

SOFTWOOD LUMBER – THE NEXT PHASE

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Long and Problematic History

The Canada-U.S. softwood lumber dispute is now in its 20th year. It is the most significant bilateral trade issue between the two countries, eluding permanent solution over all this time. The dispute originated with the first countervailing duty petition by U.S. producers in 1982 (Lumber I). The result was a finding by the Commerce Department that Canadian stumpage programs did not amount to countervailable subsidies.

Taking advantage of some changes in U.S. laws, American producers filed a second countervail petition in 1986 (Lumber II). This time, Commerce found that stumpage programs were indeed countervailable. Before the case went to the final phase, an MOU was concluded between the two governments. In return for termination of the proceedings, Canada agreed to apply a 15% export tax on all softwood exports to the United States.

Canada exercised its right to terminate of the MOU in 1991, as provincial stumpage rates increased and replaced the effect of the 15% export tax. Under pressure from American interest groups, the U.S. government began third investigation (Lumber III). Canada appealed affirmative U.S. subsidy decisions to a NAFTA panel which upheld the Canadian position by a majority vote but split 3 to 2 along national lines. The U.S. side was outraged and threatened further action.

In an attempt to achieve some measure of stability and resolve this major bilateral problem, the two governments concluded a five-year softwood agreement in 1996, capping Canadian duty free exports at approximately 15 billion board feet annually. That agreement expired in 2001. It resulted in a new petition by U.S. producers, alleging subsidies and dumping, and led to the present Commerce Department investigation (Lumber IV). In this latest case, Commerce has preliminarily determined that Canadian softwood is both dumped and subsidized, applying significant duties to Canadian imports.

Choosing the Best Legal and Policy Options

Commerce's decision on October 31st to apply its 13% anti-dumping duty (on top of an earlier countervailing duty for alleged subsidies) was an economic blow to the Canadian industry. The impact was immediate and revealed the extent of Canada's exposure to the trade remedy system south of the border and the limitations of the NAFTA dispute settlement provisions in reducing that exposure. Beyond this, it illustrates the value to U.S. producers in using trade laws as a strategic business weapon.

The case underscores the critical dilemma facing the Canadian industry, that is, whether to fight the case through various legal avenues or attempt some pragmatic settlement with the U.S. side. These same dilemmas existed in Lumber I, II and III. In this latest incarnation, in Lumber IV, pursuing the long-term legal route was initially seen as a proper strategy and one that most of the industry seemed to agree with initially. However, the long-term option cannot alleviate the immediate harm to the Canadian forestry industry and to its workers and the Canadian economy at large resulting from these contingent duties.

The economic repercussions of significant duty liability and the prospect that these may become permanent in March 2000 is thus putting pressure on the industry and on both levels of government in Canada to devise some kind of agreed solution. Such a solution inevitably means a combination of managed trade and a revision of Canadian timber management practices toward some kind of market-based system. While changes along these lines may be overdue, adjusting long-seated measures in the context of a bitter and highly-charged bilateral dispute is not the most optimum way of making policy.

A Negotiated Solution

Notwithstanding the difficulties, sensible efforts are underway to explore the modalities of a negotiated solution through high-level talks. Reports on their continuing progress vacillate between guarded optimism and downright pessimism. As recently as November 19th reports have emerged about plans by the B.C. government to radically change the provincial stumpage system. However, even these changes are suggested as inadequate to appease an aggressive and possibly implacable U.S. industry.

In the increasingly remote chance that it might work, such a negotiated solution could result in what is called a suspension agreement, allowing the case to be effectively halted. That is what happened in 1986 and again in 1996 when Canada agreed to a managed system of export taxes and quota limitations. The problem with a suspension agreement is that the clock is ticking and there is a deadline looming for its conclusion. That means that all the complex details would have to be sorted out within a window of about 90 days, making it a difficult practical problem. Trade law is not like civil litigation where settlements are possible at the foot of the courthouse steps. Resolution of trade disputes is trickier and has to be shoehorned into the precise requirements of the WTO Agreement and the time limits set out in national legislation.

Judging from comments by the U.S. softwood industry's representatives, any settlement would not only have to radically alter Canadian forest management practices and laws, but would also have to abandon the stumpage system in its entirety to bring the system in line with American ideas of a market-based auction system. That means a wholesale alteration of Canada's Crown-owned timber regime and the manner in which economic rents (stumpage fees) are set and collected.

Pending the results of ongoing talks between Pierre Pettigrew and special envoy Mark Racicot of the U.S. side, there are other fronts where the battle can be joined. While none can offer immediate relief and none are guaranteed to be ultimately successful, these may help to give Canada some additional negotiating leverage in terms of securing a successful a political settlement.

Policy Considerations versus Daily Pressures

As this note makes clear, while earlier indications were that the various players in the Canadian industry were solid in fighting the case to the very end in the hopes of a definitive legal victory, this solidarity may be waning in the face of the seriously negative impact of the anti-dumping and countervailing duties applied by the U.S. government. This makes it difficult for the Federal Government to define the right policy and to stick with that policy to the end. While the obvious long-term approach once seemed to be to take the case to the very limits of legal processes, the economic fallout, especially in B.C., combined with the apparent willingness of the U.S. government (as opposed to the U.S. industry) to attempt a deal, makes some kind of negotiated outcome an appealing prospect.

The problem here is three-fold. First, assuming some agreement is reached with the U.S. Executive, how can any such deal appease the various segments of the U.S. industry and

their lobbyists who want an both end to Canadian stumpage programs and some permanent commercial advantage over a competitive Canadian industry? Secondly, how can any negotiated outcome respect the free-trade principles and market access rights enshrined in the NAFTA? In other words, will a deal not simply replace the previous fifteen years with a new regime of managed trade? And thirdly, to the extent that Canadian forest management measures are part of the deal (which they will almost certainly be) will Canadian provinces be prepared to live with it?

Canfor's Dramatic Announcement

There is a new twist in the dispute with Canfor Corp.'s announcement on November 5th that it is filing an arbitration claim under the NAFTA investment provisions, seeking \$250 million in compensation from the U.S. government. There are several heads under Chapter 11 but the main one Canfor will likely use is the requirement in Article 1105 that obliges the U.S. government to accord "fair and equitable treatment" and "full protection and security" in accordance with international law to all Canadian investors and their investments in the United States.

This claim -- which has a long way to go before any decision is rendered by an independent arbitration panel -- is an important strategic development. It is the first use of Chapter 11 in this kind of trade dispute and therefore breaks new ground by seeking to have trade remedies adjudicated under Chapter 11 investment standards. Second, it gains negotiating leverage for Canfor and for entire Canadian softwood industry in the main dispute, taking back some of the initiative from the U.S. side.

On substantive grounds, the challenge is for Canfor to prove unfair or inequitable treatment of and discrimination against Canadian exports to such a degree that it amounts to a breach of the NAFTA by the U.S. government. This task is not an easy one. The U.S.

will argue that it is simply applying ordinary trade remedy laws as sanctioned by the WTO agreements.

On the other hand, if there is evidence that Commerce responded to political pressure and unfairly targeted Canadian softwood, it might just be possible to convince an arbitration panel that the U.S. has not given Canadian investments the kind of “fair and equitable treatment” that NAFTA and international law demands. If successful, Canfor could obtain compensation for all the anti-dumping and countervailing duties paid as well as lost profits resulting from the investigation.

Judicial Review under U.S. Law

The Canadian industry could also initiate a point-by-point challenge of both the methodology and the calculation of the preliminary margins and amounts of subsidy by the Commerce Department through additional submissions to U.S. authorities, setting the stage for application by way of judicial review to the U.S. Court of International Trade. While more is said about this below, WTO dispute panels have found U.S. dumping methodology to contravene the WTO Anti-Dumping Agreement, suggesting possible areas where the Canadian side might seek relief in U.S. courts.

A parallel option is to challenge the claim in the U.S. court system that Canadian imports have been a cause of material injury to the U.S. producers. Under WTO rules, dumping and subsidization in themselves are not illegal. It is only where these actions cause material injury that governments can apply anti-dumping or countervailing duties. In many instances, the proof of causation is a foregone conclusion. The standard is pretty low. Dumping or subsidization must merely be one of the causes of material injury and not the only cause. Nevertheless, the evidence must objectively establish this “causal

link” and Canadian exporters may have a number of arguments to fight causation under U.S. law.

While causation is established on a Canada-wide basis and is not required to be shown company-by-exporting-company, if it can be proven that softwood exports from individual Canadian sources has not contributed to that injury, it gives those exporters the possibility of seeking exclusions from the final target list. Again, this may not help Canadian producers in the short term. It shows, however, that the game is not yet over and that, even while attempts are being made to settle the dispute, there remain several battles on several fronts, including in U.S. domestic courts, that are open to the Canadian industry.

Fighting it out at the WTO

There have been major changes in the multilateral trading system since 1994 when the WTO Agreement came into effect. Under the former regime of the GATT (which was replaced by the WTO), applying anti-dumping and countervailing duties was the pretty much the preserve of governments and rarely interfered with by GATT panels. Things have changed. Instead of having to seek relief in domestic tribunals, national trade agency decisions are now regularly appealed directly to WTO dispute panels. The panels have been aggressive in examining these decisions to see if they comply with the detailed requirements of the WTO Agreement.

As well, there is now a fast-track timeline for dispute settlement at the WTO. While the U.S. can delay Canada’s first request for a panel, it cannot forestall a panel’s establishment beyond an initial 30-day period. Once convened, the panel must issue its decision within 6 months or, in exceptional cases, within 9 months. This is also of value to Canada.

Recent WTO Panel Decisions

Illustrative of these changes are a rather remarkable couple of cases, where WTO panels have scrutinized U.S. dumping decisions in great detail, concluding that the Commerce Department breached the requirements of the Anti-Dumping Agreement. While these cases focus on anti-dumping, similar reasoning applies to countervailing duties under the Subsidies and Countervailing Measures Agreement.

In *Stainless Steel Plate and Sheet from Korea*, 22 December 2000, a WTO panel found that the Commerce Department breached the Anti-Dumping Agreement and nullified and impaired benefits accruing to Korea, giving that country the right to retaliate. Similarly, although for different reasons, a subsequent WTO panel in *Hot-Rolled Steel Sheet from Japan*, 28 February 2001, found the Commerce Department's margin determinations breached the requirements of the same Agreement, giving Japan a right of retaliation.

The U.S. appealed *Hot-Rolled Steel Sheet* to the WTO Appellate Body, but the Appellate Body upheld the original panel's decision on several key points. What is of interest is what the Appellate Body said about the role of panels under the WTO Anti-Dumping Agreement. Article 17.6 of that Agreement allows WTO panels to determine whether the evaluation of facts by national agencies (i.e., the U.S. Commerce Department) was proper, unbiased and objective. The Appellate Body said that if these broad standards have not been met, a panel must hold the investigating authorities' establishment or evaluation of the facts to be inconsistent with the *Anti-Dumping Agreement*.

These steel products cases are different in their facts from the present softwood investigation. But judging from the above legally binding views of the role of WTO panels set out by of the Appellate Body, the U.S. Commerce Department -- and subsequently the ITC -- can be put to the test before the WTO. While each case has to be

fought on its merits, it is clear that Canada and the Canadian softwood industry have some important WTO options that were not previously available.

As was stated at the outset, these are not going to produce immediate results. However, in cases such as these it is important to pursue all available avenues and clearly the WTO route is a key part of any Canadian strategy.

Some Conclusions

There is no easy prescription to settle the softwood controversy. As noted, the ground seems to be continually shifting. One of the encouraging developments is the positive signs resulting from the November 6th Pettigrew-Racicot talks in Ottawa. Perhaps a deal is possible. But more recent indications are less optimistic, with word emanating from U.S. industry sources that it will take radical change to the entire Canadian forestry management system to get the U.S. side to settle.

In the meantime, there is little choice but for Ottawa, the provinces and the Canadian industry to pursue a parallel course and aggressively use all available legal means to have this entire investigation tested, both in U.S. domestic courts and at the WTO. Changes in the WTO dispute settlement system, however, give some newly-added leverage to Canada. Other options under the NAFTA have emerged in terms of the Canfor Chapter 11 arbitration claim. While any arbitration decision is a long distance off, if Canfor succeeds, even partially, it will have significant repercussions for the entire trade remedy process.

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Disclaimer Notice: This note is prepared purely as background information and is not intended to convey legal advice on any particular matter.

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