

***UNITED STATES – MEASURES AFFECTING TRADE IN LARGE CIVIL AIRCRAFT
(DS353)***

**Oral Statement of the United States
at the first substantive meeting of the Panel with the parties**

Nonconfidential Session

1. Good afternoon Mr. Chairman and members of the Panel. Thank you for coming here this afternoon to help us resolve this dispute with the European Communities. I would like to take this opportunity to introduce you to the members of our delegation.
2. We are here today because the EC asserts that the U.S. large civil aircraft producer, Boeing, is just as heavily subsidized – or more so – than the EC producer, Airbus. What is more, the EC advances that assertion – and asks the Panel to accept it – without regard to the evidence. In fact, the EC has resolutely ignored the mass of evidence showing that, with the exception of one measure, the programs it challenges are not WTO-inconsistent subsidies.
3. We see this in the EC’s first written submission. Even though the Department of Defense (“DoD”) and the National Aeronautics and Space Administration (“NASA”) contracts demonstrate that DoD and NASA purchased research and development services from Boeing, and received a valuable return, the EC insisted that those payments were in fact grants for which the government received nothing in return. Even though documents from the State of Washington showed that road improvements were general infrastructure, the EC insists they are specific to Boeing. Even though the Department of Commerce data showed that a broad variety of enterprises received funding under the Advanced Technology Program (“ATP”), the EC insists that the program is specific.
4. These are only some of the examples of the EC disregarding the evidence contrary to its claims. There are many more. We will begin today’s presentation with an overview of the key legal and factual flaws in the reasoning behind the EC’s assertions as to adverse effects and each of the groups of programs it has challenged. We will then move on to address in more detail a number of overarching problems with the EC’s reasoning. Then, we will close with a detailed review of the key flaws in the EC’s adverse effects argument.

Overview – claims of adverse effects

5. Our written submission made a large number of points – 407 pages of them, to be exact – with regard to the EC’s claims that certain U.S. programs were specific subsidies that have caused adverse effects. We do not propose to repeat each of them today. Instead, we will note the two or three most critical issues for your attention. We will begin today at what has previously been the end of the analysis, with the overarching issue of adverse effects. The arguments that alleged U.S. subsidies caused adverse effects to EC interests ignore a critical fact – that Airbus and its aircraft are doing quite well. Airbus has gained 20 percentage points in

market share since 2000. It tells the industry that its performance in 2006 was the “best” and “highest” in critical respects, and that 2007 is even better. To be sure, Airbus has experienced some problems, among them difficulties with its A380 and A350, but even Airbus admits that these have nothing to do with the alleged subsidies. And the situation continues to improve. The A380, the largest civil aircraft ever, is scheduled to enter commercial service next month. Last December, Airbus unveiled the final design of its A350, labeled the A350 XWB, with innovative technologies that it promises will give customers unprecedented cost savings.

6. The EC instead makes three basic arguments to support the proposition that the alleged subsidies caused serious prejudice to Airbus in the form of price suppression, lost sales, and market displacement/impedance.

7. First, the EC claims that the magnitude of the alleged subsidies is so great that they must have caused serious prejudice. However, as we will discuss later, the EC’s calculations grossly exaggerate the value of the alleged financial contributions and any benefit they could conceivably have conveyed to Boeing.

8. Second, the EC claims that the nature of the alleged subsidies caused Boeing to lower its large civil aircraft prices below what they otherwise would have been and gave Boeing a technology advantage in developing the 787 that it would not otherwise have had. It argues that these effects in turn caused price suppression, lost sales, and displacement or impedance. However, the EC has misunderstood the nature of the programs it attacks – they do not increase non-operating cash flow. This error by itself should end the analysis. But the EC then makes another error – asserting that increases in non-operating cash flow would lead a company like Boeing to change its pricing practices. It is the market, and not changes in cash flow, that determine Boeing’s prices.

9. The only support the EC offers for concluding that cash flow does affect Boeing’s prices is a series of propositions set out in the Cabral Report, but these are deeply and fundamentally flawed.

- In explaining how alleged subsidy payments affect Boeing, the EC assumes that Boeing spends any additional cash flow in only two ways – making payments to shareholders and using the cash to reduce its prices. The EC disregards readily available public data showing the variety of uses to which Boeing applies its free cash flow, and aggressive pricing is not one of them. In fact, Boeing can and does spend its money in a number of ways that have no effect on prices.
- The EC then assumes that Boeing has constrained access to capital, when in fact it has available sources of internal capital and faced no significant capital constraints during the relevant period.
- The EC then assumes that its theoretical model accurately depicts how Boeing’s

pricing practices would be affected by additional cash flow from the alleged subsidies, while ignoring the actual evidence of Boeing's market behavior, which is the opposite of what the theoretical model would predict.

10. The EC also asserts that the “nature” of the subsidies gives rise to “technology effects” on the 787. The EC has provided no basis to conclude that in the absence of the alleged subsidies, Boeing would have developed the 787 later than it did or differently than it did. In fact, the NASA research at issue was widely available, the composites technologies that Boeing built upon to develop the 787 were available in the commercial marketplace, and Airbus was a leader in composites technology at the time it chose to pursue the A380.

11. Third, the EC purports to have calculated with precision how the alleged subsidies collectively reduced the prices charged by Boeing on particular transactions. These calculations are, however, the product of Professor Cabral's economic model, which accepts as given the EC's exaggerated calculation of the magnitude of alleged subsidies and the erroneous propositions noted above. Professor Cabral's reliance on invalid data and an invalid methodology necessarily lead to invalid results.

12. At the same time, the EC ignores the “other factors” that are responsible for the problems Airbus has encountered in the market in the past year or two. By devoting its engineering and other resources to the A380, Airbus precluded itself from devoting those resources to development of a smaller fuel-efficient competitor to Boeing's 787, which proved to be more popular than Airbus ever imagined. And, its choice of a relatively fuel-inefficient design for the A340 created the problems Airbus now faces in marketing that aircraft in today's high fuel price environment. And finally, by systematically undercutting Boeing's prices, Airbus has set pricing expectations in the marketplace at a level that is lower than would otherwise have been the case. These choices are the true source of any difficulties Airbus now faces, and they have nothing to do with the alleged subsidies.

13. We will discuss these problems in more detail at the end of our statement today.

Overview – subsidy allegations

14. With regard to the EC's subsidy allegations, we will begin, as we did in our submission, with DoD research. The payments challenged by the EC were payments by DoD for the conduct of research and development services by Boeing and other contractors. As such they are purchases of services, a type of payment that is not a financial contribution for purposes of the *Agreement on Subsidies and Countervailing Measures* (“SCM Agreement”). Admiral Ginman will address this issue in more detail later in our presentation.

15. **DoD RDT&E.** In paying Boeing to conduct research, DoD did not, as the EC claims, get nothing in return for its money. In fact, it obtained valuable technology and information for

military purposes. At one point, the EC concedes that this is the case,¹ but claims that much of the research has “dual uses” that advance Boeing’s production of large civil aircraft. The evidence disproves this assertion. In the first place, when DoD speaks of “dual use” it means the adaptation of civil technologies for military usage – not the other way around, as the EC asserts. Second, DoD research focuses on capabilities that are not relevant to civil aircraft. For example, the C-17 research challenged by the EC pertains to development of an aircraft that can take off from a short, underdeveloped air field and air drop paratroopers and cargo from in-flight opening doors – capabilities useless for large civil aircraft. And, finally, even if some DoD-funded research had a theoretical applicability to large civil aircraft, U.S. export control laws make use of any resulting technology on large civil aircraft a practical impossibility. In short, to use SCM Agreement terminology, there is no basis to conclude that DoD research was a financial contribution or provided a benefit with regard to Boeing’s large civil aircraft.

16. It is also important to note that the EC has exaggerated the magnitude of the programs it challenges. The EC commissioned a study to put a dollar value on these programs. The evidence used to generate this number – DoD budget data – shows that the EC overstated the value by between five and seven times.²

17. **NASA R&D.** The EC has also argued that NASA research programs provided grants, and goods and services to Boeing for free. What the EC calls research “grants” were actually for NASA purchases of R&D services in furtherance of NASA’s own objectives. Therefore, as with DoD’s research purchases, these are not financial contributions within the meaning of the SCM Agreement. Mr. Willshire will address this issue in more detail later in our presentation.

18. Similarly, the alleged provision of goods and services were in fact value-for-value exchanges pursuant to Space Act Agreements, which required the user to compensate NASA by providing money or other things of value equivalent to the value of the goods or services. Boeing received nothing for free.

19. For both the R&D purchases and provision of goods and services, we would also like to point out that NASA focuses on basic, fundamental R&D covering a broad range of aeronautics topics. It does not fund the development of particular products, or promote the interests of particular companies. It disseminates the resulting knowledge to the broadest possible extent. Thus, it conveys no commercial advantage. In short, there is no basis to conclude that NASA research was a financial contribution or provided a benefit with regard to Boeing’s large civil aircraft.

20. A final point on the EC’s allegations regarding NASA is that they greatly exaggerate the

¹ U.S. first written submission, para. 156, fn. 210 (“USFWS”).

² USFWS, para. 148.

value of any NASA payments to Boeing. Where the EC claims subsidies worth \$10.4 *billion*, the contracts with Boeing under those programs amounted to under \$750 *million*, spread out over decades.

21. **IR&D/B&P.** The next allegation we would like to address is with regard to the independent research and development (“IR&D”) and benefit and proposal (“B&P”) reimbursements by DoD and NASA. These are not separate payments to contractors. They are indirect costs or “overheads”, which are normal costs of doing business incurred by a company, but not related to particular transactions. Commercial operators ultimately recover these sorts of costs as part of the prices charged to their customers. The government reflects them under certain procurement contracts by spreading them over all of the affected business of a company, and then including the share allocated to each contract in the acquisition price. The government must cover these sorts of costs in the prices it pays, or commercial suppliers will not do business with it.

22. Moreover, inclusion of these types of costs in cost-based contracts is not restricted to aeronautics research, or to DoD and NASA. This practice derives from U.S. government procurement rules applicable to all agencies for their acquisitions in all sectors. These points demonstrate that there is no benefit and no specificity.

23. **Intellectual property rights under DoD and NASA contracts.** The next allegation we would like to address is with regard to patent and data rights. One critical point is that the treatment the EC challenges arises only when a private party enters a contract with the U.S. government. It is not an independent action, but rather part of the overall deal between an agency and its contractor. It is also important to remember that, under U.S. law, patent rights accrue to the inventor. Therefore, the intellectual property clauses in a government contract do not confer rights on the contractor. Instead, they confer certain rights on the government to use inventions or data conceived by the contractor during performance of the contract. These rights are an important part of what the government obtains under its R&D contracts. As such, the rights retained by contractors are not given for free, but are part of an overall commercial transaction.

24. The EC makes much of the fact that, for historical reasons, NASA achieves the substantive result I have just described through a set of procedural steps different from other government agencies. The key point here is the substance – NASA contracts confirm certain rights in the inventor and confer certain other rights on the government. Those rights are the same under all government contracts. These points demonstrate that there is no financial contribution, no benefit, and no specificity.

25. The EC earlier this morning addressed a great deal of attention to the FSC/ETI program this morning. The critical facts here are not in dispute. The United States does not contest that FSC/ETI was an export subsidy. The EC does not contest that Boeing has stated that it will not use that subsidy after the 2006 tax year. Instead, the EC focuses on a memorandum issued by

the an Associate Chief Counsel of the U.S. Internal Revenue Service with regard to the eligibility for FSC/ETI benefits in some circumstances. As evidence, that general evaluation should not supersede the conclusion reached by Boeing with regard to its specific tax situation that it will not use that subsidy in the future. In addition, we draw your attention to the beginning of the memorandum, to a statement that the EC has ignored, saying “This advice may not be used or cited as precedent.”

26. **Advanced Technology Program.** I would like to begin this section of our statement by addressing the EC’s claim that the Department of Commerce’s grants under the Advanced Technology Program to a wide swath of U.S. industries is a WTO-inconsistent subsidy. This program is not specific and thus is not an actionable subsidy, contrary to the EC’s allegations. First, these grants are broadly available to and have been used by multiple industries. Second, Boeing has received a very small proportion of the total grants provided under this program. In fact, the standard for specificity articulated by the EC this morning would result in reading specificity completely out of the SCM Agreement.

27. **Washington state tax measures.** The Washington state Business and Occupation (“B&O”) tax adjustment provided to commercial airplane manufacturers does not constitute a WTO-inconsistent subsidy. An essential element of a subsidization claim under the SCM Agreement is a financial contribution by a Member government. The EC asserts that Washington state, by applying the B&O tax adjustment to Boeing, is impermissibly foregoing revenue that would otherwise be due. This argument ignores the relevant facts and law.

28. Under Washington state’s B&O tax structure, a good is taxed at each stage in the chain of production, leading to higher effective tax rates for more complex business activities. In order to address these discriminatory effects, referred to as “pyramiding”, Washington applies a B&O tax adjustment to certain industries. The effect of the adjustment, in the case of Boeing, is to bring Boeing’s tax rate in line with the average tax rate for all business activities in the state of Washington. Without the adjustment, Boeing’s effective tax rate is significantly higher than other business activities in the state, because of pyramiding. The B&O tax rate for Boeing after the adjustment is not a preferential rate; rather, the adjustment makes Boeing’s tax rate less discriminatory.

29. Washington state is not “due” a higher rate of revenue from aerospace manufacturing than from other businesses. Since the B&O tax rate does not confer a preferential rate on Boeing, the state is not foregoing revenue that would otherwise be due. Thus, there is no financial contribution. The EC’s claim fails on this basis alone. However, even if the Panel were to find that there is a financial contribution, the B&O tax adjustment is not specific to an industry or enterprise because several industries in Washington state also receive a B&O tax adjustment. Thus, the B&O tax adjustment is not actionable under the SCM Agreement.

30. The EC also raises challenges to other Washington state tax measures; however, in none of these cases does the EC establish that subsidization exists. Under three of the measures, sales

and use tax exemption for construction equipment, leasehold excise tax exemption and property tax exemption, Boeing has not even taken the exemption that the EC alleges constitutes a financial contribution. And, Boeing has indicated that they do not intend to take these exemptions in the future. The Washington state B&O tax credits also do not constitute a “specific” subsidy since Washington state provides similar credits to a variety of other business activities in the state.

31. **Washington state infrastructure.** In a similarly untenable claim, the EC contends that Washington state’s expansion of two public roads, I-5 and SR 527, as part of a statewide infrastructure improvement plan constitutes a subsidy. The EC makes this claim despite the fact that the SCM Agreement explicitly excludes general infrastructure from its subsidy disciplines. The expansion projects challenged by the EC are in fact quintessential general infrastructure, as they are open to the public and their use is in no way limited to anyone – let alone Boeing. A state commission studying Washington’s transportation needs identified I-5 and SR 527 as priorities because of congestion and accident rates. I-5, part of the U.S. Interstate Highway System, is used by countless businesses, tourists, and citizens, and runs from Canada to Mexico. SR 527 was identified by the Washington State Department of Transportation as a “principal arterial highway” with “mostly residential and commercial” developments.³ There is no factual or legal basis, therefore, for the EC’s claims that these projects to expand two major public roads are subsidies.

32. **City of Wichita Industrial Revenue Bonds.** As with the EC’s claims regarding Washington state, the EC’s challenges to bonds issued by the state of Kansas are replete with legal and factual inaccuracies. First, the Industrial Revenue Bonds issued by the state of Kansas neither provide a financial contribution to Boeing nor are specific to Boeing. The EC claims that Kansas’ IRB program is merely a scheme to make Boeing eligible for certain tax abatements. However, in making this allegation, the EC ignores the mass of countervailing evidence. First, the tax exemptions are no longer relevant to Boeing because Kansas has stopped assessing property tax and sales tax on commercial and industrial machinery and equipment. The vast majority of property that Boeing has financed with IRBs are machinery and equipment, which would be tax exempt regardless of the IRB program. Thus, Kansas has not foregone revenue that would be otherwise due.

33. Furthermore, the IRBs are not specific to Boeing. The IRBs are not *de jure* specific because they are broadly available to “any person, firm or corporation.”⁴ They are also not *de facto* specific. The percentage of IRBs issued to Boeing is not disproportionate, nor is Boeing a “predominant” user. Article 2.1(c) of the SCM Agreement provides that these “other factors” such as, whether an entity is a “predominant” user or disproportionately large amounts of an

³ SR 527 Route Development Plan, p. 3 (Exhibit US-208).

⁴ Kan. Stat. Ann. § 12-1740 (Exhibit EC-167).

alleged subsidy are granted to certain enterprises, should be evaluated in light of the “extent of diversification of economic activities within the jurisdiction of the granting authority.” Aircraft production has indeed been the core industry of Wichita. Thus, the amount of IRBs issued to Boeing is not indicative of predominant use. The EC also makes much of the fact that Boeing holds the bonds that are issued on its behalf. However, this situation is neither improper under the SCM Agreement (since it is the companies rather than the government of Kansas that decides who will hold the bonds), nor unique to Boeing (as other companies have also chosen to own the IRBs issued on their behalf).

34. **Kansas Development Finance Authority bonds.** With respect to bonds issued by the Kansas Development Finance Authority (“K DFA”), not a single bond under this program has even been issued to Boeing. Instead, these bonds were issued to an independent entity, unrelated to Boeing. As we will discuss in more detail, the EC repeatedly attempts to argue that financial contributions to entities other than Boeing pass through to Boeing. However, there is no basis for these arguments.

35. **Illinois programs.** With respect to the EC challenges to measures by the state of Illinois, the EC fails to establish that these measures are specific. The state of Illinois has established criteria to encourage businesses to locate their corporate headquarters in the state. These criteria are not specific to an industry or enterprise. Thus, they do not constitute an actionable subsidy under the SCM Agreement.

36. **Export contingency.** As a final point on the EC’s subsidy allegations, the Panel should note that there is no evidence to support the assertion that the Washington state tax measures under HB 2294 were export-contingent subsidies. The EC notes that the tax measures were not to become effective until the state and “a manufacturer of commercial airplanes sign a memorandum of agreement regarding an affirmative final decision to site a significant commercial airplane final assembly facility in Washington state.” A “significant commercial airplane final assembly facility”⁵ is defined as a “location with the *capacity to produce* at least thirty-six super-efficient airplanes a year.”⁶ The Boeing 787 production facility satisfies this definition.

37. However, the EC fundamentally misunderstands the Washington state measure, HB 2294, when it asserts that it is *de facto* export contingent under Article 3.1(a) of the SCM Agreement. The measure, HB 2294, does not require that 36 airplanes per year actually be produced; it simply requires that the assembly facility have the capacity to do so. This morning, the EC misstated the interpretation of export contingency the United States has provided in this dispute, and in fact misstated the standard under the SCM Agreement.

⁵ HB 2294 § 17(1)(a).

⁶ HB 2294 § 17(2)(d) (emphasis added).

38. Under Article 3.1(a) of the SCM Agreement, a subsidy is *de facto* contingent upon export performance when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings.⁷ As just discussed, the tax measures in HB 2294 are not subsidies. Moreover, even if the Panel were to find so, the state of Washington’s provision of these measures was not tied to actual or anticipated exportation or export earnings. There is no requirement that the facility sell or even produce airplanes. Nor is there any other tie to actual or anticipated exportation or export earnings. Thus, the tax measures are not contingent upon export performance. In any event, contrary to the EC’s contentions, the U.S. domestic market *can* absorb 36 superefficient airplanes.

39. Under these facts and the legal framework in the SCM Agreement, the EC’s claim of *de facto* contingency upon export performance for the Washington state tax measures are baseless.

40. Before we move on to a detailed review of the flaws in the EC’s adverse effects arguments, we would like to delve in more detail into three of the points we just made regarding the subsidy allegations.

41. The first of these is an overarching problem with the EC’s assertions regarding research and development, which account for two thirds of the subsidy value the EC has alleged. The critical point here is that these assertions rely on an incorrect premise, namely, that the Department of Defense (“DoD”) and the National Aeronautics and Space Administration (“NASA”) paid money to Boeing and received nothing in return. This incorrect premise underlies the EC assertions that NASA and DoD provide “grants” to Boeing, and that there is a benefit equal to the government’s cost of operating the programs in question. The evidence shows that the EC is wrong. In accordance with the terms of procurement contracts and agreements, Boeing provided DoD and NASA valuable services, along with the resulting information and intellectual property rights, which advanced the agencies’ government missions. That exchange of value represents a purchase of services, which is not a grant, and is not even a financial contribution, within the meaning of Article 1 of the SCM Agreement. Admiral Ginman and Mr. Wilshire will provide further information on why their agencies contract with outside suppliers, and what the agencies receive in return.

42. A second problem is the EC’s insistence on attributing funds paid to companies unrelated to Boeing as if they were payments to Boeing. The most clear-cut example of this EC practice appears in the NASA claims, where the EC treats billions of dollars of NASA funding to companies other than Boeing as a financial contribution to Boeing. It even attempts to treat NASA’s funding of its own operations as a payment to Boeing. A different, but related, problem appears in the EC’s discussion of the Washington state B&O tax and Kansas programs. In these cases, the EC treats financial contributions to Boeing’s suppliers as payments to Boeing based on

⁷ SCM Agreement, Article 3.1(a), n. 4.

the assertion, without support of any credible evidence, that these independent and unrelated companies somehow (and contrary to expectations for a profit-maximizing actor) passed the alleged subsidies through to Boeing.

DoD purchases of R&D services

43. We will now move on to a more detailed discussion of the first problem we identified – the notion that DoD and NASA received nothing in exchange for the funds they devoted to purchasing research and development services from Boeing. This assertion is critical to the EC’s argument because it is necessary both for the assertion that these agencies’ contracts with Boeing are really grants, and that the magnitude of any benefit is equal to the price that the agencies paid for Boeing’s services. It is also critical because the EC’s claims regarding R&D services account for almost two thirds of the alleged subsidies by value.

44. The assertion that DoD and NASA received nothing is, to be clear, untrue. The procurement contracts and agreements challenged by the EC require the contractor to perform specified work and to provide deliverables. Payment is contingent on completion of those requirements. These contracts meet the ordinary meaning of the term “purchase,” namely, acquisition by payment. And there is no question that research and development is a service. Therefore, these payments are purchases of services.

45. Good afternoon. Mr. Chairman and distinguished Panel members, my name is Dick Ginman. I am the Deputy Director of Defense Procurement and Acquisition Policy at the Department of Defense. Our office is charged with developing policies and providing guidance and oversight that effectively deliver equipment and services to the armed forces and other DoD agencies and ensuring that the government’s funds are well spent.

46. DoD acquires goods and services to fulfill military objectives. DoD is not interested in, nor does it structure its programs to promote, civil aviation.

47. DoD’s acquisition of research, development, testing, and evaluation (“RDT&E”) services proceeds first from an identification of military needs. One of the armed services or a DoD agency identifies an R&D objective, and the need to contract out for the R&D services to meet that objective, often because DoD scientists are occupied with other projects or do not have the requisite knowledge. We then issue a notice to the general public seeking proposals for how to meet that objective. Based on any proposals we receive, DoD conducts a competition and evaluates which proposal provides the best value, in the form of meeting DoD’s objectives. It then negotiates a contract or other agreement with the winning contractor.

48. What does DoD get under an RDT&E contract or other agreement? Most importantly, it obtains the work of knowledgeable contractor employees directed toward meeting the DoD objectives. An RDT&E contract typically states a research objective and describes the steps the contractor will take to meet that need. The contractor is required to provide reports and briefings

for DoD employees on the progress of the work. The contractor also grants the government the right, free of charge, to use any patented invention that the contractor develops under the contract. That right extends to the use of that invention by any other contractor in furtherance of work for the government. DoD also obtains data rights, which again may include the right to convey data developed under the contract to other contractors.

49. This work, and any resulting information or technologies that result from the work are of tremendous value to the Department and advance U.S. defense objectives. RDT&E activities performed by contractors may identify a new technology that leads to a new weapons system, may improve the performance of an existing weapons system, or may decrease the cost of acquiring or using an existing weapons system.

50. DoD operates under a set of regulations that are designed to ensure that the U.S. government gets the best deal possible for the money it is spending. Where there is a market price, we pay the lowest available market price. Where a good or service is not commercially traded, we develop an acquisition cost that reflects the commercial cost of providing the good or service. This approach, which results in what we call “cost-type” contracts, is also a market-based approach, in that the costs are based on the contractor’s market-based costs for inputs, including materials and labor, and overheads.

51. Our acquisition regulations require competitive bidding wherever possible, a practice that forces contractors to provide the greatest value for the lowest price. The competitive process gives DoD an insight into a contractor’s costs and capabilities that we can use to better negotiate when that contractor is a sole bidder. In addition, competitive acquisitions provide benchmarks that allow us to evaluate whether any noncompetitive transaction provides the best value for the government.

52. Once a contract has been signed, there is a subsequent process to ensure that the contractor meets its obligations. The contracting officer monitors compliance, supported by the Defense Contract Management Agency (“DAMA”). For a major contractor like Boeing, DAMA has a staff that specializes in the contractor’s operations and who work to ensure that all of its requests for payment are in fact justified. In addition, the Defense Contract Accounting Agency (“DCAA”) provides an audit function to ensure that contractors are maintaining financial systems that ensure accurate claims for payment, consistent with all of our applicable rules.

53. These rules exist precisely because, contrary to what the EC stated in its first written statement, DoD does get value in return for its money – and wants to make sure that the contractor does what it promised to do.

NASA purchases of R&D services

54. My name is Bill Willshire. I am the Deputy Director of the Aeronautics Research Directorate at NASA Langley Research Center. I have had a 30-year public service career at

NASA, roughly 16 years as a researcher, 10 years leading NASA’s aircraft noise reduction projects, and the remainder helping to lead project management organizations.

55. NASA, as a U.S. federal agency, operates under the same basic legal framework of the U.S. government procurement laws as the U.S. Department of Defense when it comes to contracting for research and development services.

56. However, NASA has a very different mission than the Department of Defense, which means that our needs, and our ways of meeting those needs, are also different. NASA is a civilian agency, and does not purchase or develop weapons systems. Our mission is to develop knowledge and to disseminate that knowledge as broadly as possible. Our authorizing legislation, known as the Space Act, is quite clear on this point. It sets as agency objectives, among other things:

- The expansion of human knowledge of the Earth and of phenomena in the atmosphere and space;
- The improvement of the usefulness, performance, speed, safety, and efficiency of aeronautical and space vehicles; and
- Cooperation by the United States with other nations and groups of nations in work done pursuant to the Act and in the peaceful application of the results thereof.⁸

The Space Act also instructs NASA’s Administrator to “provide for the widest practicable and appropriate dissemination of information concerning its activities and the results thereof.”⁹ Our research is aimed at advancing the general state of knowledge for the public good. We do not conduct or contract for research pertaining to the commercial projects of any company.

57. The EC alleges at several points that our research has an effect on the competitiveness of the United States in general, and on the air transport sector in particular. The EC has also noted that one of NASA’s statutory objectives is “the preservation of the United States preeminent position in aeronautics and space through research and technology.”¹⁰ However, what they fail to note is that we pursue that objective in the context of our other statutory mandates. Therefore, our aeronautical research portfolios have always been very broad, with emphasis on fundamental research potentially applicable to the widest range of applications, from personal air vehicles to

⁸ Space Act, § 102(d)(1) and (7); 42 U.S.C. § 2451(d)(1) and (7) (Exhibit EC-286).

⁹ Space Act, § 203(a)(3); 42 U.S.C. § 2473(a)(3) (Exhibit EC-286).

¹⁰ Space Act, § 203(a)(9); 42 U.S.C. § 2473(a)(9) (Exhibit EC-286).

rockets and spacecraft. Many research areas, such as hypersonics or self-healing materials have little relevance today or in the future to large civil aircraft manufacturers. In short, we focus on pre-competitive research, and do not conduct research to develop particular large civil aircraft models.

58. For example, NASA performs extensive research in air traffic management and air traffic safety. This is a topic of primary interest to airlines and the traveling public. However, it has little relevance to the production of large civil aircraft. Moreover, any improvements in air traffic management provide no advantage to Boeing or any other aircraft. Safer skies help all aircraft equally, be they Boeing, Airbus, or even smaller aircraft produced by other WTO Members. More importantly, they benefit passengers by making the air traffic system safer, more capable, and more efficient in the United States and throughout the world.

59. Improving fuel consumption is another area in which NASA's work applies most directly to airlines and the flying public. In one recent project, NASA studied ways to modify airplane flight paths to decrease the amount of fuel consumed and noise impact during landing. The beneficiary will be the airlines, which will pay lower fuel costs, and the general public, which will ultimately benefit from reduced aircraft emissions. And, I should add, more efficient flight paths may be used by any aircraft, so again, there is no advantage to Boeing.

60. Propulsion is another area in which NASA performs extensive work that is not directly applicable to Boeing (or Airbus, for that matter). The EC concedes this point, and that propulsion research should not be treated as a subsidy to Boeing, which does not produce engines. However, the EC understates the amount of the NASA aeronautics budget that is spent on propulsion research.

61. In line with our broad objectives, when NASA develops its research objectives for civil aviation, it obtains a broad range of input. It seeks the advice of the NASA Advisory Council, which includes individuals drawn from universities, former government employees, private research companies, aerospace companies, and companies in other industries. We also seek comments from the broader public. Based on all of this input, NASA establishes ambitious, long-term research goals. During implementation of our research plans we typically request proposals for activities that could contribute to reaching those goals. We then evaluate the various proposals, and proceed with a combination of in-house and out-of-house research activities that do the most to advance the agency's goals. This may mean that NASA's own scientists perform research, other government agencies perform research, we award a grant to a university, or sign a contract with a private entity, like a private research institute or a commercial producer. In general, NASA contracts for R&D services otherwise not available, but which are necessary to meet NASA objectives.

62. Unsurprisingly, given their expertise in technology issues, we often contract with major technology companies, including Boeing, Northrup Grumman, Lockheed, Honeywell, or Raytheon. But the assertion that Boeing gets some special advantage is not correct. When

Boeing competes for NASA R&D, it is subject to the same evaluation factors and rules as other competitors. When NASA selects Boeing as a result of such competitions, the contract terms and conditions are those published in the competitive solicitation and the Federal Acquisition Regulations, to which all of the contractors are subject.

63. Therefore, the EC’s view that NASA research is primarily directed to advancing Boeing’s interests is simply not true. Equally untrue is the EC’s claim that NASA (or the U.S. government) gets nothing in return for the money they spend buying R&D services. NASA was established to promote “the expansion of human knowledge of the Earth and of phenomena in the atmosphere and space” and “the improvement of the usefulness, performance, speed, safety, and efficiency of aeronautical and space vehicles.” And it was instructed to do so by “provid{ing} for the widest practicable and appropriate dissemination of information.” The most important return that NASA gets for its expenditures on aeronautics research is knowledge and technology, documented in reports and other information generated by R&D activities. The results of NASA research are ultimately shared globally and form the basis for future discoveries and advancements in the United States and throughout the world. Accordingly, NASA maintains the world’s largest open database of aeronautics research and information. If NASA did not fund the research being questioned, the research results and breakthroughs would probably not be available today, and might not happen at all. If this research had been conducted by the aerospace industry without NASA participation, the results would not be subject to public release. In essence, NASA has created and continues to be a primary contributor to the world’s aeronautics library. Among other things, this forms part of the global aerospace knowledge base used as a foundation for education.

64. Another concrete return on NASA’s research investments appears in safety statistics. Even though the number of hours flown by U.S. carriers has increased substantially over the last 20 years, the rate of accidents has fallen, and the rate of accidents with deaths or serious injuries to passengers has fallen the most significantly. That is in large part due to safety research performed by NASA and other government agencies that NASA supports. And, it helps everyone equally, Airbus and Boeing included.

65. Before ending, I’d like to address briefly another allegation that the EC has made – that NASA furnished government-owned property, provided institutional support, and dedicated federal scientists, engineers, and research facilities to Boeing’s development of large civil aircraft in return for nothing from Boeing.

66. NASA personnel are responsible for achieving NASA objectives, including the appropriate management of contracts. At one point, the EC admits that NASA employees’ role was to oversee NASA operations and make sure that Boeing completed the tasks assigned it under the contract.¹¹ The point that the EC fails to see is that when NASA devotes scientists,

¹¹ EC first written submission, para. 500 (“ECFWS”).

research engineers, or facilities to work on NASA programs, they are there to achieve NASA's goals, not Boeing's. They are held responsible to senior NASA managers, the Executive Branch, Congress, and ultimately to our citizens. They are not providing goods or services to Boeing. They are instead working to produce research results to achieve NASA objectives and then to disseminate the research results to the broader community.

67. The EC also recognizes that NASA occasionally provides goods and services to outside entities, including Boeing, pursuant to Space Act Agreements.¹² The United States has provided examples of agreements with Boeing regarding aeronautics research in the first written submission. As pointed out in that submission, the scope of these agreements is quite limited. More importantly, Space Act Agreements require a private signatory to give NASA value – money, goods, or services – equivalent to what NASA provides to the signatory. Boeing provided such a return in each of the Space Act Agreements that the United States provided in its written submission. Therefore, as with the contracts, there is no support for the assertion that NASA got nothing in return for facilities or services that it made available to outside entities.

Financial contributions to companies other than Boeing

68. A second overarching problem with the EC argument is its treatment of financial contributions to companies and persons that are not related to Boeing. It appears that the EC view is that payments to Boeing's competitors in the military aerospace market, payments to public universities, payments to Airbus suppliers, and even salaries paid to government employees who have nothing to do with Boeing – all get treated as subsidies to Boeing.

69. This is surprising because in the past, the EC has vigorously advocated the position that only financial contributions to the legal person that actually produces a product can be treated as subsidies to that product. Even more surprising is that the EC proposes to treat these expenditures as financial contributions to Boeing without any credible evidence of receipt by Boeing of a government payment, good, or service.

70. Several EC arguments fail because of this problem. For example, the EC treats bonds issued by the Kansas Development Finance Authority to Spirit AeroSystems as a financial contribution to Boeing. However, Boeing did not apply for or receive such bonds, and did not own Spirit at the time that company applied for or received the K DFA bonds. In fact, at the time the bonds were issued, Spirit's primary business directive was to expand its role as a supplier to Airbus. Shortly thereafter, it purchased the facilities of one of Airbus' major U.K. suppliers. It is now negotiating to buy directly some of the Airbus-owned facilities that supply components for Airbus large civil aircraft. Yet, in the EC's view, these bonds are entirely a benefit to Boeing. Similarly, the EC argues that Industrial Revenue Bonds ("IRBs") granted by the City of Wichita with regard to Spirit, in fact provide actionable subsidies to Boeing.

¹² ECFWS, para. 501.

71. In its discussion of the Washington B&O tax rate adjustment, the EC recognizes that tax rate reductions for other aerospace manufacturers apply to all entities engaged in aerospace manufacturing, not just to Boeing. In fact, some of the entities that receive the B&O tax adjustment for aerospace manufacturing activities do not even supply to Boeing. Nevertheless, the EC claims that the full value of the tax rate adjustment over 20 years is a financial contribution to Boeing.

72. In these cases, the EC treats financial contributions to Boeing's suppliers as benefits to Boeing based on the assertion that these independent and unrelated companies somehow (and contrary to expectations for a profit-maximizing actor) passed the alleged subsidies through to Boeing. It bases this allegation on economists' reports that as a matter of economics, the benefit of any alleged subsidies can be assumed to have passed through to Boeing. The report of Dr. Dorman, which is at Exhibit US-186, demonstrates that the EC's economists failed to account for the realities of the large civil aircraft industry.

73. When it comes to NASA, the EC includes contracts with other, non-Boeing suppliers of R&D services, and grants to universities as financial contributions to Boeing. It then takes the further step of treating NASA's payments to its own employees as financial contributions to Boeing. This is not a small problem. You may recall that earlier, I mentioned that the EC alleged subsidies worth \$10.4 *billion*, while NASA actually paid Boeing less than \$750 *million*. The remaining \$9.6 billion – the vast majority of the EC claim – consists of payments to universities, payments to contractors other than Boeing, compensation for NASA employees, and other operating expenses.

74. With regard to NASA's budget, the EC provides neither evidence nor reasoning as to why such payments not made to Boeing should be treated as subsidies to Boeing. It simply ignores the distinction between Boeing and the actual non-Boeing recipients, and asserts that a benefit to Boeing exists.

75. In short, the EC treats a financial contribution to one entity as a benefit based on nothing more than assertions unsupported by any evidence. This is insufficient under Articles 1 and 2 of the SCM Agreement, which require a linkage between the recipient of the financial contribution and the entity that has allegedly benefitted from the subsidy. The EC has failed to demonstrate that such a link exists, and as such has failed to meet its burden of proof.

Washington B&O Tax Adjustment

76. The third problem with the EC subsidy allegations that we will discuss in detail today lies with the EC's treatment of the Washington State Business and Occupancy Tax ("B&O Tax"). The B&O tax applies a wide variety of different nominal tax rates to different activities. It periodically adjusts nominal rates – usually downward – for particular activities to achieve equity in the form of effective rates. In the case of aerospace manufacturing activities, a 2003 law provided for a two-stage reduction in the B&O tax rate from one of the highest levels to the

middle of the range. This is tax equalization – not a subsidy. In addition, the EC also mischaracterizes critical elements of the market for large civil aircraft when it claims that B&O tax adjustments for aerospace manufacturers other than Boeing pass through to Boeing.

77. Good afternoon, Mr. Chairman, distinguished members of the Panel. I appreciate the opportunity to speak to you today. My name is Mark Craig, and I am the Assistant Director, Legislative Policy Division, Department of Revenue, of the State of Washington.

78. The EC challenges the state of Washington’s adjustment of the B&O tax rate for aerospace manufacturing from 0.484 percent to 0.4235 percent, effective October 1, 2005, and to 0.2904 percent, effective July 1, 2007. To put the adjustment in context, I would like to provide an overview of the B&O tax policy.

79. The B&O tax system taxes different categories of business activities at different rates. First, Washington’s B&O tax sets up different tax rates for four major activity classifications: manufacturing, wholesaling, retailing, and professional services. These activities are further divided into 36 different categories of business activities, each with their own tax rates. These activities include manufacturing of semiconductor materials, international investment management services, tour operators, manufacturing of biodiesel/alcohol fuel and raw seafood, and warehousing or reselling of prescription drugs, among others.

80. Under this structure, there is no uniform B&O tax rate that applies to different business activities. Instead, there is a range of B&O tax rates that the state of Washington applies depending on a firm’s business activities.

81. The B&O tax system has several inherent advantages for both businesses and for the state. For businesses, it is less administratively burdensome than many other tax systems. For example, because most businesses pay at a single fixed rate with few or no deductions, the cost to firms to comply is relatively low. In addition, the B&O tax is predictable and the rates are relatively low. For the state, the cost to administer the tax is also relatively low. The B&O tax also provides a stable source of revenue to the state, even in economic downturns. Therefore it is not surprising that Washington relies on the B&O tax for a greater percentage of its revenue (18.5%) than other states rely on corporate income taxes.

82. Washington has stuck with the B&O tax regime because of the advantages I just mentioned. However, the state also recognizes and tries to address certain disadvantages of the B&O tax regime.

83. The most important disadvantage that the state seeks to alleviate is something we refer to as “pyramiding.” The B&O tax regime applies a tax on a good at each stage of the production chain, and the tax is applied to the *gross* value of the good. As a good moves through the chain of production, the gross value of the product increases at each stage because it includes the value of intermediate products from each preceding stage of production. In other words, a product

used as an input in the first stage of the production will be taxed multiple times i.e., the input will be included in the gross value of the product at each stage of production. As a result, the effective tax rate of a good at the end of the chain of production is much higher than the nominal rates applied over the course of the chain of production. Not surprisingly, the more complex a business activity is the higher the B&O effective tax rate is.

84. Because tax neutrality is a core principle in the state's tax policy, we have a history of addressing these discriminatory effects of pyramiding by adjusting the nominal tax rates for activities in capital-intensive or complex sectors, including aerospace manufacturing, as well as aluminum manufacturing, biofuel manufacturing, timber products manufacturing, high technology manufacturing, and various types of food manufacturing and processing.

85. Aerospace manufacturing is, in fact, one of the most complex business activities in the state, involving multiple steps and multiple entities. Thus, the effects of pyramiding on aerospace manufacturing are more acute than for most other industries. For example, the average number of times the B&O tax pyramids across all industries i.e., the average number of times that a single good is taxed in the chain of production, is 2.5 times. The average rate of pyramiding for aerospace manufacturing activities, however, is 5.3 times.

86. The B&O tax adjustment minimizes this discriminatory effect of the B&O tax. The B&O tax adjustment for aerospace manufacturing, specifically, brings the effective tax rate in line with (though still *above*) the average effective rate for all business activities in the state. So, the state of Washington is not creating a favorable rate for Boeing or aerospace manufacturing compared to other businesses, as the EC would have you believe. Rather, the state is alleviating the discriminatory impact of pyramiding on complex, multi-step business activities.

87. The state of Washington's policy concern regarding equitable levels of taxation across industries is illustrated by a 2002 report of the Washington State Tax Structure Study Committee. That report, submitted to the Washington State legislature, detailed the differential effects of the B&O tax and is attached to the U.S. first written submission as Exhibit US-180. It identifies neutrality as a core principle that the tax regime should embody. The study also identified pyramiding as a concern precisely because its discriminatory effects undermine tax neutrality.

88. Thus, the adjustment of sectoral B&O tax rates reflects an effort by the State of Washington to address the shortcomings of the B&O tax structure, specifically the discrimination among industries. What the tax report makes clear is that the state of Washington's concern with the differential tax rates resulting from the B&O tax structure is a concern that stretches across industries. Indeed, it is a statewide tax policy concern.

89. The B&O tax adjustment for aerospace manufacturing brings the effective tax rate for that industry more in line with other industries subject to the B&O tax rate. Even with the adjustment, Boeing does not pay a preferential rate; it pays a rate *above* the average B&O

effective tax rate for other industries in the state.

90. That description of Washington’s B&O tax adjustment demonstrates that it is not a WTO-inconsistent subsidy. First, by enacting the B&O tax reduction the state of Washington is not providing a financial contribution. The EC’s claim fails on this basis alone. Even aside from the fact that the tax adjustment is not a financial contribution, no benefit is conferred on Boeing nor is the B&O tax reduction specific to an industry or enterprise.

91. Article 1.1(a)(1)(ii) of the SCM Agreement provides that a “financial contribution” exists where “government revenue that is *otherwise due* is foregone or not collected.” In setting forth its claim, the EC fails to recognize that by virtue of the B&O tax adjustment the state of Washington is not foregoing revenue that is otherwise due.

92. As the Appellate Body has stated, merely refraining from imposing a tax or collecting revenue is insufficient to create a financial contribution.¹³ Rather, foregone revenue is only “otherwise due” within the meaning of that provision if the government refrains from collecting revenue that it could have collected in another situation.¹⁴ Thus, the fact that the State of Washington could have taxed Boeing at a higher rate than it did is insufficient to constitute a financial contribution. A WTO Member could, in theory, tax all revenue. As the Appellate Body has also stated, revenue foregone should be evaluated in light of an objective point of reference. Specifically, it is the Member’s own tax rules that serve as a benchmark for determining whether revenue foregone is “otherwise due”.¹⁵

93. The relevant benchmark for analyzing the B&O tax reduction is Washington state’s own tax regime. As Mr. Craig explained, the state of Washington applies different B&O tax rates to different business activities and applies sectoral adjustments with the goal of achieving tax neutrality. Thus, the range of B&O tax rates that Washington applies to different activities serves as an appropriate benchmark for determining whether the tax adjustment for aerospace manufacturing constitutes revenue foregone that is “otherwise due” to the state of Washington.

94. In contrast, the EC’s analytical framework for analyzing revenue foregone that is “otherwise due,” raises the very concern the Appellate Body raised. In other words, the EC seeks to analyze revenue foregone in the abstract without reference to Washington’s own tax rules. The EC claims that under the tax measures applied in HB 2294 “{t}he State of Washington is required to forego tax revenue that it otherwise would have collected from Boeing

¹³ *United States – FSC 21.5 (AB)*, para. 88.

¹⁴ *United States – FSC (AB)*, para. 90.

¹⁵ *United States–FSC (AB)*, para. 90; *United States–FSC 21.5 (AB)*, para. 89.

or its suppliers.”¹⁶ However, the EC’s contention focuses on the simple fact of the adjustment, to the exclusion of its context.

95. Because there is no foregone revenue, the B&O tax adjustment does not provide a financial contribution to aerospace manufacturing or to Boeing. Without a financial contribution by a government, there is no WTO-inconsistent subsidy.

Adverse effects

96. We now turn to the adverse effects portion of this dispute. To put the EC arguments in perspective, it is useful to begin with an overview of Airbus’s performance. Exhibit US-1112 is a graph showing Airbus and Boeing market share from 2000 to 2006. You can see that Airbus has gained significant market share over this period – 20 percentage points. At least before its well-publicized production problems with the A380 program, it was reporting record profits. Those problems have nothing to do with subsidies, a point that Airbus itself makes in the EADS May 2007 report to shareholders, which we have excerpted in Exhibit US-1113.

97. In fact, the Airbus presentation slide in Exhibit US-1114 points out that 2006 was its “best ever year in deliveries,” its “2nd best year in orders,” and its “highest ever industry backlog.” The data back this assessment, notwithstanding the views expressed in the EC’s written submission. And, Airbus’ outlook has only improved this year. The A380 has begun to attract new orders, and will make its first commercial flight next month. The A350 XWB is charging ahead after its unveiling last December, with orders of the -900 and -1000 models at levels similar to those of the Boeing 777. Meanwhile, the company’s workhorses, the A320 and A330 continue to sell at or near record levels, leading Airbus to boost production rates for both models. By any reasonable measure, Airbus’ large civil aircraft operations have been, and will continue to be, very strong.

98. The EC’s efforts to convince this Panel that alleged U.S. subsidies are causing adverse effects to these Airbus aircraft have no support. As a first step, it is useful to be clear about exactly what the EC is alleging. The EC is not making a claim under Article 5(a) of the SCM Agreement, which covers injury to its domestic industry. Nor is the EC making a claim under Article 5(b) of nullification or impairment of benefits accruing directly or indirectly to other Members under GATT 1994. The EC’s only claims are of serious prejudice under Article 5(c).

99. Within the category of serious prejudice, it is important that the EC claims that serious prejudice results exclusively from match-ups of certain aircraft. That is, in the EC’s view, alleged subsidies to Boeing’s 737NG cause serious prejudice exclusively to the A320 and its derivatives, and not to the A330, A340, A350, or A380. The matches for the 787 are the A330 and A350 Original and XWB-800, and the matches for the 777 are the A340 and the A350

¹⁶ ECFWS, para. 130.

XWB-900/1000. The EC apparently concedes that the alleged subsidies have nothing whatsoever to do with the problems faced by the A380.

100. It is also important that the EC is only alleging certain types of serious prejudice with regard to particular aircraft. For example, it has not claimed displacement or impedance of sales into the U.S. market with regard to the A320 or A340. And, the only allegation of serious prejudice with regard to the A350 XWB-900 and A350 XWB-1000 is that 777 pricing causes a threat of price suppression to future orders. Significantly, the EC does not allege price undercutting, price depression, threat of price undercutting, or threat of price depression.

101. Finally, the EC has posited two types of causal links between the alleged subsidies and these forms of serious prejudice. With regard to the A320, A340, and A350 XWB-900/1000, the only such causal link that the EC asserts is that the alleged subsidies result in Boeing charging lower prices for the 737 and 777, which either force Airbus to lower its prices or result in lost sales. With regard to the A330 and A350 Original and XWB-800, the EC asserts that the alleged subsidies had both this type of “price effect” and also “technology effects” that made it more difficult to sell Airbus aircraft.

102. To help organize our presentation, we are submitting Exhibit US-1115, which indicates which allegations of serious prejudice the EC has made with regard to each aircraft, and how it proposes to demonstrate a causal link between the alleged subsidies and that serious prejudice.

103. For the EC to prevail on any of these claims, it must establish (1) that a specific subsidy or subsidies exist, (2) that one of the conditions listed in Article 6.3 of the SCM Agreement – in this case, displacement/impedance, significant price suppression, or lost sales – has occurred, and (3) that the condition is the “effect of the subsidy.” The Appellate Body has found that this last step requires the demonstration of a “causal link” between the subsidy and the conditions referenced in Article 6.3, which must ensure that the effects of factors other than any subsidies are not attributed to the subsidies.¹⁷

104. Although the EC devoted a great deal of attention to this issue in its first written submission, it failed to meet these requirements for any of its claims. We have already discussed some of the errors with the claims of the existence of a subsidy, and will not delve any further into that topic. With regard to the Article 6.3 conditions, the EC has provided no basis to conclude that there has been displacement or impedance or significant price suppression of any Airbus aircraft.

105. When it comes to establishing the existence of a causal link, the EC relies on a number of assertions that are inconsistent with the facts. It asserts that the magnitude of the subsidies is so large that they must have caused serious prejudice. However, the EC’s magnitude calculations

¹⁷ *Cotton (AB)*, paras. 429, 435-437.

grossly overstate any benefit conceivably attributable to the programs at issue, so that any conclusions drawn from that calculation are invalid. The EC argues that the “price effects” of the alleged subsidies resulted in Boeing charging prices lower than it otherwise would have charged. However, this argument relies on a series of propositions that are inapplicable to Boeing and inconsistent with the evidence. The EC’s attempt to calculate the dollar value of the alleged “price effects” relies on Professor Cabral’s economic model. As that model accepts as true the EC’s exaggerated subsidy magnitude calculation and assumes the truth of the invalid propositions underlying the EC’s price effect theory, its output would be invalid even if the model were otherwise sound. The EC’s argument that the “technology effects” of the alleged subsidies expedited the development of the 787 is contrary to the evidence showing that Boeing based that aircraft on commercially available technology, and used only technologies that, unlike DoD-sponsored research, had a documented *civil* origin. Government R&D programs, in contrast, were not a factor in Boeing’s decision to launch the 787, and were not a factor in its development.

106. Finally, the EC simply ignores other factors that explain any problems that Airbus currently faces. These include Airbus’ deliberate decisions to develop the A380 instead of a small fuel efficient airplane like the 787, to develop its A340 (without regard to fuel economy) as a four-engine aircraft, and to undercut Boeing’s prices to gain market share.

Displacement/impedance

107. The EC alleges the existence of three of the conditions listed in Article 6.3 of the SCM Agreement. The first of these, referenced in subparagraphs (a) and (b) of that article, deals with displacement or impedance of Airbus’ imports into the United States and exports to third country markets. From the outset, the EC errs by addressing its analysis to “orders” of large civil aircraft, when the text of the Agreement addresses imports and exports. In the large civil aircraft market, that can only mean physical delivery of the finished products. “Orders,” however, occur long before such deliveries, and are frequently deferred or cancelled, so they are not in any way equivalent to imports or exports.

108. It is also important to note that the EC skews the displacement/impedance analysis by addressing only data for 2004 to 2006. This period is unduly short in the context of this market. It ignores the length of the large civil aircraft business cycle – 2004 to 2006 represents an “up” portion of the business cycle that is continuing, and can only be properly understood in the context of the “down” portion of the cycle, which began in 2001. Exhibit US-1116 reflects Airbus’ own view of its success in gaining market share across the business cycle, which covers a period beginning long before 2004.

109. It is clear that the evidence does not support a claim of displacement or impedance in any of the markets identified by the EC. We have prepared US-1117, which we will distribute in the confidential session, showing global, aggregate third country, and, where the EC has made a country-specific displacement/impedance claim, country-specific data. (There will be no A350

deliveries until at least 2013.) That exhibit shows that none of the countries the EC identifies as a “third country market” qualifies as a market for purposes of Article 6.3(b). Many of them had only small and sporadic deliveries over the course of the relevant period. The EC itself warned that “{t}he Panel should be cautious in considering market-share data from individual countries for specialized and expensive capital goods such as LCA.”¹⁸ Most of the relevant information is confidential, but we can say publicly that the EC’s fragmentary third-country data demonstrate the accuracy of this observation – the data is simply too limited to draw any reliable conclusions. To the extent that, in this global market, deliveries to any single country could yield enough to assess a third country displacement/impedance claim, none of the third countries identified by the EC fits that description.

Significant price suppression

110. The EC asserts that significant price suppression exists because Airbus’ prices have not risen more than they did. In the context of the SCM Agreement, price suppression is the failure of prices to increase by the amount that would otherwise be expected. But, due to outside factors like Airbus’ missteps in launching the A350, unattractiveness of the A340 in a high fuel cost environment, and Airbus undercutting of Boeing prices in major A320 campaigns, there is no reason to expect Airbus’ prices to have increased more than they actually did.

111. Most of the relevant information is BCI or HSBI, which we will discuss in the confidential session.

112. In light of Airbus’ very deliberate price undercutting strategy, which allowed Airbus to displace Boeing as the world’s largest manufacturer of large civil aircraft, the increase in Airbus aircraft prices is no lower than what would be expected. Therefore, the EC has no legitimate price suppression claim.

Significant lost sales

113. As most of the information relevant to the EC’s lost sales claims is confidential, the United States will address this part of the EC’s adverse effects case in the confidential portion of this hearing. For purposes of this public session, all we can say is that:

- Boeing did indeed win a number of sales campaigns during the reference period, as did Airbus.
- Campaign-specific evidence, much of it supplied by the EC, demonstrates each of the Boeing victories was a function of factors entirely unrelated to the alleged subsidies.

¹⁸ ECFWS, para. 1535.

- The evidence shows systematic, widespread price undercutting by Airbus, not Boeing.
- There is no evidence to suggest that, but for alleged subsidies, Boeing could not, or would not, have priced as it did.

The EC’s calculation of the magnitude of the alleged subsidies does not establish a causal link with any of the effects-related variables cited by the EC

114. Suppose that we could set aside the EC’s failure to establish the existence of significant price suppression or displacement or impedance. The EC has still failed to establish the causal link between the alleged subsidies and the serious prejudice that it alleges has occurred. The EC has posited two causal links – the so-called “price” and “technology” effects of alleged subsidies – and presented three assertions that it claims establish the existence of those causal links.

115. The first assertion, underlying both of the asserted causal links, is that the magnitude of the alleged subsidies is such that they cause the serious prejudice identified by the EC. However, as we discussed earlier, the EC has based its calculation of magnitude in this dispute on mischaracterizations of the nature of the U.S. government programs and gross exaggerations of any conceivable benefits to Boeing.

116. To illustrate, the EC claims that Boeing and McDonnell Douglas received \$10.4 billion in subsidies under NASA R&D programs. However, the reality is that over the 20 years from 1986 to 2006, Boeing and McDonnell Douglas *combined* received less than \$750 million in payments, which were not subsidies, and were spread over decades under NASA R&D programs – and all of it was in payment for R&D services provided to NASA, which were not related to the development of any particular aircraft. The remaining \$9.65 billion that the EC asserts was the equivalent of free cash to Boeing actually consisted of costs incurred by the U.S. government in running a government agency (such as NASA’s in-house research and overhead), and payments to NASA contractors and grantees other than Boeing. In other words, these payments were not “cash” to Boeing, and did not cover the costs of anything that Boeing would otherwise have had to do on its own.

117. Similarly, the EC has “calculated” the cash flow benefit to Boeing under the U.S. Defense Department’s RDT&E program at \$2.4 billion by treating a portion of the entire research budget, including significant DoD overhead, as free cash to Boeing. For the two DoD programs for which publicly available payment information is available, the EC’s estimates of the amount Boeing received are, respectively, five times and seven times the amounts Boeing actually received. Even these lower actual values do nothing to advance the EC claims. Boeing’s large civil aircraft division, BCA, does not contract with the Defense Department, and the EC concedes that all the research was for military applications. Therefore, DoD RDT&E was not related in any way to Boeing’s large civil aircraft operations.

118. In short, the EC’s subsidy magnitude calculations produce a result that the evidence does not support. Therefore, that calculation cannot support the EC’s arguments that the magnitude of the alleged subsidies was large enough to have the claimed price and technology effects.

The EC’s description of the nature of the alleged subsidies does not establish a causal link with any of the effects-related variables cited by the EC

119. According to the EC, the “nature” of the alleged U.S. subsidies has been to cause serious prejudice by:

- providing “free cash” to Boeing, which the company used to lower the prices of its 737, 777 and 787 aircraft; and
- providing Boeing with the technology that enabled Boeing to bring the 787 to market when it did in 2005.

The evidence contradicts these assertions.

120. As we have just explained, the alleged subsidies do not provide “free cash” to Boeing. The great majority of the alleged subsidies are programs under which the United States Government contracted with Boeing for R&D work that the Government, not Boeing, wanted done. Boeing got nothing for “free” – it had to perform work for the Government in exchange for any payment it received.

121. Moreover, the evidence contradicts the EC’s theory as to how any subsidies that may have increased Boeing’s non-operating cash flow caused Boeing to lower its prices for the 737, 777, or 787. As the EC recognized in paragraph 1390 of its first written submission:

“It is, of course, impossible to trace precisely how Boeing has used any given dollar of U.S. subsidies.”

Yet the EC claims that the economic model prepared by Professor Luis Cabral does just that – trace the effects of the wide variety of alleged subsidies with startling precision. According to the model, every dollar of alleged R&D subsidies leads Boeing to distribute 15 cents in payments to shareholders and to “invest” 12 cents in more aggressive pricing of its new aircraft, 47 cents in more aggressive pricing of its old aircraft to new buyers, and 26 cents in increased R&D. But notwithstanding this numerical precision, the model of Professor Cabral cannot withstand even a minimum of scrutiny.

122. First, according to Professor Cabral, if a company like Boeing were to receive subsidies that increase its non-operating cash flow, the company can use the subsidy in one of two ways. Either the subsidy recipient will simply pocket the subsidy – for a corporation, that means returning the extra cash to shareholders – or it will use the subsidy to lower civil aircraft prices.

In fact, there is nothing to support this assumption. Boeing's financial statements, which the Cabral Report ignores, show that Boeing's uses for free cash flow do not involve investment in aggressive pricing, and instead extend to paying down debt, making acquisitions, and funding pension obligations. By ignoring the range of possible uses of additional non-operating cash flow, the Cabral model channels funds into a limited set of uses unrepresentative of Boeing's experience.

123. More importantly, as Professor Cabral expressly acknowledges in paragraph 22 of his report, his model of how firms use subsidies rests on the assumption that the subsidy recipient is constrained in its access to capital markets. If a firm has unconstrained access to capital markets, then it will invest in all of the profitable opportunities that it has available to it. According to Professor Cabral, his model applies only to a firm that for some reason cannot obtain all of the capital that it could profitably invest. He attempts to model how such a firm would ration its limited capital among profitable investments, and how it would respond if subsidies provided additional non-operating cash flow that could be used to satisfy a need for additional investment capital. But he explains that, for a firm that does not face constraints in its access to capital, "an increase in government subsidies would be entirely reflected in higher dividends; it would have no effect on the investment level" (para. 22, emphasis added).

124. The evidence shows, however, that Boeing is not constrained in its access to capital. Boeing has not, as a factual matter, been forced to ration scarce capital among multiple investment opportunities. Rather, Boeing has access to all of the capital that it could profitably invest, and indeed has returned significant excess funds to its shareholders in recent years through dividends and share repurchases. Therefore, even if Boeing were motivated to make profitable investments of the type Professor Cabral discusses – or any other profitable investments – it has the ability to make those investments entirely apart from any alleged subsidies. Put another way, the key assumption of Professor Cabral's model – that the firm in question is constrained in its access to capital – simply does not apply to Boeing.

125. Thus, on Professor Cabral's own terms, subsidies that increase the cash flow of a company like Boeing have "no effect" on its level of investment. But the only price effects of subsidies that the Cabral Report describes are the price effects that would flow from the types of increased investments that the report asserts. As we have shown in detail in our written submission, there are numerous additional flawed assumptions and conclusions in the Cabral Report's calculations of how subsidies would be allocated among additional price-distorting investment opportunities. But the key assumption underlying the EC application of the Cabral Report – that Boeing could not access enough capital to invest in available opportunities without subsidies – is simply false.

126. Other than the flawed Cabral Report – which, on its own terms, does not even apply to a company like Boeing – the EC has presented no evidence to support its contention that any non-operating cash flow from alleged subsidies have affected Boeing's prices for the 737, 777, or 787. Indeed, the evidence demonstrates precisely the opposite: Boeing's market pricing has not

been any different than it would have been “but for” the alleged subsidies. Boeing executives have explained that the allegedly subsidized contracts have no bearing on the prices they set for Boeing’s large civil aircraft. Exhibit US-275(HSBI) contains the Boeing affidavit explaining its pricing policies. Second, if the EC's claim of a relationship between the alleged subsidies and “aggressive” pricing on Boeing's part were accurate, there would be evidence of widespread price undercutting by Boeing. There is none. To the contrary, the data show that Boeing lost key sales and market share to Airbus because Boeing has always been reluctant to match Airbus on pricing, especially during the period 2001-2003 when the alleged subsidies were at their peak.

127. Just as the evidence contradicts the EC’s assertion that subsidies provided “free cash” to Boeing that affected Boeing’s civil aircraft prices, so too does it contradict the EC’s assertion that Boeing could not have brought its 787 to market when and as it did without the “technology effects” provided by certain government programs. The EC focuses on the advantage Boeing allegedly received in critical composites technology. However, no such advantage existed when Boeing launched the 787. In fact, as Exhibit US-1118 shows, Airbus itself claims to “lead{} the industry in the use of weight-saving composite materials in civil aircraft,” including on the A380, which, according to Airbus, uses “more composites than any previous commercial aircraft.”¹⁹

128. The EC ignores that in the late 1990s, Boeing and Airbus were similarly situated with respect to their access to composite and other technologies, but drew different conclusions about how to develop that technology to meet market demands in light of the projected increase in air traffic at major hubs. Starting from that point, Airbus decided to invest in the development of a very large new aircraft, the A380, which could fly more passengers on hub-to-hub routes. Boeing decided to invest its resources in a new smaller, fuel-efficient aircraft, the 787, that could fly passengers economically on point-to-point routes. Boeing relied entirely on its own development funds to bring the 787 to market. In choosing to focus on the A380, Airbus also chose not to commit major resources to a 787 type of aircraft. The EC cannot now blame that choice, or the consequences of it, on Boeing (much less on the effects of any alleged subsidies to Boeing).

129. Michael Bair, the General Manager of Boeing’s 787 program, has provided an affidavit that describes in detail the reasoning behind Boeing's decision to bring the 787 to market and the technology Boeing relied on to bring it to market. His key points are:

- At the time Boeing decided to launch the 787, the basic technologies, including composite technology, used to develop the airplane were generally available in the commercial marketplace. An all-composite business jet was already on the market, and Airbus itself was an industry leader in composites technologies.

¹⁹ “Composite Leadership,” The Airbus Way (Exhibit US-303).

- The breakthroughs that Boeing and its suppliers made in the efficiency of producing composite parts and components and on other 787 challenges were the product of their own R&D efforts, and were accomplished without the aid of any of the programs challenged by the EC.
- If Airbus had not decided to invest \$12 billion (which later ballooned to \$15 billion) to launch the A380, like Boeing, it could have devoted its resources to bring to market a new aircraft based on composite technology in the same timeframe as Boeing's development of the 787. However, once it committed to the A380, it did not have the engineering and other resources needed to simultaneously develop a competitive A350.

130. The nature of the subsidies in question further belies the EC's theory. NASA funds research at relatively early stages of development, and has a commitment to making the results of its research publicly available as quickly as possible. It is simply not possible to build a commercial advantage based on this type of research. DoD funds only military technologies. The results of DoD-funded research are therefore covered by U.S. export control laws. That makes the technology unusable for a product like the 787, which will be sold and flown throughout the world.

Other factors

131. In contrast to the EC's reliance on assumption and assertion, persuasive evidence, much of it supplied by the EC, shows that the prejudice that the EC attributes to the alleged subsidies is, in fact, attributable entirely to other factors:

- As the EC's sales documents prove, the suppression of prices for the A320 about which the EC complains is the result of, and is directly traceable to, a series of sales campaigns in which Airbus deliberately undercut Boeing's prices in order to capture key Boeing accounts.
- Because of its four-engine design, the A340 is fuel inefficient. In a time of very high fuel costs, this is a significant disadvantage. Additional performance problems associated with this particular aircraft have added to this problem, forcing Airbus to lower the A340 prices to compensate, as reflected in the comments set out in Exhibit US-1119. Thus, any suppression of A340 prices in the result of Airbus' design decisions, which have nothing to do with alleged subsidies to Boeing.
- The alleged suppression of prices for the A330 and A350, and the sales lost by these aircraft to Boeing's 787, are the direct consequence of Airbus' decision to focus on the A380 while Boeing chose to focus on developing a smaller aircraft. Subsequent events have validated Boeing's analysis of the market. Because of its

product development choices, Airbus had no aircraft that could compete effectively with the 787 until it unveiled the A350 XWB. Nor can there be any realistic claim of price suppression, as Boeing has consistently charged more for the 787 than Airbus has charged for competing aircraft.

Threat of serious prejudice

132. Lastly, the EC argues that even if the data do not support a finding of serious prejudice, the alleged subsidies threaten to cause serious prejudice to its (and Airbus’) interests because their supposed “price” and “technology” effects will continue. In the first place, its threat of serious prejudice arguments merely incorporate its serious prejudice arguments. It provides no independent basis to conclude that if there is no serious prejudice, the situation is likely to develop into serious prejudice in the future. In fact, the evidence shows that any change in Airbus’ condition is likely to be an improvement.

133. Although Airbus experienced some difficulties in 2006 when the A380 production problems and the inadequacies of its first A350 designs came to light, it is already recovering. The trend is upward.

DSU Article 13

134. I know we are getting to the end here, but before concluding, I would like to raise a few points related to the EC’s statement regarding Article 13 of the DSU. As an initial point, the United States sees no relevance to the EC’s assertion regarding the Annex V process in DS317. You are aware of our firm views that the EC is at fault, and I will not repeat them here.

135. The Panel indicated in its communication of August 30, 2007, that it welcomed further explanation of the parties views on the question of whether questions posed by the EC were “necessary to resolve the matter before the Panel.” They are not.

136. Article 13 specifies that “[a] Member should respond promptly and fully to any request by a panel for such information as the panel considers necessary and appropriate. The Appellate Body has provided further guidance on this authority, indicating that under Article 13, a Panel may request “information . . . to help it to understand and evaluate the evidence submitted and the arguments made by the parties, but not to make the case for a complaining party.”²⁰ The EC notes that, in *Canada – Aircraft*, the Appellate Body stated that a panel’s authority under Article 13 “is *not* made conditional . . . upon the other party to the dispute having previously established,

²⁰ *Japan – Measures Affecting Agricultural Products*, WT/DS76/AB/R, para. 129, adopted 19 March 1999.

on a *prima facie* basis, such other party’s claim or defence.”²¹ The Appellate Body has never suggested that it intended its findings in *Canada – Aircraft* to supersede the *Japan – Varietals* findings, which were adopted a mere five months earlier. Therefore, they should be read together.

137. There is, in fact, no conflict. As noted in *Japan – Varietals*, a panel may request information necessary “to understand and evaluate the evidence submitted and the arguments made by the parties.” *Canada – Aircraft* indicates that there is no need to find that the evidence and argumentation already before the panel by itself amounts to a *prima facie* case. Read in this light, the prohibition in *Japan – Varietals* means that the panel may not go beyond the evidence and argumentation before it to add information that would “make the case for the complaining party” or support arguments that the complaining party has not made.

138. It is clear that the EC is merely seeking to have the Panel request information in the hope that the information might help the EC meet its burden of proof in this dispute, not to help the Panel in its evaluation of the information presented by the parties.

139. The EC has provided no basis for the Panel to conclude that the information it seeks is necessary to understand or evaluate the evidence or arguments presented by the parties. It has merely listed a series of generic rationales, without explaining why it considers the existing evidence or argumentation to be less than is necessary, or how the documents it seeks would help the Panel understand or evaluate the evidence or argumentation presented by the Parties. We should note also that the very format of the questions seems to miss the point of Article 13. The EC is not seeking “information” directed to addressing an argument made by the EC or the United States. It is, instead, listing generic categories of documents, without regard as to whether they contain information of the type sought by the EC.

Conclusion

140. Thank you for your attention today. We have kept this statement deliberately short. You have devoted a substantial amount of time to reading our arguments in the U.S. first written submission. Rather than subject you to an extended summary of everything you already have read, we would like to leave as much time as possible for us to address your questions and concerns. We would, however, like to emphasize that this statement has addressed only those issues that we thought would most benefit from an oral explication. We do not mean to imply that any other issue is of lesser importance. We will be pleased to address any of the issues in this dispute in our discussion with you during the remainder of this meeting.

²¹ *Canada – Aircraft*, WT/DS70/AB/R, para. 185.