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[Canadian Lumber Subsidies] [Loose]

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THE PROBLEM OF CANADIAN LUMBER SUBSIDIES CONTINUES

The U.S. Government recently found that Canadian lumber subsidies injure the U.S. industry. The Commerce Department preliminarily found a subsidy of 14.5%, but reduced that figure to 6.5% at final and imposed an equivalent duty.

The U.S. industry demonstrated a subsidy of well over 20% The low final subsidy finding resulted from several errors and, perhaps, excessive caution in quantifying the subsidies. Canada, however, is arguing for reversal of the determinations before panels formed under the U.S.-Canada Free Trade Agreement (FTA).

The problem stems from Canada's noncompetitive system of allocating timber. Canadian provinces set timber prices administratively at one-fourth to one-half the competitive rate. A virtual ban on log exports ensures that the benefits of timber subsidies inure only to Canadian mills. See Tab A.

Subsidized Canadian lumber injures the U.S. industry. U.S. firms face a devastating cost-price squeeze in which subsidized imports suppress U.S. lumber prices while timber prices are increasing. Absent a subsidy offset, an estimated 15,000 additional production jobs will disappear. See Tab B. In addition to injuring the U.S. industry, the Canadian subsidies are environmentally harmful. See Tab C.

After a preliminary subsidy finding in 1986, the United States and Canada negotiated a Memorandum of Understanding (MOU) which imposed an export tax on Canadian lumber. The MOU was a compromise and offset only part of the subsidy. In 1991, however, Canada unilaterally abrogated the MOU. See Tab D. This lead directly to the recent case, in which the affirmative subsidy and injury findings were made. See Tab E.

A preliminary report issued by a dispute settlement panel under the auspices of the General Agreement on Tariffs and Trade, prepared in response to Canadian claims that the self-initiation of the lumber case violated international law, fully supports the imposition of countervailing duties. On all the key issues, the panel's findings and analysis sanctions the lumber investigation and the legal grounds for the duty calculation. See Tab F.

The U.S. industry should win the **FTA appeal**. FTA panels are required to apply U.S. law as a U.S. court would. U.S. law requires agencies to base decisions on substantial evidence -- a standard easily met by the thorough deliberations of Commerce and the International Trade Commission. In fact, under that standard, the subsidy finding should be higher as Commerce has now acknowledged that it undercalculated the subsidy rate. See Tab G.

The U.S. case before the panels is strong but Canada hopes for a political decision. Anything less than a decision on the merits is unacceptable and could adversely affect evaluation of the proposed dispute settlement system in the NAFTA.

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Divider Title: **A**

THE SUBSIDY: UNDERVALUING CANADIAN GOVERNMENT TIMBER

- In Canada, the provincial governments own over 90% of the timber and sell the vast bulk of that timber at below-market rates. These "administered" provincial fees range from one-fourth to one-half of the competitive rates. See Figure 1.

- Canadian studies and experts, including the B.C. Forest Resources Commission and three Ministers of Forests past and present, have noted that timber awarded administratively sells at a fraction of the price of that sold competitively.

- This is a countervailable subsidy under both U.S. and international law. The GATT supported our right to take action.

- In addition, the federal and provincial governments maintain broad restrictions on the export of logs. Especially in British Columbia, the effect of these export restrictions is to ensure that the benefit of timber subsidies is reserved only to Canadian mills. These restrictions artificially decrease the cost of the chief input to softwood lumber. As a result, even the price of timber sold "competitively" in British Columbia is far below the full market value.

- The reason that Canadian governments sell timber at below-market rates and restrict log exports is to subsidize their lumber industry and artificially encourage production of Canadian lumber, at the expense of otherwise competitive U.S. firms. This policy of subsidization of the Canadian softwood lumber industry has been enormously successful as the Canadian share of the U.S. lumber market steadily rose until adoption of the 1986 MOU. See Figure 2. With Canada's unilateral termination of the compromise MOU, its share of the U.S. market is again rising.

- There are at least three victims of the Canadian policy of subsidization of the Canadian lumber industry:

  i) The U.S. lumber industry: While U.S. lumber mills obtain competitively-bid timber resources, their Canadian competition obtains subsidized, below-market timber from Canadian governments -- the cost: U.S. jobs.

  ii) The forests of Canada: As various Canadian academics and environmentalists have shown, by providing timber at below-market rates, the Canadian governments encourage waste and over-harvesting of the forest resource.

  iii) The Canadian taxpayer: Whereas the U.S. and state governments receive market-value for their timber, provision of Canadian timber at cut-rate prices a fraction of the price of similar timber in the United States constitutes a veritable raid on the public fisc of Canada.

THE CANADIAN LUMBER INDUSTRY IS MASSIVELY SUBSIDIZED

The present softwood lumber trade dispute is the latest chapter in a battle that has been fought in the United States market for over 20 years and in the Department of Commerce for the past 10. Between 1975 and 1986 (when the United States finally took limited action against Canadian lumber subsidies), Canadian penetration of the U.S. softwood lumber market rose steadily from 18% to 33% largely as a result of massive Canadian subsidies. After imposition of the U.S.-Canada Softwood Lumber Memorandum of Understanding in 1986, which contained a partial subsidy offset, Canadian market share began to drop but only in 1990 did it again reach levels comparable to 1979. In October of 1991, Canada unilaterally terminated the MOU.

The Canadian Subsidy System

In Canada, almost all timber is owned by the government, and unlike in the United States, where government timber is sold by auction, Canadian governments do not try to recover the value of the timber that is sold to the lumber industry. Rather, Canadian timber is used primarily as an engine of economic development. Timber in Canada is provided as a subsidized input to the softwood lumber industry to create artificially mill employment.

Stumpage Subsidies

Nationwide, from the Atlantic to the Pacific, administered stumpage prices in Canada are dramatically lower than fees for the small quantity of timber that is sold competitively in Canada or fees for similar timber similarly situated across the U.S. border. A cross-border analysis of stumpage fees demonstrates that Canadian timber sells for one-fourth to one-half the value of similarly situated U.S. timber. See Figure 1. As a result, artificially-created Canadian employment comes at the expense of otherwise competitive U.S. lumber mills and jobs.

Historically, low stumpage prices in Canada have been utilized as a means of encouraging economic development. Professor Tom Waggener of the University of Washington recently noted that

> Canada has used long-term noncompetitive tenures for Crown forest lands to support regional development objectives.

Numerous Canadian studies and observers have concurred. David Haley, a noted professor of forestry at the University of British Columbia, observed in a 1980 study that:

> There is little doubt that the principle reason for higher stumpages in the [U.S.] Pacific Northwest is that all public agencies involved in timber production encourage competitive bidding for standing timber, whereas in British Columbia competitive sales of timber have been virtually eliminated. . . . There is good reason to believe that if public timber in British Columbia was sold competitively, stumpages, in many cases, would be bid well above their appraised level and direct Crown revenues would be substantially increased, particularly in those regions of the Province where accessible, high quality stands of timber are in short supply.[1/]

Bob Williams, former B.C. Minister of Forests, noted in 1987:

> We weren't charging for trees and the [United States] had a competitive bidding system on their public lands that sometimes had their companies paying ten times what our companies were paying for the same timber.

1/ D. Haley, A Regional Comparison of Stumpage Values in British Columbia and the United States Pacific Northwest, The Forestry Chronicle 225 (October 1980).

The Americans saw this as a subsidy -- and they were right.[2]

The subsidies to Canadian lumber mills continue today. The B.C. Truck Loggers Association noted in 1991 that "[w]e cannot afford to continue the 'cheap wood' syndrome," while the Canadian Federation of Independent Businesses stated that "British Columbia's forest industry is dominated by large wasteful giants [who] . . . want their 'sweetheart deal' in perpetuity."

Tenureholders also benefit from a system that provides the tenureholders stability and a favorable regulatory climate. The 1991 British Columbia Forest Resources Commission found that

> the award of harvesting rights through tenure had two main goals -- to encourage job-creating investments in manufacturing facilities through a secure wood supply, and to provide incentives for forest companies to carry out forest renewal programs. History has shown that while the employment and investment incentives <u>worked very well</u>, the forest renewal incentives were much less consistent.[3]

Dan Miller, the current B.C. Minister of Forests, noted that "we have received a much higher value for wood [sold competitively] that what we receive for wood" sold to the major lumber mills; "it's pretty clear there could be a higher value."[4] Such overt use of government resources on behalf of the lumber industry is typical of Canadian governmental policy.

2/ The Undercurrent, Bowen Island, B.C. (February 13, 1987).

3/ Forest Resources Commission, <u>The Future of Our Forests</u> 35 (April 1991)(emphasis added).

4/ <u>The Westcoast Logger</u> 38 (July 1991).

The Log Export Ban

With the provision of cheap, below-market timber, Canada must maintain a broad restriction on the export of raw logs -- otherwise U.S. mills would compete for the undervalued resource and drive log prices up to market levels. Absent the federal and provincial log export bans, the price of timber sold competitively in Canada would be the same as similarly situated timber in the United States.

> Without these restrictions, domestic log prices for most species and grades would certainly be higher than current levels, as domestic mills would be forced to compete for raw materials at higher prices in the world market.[5/]

Canada is simply unwilling to compete in a fair market.

The Canadian log export bans differ in purpose and effect from U.S. log export restrictions. The U.S. restrictions only affect government land in the Pacific Northwest, which includes less than 25% of all timber in that region. As a result, these restrictions have little or no effect on average price. Unlike Canadian restrictions, which are aimed at protecting stumpage subsidies, the U.S. restrictions are intended to ensure that countries with market access barriers, particularly Japan, cannot bid unfairly against U.S. operators.

Significantly, considering the effects of the Canadian log export ban in the calculation of Canadian lumber subsidies does not affect the U.S. restrictions. In a March 1992 letter to

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5/ B.C. Special Log Export Policy Committee, <u>Legislation, Policies and Procedures of Log Exports from British Columbia</u> 35 (1983).

Senator Packwood, Ambassador Hills noted that the countervailing duty case has no legal ramifications for the continuation of U.S. restrictions.

Conclusion

The U.S. lumber industry is not suffering from fair competition with a more efficient competitor; instead, it is being forced to grapple with a competitor that benefits from below-market natural resource inputs. As the International Trade Commission found in a 1985 report on the effects of natural resource pricing by foreign governments: "The production cost savings realized by a foreign producer vis-a-vis a U.S. producer of like merchandise may be used by the foreign producer in a number of ways in order to gain a competitive advantage in the U.S market."[6] This is exactly what is happening with Canadian timber subsidies and exactly what the countervailing duty law is intended to redress.

6/ Potential Effects of Foreign Governments' Policies of Pricing Natural Resources, Inv. No. 332-202, USITC Pub. No. 1696, xix (May 1985).

FIGURE 1

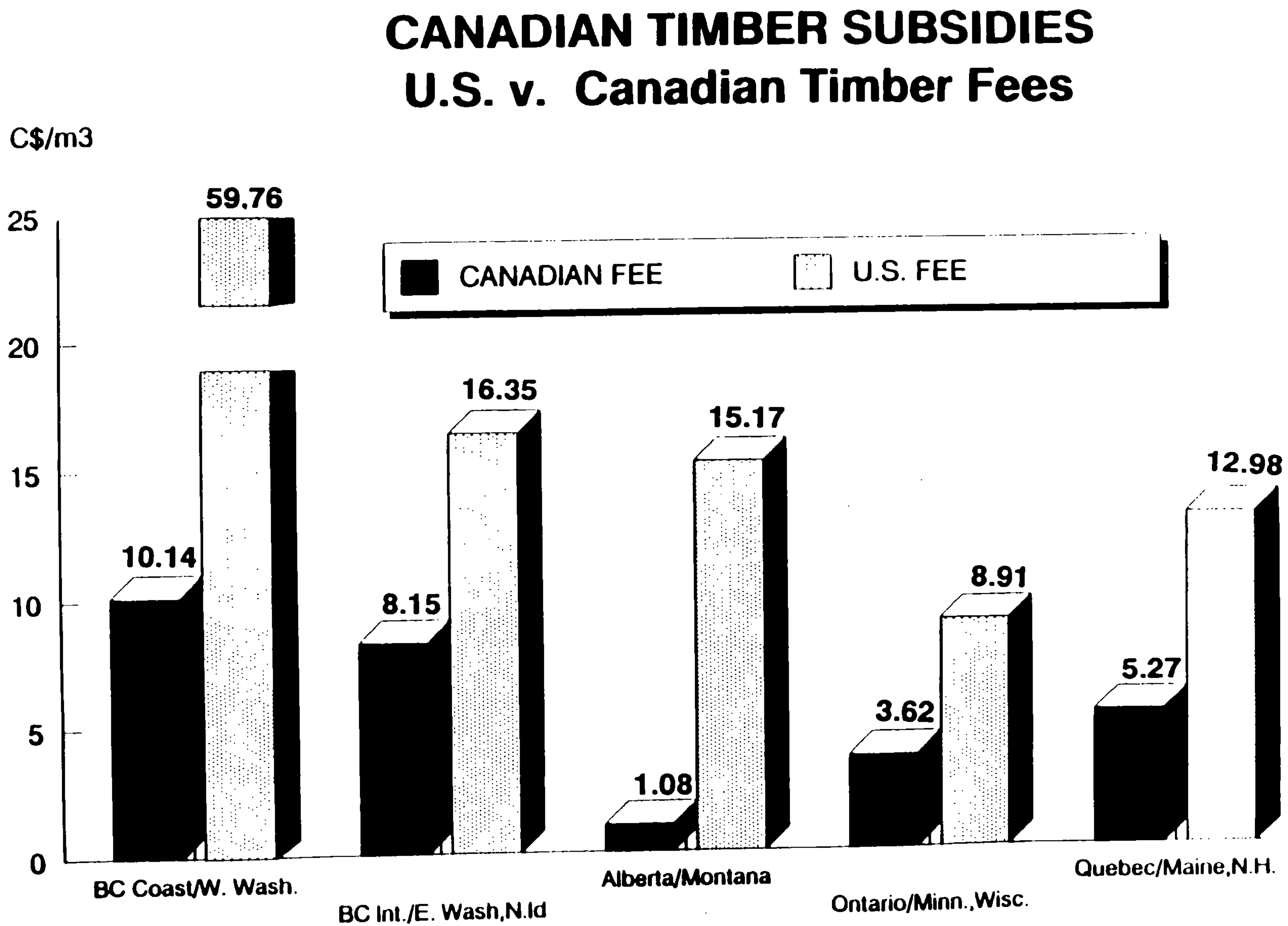
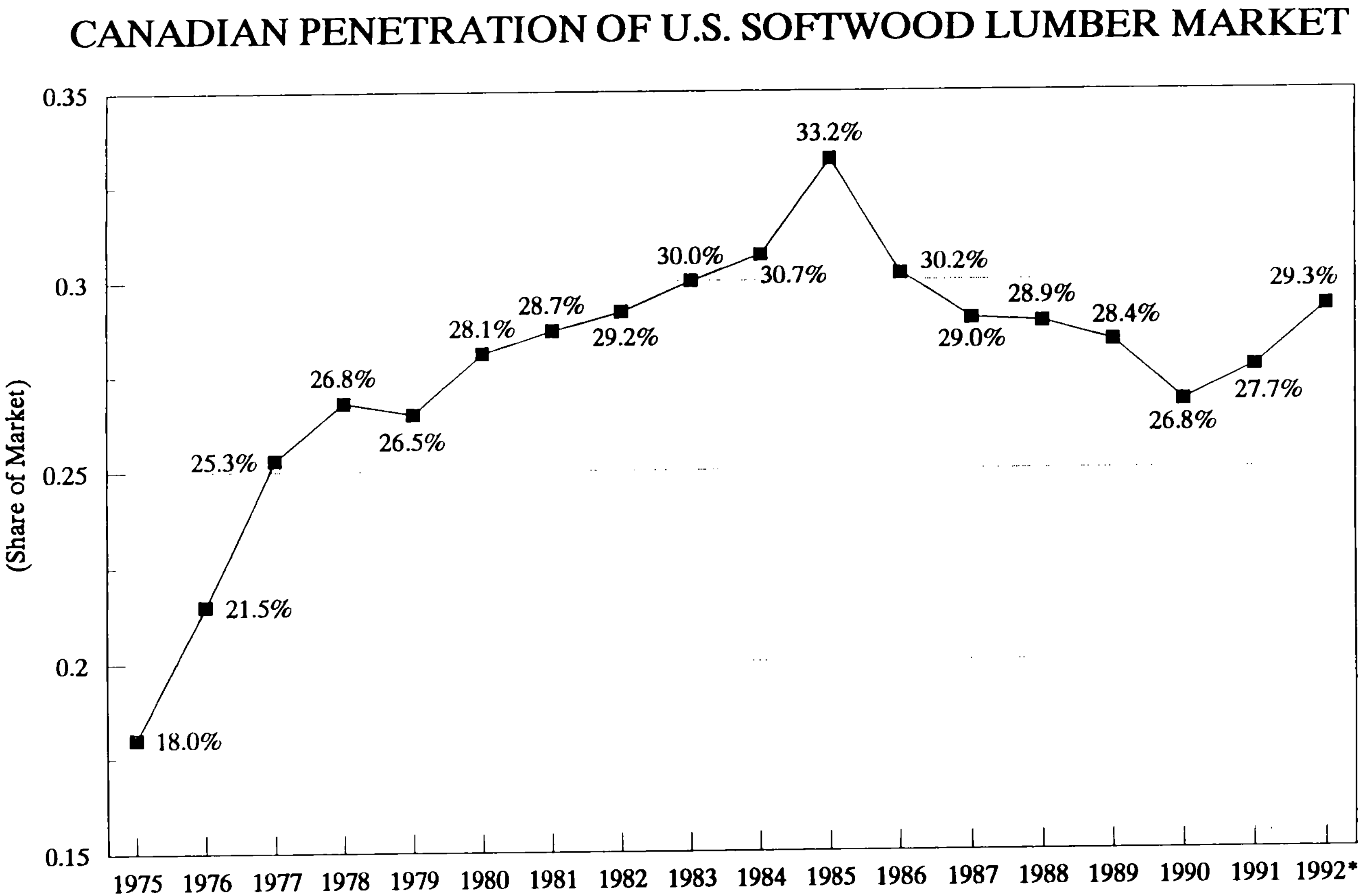

CANADIAN TIMBER SUBSIDIES
U.S. v. Canadian Timber Fees
C$/m3
CANADIAN FEE
U.S. FEE
25
20
15
10
5
0
59.76
10.14
16.35
8.15
15.17
1.08
8.91
3.62
12.98
5.27
BC Coast/W. Wash.
BC Int./E. Wash,N.Id
Alberta/Montana
Ontario/Minn.,Wisc.
Quebec/Maine,N.H.

FIGURE 2



Source: National Forest Products Association

*Data for 1992 is only through November 1992.

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Divider Title: **B**

THE INJURY: SUBSIDIZED CANADIAN LUMBER STEALS U.S. LUMBER JOBS

- Subsidization by Canadian governments, which artificially increases Canadian lumber production, severely and directly harms the U.S. lumber industry. Subsidized imports have an important, unfair advantage in such a price-sensitive market.

- The U.S. lumber industry closed more than 650 lumber mills between 1977 and 1985, resulting in an employment decrease of more than 25%. During this same period, Canadian lumber production increased 30%, and 85 Canadian lumber mills began operations. Since 1970, the Canadian lumber industry has performed significantly better than the U.S. industry. See Figure 3.

- Subsidization of Canadian lumber production resulted in an increase in the Canadian share of the U.S. market from 18% in 1975 to 33% in 1985. See Figure 2. As a result of the partial subsidy offset in the Memorandum of Understanding (MOU), the Canadian share of the U.S. softwood lumber market subsequently stabilized at approximately 27% before again rapidly increasing after Canada's unilateral termination of the softwood lumber MOU.

- Since 1986, U.S. timber prices have increased as a result, in part, of supply constraints due to environmental regulations. Subsidized Canadian timber prices have not increased significantly. At the same time, real U.S. lumber prices dropped from 1988 through 1991 and have not reached pre-1980 prices even after the 1992 price spike (mainly engendered by a combination of increasing consumption and constrained supply). As a result, U.S. mills are caught in a cost-price squeeze. See Figure 4. With 28% of the U.S. market, subsidized Canadian lumber (which as a result of the subsidies does not face increased timber fees) has significantly depressed U.S. lumber prices, contributing to the cost-price squeeze.

- Subsidized Canadian softwood lumber is a significant cause of material injury to the U.S. industry. Other building products -- facing the same recessionary pressures, the same timber price increases, but not facing subsidized imports -- have fared much better than the softwood lumber industry. See Figure 5.

- The U.S. International Trade Commission has determined three times since 1986 that subsidized Canadian imports cause material injury to the U.S lumber industry. These determinations are a clear indication of the true impact of these imports.

SUBSIDIZED CANADIAN LUMBER INJURES THE U.S. INDUSTRY

The International Trade Commission correctly determined in June 1992 that subsidized Canadian imports materially injure the U.S. lumber industry. This was the fourth time in four investigations that the ITC found injury to exist. The existence of injury and of a causal link between the injury and Canadian subsidies is well established.

Pre-MOU Injury

Prior to the partial subsidy offset contained in the softwood lumber Memorandum of Understanding in 1986, unchecked Canadian subsidies devastated the U.S. industry. According to the International Trade Commission, from 1977 to 1985, more than 650 U.S. lumber mills were forced to close, while in the same period 85 Canadian mills opened. U.S. softwood lumber employment dropped by over 25% during the period 1977 to 1985.

From 1977 and 1985, Canadian production of softwood lumber increased from 17.2 billion board feet (BBF) to 22.3 BBF -- or 30%.[1/] During the same period, U.S. production decreased 4%.[2/] Historically, the share of the U.S. market held by the Canadian industry has been approximately 21%, but had grown to 33% by

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1/ Western Wood Products Association Dominion Bureau of Statistics.

2/ Id.

1985.[3/] This cost the U.S. industry over $1 billion in annual sales.

The large timber subsidies available to the Canadian softwood lumber industry have allowed it to consistently wrest market share from the otherwise competitive U.S. industry. From 1970 until the imposition of the corrective measures negotiated in the MOU in 1986, Canadian softwood lumber production grew more rapidly than U.S. production during every economic expansion and shrank more slowly than U.S. production during every recession. See Figure 3. These trends combined to dramatically increase the Canadian share of the U.S. softwood lumber market. See Figure 2.

The MOU Limited the Subsidies' Effects

The MOU decreased -- but did not eliminate -- the injury to U.S. producers from subsidized Canadian timber. Canadian market share dropped from a high of 33% in 1985 to an average of 28% over the last four years. Had Canada's U.S. market share remained at its pre-MOU level, the United States would have lost almost 3 billion board feet of production (worth over $650 million in sales) and 15,000 direct jobs. Since the MOU was only a partial subsidy offset, however, and did not address the fundamental problem of the administered timber give away, the injury from subsidized Canadian lumber remained.

3/ From 1970 to 1975 the Canadian industry share of the U.S. market was an average of 20.7%. From 1975 to 1979 this average share rose to 22.8%. By 1985, the Canadian share had risen to 33.2%. See Figure 2.

Injury Today

The U.S. industry has continued to suffer employment losses. Since 1988, 13,400 production workers have lost their jobs.[4/] Subsidized imports of Canadian softwood lumber have contributed to those losses by taking sales and artificially depressing U.S. prices.

Since 1988, Canada's share of the U.S. market has increased consistently in terms of value as Canadian mills have aggressively pursued value-added sales. In volume terms, Canada controls over one-fourth of the U.S. market -- averaging 28% over the past four years and rising from a low of 26.2% in the first quarter of 1991 to 28.9% in the first quarter of 1992 (after termination of the MOU).

Without the subsidy offset of the MOU or U.S. countervailing duties, Canadian market share could once again reach its pre-1986 levels and cost the U.S. industry over $600 million in sales. This could result in the loss of over **15,000** U.S. production jobs.

Subsidized Canadian lumber affects financial performance. For example, while regulatory efforts to protect the old-growth habitat of the northern spotted owl have severely constrained U.S. timber supply in the Pacific Northwest, dramatically increasing timber prices, Canadian timber subsidies have protected Canadian mills from market forces and held their timber fees relatively flat. U.S. lumber prices, adjusted for inflation,

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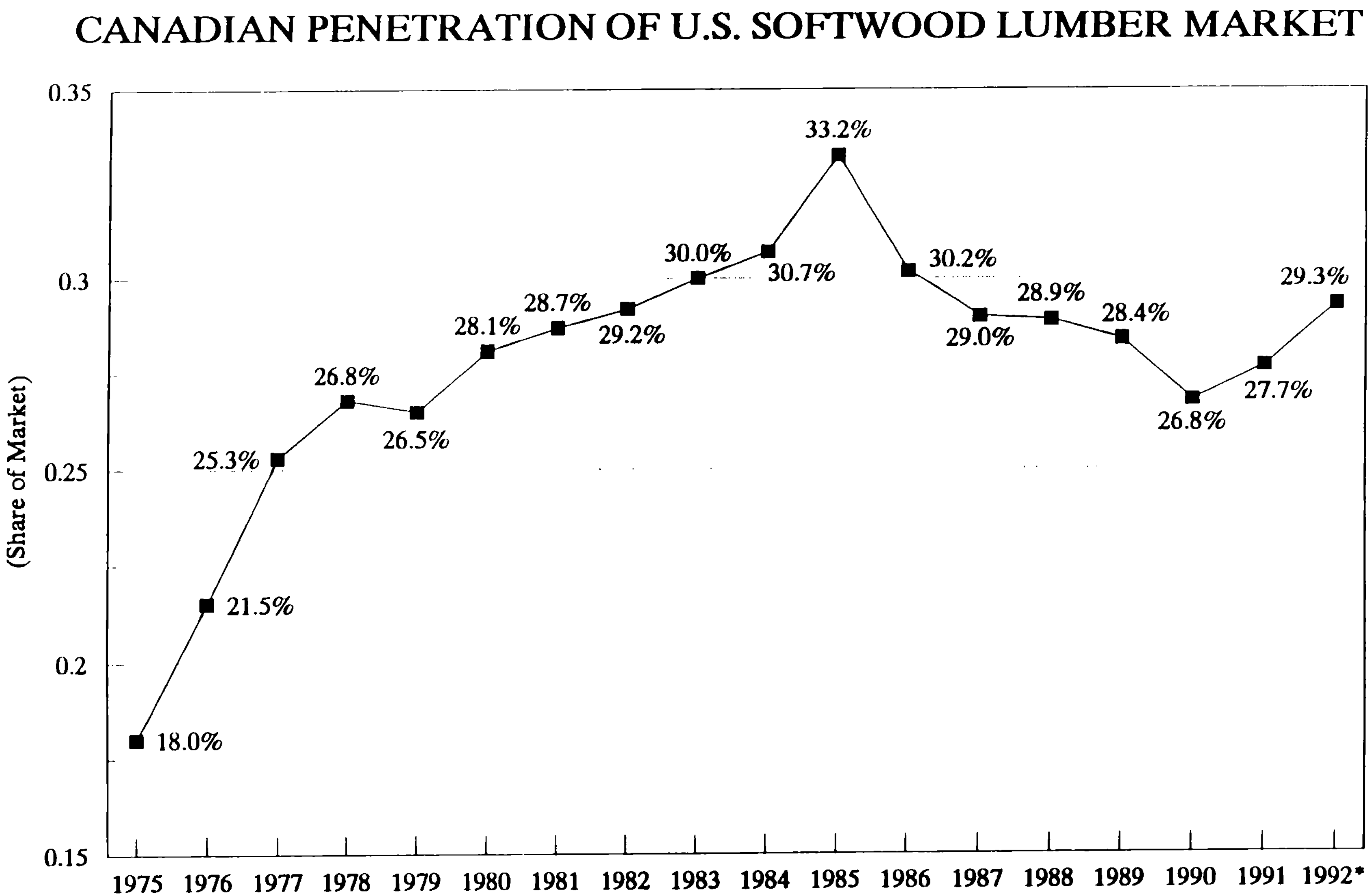
4/ Employment data are for sawmills and planing mills. U.S. Bureau of Labor Statistics.

have been dropping since 1988 in large part due to the price suppressing effects of imports of subsidized Canadian softwood lumber. The combination of increased supply costs (not faced by the subsidized competition) and decreasing real prices have placed U.S. mills in a cost-price squeeze. <u>See</u> Figure 4.

The causal effect of subsidized Canadian lumber on the U.S. lumber industry can be gauged by the fact that the U.S. building products industry, which has faced the same recession and timber supply concerns as the softwood lumber industry, has performed much better than the lumber industry. <u>See</u> Figure 5. The main reason for this superior performance is that building products do not compete with subsidized Canadian exports.

The United States Government must remain cognizant of the fact that the International Trade Commission has determined three times since 1986 that subsidized Canadian imports cause material injury to the U.S lumber industry. These rulings constitute a warning -- failure to impose a subsidy offset risks the devastation of a major U.S. industry already buffeted by other pressures.

FIGURE 2



Source: National Forest Products Association

*Data for 1992 is only through November 1992.

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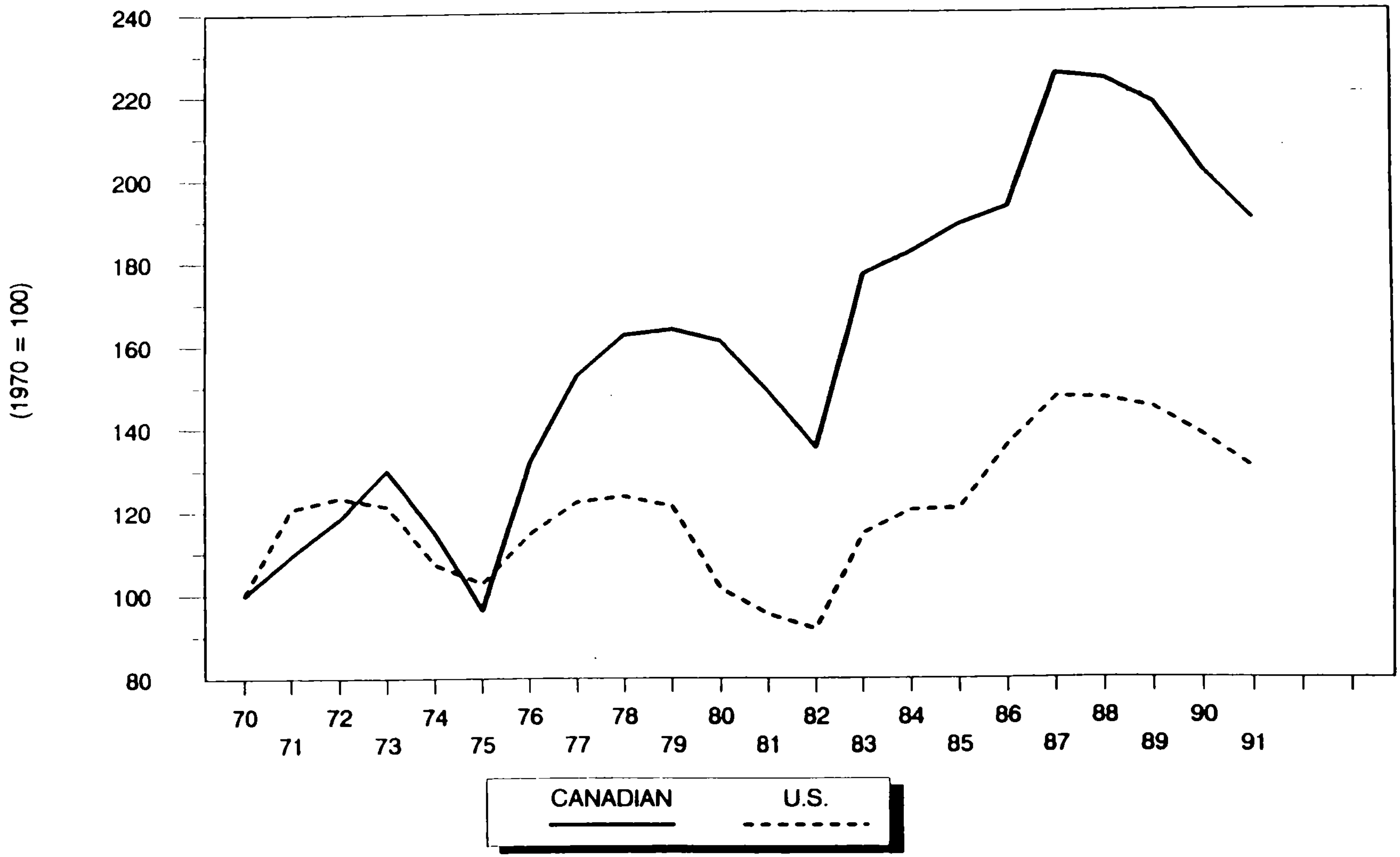
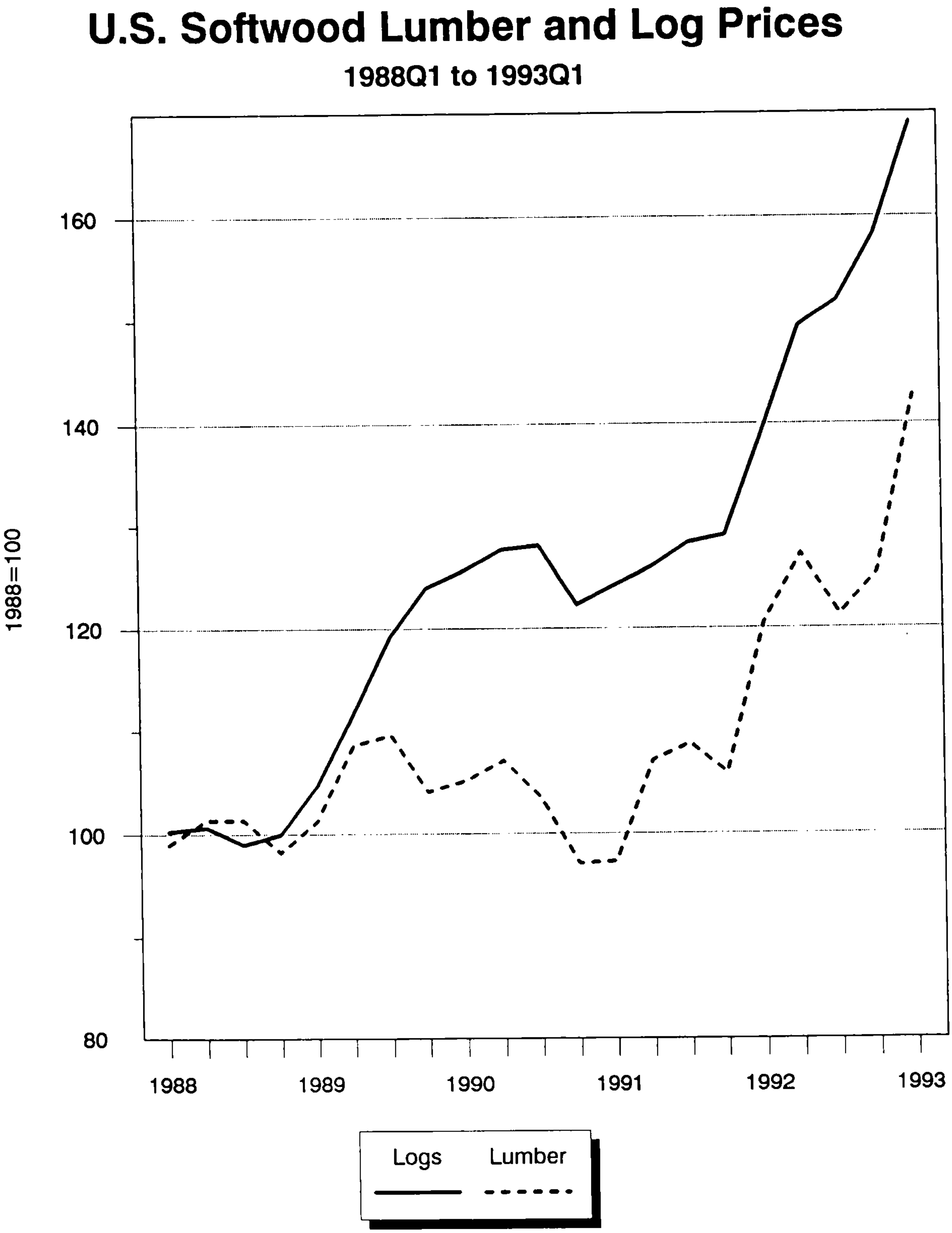
FIGURE 3

Softwood Lumber Production Index



Sources: Random Lengths, Yardstick 19-20 (March 1992); Statistics Canada; and Random Lengths Yearbook, various years.

FIGURE 4



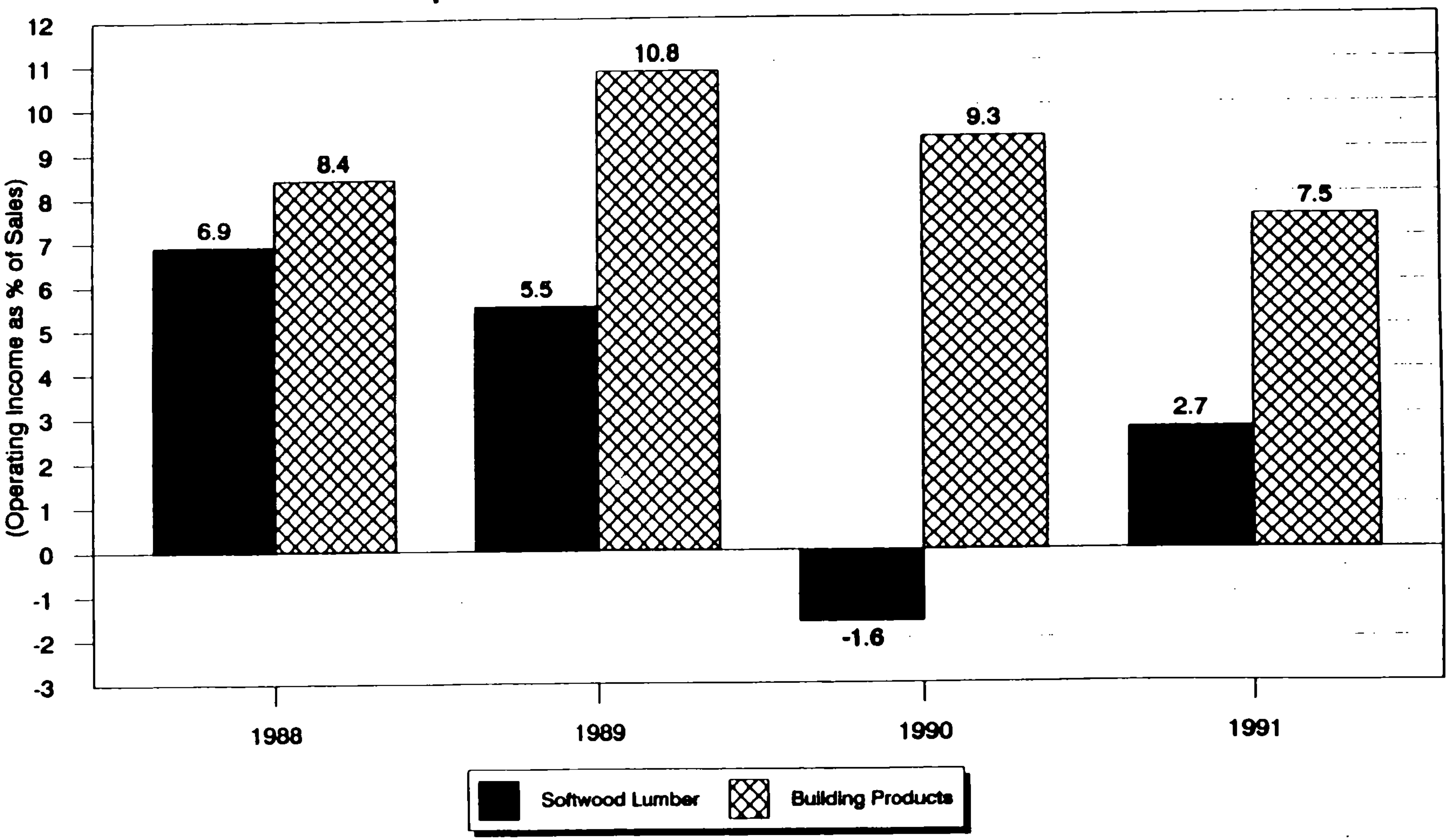
1993Q1 estimated based on January 1993 only.

Source: U.S. Bureau of Labor Statistics. The PPIs for softwood logs (WPU085101) and bolts, and softwood lumber (WPU0811) respectively were used.

sftwood3.drw/lumeqz.wk1 (nd4)

FIGURE 5

Operating Profit Margins: Softwood Lumber Compared to Other Building Products



Source: Calculated from data submitted in response to USITC producers' questionnaires.

opmalumb drw[lumber II epo]

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Divider Title: **C**

CANADIAN SUBSIDIES HARM THE ENVIRONMENT

- Canadian subsidized timber-pricing undervalues Canada's public timber resource and thus encourages wasteful timber processing and harvesting.

    - Both the British Columbia Forest Resources Commission and Canadian environmental organizations have decried the "waste in the woods" resulting from timber subsidies.

    - U.S. companies which must pay competitive prices for timber tend to use much more of each log than do their Canadian counterparts, according to Canadian forestry experts.

- Subsidized Canadian lumber depresses U.S. lumber prices and makes it more difficult for U.S. timber owners to undertake adequate reforestation efforts.

- Canadian subsidies increase U.S. exports of logs. By depressing the price U.S. mill owners receive for their lumber, these subsidies reduce the amount of money mill owners can spend to buy logs. As a result, foreign buyers (many from countries with market access barriers to U.S. lumber imports) can outbid U.S. mill owners for logs.

- Sound trade policy and environmental policy support taking action to offset Canadian timber subsidies.

SUBSIDIES AND ENVIRONMENTAL HARM

Canadian lumber subsidies cause environmental harm both in Canada and the United States. In Canada, they cause wood to be used inefficiently; in the United States, they hinder heightened reforestation efforts and encourage log exports by making it more difficult for mills to process timber profitably domestically. Offsetting Canadian timber subsidies, and discouraging undervaluation of timber, is sound trade and environmental policy.

Wasteful Canadian Timber Practices

There is widespread sentiment in British Columbia that timber subsidies encourage the inefficient use of timber. A 1991 report by the British Columbia Forest Resources Commission noted concerns that "too much timber is being wasted in the wood because major tenure holders have too much non-competitive wood available." As Canadian forestry expert Peter Pearse has noted:

> The price of logs [in Canada] is artificially low. And because the price does not reflect their true value, there is no pressure to get the maximum returns from each log. . . . It's not surprising that an American miller who is paying a hell of a lot more for stumpage is going to be more careful about what they [sic] got out of a load of logs.

Canadian environmentalists also have criticized the subsidies. The Western Canada Wilderness Committee, in a letter to Congressman Ron Wyden (March 21, 1992), noted that Canadian wood subsidies exist and that "these subsidies in their current form are harmful to the Canadian people." The Sierra Club of Western Canada also acknowledged in a letter to Congressman Wyden (March 23, 1992) that Canadian timber-pricing "does not provide opportunities for the most efficient and best use of the timber."

Subsidies Hinder Reforestation

As a result of timber undervaluation, Canadian funds for reforestation are less than they otherwise would be. Indirectly, the Canadian subsidies also artificially limit the value of timber (and funds available for reforestation) in the United States. Any such undervaluation is bad for sound forestry practices. The enormous environmental advantage implicit in offsetting the Canadian timber subsidies should not be permitted to evaporate.

Canadian Subsidies Encourage U.S. Exports of Logs

By artificially depressing the price U.S. mill owners receive for their lumber, Canadian timber subsidies reduce the amount of money mill owners can spend to buy logs. Mill owners are faced with a cost-price squeeze, in which subsidized Canadian lumber holds down lumber prices while log costs are rising. See Tab B. This economic dynamic makes it increasingly difficult for U.S. mills to process logs domestically at a profit. As a result, foreign buyers (many of whose countries maintain significant market access barriers to foreign lumber), in many cases are able to outbid U.S. mill owners for logs.

For example, one major U.S. company was recently able to open a closed sawmill in Oregon and divert logs that would otherwise have been exported to domestic production because of improved market conditions. This type of domestic production is discouraged to some extent by the Canadian timber subsidies.

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Divider Title: D

THE RELIEF: THE MOU AND CONTINUATION OF THE CANADIAN SUBSIDIES

- In 1986, the U.S. industry brought a countervailing duty case against subsidized Canadian lumber and won a preliminary determination from the Department of Commerce that Canadian lumber production benefitted from a 15% subsidy. At Canada's behest, the U.S. Government agreed to a negotiated compromise and entered into the Memorandum of Understanding ("MOU").

- The MOU partially offset the Canadian lumber subsidies. It did not, however, create a competitive timber pricing system in Canada. Instead, Canadian lumber was subjected to an export tax in lieu of stumpage fee increases. Alternatively, stumpage fees could be increased, but competition wasn't required.

- The Department of Commerce monitored Canadian compliance with the agreement throughout its duration. This monitoring was necessary in light of numerous apparent attempts to circumvent the duties by Canadian importers.

- At the time the MOU was unilaterally terminated, the Canadian government claimed that the MOU was unnecessary given increased timber fees in Canada, so-called "replacement measures" under the MOU. In fact:

    - Over one-third of Canadian lumber production was still subject to the MOU's export tax provisions.

    - Even in those provinces that had increased timber fees and eliminated the export tax, monitoring and consultations under the MOU were critical.

    - Even the Canadian Maritime Provinces agreed that the MOU was still needed.

- British Columbia, the largest lumber producing province, did completely replace the lumber export tax with higher timber fees. Even in British Columbia, however, a competitive system of stumpage was not put in place, and **timber still sold for a fraction of its value.**

THE MEMORANDUM OF UNDERSTANDING

The Coalition for Fair Lumber Imports submitted a countervailing duty petition to the Department of Commerce on May 19, 1986. That petition alleged that Canadian stumpage systems conferred countervailable subsidies on the Canadian industry and provided new information with respect to key issues of subsidy methodology. After a preliminary finding of injury,[1/] the Department of Commerce issued a preliminary affirmative ruling in October of 1986.[2/] The Department preliminarily determined that Canadian lumber benefitted from a 15% subsidy and imposed a preliminary countervailing duty of 15% to offset the subsidy.

At Canada's request, a Memorandum of Understanding (MOU) was negotiated to settle that dispute. The MOU required the Canadian provinces to collect an export tax of 15% or to implement replacement measures (i.e., increase in timber fees and obligations) equivalent to 15%. Furthermore, it established a comprehensive monitoring program of Canadian timber subsidy activities by the Department of Commerce.

The MOU was not a complete solution to the problem of subsidized Canadian lumber. Whereas the domestic industry had calculated over a 30% rate of subsidization, the MOU imposed only a partial offset of 15%. More importantly, Canadian timber was still being sold non-competitively and these sales distorted the entire North American timber market. As the value of timber has

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1/ Softwood Lumber from Canada, 51 Fed. Reg. 25,752 (1986)(preliminary affirmative determination).

2/ Certain Softwood Lumber Products from Canada, 51 Fed. Reg. 37,453 (1986)(preliminary affirmative determination).

increased since 1986, the gap between the Canadian administered price and the market price again began to grow. Thus the replacement measures adopted by British Columbia (and to a lesser extent by Quebec) did not fully close subsidy gap and enormous subsidies remained.

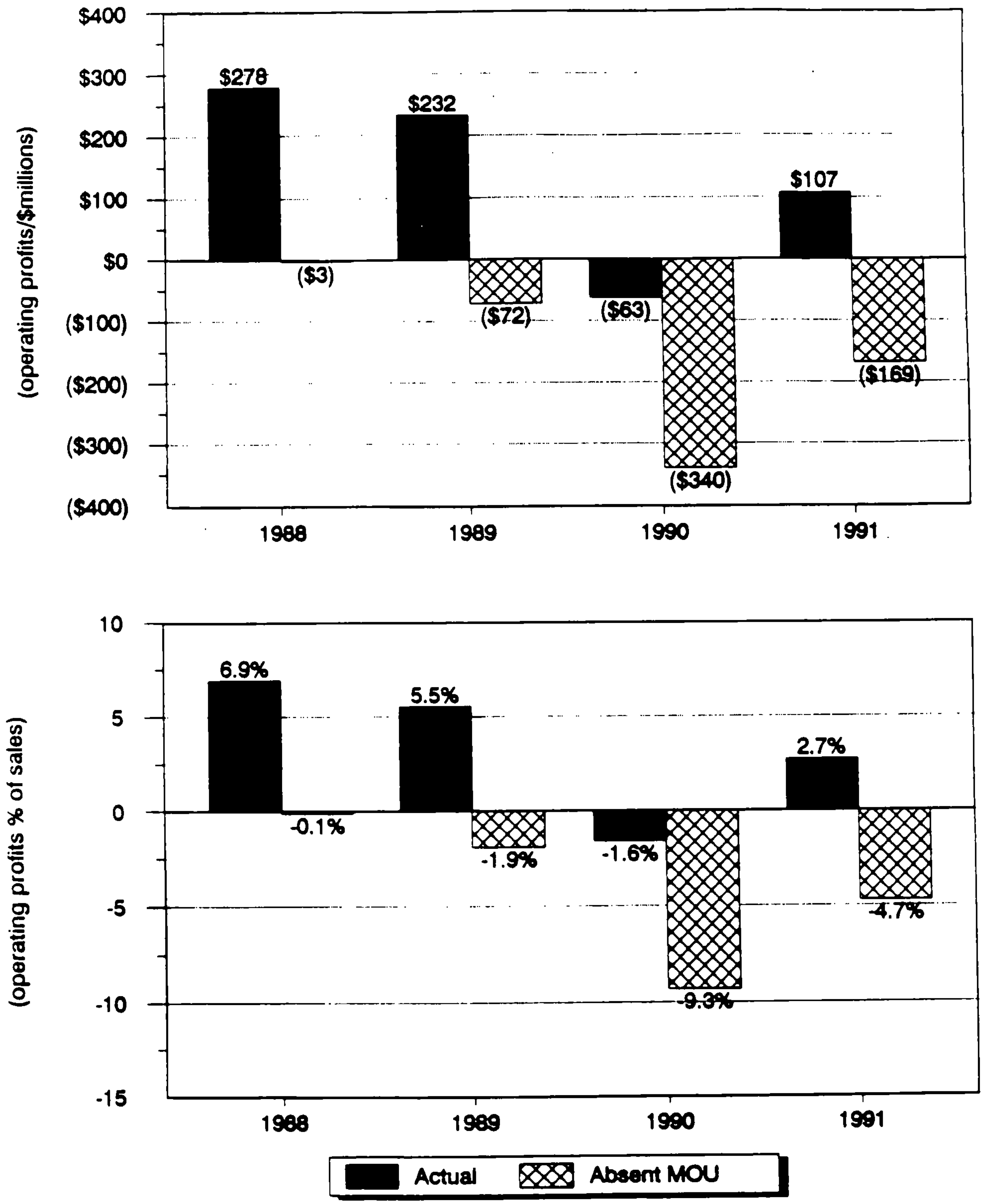
Contrary to Canadian claims, the MOU was necessary even after replacement measures had been implemented. One-third of Canadian lumber production still was subject to export taxes; the elimination of the taxes immediately benefitted such lumber production.

Furthermore, experience under the MOU demonstrated that the monitoring provisions of the MOU remained necessary. There was considerable evidence that importers attempted to circumvent the export tax, particularly by misclassifying lumber into tariff categories not subject to the duty. Imports in some of these categories jumped over 100% after the MOU was imposed. At the same time, the Department of Commerce, in monitoring the MOU, often consulted with Canada on "minor" regulatory changes made by the provinces that could have the effect of eroding the MOU's effect.

Under the MOU, import penetration of Canadian lumber fell from 33% to about 28% before stabilizing. Thus, while the MOU did not fully offset Canadian lumber subsidies, it prevented further sharp increases in import penetration and went far toward mitigating the injury suffered by the U.S. industry as a result of imports of subsidized Canadian lumber. <u>See</u> Figure 6.

FIGURE 6

Absent the MOU, U.S. Lumber Profitability Would Have Been Lower



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Divider Title: **E**

THE 1991/92 INVESTIGATION

- In October 1991, Canada unilaterally terminated the negotiated settlement it had requested -- the MOU. At that time, over one-third of Canadian lumber production was subject to the MOU export tax, and 100% was subject to monitoring to ensure compliance with the MOU -- which had been a serious problem since 1986.

- Despite the fact that the Administration had repeatedly committed itself to imposing Section 301 sanctions if Canada ever withdrew from the MOU, the Department of Commerce instead self-initiated a countervailing duty investigation to assess the extent of Canadian subsidies in the absence of the MOU. The U.S. lumber industry demonstrated that the Canadian lumber industry continues to benefit from enormous subsidies and that subsidized lumber imports materially injure the industry.

- In March 1992, the Department of Commerce preliminarily found that Canadian lumber producers benefit from a subsidy of 14.5%.

- Subsequently, the Commerce Department more than halved its subsidy determination and found only a 6.5% subsidy rate.

- The Canadian Government and industry waged an intense lobbying campaign, employing, among others, Canadian Prime Minister Mulroney, former U.S. government officials lobbying on behalf of the Canadian Government, 15 law firms, several PR firms, and well-connected Washington lobbyists. The goal of this campaign was to get the case dismissed based on "foreign policy" considerations in disregard of the law.

1991 CANADIAN LUMBER SUBSIDIES INVESTIGATION

The countervailing duty case now being appealed to a binational panel established under the U.S.-Canada Free Trade Agreement arose out of the Canadian Government's unilateral termination of the MOU in October 1991. The Department's self-initiation of the case resulted in a preliminary duty of 14.5%, which was reduced at the final determination to 6.5% in the face of inaccurate data submitted to the Department of Commerce by the Canadian industry and after an intense Canadian lobbying effort.

Termination of the MOU

Termination of the MOU left the U.S. industry vulnerable to increased imports of subsidized Canadian lumber. Over one-third of Canadian lumber production was still subject to the subsidy offset provisions of the MOU. In addition, monitoring of Canadian compliance was halted despite years of minor violations of the MOU and grudging Canadian compliance with this treaty.

Without the subsidy offset of the MOU or U.S. countervailing duties, Canadian market share could once again reach its pre-1986 levels and cost the U.S. industry over $600 million in sales. This could result in the loss of over **15,000** U.S. production jobs.

The administration had repeatedly promised that Canadian violation or termination of the MOU would result in imposition of Section 301 duties against imports of subsidized Canadian lumber to protect the U.S. industry. Instead, the U.S. Trade Representative imposed provisional duties and the Department of Commerce began a long and arduous countervailing duty investigation.

The Subsidy Determination

The Department of Commerce made a preliminary determination that Canadian lumber benefitted from a 14.5% rate of subsidization.[1/] The rate of subsidy preliminarily determined by the Department of Commerce was halved by the final determination and a subsidy of only 6.5% was found. The reduction was based upon faulty analysis and data provided by the Canadian industry and, perhaps, an excess of caution by the Department. Canada immediately appealed the final Commerce determination to a binational panel under the U.S.-Canada Free Trade Agreement.

The Department's principle subsidy methodology was firmly grounded in U.S. law and Department practice. On certain calculation issues, however, the Department took a number of positions that significantly decreased the countervailing duty rate and were not based on evidence on the record. For example, notwithstanding both voluminous evidence from the Canadian governments themselves that sawtimber and pulpwood are different goods (pulpwood is of inferior quality that is chipped to make pulp) and Department precedent, the Department determined that they were identical goods. The effect of this single determination was to lower the countervailing duty rate by almost one and a half percentage points. Now the Department admits that it significantly underestimated the subsidy.

1/ This 14.5% subsidy was found in addition to the 15% subsidy offset being collected under the MOU. Thus, the actual rate of subsidization was almost identical to the 30% subsidy alleged by the U.S. industry in 1986.

In addition, notwithstanding economic studies performed by leading forestry economists outside the context of this case, admissions by Canadian governments in the case that log hauls of 200-300 miles were not uncommon and strong economic evidence from the Coalition that the log export restrictions affected prices even beyond the actual log haul distances, the Department determined that the effect of the log export restrictions on Canadian log prices was only felt in forest regions within 100 miles of the U.S. border.

The Injury Determination

The International Trade Commission determined on a 4-2 vote in June 1992 that imports of subsidized Canadian softwood lumber cause material injury to the U.S. domestic industry. This decision correctly noted that the U.S. industry was injured, and that subsidized Canadian imports were a significant cause of that injury. Canada also appealed this determination to an FTA panel.

Canadian Political Campaign

Canada spared no expense in attempting to subvert the U.S. legal process. Prime Minister Brian Mulroney asked President Bush to intervene personally, which would have violated the law, while former Secretary of State Baker and National Security Advisor Brent Scowcroft were also personally lobbied by senior Canadian government officials. It is likely that President Clinton will also be asked to intervene to protect Canadian lumber subsidies. The purpose of this lobbying campaign was to persuade the administration to terminate the investigation on foreign policy grounds.

In addition, Canada spent tens of millions of dollars on 20 law and PR firms and former U.S. and Canadian government officials in its efforts to protect its timber subsidies.

This effort to protect Canadian lumber subsidies must not succeed.

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Divider Title: **F**

COMMERCE'S ACTION WAS GATT-CONSISTENT

- The preliminary report by a GATT dispute settlement panel convened at Canada's request rejected Canadian arguments that the U.S. Government did not have any basis for self-initiating a countervailing duty case against Canadian natural resource subsidies.

- More importantly, the GATT panel report contained analysis supporting the U.S. Government on four major points.

  - The GATT panel found that natural resource subsidies may be subject to countervailing duties.

  - Under the reasoning of the panel, export restrictions which have the effect of subsidies can be subject to countervailing duties since they are not exempted from the list of possible subsidies in the GATT.

  - While not directly ruling on the issue, the GATT panel noted that substantial evidence supported the rejection of Canada's application of economic rent theory to forestry.

  - The GATT panel explicitly found the comparison of noncompetitive timber prices charged by the provinces to major lumber companies to prices charged to other buyers under different programs to be valid. Thus the Panel rejected Canada's arguments that the only measure of natural resource subsidies is the cost to the government of providing the good.

- The GATT panel report effectively refutes Canada's repeated and baseless insistence that the U.S. Government unjustly countervailed Canadian lumber subsidies. In fact, the United States has acted consistent with its international obligations to offset injurious subsidies after Canada unilaterally withdrew from a settlement.

THE GATT PANEL REPORT SUPPORTS THE U.S. POSITION

Canada appealed the U.S. Department of Commerce's decision to self-initiate a countervailing duty case against Canadian subsidies to a dispute resolution panel established under the auspices of the General Agreement on Tariffs and Trade (GATT). The preliminary report rendered by the GATT Panel fully supports the actions of the U.S. Government with respect to self-initiation, and, further, its analysis supports Commerce's actual subsidy determinations on stumpage and log export restriction subsidies.

The report provides a detailed analysis by leading subsidy experts of the potential countervailability of natural resource subsidies, including a discussion of specificity, and the alleged relevance of economic rent and preferentiality. Indeed, the legal learning of the GATT panel is extremely probative on the issue of the countervailability of export restrictions as well.

During the course of the Commerce panel proceedings, the Department of Commerce submitted the GATT panel report to the binational panel, stating that

> to the extent that Canadian Complainants have argued that U.S. law must be interpreted consistently with the GATT and that the actions of Commerce in the instant investigation allegedly violated various GATT provisions, the attached ruling shows that such arguments are without merit. Accordingly, the GATT panel ruling and the reasoning reflected therein, while not binding on this Panel, are worthy of this Panel's attention.[1/]

The GATT panel report is relevant in the following four respects.

1/ Letter from Mr. William D. Hunter, United States Department of Commerce, to The Honorable James R. Holbein, U.S. Secretary, Binational Secretariat at 1 (January 29, 1993).

Countervailability of Stumpage Subsidies

The GATT panel establishes that natural resource pricing can provide a countervailable subsidy. First, the panel explicitly approved initiation against Canadian stumpage subsidies. Second, the opinion notes that where the drafters of the GATT wanted to expressly preclude certain actions or practices from the definition of a subsidy, they knew how to do so; no such preclusion exists with respect to natural resource subsidies.

Countervailability of Log Export Restrictions

While the GATT panel declined Canada's invitation to rule on the potential countervailability of log export restrictions directly, the discussion of the countervailability of natural resource pricing is fully relevant to the export restriction issue. Canada argued to the GATT panel that natural resource pricing could not, as a matter of law, result in a countervailable subsidy. The basis for this argument was much the same as Canada's argument before the binational panel that export restrictions cannot, as a matter of law, result in a countervailable subsidy. The GATT panel's conclusion in this regard is worth quoting at length:

> [N]either Article VI of the General Agreement nor the Agreement [Subsidies Code] provided a general definition of the term "subsidy". The closest the agreements came to defining the term was in Article VI:3 of the General Agreement, and in a virtually identical provision in Article 1, footnote 4 of the Agreement. Article VI:3 of the General Agreement provided in relevant part:
>
> > "The term 'countervailing duty' shall be understood to mean a special duty levied for the pur-

> pose of offsetting any bounty or subsidy bestowed, directly or indirectly, upon the manufacture, production or export of any merchandise."
>
> 39. The Panel noted that where the drafters of the General Agreement and the Agreement had intended to exclude certain government measures from the coverage of the term "subsidy", they had explicitly provided for such exclusion, e.g. tax exemptions or rebates pursuant [to] Article VI:4 of the General Agreement. No such explicit exclusion could be said to be contained in either agreement with respect to natural resource pricing practices.

GATT Panel Report at ¶¶ 38-39. The GATT panel could have been writing about export restriction subsidies.

Economic Rent

In addressing the Canadian Parties' economic rent arguments (that no additional timber was harvested in Canada as a result of below-market timber rates because principles of economic rent allegedly apply to forestry), the GATT panel observed:

> that there were also a number of studies suggesting, contrary to the argument of Canada, that stumpage fees did in fact affect prices and output of lumber. In the Panel's view, whereas the setting of the price for access to the natural resource in and of itself might relate only to the revenue collection function of government and might not constitute a benefit in connection with the harvesting or extraction of that resource, if the conditions of access were such that stumpage was available only to a specific group of enterprises, then the stumpage program could potentially be considered a benefit in connection with the right of access to harvest the resource.

GATT Panel Report at ¶ 45. While the panel did not rule dispositively on the issue, the clear import is that Commerce had substantial evidence to reject Canada's tortured economic argument. In fact, Canadian timber subsidies have a major impact on U.S. producers.

Preferentiality Benchmarks -- Competitive Prices

In responding to Canada's argument that competitive prices or prices from other jurisdictions could not be used as a benchmark for determining the degree of subsidy provided in the government pricing of natural resources, the GATT panel found:

> that in determining whether or not a subsidy existed it was not necessarily unreasonable for the Department of Commerce to attempt to make stumpage price comparisons as a measure of "preferentiality." In the view of the Panel, preferential pricing could be one of several elements relevant to examining the question of subsidy.

GATT Panel Report at ¶ 52.

Conclusion

The preliminary GATT panel report refutes Canadian complaints that the U.S. Government acted unfairly or against international law. To the contrary, the actions of the U.S. Government in offsetting injurious Canadian subsidies were fully consistent with the GATT and U.S. law. U.S. lumber producers are entitled to a full offset against what the GATT jurists recognize are countervailable.

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Divider Title: **G**

CANADIAN LUMBER SUBSIDIES BINATIONAL REVIEW

- Canada has appealed both the subsidy and the injury determinations to binational panels under the FTA in the hope of having the decisions reversed.

- Binational panels are to decide whether U.S. agency determinations are consistent with U.S. law. In particular, a determination should be reversed or remanded only if it is "not based on substantial evidence, or is otherwise not in accordance with law." The decisions are to be upheld if reasonable and not "precluded" by the statute.

- The determinations of Commerce and the ITC both easily meet that standard.

  - Commerce's determinations were based on longstanding Department methodology and generally supported by substantial evidence developed in the investigation.

  - Consistent with U.S. law and the evidence, the subsidy rate could only be increased. Commerce admitted that it incorrectly undercalculated the subsidy rate. The Coalition has demonstrated other errors which, if corrected, will further increase the subsidy rate.

  - This is the third time the ITC has found that Canadian lumber subsidies injure U.S. industry. Like Commerce, the Commission devoted large resources to the case and supported its determinations with close reasoning and factual evidence.

- Unfortunately, there have been instances where these review panels seem to function as arbitration panels rather than as if they were U.S. courts. As a result, the standard of review often is much higher, and the likelihood of an improper remand or reversal by the panel of U.S. agency decisions much higher.

- This is an extremely important test case. If the panel exceeds its mandate, it will call into question the viability of the entire dispute settlement process in this and similar trade agreements with Canada and other nations.

THE UNITED STATES SHOULD WIN AT THE FTA

Canada has appealed both the subsidy and the injury determinations to FTA binational panels in the hope of having the decisions reversed. Under the applicable legal standard, however, the FTA panels should uphold the decisions of both agencies, and should considerably increase the subsidy rate found by Commerce. Commerce has requested an opportunity to correct several errors in the final subsidy calculation that had decreased the actual subsidy rate; these errors alone are significant. In addition, Commerce made other errors that decreased the subsidy rate which the panel should remand to Commerce for reconsideration.

Jurisdiction

Binational panels have no jurisdiction to hear the softwood lumber appeal. Generally, appeals of countervailing duty cases involving Canada must be handled by binational panels. Article 2009 of the Free Trade Agreement, however, <u>explicitly</u> exempts disputes "arising out of the MOU" from panel review. This dispute arose out of the termination of the MOU. Key Members of Congress clearly understood that this type of case would not end up before a panel.

Notwithstanding the clear intent of Article 2009, the U.S. Government acceded to Canadian demands that this case, which the U.S. lumber industry has fairly won, be subjected to review by binational panels. As a result, both the Commerce and ITC panels incorrectly found jurisdiction over the lumber decisions.

Standard of Review

Binational panels are to determine whether administrative countervailing duty and antidumping determinations are consistent with U.S. law. In particular, the applicable standard of review is the same as that for the Court of International Trade: an agency determination should be reversed or remanded only if it is "not based on substantial evidence, or is otherwise not in accordance with law." The determinations of Commerce and the ITC both easily meet that standard. As the Federal Circuit recently explained the proper standard of review,

> [T]the courts must defer to an agency's interpretation of the statute an agency has been charge with administering provided its interpretation is a reasonable one. . . . "When faced with a problem of statutory construction, this Court shows great deference to the interpretation . . . by the officers or agency charged with its administration."[4/]

Commerce's determinations were based on longstanding Department methodology and generally supported by substantial evidence developed in the investigation. The thorough deliberations of Commerce, in particularly on the over-arching methodological issues, and Commerce's conservative subsidy calculations should make it difficult for a panel to find fault with the Department's determination.

In fact, consistent with U.S. law and the evidence, the subsidy rate could only be increased. Commerce requested that the subsidies panel remand several key decisions so that Commerce

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4/ PPG Industries, Inc. v. United States, 928 F.2d 1568, 1571 (Fed. Cir. 1991), quoting Udall v Tallman, 380 U.S. 1, 16 (1965).

could properly calculate the subsidy rate. On four key issues Commerce admitted it ignored record evidence submitted by the Coalition or did not adequately explain the basis for its decision. In addition, the Coalition demonstrated other errors by Commerce which, if corrected by the Panel, would significantly increase the rate.

The International Trade Commission's decision also rests on firm foundations. This is the fourth time the ITC has found that Canadian lumber subsidies injure the U.S. industry. Like Commerce, the Commission devoted substantial resources to the case and supported its determinations with close reasoning and factual evidence.

Unfortunately, there have been instances where these review panels seem to function as arbitration panels rather than as if they were U.S. courts. A dissenting panelist recently lamented that one panel decision

> severely distorts both United States countervailing duty law and the proper role of binational panels under the United States- Canada Free Trade Agreement.[5/]

In another recent panel case involving pork, two ITC commissioners lambasted the panelists for forcing them to overrule the finding in favor of the domestic industry on shaky grounds.

Thus, the standard of review often is much higher, and the likelihood of an improper remand or reversal by the panel of U.S. agency decisions much higher, for FTA panels than for U.S. courts which the FTA is supposed to follow.

5/ Live Swine from Canada (M. Belman, dissenting).

This is an extremely important test case. On the merits, the U.S. Government has a strong case. If the panel exceeds its mandate by remanding or reversing the agency on uncertain grounds, it will call into question the viability of the entire dispute settlement process in this and similar trade agreements with Canada and other nations. In particular, given the May 6, 1993 due date of the panel opinion in the subsidy case, it is likely that the NAFTA dispute resolution provisions will be scrutinized in light of the lumber case.