

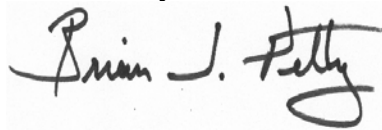
27 April 2007

The Honorable Susan C. Schwab  
United States Trade Representative  
Executive Office of the President  
Washington, DC 20508

Dear Ambassador Schwab:

Pursuant to Section 2104 (e) of the Trade Act of 2002 and Section 135 (e) of the Trade Act of 1974, as amended, I hereby transmit the report of the Industry Trade Advisory Committee on Automotive Equipment and Capital Goods (ITAC 2) on the US-Korea FTA, reflecting a division of opinion on the proposed Agreement.

Sincerely,

A handwritten signature in black ink that reads "Brian T. Petty". The signature is written in a cursive style with a large, stylized initial "B".

Brian T. Petty  
Chair, ITAC 2

cc: Trade Advisory Center  
Richard Reise

**The U.S.-Korea Free Trade Agreement**

**Report of the  
Industry Trade Advisory Committee on Automotive Equipment  
and Capital Goods (ITAC 2)  
April 27, 2007**

April 2007

## **ITAC 2 Advisory Committee Report to the President, the Congress, and the United States Trade Representative on the US-Korea Free Trade Agreement**

### **I. Purpose of the Committee Report**

Section 2104 (e) of the Trade Act of 2002 requires that advisory committees provide the President, the US Trade Representative, and Congress with reports required under Section 135 (e) of the Trade Act of 1974, as amended, not later than 30 days after the President notifies Congress of his intent to enter into an agreement.

Under Section 135 (e) of the Trade Act of 1974, as amended, the report of the Advisory Committee for Trade Policy and Negotiations and each appropriate policy advisory committee must include an advisory opinion as to whether and to what extent the agreement promotes the economic interests of the United States and achieves the applicable overall and principle negotiation objectives set forth in the Trade Act of 2002.

Pursuant to these requirements, ITAC 2 hereby submits the following report.

### **II. Brief Description of the Mandate of ITAC 2**

The Industry Trade Advisory Committee on Automotive Equipment and Capital Goods (the Committee) is established by the Secretary of Commerce (the Secretary) and the United States Trade Representative (the USTR) pursuant to the authority of section 135 (c)(2) of the 1974 Trade Act (Public Law 93-618), as delegated by Executive Order 11846 of March 27, 1975. In establishing the Committee, the Secretary and the USTR consulted with interested private organizations and took into account the factors set forth in section 135 (c)(2)(B) of the Act.

### **III. Executive Summary of Committee Report**

ITAC 2 is divided on the Agreement. Generally, the manufacturers of capital goods see it as an important milestone in providing market access to a country and region historically protectionist. Significantly, US manufacturers of electrical equipment will benefit substantially by Korean tariff reductions and eliminations, where the sector has already returned to running a trade surplus with Korea. However, in terms of US automotive equipment manufacturers, the outcome is mixed. Attached to this report are specific separate comments by General Motors Corp. and Ford Motor Co.

The investment Chapter of the Agreement is on balance positive and an important signpost for other regional FTAs.

### **IV. Advisory Committee Opinion on Agreement**

## **Automotive Provisions**

ITAC 2 has consistently expressed a strong interest in the treatment of automotive issues in the KORUS negotiations because of the large and historically unbalanced automotive trade between the two countries. Last year, Korea exported more than 700,000 cars, vans and SUVs to the United States. US auto exports over the same period totaled just over 4,000.

US auto companies and ITAC 2 had recommended that US trade negotiators take an unconventional approach to the automotive provisions of the FTA and precondition the phase-out of US automotive tariffs on the demonstration of Korean automotive market openness in terms of improved import penetration that is on par with that of other OECD countries.

In the Agreement, the US does not include a performance metric approach. The US will provide immediate, duty free access for over 90% of passenger cars currently exported from Korea. In a parallel provision, Korea will allow immediate duty free access for US exports of most categories of cars and trucks. The Agreement includes provisions dealing with Korean current technical barriers to trade and provides a mechanism for accelerated dispute settlement of future problems should they arise. Motor vehicle suppliers recognize that auto parts tariffs in both countries are immediately reduced to zero and that the Agreement ensures equivalent treatment between remanufactured and new goods.

### **Tariffs**

In earlier advice to USTR and DOC, ITAC 2 noted “the handling of auto and trucks tariffs issue is critical to all other components of any auto package in the final US proposal.” ITAC 2 recommended using phase-out of US automotive tariffs as leverage to achieve progress on Korean TBTs.

#### **FTA Outcome:**

Korea tariffs:

- Immediate reduction of the 8% auto tariff to zero
- At this writing, language remains bracketed concerning the tariff treatment of vehicles with engines of 1500cc and below and the status of US hybrid vehicles
- Immediate reduction of the truck tariffs to zero
- Immediate reduction to zero on auto parts tariffs

US tariffs:

- Immediate reduction of the 2.5% car tariff to zero for cars with engine of 3.0 liters or less linear phase-down to zero over 3 years of the 2.5% car tariff for Korean imports with engine sizes of 3.0 liter or more
- Linear phase-down of the 25% truck tariffs to zero over 10 years
- Immediate reduction to zero on auto parts tariffs

### **Taxes**

In its advice to USTR and DOC, ITAC 2 recommended ending the use of engine displacement as a basis for automotive taxes and a reduction in the overall tax burden on the auto sector.

**Special Consumption Tax (SCT):** As provided in the FTA, Korea will, over a three year period, reduce the number of displacement categories and lower the maximum tax rate from 10% to 5%. The new SCT structure will be: 1,000 cc or less – no tax; and 1,000 cc or more – 8% immediately and 5% within three years.

**Annual Vehicle Tax:** The FTA provides for an immediate reduction in the number of engine displacement categories for this annual registration tax from five to three. In addition, the current highest tax applied will be reduced from the 220 won per cc to 200 won per cc. The tax will be structured as follows:

- 1,000 cc or less – 80 won-per-cc
- 1,000-1,500 – 140 won-per-cc
- 1,500 or more – 200 won-per-cc

**Subway Bond:** The FTA includes a side letter in which the Korean government commits that it will not increase the current rate of the subway bond. In the letter, the Korean Government also agreed to publicize the fact that 80% of the bond is refundable soon after the purchase of the car.

### **Technical Barriers to Trade (TBTs)**

ITAC 2 recommended that Korea eliminate the current automotive TBTs that have been on the table for discussion throughout the course of this negotiation and agree to an effective mechanism for resolving future TBTs.

### **ITAC 2 KULEV Recommendation:**

One of the TBT issues on the table for the negotiations was Korea's Ultra Low Emission Vehicle regulation (KULEV). KULEV is largely based on the US California Low Emissions Vehicle II regulation, but the changes Korea had made to their regulation would be burdensome to low-volume exporters. ITAC 2 recommended that vehicles certified for sale in California be deemed to be in compliance with Korea's emission requirements

### **Korean Ultra Low Emission Vehicle (KULEV) Outcome:**

The changes to the KULEV requirement that were negotiated in the FTA are as follows:

- For a manufacturer selling no more than 4,500 gas powered vehicles annually in Korea, the fleet average Non-Methane Organic Gas (NMOG) requirement would be 0.075 g/mile in 2009 and 2010 model years. In 2011 and beyond the fleet average requirement would be the same as that enforced by California Air Resources Board (CARB). Under CARB's current provisions, a fleet NMOG average of 0.075 grams/mile would continue to apply until such time as CARB revises these provisions. In this case, a fleet composed of 100% LEV would comply.
- For a manufacturer selling between 4,501 and 10,000 gas powered vehicles annually in Korea, the fleet average NMOG requirement would be 0.060 grams/mile in 2009 and 2010 model years, In 2011 and beyond, the fleet average requirement would be the same as that enforced by CARB. In this case, the fleet would require a mix of LEV and ULEV, with the ULEV comprising slightly more than 40% of the total.
- Vehicle manufacturers selling over 10,000 gas powered vehicles annually in Korea shall be subject to the California ULEV NMOG standard of 0.04 grams/mile in 2009 and 0.038 in 2010.

ITAC 2 seeks confirmation in writing that this new regulation is identical to the NMOG requirement in the State of California.

**ITAC 2 OBDII Recommendation:**

That the Korean Government adopt the same means and tests to implement the OBDII regulation as accepted in the US before full implementation in 2009, and accept US test reports.

**OBDII Outcome:**

Korea will delay implementation of the On Board Diagnostics (OBD II) regulation until January 1, 2009 for manufacturers that sell 10,000 or fewer vehicles per year in Korea.

**ITAC 2 “Self-Certification” Recommendation**

ITAC 2 recommended that the proposed change to Korea’s defect investigation provisions that limit the use of equivalent standards to meet Korean standards be dropped, since it would not improve safety, but would make certification of low-volume imports much more difficult.

**Outcome**

After Korean safety standards are issued, the FTA provides a two-year grace period for imported vehicles. Proof of meeting the regulations is only necessary if the vehicle has been recalled for legitimate reasons. If a manufacturer sells fewer than 6,500 vehicles in the previous year, it can comply with either the 42 KMVSS items or the corresponding US FMVSS standards. If a manufacturer sells more the 6500 vehicles, it must comply with all 42 KMVSS standards.

ITAC 2 seeks confirmation that this new regulation ensures that vehicles certified as meeting all US safety regulations will be accepted as meeting all Korean safety regulations, up to 6,500 vehicles per manufacturer.

**Future TBTs – Accelerated Dispute Settlement**

ITAC Recommendation:

Any Dispute Settlement procedure must have sufficient “teeth” in its application to deter Korea from continuing to use TBTs to protect its auto market from imports.

**Outcome**

The FTA contains an Alternative Dispute Settlement Mechanism for the auto sector that would shorten the DS process to no longer than six months. An auto tariff ‘snapback’ provision is included in this DS system. This would allow the MFN passenger car tariff (but not the truck tariff) to be re-imposed as a retaliatory tool as part of the appeals process if a DS panel determines there has been a "nullification and impairment of expected benefits" as well as "material injury". If this dispute settlement mechanism is not used within 10 years, the provision will sunset.

**Rules of Origin**

ITAC 2 recommendation:

ITAC 2 recommended that the rule of origin methodology be net-cost only with a regional value content of 35%.

## **Outcome**

The FTA allows for three rule of origin methodologies: net cost, adjusted value/build-up and adjusted value/build-down. The methodologies used are virtually identical to those used in the US Central American Free Trade Agreement. The Regional Value Content levels assigned for vehicles considered eligible for FTA treatment are respectively: 35% for the net cost method; 35% for AV build-up; and 55% for AV build-down.

## **Investment**

With respect to the protection of US investment, the investment chapter of the Agreement generally contains the primary protections sought by the Committee and included in the Trade Promotion Authority legislation, enacted as part of the Trade Act of 2002. These include a broad definition of “investment”; guarantees of prompt, adequate and effective compensation for expropriation; a ban on performance requirements; and commitments to provide national treatment, most-favored nation treatment, fair and equitable treatment and full protection and security, and free transfer of capital. Very importantly, the Agreement includes the investor-state dispute settlement mechanism that is vital to afford US investors the opportunity to ensure that their investments are protected against arbitrary, discriminatory and unfair government actions. In addition, the Agreement provides for investor-state dispute settlement with respect to the breach of existing and future investment agreements that a US investor has entered into with the Government of Korea.

The Agreement also provides for protections against direct and indirect expropriation, consistent with US legal principles and practice. The Parties agreed in a side letter to confirm that the protection for expropriation applies, as in the United States, to rights under contract and all other property rights in an investment. With regard to indirect expropriation, the Agreement provides protections consistent with US case law, most notably the Supreme Court’s decision in *Penn Central Transp. v. New York City* (1978). The language clarifying the fact that, except in rare circumstances, government regulatory actions do not generally rise to the level of an expropriation was modified slightly from prior agreements and reflects more strongly US indirect expropriation principles. The Agreement also incorporates improved transparency in investor-state mechanisms as sought by the Trade Act of 2002 and provides for the consideration of a bilateral appellate mechanism after three years.

The Committee notes the Agreement’s investment chapter includes an exception that differs from the US model. While the Committee would have preferred that this provision not be included, the Committee recognizes that this exception can only be used in extraordinarily limited circumstances. The Agreement includes a very narrow exception from national treatment and performance requirement obligations for limits on the establishment or acquisition of an investment under Korea’s Foreign Investment Promotion Act where a measure is necessary to protect the public order. Under this provision, Korea has the burden to demonstrate several circumstances are present, including that the measure is adopted and maintained only where the measure poses a genuine and sufficiently serious threat to the fundamental interests of society, is not applied in an arbitrary and unjustifiable manner, does not constitute a disguised restriction on investment, and is proportional to the objective it seeks to achieve. The Committee urges that this provision not be included in future agreements.

With respect to ensuring access to US investment, the Agreement makes substantial progress in reducing the barriers to such investment. Overall, the Agreement assures US investors greater opportunities to establish, acquire and operate investments in Korea in all sectors, except where a reservation has been taken in a particular sector area.

**V. Membership of Committee (list of members)**

Brian T. Petty	Gary Held	John J. Meakem	Thomas L. Trueblood
Stephen J. Collins	Leslie A. Hennessy	Mustafa Mohatarem	Simonetta Verdi
Durga D. Agrawal	Jon E. Jenson	Carl Occhialini	Franklin J. Vargo
Gary F. Devlin	Lee Kadrich	Robert S. Perkins	L. Ann Wilson
Thomas M. Egan	William C. Lane	John W. Rauber, Jr.	Nick S. Yaksich
William Gager	Stephen Latin-Kasper	Linda M. Spencer	A. Steven Young
David R. Gridley	Patrick W. McGibbon	Jon Taylor	James Zawacki



# *Ford Motor Company Assessment of the Automotive Provisions of the US-Korea FTA*

## **I. Overall Assessment of the Agreement**

As a result of the continued closed nature of the Korean automotive industry, and the failure of two previous agreements with Korea that saw no meaningful increase in U.S. auto exports, ITAC-2 and U.S. auto companies' recommended a new approach be taken in these negotiations. Specifically, ITAC-2 recommended using the leverage of preferential access for Korean automakers to the US market as a means to ensure that the heavily restricted Korean auto market is fully opened and beginning to resemble import market share penetration of all other industrialized nation auto markets. To achieve this, the U.S. auto companies recommended that any tariff reductions for Korean vehicles imported into the U.S. be conditional on measurable, significant, and sustained opening of the Korean auto market. This recommendation, as USTR have stated publicly after the conclusion of the FTA negotiation, was not accepted.

The FTA negotiation that was concluded on April 1 instead will provide immediate, unconditional duty free access for over 90% of the 700,000 passenger cars currently exported from Korea. Ford is disappointed that ITAC's negotiating advice and approach was not accepted. Ford is also disappointed with the lopsided benefit provided immediately to the Korean auto industry and the Korean economy resulting from U.S. concessions made on its vehicle tariffs, particularly in the absence of any benchmarks to track whether serious market opening progress is being made in Korea's closed auto market. In effect this will reward Korean manufacturers for 20 years of unfair trade practices by the Korean Government.

While some progress was achieved with respect to existing non-tariff barriers (NTBs), Ford has concerns regarding the effectiveness of the Dispute Settlement Panel and is disappointed that after 20 years of a closed Korean market, the burden of proof continues to be borne by U.S. exporters to demonstrate the existence of TBTs and to demonstrate "injury" before any appropriate remedy is applied. Ford is also concerned that this agreement may at best perpetuate small volume opportunities for import manufacturers into Korea while completely opening the U.S. market to Korean imports.

## **II. Tariffs**

Ford asserts that the immediate and clear beneficiary of vehicle tariff provisions arising out of the KORUS FTA will be manufacturers exporting vehicles from Korea to the U.S. At 2006 export levels, Korean automakers will receive an immediate cost savings estimated at up to 40 times that of U.S. OEMS exporting to Korea.

Today Hyundai and Kia have approximately 1,300 dealers operating in the U.S. compared to one surviving Ford dealer operating in Korea. The rapid elimination of the U.S. vehicle tariff, following 20 years of closed market access into Korea, will further lock-in the one-sided nature of automotive trade between Korea and the U.S.

Ford also notes that this assessment of the agreement is being made while the issue of tariffs on U.S. hybrid vehicle exports to Korea remains unresolved. This issue is significant given Ford's (and other U.S. based manufacturers) current and forecast hybrid production in the U.S.

### III. Non-Tariff Barriers

#### Korea Auto Taxes

##### 1. Consumption Tax

**Ford assessment:** For more than ten years, U.S. auto companies have recommended that Korea adopt a value-based auto consumption tax, rather than a tax structure based on engine size.

The changes to the automotive consumption tax are a welcome improvement from the current system. The tax changes reduce, while not eliminating the discrimination based on engine size, that forms the basis of Korea's auto consumption tax.

##### 2. Annual Vehicle Tax

**Ford Assessment:** This change represents an incremental improvement in the level of discrimination contained in this engine based annual tax. As structured on the current system as well as in the revised structure, nearly all U.S. exported vehicles will continue to be placed in the highest taxed category in the Korean market. Thus, while the top rate applied to U.S. exports is slightly reduced, it is still twice the level applied to vehicles in the lowest tax category and 40% higher than the next closest vehicle tax category, which applies to most Korean vehicles. The overall impact for U.S. automakers, in commercial terms, is minimal.

##### 3. Subway Bond Tax

**Ford Assessment:** The Korean government does not eliminate the tax or change its structure, but simply commits to 'capping' the tax at current values. Since the tax continues to be applied based on engine displacement it continues to be discriminatory against import manufacturers.

### IV. Technical Barriers to trade:

**Ford Assessment:** Despite some improvement as a result of the negotiations, Korea continues to complicate the auto certification process by mixing U.S. and European safety and emissions regulations. This is a major non-tariff barrier system, since a vehicle certified for Korea may need to be specifically designed for that unique set of regulations, representing a significant technical hurdle and cost without any corresponding improvement in safety or environmental performance.

#### A. KULEV – Korean Ultra Low Emission Vehicles.

**Ford Assessment:** This FTA provision does not eliminate the Korea KULEV requirement, as recommended. However, if U.S. automakers' current interpretations are correct (and this must be verified in writing by the U.S. government), this FTA provisions does remove, the trade-distorting effect of the current regulation.

Ford wishes to stress that this assessment of the benefits of this FTA provision are contingent upon securing a far more precise and detailed clarification and written interpretation of this language.

#### B. OBD Requirement

**Ford Assessment:** These provisions do not remove the offending TBT as strongly recommended by the ITAC. The provision provides a slight delay for small volume exemption to deal with the problem.

Korea's gasoline OBD requirements are consistent with the provisions of California's requirements. However, for California, manufacturers have large "OBD families" in which manufacturers group several models of vehicles and represent those models with a worst case demonstration of OBD compliance. If a model sold in

Korea was not the same model, emission standard, or vehicle class as that which was used for demonstration in California, a new demonstration may need to be conducted for Korea. This may require additional prototype vehicles, aged catalysts, and documentation preparation.

**Diesel Emissions and OBD** - Korea's diesel emissions and OBD standards are based on European requirements. Ford believes that Korea should accept light-duty diesel vehicles complying with California emissions and OBD requirements.

**Heavy-Duty Emissions Standards** - Korea's heavy-duty emissions standards are based on European test procedures. Ford believes that Korea should accept heavy-duty vehicles/engines complying with California emissions requirements.

Ford emphasizes that its assessment of these technical provisions is based on the initial interpretation by those few industry experts who have been briefed on its general outline. Prior to signature, this FTA provision will also require a detailed U.S. government approved written interpretation, upon consultation with industry, that will be considered part of the US record of implementation of the agreement should it go into effect.

#### C. Self-certification in Safety compliance

**Ford Assessment:** Prior to signature Ford requests that, due to the highly technical nature of this subject, a more precise and detailed clarification of this provision be secured in writing to ensure that US certified vehicles will be accepted as meeting all Korean safety regulations.

## V. Future NTBs – Accelerated Dispute Settlement

**Ford Assessment:** Ford believes that both the 2.5% auto tariff and the 25% light truck tariff should have been included in the snapback provisions, as they are the applicable tariffs covering the US passenger car and truck fleets.

Ford also has concerns with the requirements a U.S. manufacturer must meet before the U.S. government would be compelled to bring a case to Dispute Settlement. Ford is extremely disappointed that after a 20 year history of using Korean TBTs to effectively close the Korean market, and two failed MOUs (1995, 1998), the burden continues to fall on US auto companies to demonstrate the existence of NTBs and to demonstrate "injury" before any appropriate remedy is applied.

## VI. Rules of Origin

**Ford Assessment:** While the U.S. industry during the course of the negotiation questioned why methodologies other than a net cost based system was necessary, Ford nonetheless find these three methods for assessing origin for eligible vehicles acceptable. The percentages agreed to be used for each methodology to confer eligibility are also in line with industry recommendations.

The Korean government has insisted on several occasions since the signing of the KORUS FTA that products manufactured in the Kaesong Industrial Zone in the Democratic Peoples Republic of Korea (North Korea) will ultimately be permitted for inclusion as South Korean content for purposes of the FTA. As the Kaesong Industrial Zone lies outside of South Korea, and considering the high level of controversy regarding the treatment of labor in the zone and the fact that local South Korean operators contract labor with, and make

payments directly to, the government of the North Korea, Ford does not believe that exports that include Kaesong labor or components meet a fair or appropriate qualification for South Korean content. As this matter remains unclear in the interpretations of the U.S. and Korean Governments, Ford requests in writing before the signing of the Agreement a definitive interpretation from the United States that the use of any components, labor or other originating value or material from the Kaesong Industrial Zone does not and will not qualify as South Korean content under this FTA.

## **VII. Status of 1995 and 1998 US-Korea Automotive Memoranda of Understanding**

**Ford Assessment:** Ford urges that an understanding that the 1995 and 1998 U.S.- Korea Automotive Memoranda of Understanding continue to remain in force in full and that this be verified in writing between the U.S. and Korean governments before the signing of the Agreement.

# General Motors Corporation Assessment of the Automotive Provisions of the US-Korea FTA

## I. Overall agreement

**Assessment:** GM believes that the KORUS Agreement concluded on April 1 has addressed the auto industry's concerns. In addition, it provides a deterrent to future Korean non-tariff barriers with a special accelerated dispute settlement mechanism containing a "snap back" provision. Given the current imbalance in trade between the two countries the benefits will skew, for the near term, to Korea. Therefore, we are neutral on the agreement. Our assessment of each provision follows.

## II. Tariffs

**Assessment:** The rapid elimination of tariffs will create opportunities for greater bilateral trade in automotive products. For U.S. automakers, there is a welcome cost benefit from the immediate reduction of Korea's 8% auto tariff, both in its application at the border and in its cascading effect on Korea's automotive taxes. This will result in a substantial cost savings for U.S. vehicles exported for sale in Korea. Korea-based manufacturers will also enjoy the benefit of cost savings on the vehicles they export to the United States. On balance, the benefit to Korea from the tariff reductions will be far greater than the benefit to U.S. companies because of the very substantial imbalance in auto trade.

## III. Auto Taxes

**Assessment:** Korea has agreed to reduce its dependence on engine displacement as the basis for taxation and has reduced the overall tax burden on the auto sector. The tax provisions in the agreement will provide cost savings for U.S. vehicles and eliminate discrimination against imports.

## IV. Technical Barriers to Trade

- **KULEV Assessment:** The negotiated KULEV requirements are sufficiently harmonized with the California LEV II that U.S. auto companies will be able to export U.S. vehicles that are certified to meet the California Air Resources Board (CARB) requirements. There are no caps on the volumes that U.S. makers can export.
- **OBD II Assessment:** The harmonization of the KULEV regulation with California emission requirements sufficiently addresses the concerns of this company regarding Korean OBD II.
- **Self-certification in Safety Compliance Assessment:** Our understanding of the negotiated resolution is that U.S. vehicle exporters have a compliance grace period of at least two years after new KMVSS standards are issued and will have a low volume exemption for up to 6,500 U.S.-FMVSS compliant vehicles. This is a satisfactory outcome.

## V. Future TBTs – Accelerated Dispute Settlement

**Assessment:** The duty "snap-back" provision represents an innovative approach that has the potential to discourage the creation of new non-tariff barriers or reinstatement of old ones. It is the only snap back mechanism in any US FTA and it is sector specific.

## VI. Rules of Origin

**Assessment:** The content level and formulas in the agreement are acceptable.

## VII. Status of 1995 and 1998 US-Korea Automotive Memorandums of Understanding

**Assessment:** We were pleased to learn through briefings with USTR that the MOUs are still in force. We request confirmation that the 1995 and 1998 Memorandums of Understanding will stay in force after the KORUS FTA is implemented, because this appears nowhere in the text of the FTA.

