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TRADE LAW MEMORANDUM

THE SOFTWOOD LUMBER FILE

IMPORTANT DEVELOPMENTS

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The latest turn in the ongoing softwood saga is a critical ruling by a WTO dispute settlement panel, July 26, 2002, that seems to have found in Canada's favour on a number of seminal points.

The ruling is confidential and won't be released until early September. However, sources have provided some insights into the general thrust of the latest decision. The Canadian side says it is a victory. The U.S. side says such claims are exaggerated.

These are outlined below. Before doing so, it is timely to briefly review a bit of the complicated history of the softwood dispute.

Some Recent Background – The Softwood Lumber Agreement

The current incarnation of the dispute ("Softwood IV") began with Canada's termination of the bilateral Softwood Lumber Agreement ("SLA") on March 31, 2001. This immediately led to the filing of two petitions by the U.S. industry (grouped together as

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the Coalition for Fair Lumber Imports) in April 2001, alleging both dumping and unfair subsidization of Canadian exports.

The SLA had been in effect from April 1, 1996, to March 31, 2001. As an offset to provincial stumpage programs, it required Canada to impose an export tax of \$50.00 per 1,000 board feet on softwood exports in excess of 14.7 billion board feet annually. The 14.7 billion board feet level was effectively the Canadian duty-free import quota into the U.S. market.

The Commerce Department Investigation

With the filing of the petition by the U.S. Coalition, the U.S. Department of Commerce almost immediately began separate anti-dumping (“AD”) and countervailing duty (“CVD”) investigations into Canadian import pricing.

Following its investigation, the DOC issued a “preliminary” CVD determination on August 9, 2001, holding that provincial stumpage programs were subsidies under U.S. law and imposing a 19.31% provisional countervailing duty on all Canadian imports (plus additional anti-dumping duties averaging over 12%).

Canada immediately sought recourse at the WTO, leading to the establishment of the first of several dispute panels in December 2001 and, ultimately, to the interim ruling by that panel on July 26th.

The ruling covers the DOC preliminary subsidy determination only. The final subsidy determination was issued by the DOC on May 2, 2002, imposing lightly lower duties of 18.79 percent. That final determination is the subject of a second WTO dispute that will

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be adjudicated by another panel later this year. The July 26th interim ruling will have a decisive bearing on that second panel, since the issues are virtually the same.

At issue is close to \$10.0 billion dollars in Canadian lumber exports to the United States.

DOC Uses Wrong Approach in Cross-Border Benchmarks

From Canada's viewpoint, the most important part of the July 26th interim ruling is the conclusion that the DOC applied the wrong methodology in determining that stumpage programs conferred benefits on Canadian producers, a methodology that contravened the provisions of the *Subsidies and Countervailing Measures* ("SCM") Agreement.

The DOC had valued Canadian stumpage on the basis of "cross-border benchmarks", comparing the value conferred by provincial programs with the value of the resource in the U.S. under prevailing American market conditions. In other words, the DOC valued of Canada's stumpage programs by comparing those programs with private timber sales in the U.S. and not on such sales in Canada.

The panel said this was wrong and that the value of the benefit, if any, has to be based on Canadian conditions. Under the *SCM Agreement*, the amount of a benefit must be determined "in relation to the prevailing market conditions in the country under investigation". The disapproval of cross-border benchmarks is an important victory for Canada.

Pass-Through Benefits

An aspect of countervailing duty law is the notion of “pass through”, which measures the extent to which a subsidy to upstream producers is actually passed through to the downstream producers of the final product.

Since the benefits of a subsidy, in whole or in part, may not always be passed by the recipient down to the final producer of the goods, this analysis is essential. In the absence of a pass-through, the price of the final product would not reflect the value of the subsidy and its sale in a foreign market would not entail a less-than-free-market-price.

In the case of downstream softwood producers that acquired timber from the original producer and then exported the final product, the DOC simply assumed that the total value of the stumpage was passed through. The WTO disagreed and said that without such analysis, the DOC subsidy calculation could not stand.

Stumpage is the Provision of a “Good”

Canada lost an important argument in its claim that the DOC breached the *SCM Agreement* in classifying stumpage as a countervailable benefit. Canada had argued that stumpage was a right or license to harvest timber and not either a “good” or a “service” provided by a government, as required under the *SCM Agreement* before countervailing duties could be applied.

The panel disagreed. It decided that the provision of access to timber is a “good”, thereby bringing stumpage programs within the definition of a subsidy. However, because the DOC’s use of cross-border benchmarks was found to be contrary to the *Agreement*,

Canada's loss on the broader question of whether stumpage is a countervailable benefit may be partially or even substantially offset.

The key element in Canada's challenge of the DOC's final subsidy determination now will be the proper measurement of the stumpage benefit. If Canada can show that stumpage fees set by governments equate with Canadian private stumpage sales and therefore no actual benefit is provided, it will carry the day.

Should Canada succeed at the WTO in the final phase of the case, the DOC would have to alter its subsidy determination or, failing that, the U.S. would have to compensate Canada (and indirectly, the Canadian producers) for future trade losses suffered under these decisions.

NAFTA Chapter 19 Challenges

Separate from these WTO challenges, the Government of Canada, plus Canadian provinces, industry associations and companies, initiated Chapter 19 NAFTA panel reviews of the U.S. final subsidy and dumping determinations in April 2002.

While the WTO cases are based on the *SCM Agreement*, the NAFTA proceedings are based on allegations that the DOC erred in applying U.S. domestic law and made major errors of fact in reaching its decision, allowing for a "judicial" review by the panel.

Pleadings have yet to be submitted by the parties but it is expected that Canada's brief will be filed shortly. Oral hearings are scheduled for November 2002 and the NAFTA panel decision will be issued in mid-February, 2003.

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If Canada succeeds, it could obtain a remand order, possibly with instructions to the DOC as to how to determine the amount of subsidy and/or dumping margins. The review standard in these Chapter 19 cases, however, is very high.

Canfor Proceeds with Chapter 11 Investment Claim

Together with the Government of Canada's WTO and NAFTA cases, Canfor Corporation initiated binding arbitration against the U.S. government in November 2001 under the NAFTA investment provisions (Chapter 11). As permitted under Chapter 11, Canfor invoked the United Nations Commission on International Trade Law (UNCITRAL) Arbitration Rules.

Canfor's actual statement of claim was only filed on July 9, 2002. It alleges that the U.S. government violated NAFTA by failing to ensure that Canfor, as an "investor" in the U.S., was treated fairly and equitably and in accordance with national treatment. Canfor argues, *inter alia*, that the DOC's determination that Canadian stumpage programs are subsidies is both arbitrary and unreasonable and gives unfair advantages to Canfor's U.S. competitors in contravention of these Chapter 11 obligations.

If Canfor succeeds, it will be entitled to monetary compensation from the U.S. government for the injury it has suffered.

However, an unrelated case involving a claim against Canada and Canada Post under NAFTA Chapter 11 by UPS could have a bearing on Canfor's case. While the UPS case has not yet been decided, Canada, supported by the two other NAFTA governments, is arguing for a restrictive interpretation of the kind of claims that can be brought under these Chapter 11 provisions.

Some Concluding Comments

Each of these cases has a long way to go. The U.S. government will almost certainly appeal each WTO panel decision to the Appellate Body, adding a further 12-months to the time-period. Canfor's NAFTA case will take at least 18 months before an arbitration decision, possibly longer.

This means that the negotiation route between governments still offers the best prospect for any early resolution of this ongoing dispute. Trade Minister Pettigrew immediately called for such negotiations and a long-term settlement after the interim WTO ruling was issued. Some in Canada believe that the apparent win at the WTO will boost the prospect of such negotiations. Time will tell.

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LLH/gdm
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