found that a measure “affects” the internal sale, offering for sale, purchase and use of an imported product, because it provided an incentive to purchase local products.¹³² In *Canada – Wheat Exports*, the panel found that a Canadian measure “affects” internal distribution of like products, because it created a disincentive to accept and distribute imported grain.¹³³

94. In this instance, China’s Auto Policy, Decree No. 125 and Announcement No. 4 work together to create an incentive to purchase domestic auto parts. By establishing a system that

¹²⁸ *US – FSC (Article 21.5) (AB)*, para. 210. See also *Canada – Autos (Panel)*, para. 10.80; and *India – Autos*, para. 7.196.

¹²⁹ *EC – Bananas III (Panel)*, para. 7.175.

¹³⁰ *India – Autos*, para. 7.196.

¹³¹ *India – Autos*, para. 7.196.

¹³² *India – Autos*, para. 7.197.

¹³³ *Canada – Wheat Exports (Panel)*, para. 6.267.

(1) levies an internal charge equal to 25% of the total value of imported parts used in the automobile, and (2) imposes burdensome administrative recording requirements when a certain threshold of imported parts are used in the manufacturing of vehicles, China has established a disincentive to purchase, use and distribute imported auto parts. Thus the measures at issue “affect” the international sale, offering for sale, purchase, distribution, and use of imported auto parts.

3. By Establishing Thresholds on the Use of Imported Auto Parts that Trigger Additional Internal Charges and Burdensome Procedural Requirements, the Measures Accord Less Favorable Treatment to Imported Auto Parts than to Domestic Auto Parts

95. The last element for determining a breach of Article III:4 is to assess whether the measures accord less favorable treatment to imported products relative to the domestic product. Previous panels have found that measures meet this element of the analysis if they impose requirements on foreign products that are not imposed on domestic products;¹³⁴ create an incentive to purchase and use domestic products or a disincentive to utilize imported products;¹³⁵ or “adversely affect . . . the equality of competitive opportunities of imported products in relation to like domestic products.”¹³⁶ Significantly, the Appellate Body in *US – FSC (Article 21.5)* noted that a measure could still be inconsistent with Article III:4 even if unfavorable treatment did not arise in every instance.¹³⁷

¹³⁴ *Canada – Wheat Exports (Panel)*, para. 6.185.

¹³⁵ *India – Autos*, para. 7.201.

¹³⁶ *US – FSC (Article 21.5) (Panel)*, para. 8.158.

¹³⁷ *US – FSC (Article 21.5) (AB)*, para. 221.

96. Here, the measures treat foreign parts less favorably than domestic parts by creating different competitive conditions for the parts so that protection is afforded to the domestic products. This is done in two ways.

97. With respect to the first, *i.e.*, through the application of the additional charge, consider the following: When a manufacturer assembles a vehicle, the manufacturer can choose to include either an imported part or, if one is available, a domestic part. As explained above, the measures establish thresholds (*i.e.*, what constitutes “features of a complete automobile”) for the number of imported parts that can be included in a finished vehicle; if the threshold is exceeded, then a charge equal to 25% of the value of each imported part (instead of the import duty on the imported part) is imposed on each and every imported part included in the vehicle. The measures accordingly alter the conditions of competition by creating a significant incentive to include domestic parts over imported parts. The following example illustrates this dynamic:

	CIF Value	Charge/Tarif f	Total Charges
Parts Imported by Manufacturer	\$13,500	10%	\$1,350
Imported Parts Purchased from Suppliers	\$4,000	10%	\$ 400
Domestic Parts Purchased from Suppliers	\$12,500		
			\$1,750
Parts Imported by Manufacturer	\$13,500	25%	\$3,375
Imported Parts Purchased from Suppliers	\$5,000	25%	\$1,250
Domestic Parts Purchased from Suppliers	\$11,500*		
			\$4,625

* This amount is less than the 40% localization requirement of Article 21(3) of Decree No. 125, resulting in the imposition of the additional internal charge.

98. As this example illustrates, the measures provide a significant incentive to purchase local parts rather than imported parts. In this example, the purchase of an additional \$1,000 worth of local parts avoids the imposition of an additional \$2,875 charge.¹³⁸ As such, the conditions of competition created by the measures strongly favor domestic auto parts, resulting in the foreign parts being treated less favorably.

99. The second method by which the measures treat foreign parts less favorably than domestic parts is through the imposition of burdensome administrative reporting requirements on any manufacturer who chooses to use imported auto parts in building an automobile in China. These requirements also create different competitive conditions for the imported parts so that protection is afforded to the domestic products.

100. As detailed above, Decree No. 125 requires manufacturers to perform a “self-evaluation” to determine the number of imported parts used in the assembly of a particular vehicle model.¹³⁹ To perform this self-evaluation, a manufacturer must catalogue all the parts of each model it manufactures, determine whether, under the measures, the parts are foreign or domestic, and calculate the thresholds for each assembly system and the overall price percentage of imported parts in the model. Should this self-evaluation result in a determination that the imported parts used constitute “features of a complete automobile,” as defined in the Decree, the manufacturer must register the vehicle model with CGA. None of this is required if the manufacturer uses only domestic auto parts.

¹³⁸ And even after a manufacturer triggers one of the thresholds in the measures, the measures continue to create incentives to buy domestic parts by providing that the remainder of the parts used, if not imported, would not be subject to the additional 15% charge.

¹³⁹ See Section III.F, *supra*.

101. To register the vehicle model with CGA, the manufacturer must include the following information:

- a description of the manufacturer;
- the annual production plan for the vehicle model;
- a list of all domestic and foreign suppliers; and
- a detailed list of all imported and domestic parts used in the model being filed.

This information must then be constantly updated to take into account changes in the source and relative price of various parts of every automobile model, as well as changes to individual automobiles (*e.g.*, if optional imported parts are fitted on an individual vehicle).

102. Further, if imported parts are used, China’s special payment system for the internal charges requires that the imported parts – if entering China through a port not administered by the local customs office where the manufacturer is located – be “transferred” to the local customs office, where the manufacturer is required to maintain a general financial guarantee in an amount no lower than the average total amount of total duties payable by the enterprise for its average monthly imports of parts and components. The manufacturer is required to make payments on a monthly basis, at which time the following information is required: verification report, the previous month’s total production figures, and a list of parts and components used by the manufacturer in the prior month to assemble completed vehicles.

103. Should the manufacturer use imported parts that he himself did not import, the manufacturer is required to maintain records regarding the actual importer of record, and any evidence of duties and value-added taxes paid.

104. None of these burdensome reporting requirements are necessary for manufacturers who choose to use only domestic auto parts to manufacture automobiles in China. Such

administrative requirements thus create different competitive conditions for the imported parts so that protection is afforded to the domestic products.

105. In sum, the imposition of internal charges and burdensome procedural requirements on manufacturers who use imported rather than domestic parts results in a breach of Article III:4 of the GATT 1994.

D. China’s Measures Are Inconsistent with Article 2.1 and Paragraph 1(a) of Annex 1 of the TRIMs Agreement

106. China’s measures are inconsistent with Article 2 of the TRIMs Agreement. First, these measures fall within the types of measures covered in the Illustrative List in the Annex to the TRIMs Agreement. Illustrative List 1(a) provides:

1. TRIMs that are inconsistent with the obligation of national treatment provided for in paragraph 4 of Article III of GATT 1994 include those which are mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage, and which require:

(a) the purchase or use by an enterprise of products of domestic origin or from any domestic source, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production.

107. The Chinese measures at issue provide an advantage, *i.e.*, an exemption from paying the internal charge and related burdensome administrative requirements, for auto manufacturers that decide to purchase or use domestic auto parts. Thus, the measures require “the purchase or use by an enterprise of products of domestic origin or from any domestic source” so as “to obtain an advantage”; they fall squarely within the Illustrative List of measures covered by the TRIMs Agreement.

108. Further, under Article 2 of the TRIMs Agreement, a TRIM that is inconsistent with Article III of the GATT 1994 is also inconsistent with the TRIMs Agreement.¹⁴⁰ As the measures at issue are already determined to be “trade-related investment measures” in that they fall squarely within Illustrative List 1(a) of the TRIMs Agreement, and they are also inconsistent with China’s obligations under Article III:4 (as discussed above), these measures are thus inconsistent with Article 2 of the TRIMs Agreement as well.

E. China’s Measures are Inconsistent with Article III:5 of the GATT 1994

109. China's Measures are also inconsistent with Article III:5 of the GATT 1994. That provision states:

No contracting party shall establish or maintain any internal quantitative regulation relating to the mixture, processing or use of products in specified amounts or proportions which requires, directly or indirectly, that any specified amount or proportion of any product which is the subject of the regulation must be supplied from domestic sources. Moreover, no contracting party shall otherwise apply internal quantitative regulations in a manner contrary to the principles set forth in paragraph 1 [of GATT Article III].

110. China’s measures at issue impose additional internal charges and burdensome administrative requirements if, among other things, the quantity of the imported parts and components used by a car manufacturer (1) exceed specified limits on the number of imported assembly systems, or (2) results in the total price of the imported parts and components being 60% or more of the total price of all parts and components in the finished vehicle. Given that these provisions are expressed in quantitative terms, they are by their nature “quantitative

¹⁴⁰ TRIMs Agreement, Art. 2 (“Without prejudice to other rights and obligations under GATT 1994, no Member shall apply any TRIM that is inconsistent with the provisions of Article III or Article XI of GATT 1994.”).

regulations.” Moreover, given that their terms specify the quantitative amounts of imported parts that would result in the internal charges and reporting requirements being applicable, the measures are also quantitative regulations that relate “to the mixture, processing or use of products in specified amounts or proportions,” and require that a specified amount or proportion of an automobile be supplied from domestic sources or else a penalty in the form of an additional charge is assessed. As such, the Chinese measures are inconsistent with Article III:5 of the GATT 1994.¹⁴¹

F. China’s Measures Are Inconsistent with Part I.7.2 of the Accession Protocol

111. Part I.7.2 of China’s Accession Protocol states in relevant part: “In implementing the provisions of Articles III and XI of the GATT 1994 and the Agreement on Agriculture, China shall eliminate and shall not introduce, re-introduce or apply non-tariff measures that cannot be justified under the provisions of the WTO Agreement.”¹⁴²

112. Therefore, by introducing measures that are inconsistent with Article III:2, Article III:4, and Article III:5 of the GATT 1994 and that thus cannot be justified under the provisions of the

¹⁴¹ Although the first sentence of Article III:5 clearly applies to China’s measures, the United States notes that, in the alternative, the measures would be inconsistent with the second sentence of Article III:5, as they are “otherwise” applied by China “in a manner contrary to the principles set forth in” Article III:1. Article III:1 contains the “general principles” of Article III as a whole, which is “that internal measures should not be applied to imported or domestic products so as to afford protection to domestic production.” Based on all of the relevant facts and circumstances, as set out above in the Statement of Facts, China’s measures adversely affect the equality of competitive opportunities of imported auto parts in relation to like domestic auto parts, and thus are contrary to principles set forth in Article III:1. *Cf. Japan – Alcoholic Beverages (AB)*, pages 27-30 (applying the second sentence of Article III:2 of the GATT 1994).

¹⁴² WTO, Accession of the People's Republic of China, Decision of 10 November 2001, WT/L/432, November 23, 2001, Part I.7.2 (JE-1). Paragraph 1.2 of the Accession Protocol states: “The WTO Agreement to which China accedes shall be the WTO Agreement as rectified, amended or otherwise modified by such legal instruments as may have entered into force before the date of accession. This protocol, which shall include the commitments referred to in paragraph 342 of the Working Party Report, shall be an integral part of the WTO Agreement.”

WTO Agreement, China’s measures at issue consequentially are in breach of Part I.7.2 of China’s Accession Protocol.

G. China’s Measures Are Inconsistent with Part I.7.3 of the Accession Protocol and Paragraph 203 of the Working Party Report

113. Part I.7.3 of China’s Accession Protocol states in relevant part: “China shall, upon accession, comply with the TRIMs Agreement, without recourse to the provisions of Article 5 of the TRIMs Agreement. China shall eliminate and cease to enforce . . . local content . . . requirements made effective through laws, regulations or other measures.”¹⁴³ Paragraph 203 of the *Working Party Report on the Accession of China* (WT/MIN(01)/3) (“Working Party Report”) reiterates this obligation.¹⁴⁴

114. In light of the earlier discussion that China’s measures are inconsistent with obligations under Article 2 of the TRIMs Agreement, and in light of the fact that the measures effectively maintain the local content requirement initially set forth in China’s *Automotive Industry Industrial Policy* of July 3, 1994, China’s measures at issue consequentially are inconsistent with China’s obligations under Part I.7.3 of China’s Accession Protocol and paragraph 203 of the Working Party Report.

H. In the Alternative, China’s Measures Are Inconsistent with Article II of the GATT 1994 and Paragraph 93 of the Working Party Report

115. As the United States has explained above, China’s measures at issue are internal charges and other internal requirements, not border measures. Accordingly, the United States submits

¹⁴³ Accession Protocol, Part I.7.3 (JE-1). Article 5 of the TRIMs Agreement *inter alia* relates to transitional arrangements for developing countries.

¹⁴⁴ Paragraph 203 of the Working Party Report is also an integral part of the WTO Agreement, as it is listed in paragraph 342 of the Working Party Report as a commitment “given by China,” which – pursuant to paragraph 1.2 of the Accession Protocol – shall be an integral part of the WTO Agreement.

that these measures are to be analyzed under (and are inconsistent with) the obligations set out in Article III of the GATT 1994.

116. Nonetheless, even if the measures were considered border measures, China’s measures would be inconsistent with Article II of the GATT 1994 and Paragraph 93 of the Working Party Report.

117. First, if China’s measures are considered to result in the imposition of customs duties subject to Article II obligations, the measures would result in the imposition of customs duties in an amount greater than allowed under Article II. In particular, Article II:1(a) provides that “[e]ach contracting party shall accord to the commerce of the other contracting parties treatment no less favorable than that provided for in the appropriate Part of the appropriate Schedule annexed to this Agreement.” Article II:1(b) goes on to require that:

The products described in Part I of the Schedule relating to any contracting party, which are the products of territories of other contracting parties, shall, on their importation into the territory to which the Schedule relates, and subject to the terms, conditions or qualifications set forth in that Schedule, be exempt from ordinary customs duties in excess of those set forth and provided therein. Such products shall also be exempt from all other duties or charges of any kind imposed on or in connection with the importation in excess of those imposed on the date of this Agreement or those directly and mandatorily required to be imposed thereafter by legislation in force in the importing territory on that date.

118. Under China’s Schedule of Concessions and Commitments, most motor vehicles are classified under items 8702 through 8704, while auto parts and components are classified under several different items including 8407-8409 (engines and engine parts), 8707 (bodies for motor vehicles), and 8708 (parts and accessories of motor vehicles). China’s final bound tariff rate for complete vehicles is 25%, while its bound rate for auto

parts and components is 10% (and in some cases, even lower).¹⁴⁵ Accordingly, should the 25 percent charges under the measures be considered customs duties on auto parts, those charges would violate China's tariff binding (of 10 percent or lower) on such parts.

119. Second, should China's measures be considered border measures rather than internal measures subject to Article III, the 25 percent charge on imported CKDs and SKDs would be inconsistent with China's commitments in Paragraph 93 of the Working Party Report. Part I.1.2 of the *Protocol on the Accession of the People's Republic of China* provides that the Protocol, which includes the commitments referred to in paragraph 342 of the Working Party Report, shall be an integral part of the WTO Agreement.¹⁴⁶ Paragraph 342 of the Working Party Report includes China's commitment reproduced in paragraph 93 of the Working Party Report. As a result, China's commitment in paragraph 93 of the Working Party Report is an integral part of the WTO Agreement.

120. Paragraph 93 of the Working Party Report provides,

Certain members of the Working Party expressed particular concerns about tariff treatment in the auto sector. In response to questions about the tariff treatment for kits for motor vehicles, the representative of China confirmed that China had no tariff lines for completely knocked-down kits for motor vehicles or semi-knocked down kits for motor vehicles. If China created such tariff lines, the tariff rates would be no more than 10 per cent. The Working Party took note of this commitment.¹⁴⁷

¹⁴⁵ The United States notes that the first submission of the EC contains a detailed discussion of the differentials between China's binding of its tariffs on complete vehicles and China's binding of its tariffs on automotive parts.

¹⁴⁶ WT/L/43 (Exhibit JE-1).

¹⁴⁷ WT/ACC/CHN/49 (Exhibit JE-26).

121. To the extent that the charges imposed by the measures are considered to be tariffs, the measures would in effect specify a tariff line for CKDs and SKDs that imposes a 25% tariff, rather than a 10% tariff as required under the Working Party Report.

I. China’s Measures Constitute an Import Substitution Subsidy in Breach of Articles 3.1(b) and 3.2 of the SCM Agreement

122. China's measures impose additional duties and other requirements on imported auto parts, thereby resulting in a breach of China's obligations under Article III of the GATT 1994. Another way to view these charges is that they exempt manufacturers from the charges otherwise due if they use domestic auto parts rather than imported auto parts. From this perspective, the measures constitute an import substitution subsidy in breach of Articles 3.1(b) and 3.2 of the SCM Agreement.

123. The reduction available for using domestic parts is a subsidy pursuant to Article 1.1 of the SCM Agreement. First, pursuant to the chapeau of Article 1.1(a)(1), the reduction is a “financial contribution” by the Chinese Government, where “government revenue that is otherwise due is foregone or not collected.”¹⁴⁸ Under China’s measures, on domestic parts the government foregoes the difference between the across-the-board 25 percent charge on auto parts and the customs duty (10 percent or less) applied to imported parts. Likewise, on certain imported parts, the government foregoes the difference between the across-the-board 25 percent charge and the customs duty (10 percent or less) when the thresholds for using domestic parts in a finished

¹⁴⁸ Article 1.1(a)(1)(ii) of the SCM Agreement.

vehicle are satisfied. Second, this financial contribution results in a “benefit . . . conferred,” pursuant to Article 1.1(b) of the SCM Agreement, because the auto manufacturer is able to retain the amount of money equivalent to the amount of revenue foregone by the government.

124. Article 2.3 of the SCM Agreement further specifies that a subsidy shall be deemed "specific" if it falls within the provisions of Article 3 of the SCM Agreement relating to "prohibited" subsidies. As shown below, China's measures are "prohibited" and therefore are deemed "specific" within the meaning of Article 2.3 of the SCM Agreement.

125. China's measures are "prohibited" within the meaning of Article 3.1(b) because they are "contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods." China's measures are contingent upon the use of domestic over imported goods, in that the subsidy provided by these measures is only available to an auto manufacturer when (1) the quantity of the domestic parts and components used by the auto manufacturer exceeds specified thresholds on the number of domestic assembly systems or (2) the quantity of the domestic parts and components used by the auto manufacturer results in the total price of the domestic parts and components being more than 40 percent of the total price of all parts and components in a finished vehicle. As such, the measures violate Articles 3.1(b) and 3.2 of the SCM Agreement, which provide that a Member shall neither grant nor maintain subsidies contingent upon the use of domestic over imported goods.

126. Since China's measures amount to a prohibited subsidy, the provisions of Article 4.7 of the SCM Agreement apply. Those provisions provide that the panel shall recommend that the subsidizing Member withdraw the subsidy without delay, and that the panel shall specify in its recommendation the time-period within which the measure must be withdrawn.

VI. CONCLUSION

127. For all the reasons set out above, the United States requests that the Panel find that:

- China's measures are inconsistent with China's obligations under Articles III:2, III:4, and III:5 of the GATT 1994;
- China's measures are inconsistent with China's obligations under Article 2.1 and Paragraph 1(a) of Annex 1 of the TRIMs Agreement;
- China's measures are inconsistent with China's obligations under Part I.7.2 of the Accession Protocol; and
- China's measures are inconsistent with China's obligations under Part I.7.3 of the Accession Protocol and Paragraph 203 of the Working Party Report.

128. In addition, the United States requests that the Panel find that China's measures are inconsistent with China's obligations under Articles 3.1(b) and 3.2 of the SCM Agreement, and accordingly that the Panel issue the recommendations set out in Article 4.7 of the SCM Agreement.