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Softwood Lumber: Exact Significance of the Recent Canadian Victory before the WTO and Prospects in the Context of the Pending Second Lumber Case

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Recently, the WTO Panel in charge of the softwood lumber case brought by Canada against the United States ruled in favor of Canada. The "benefit conferred" criterion played a critical role in the ruling, which concluded that the United States used a flawed cross-border methodology to demonstrate the existence of such a benefit. However, the Canadian victory would have been more decisive if the WTO panel had found the absence of a governmental financial contribution. The cross-border methodology will be once again at the heart of the pending second lumber case before the WTO. This article evaluates the prospects for the case in this context.

Keywords: Canada, cross-border methodology, dispute, financial contribution, softwood lumber, stumpage, United States, WTO

Introduction

On September 27, 2002, the WTO Panel in charge of the Canadian softwood lumber case opposing Canada (as complainant) to the United States issued its final report.[1] Before examining the conclusions of this report, let us recall that the U.S. countervailing duties on Canadian softwood lumber were based on the allegedly below-market fees charged by some Canadian provinces for stumpage rights granted to Canadian softwood lumber producers on *public* lands. Stumpage is the right to cut standing timber.

Thus, the central question before the WTO Panel was whether the United States may, in light of its WTO international obligations, consider the allegedly low Canadian stumpage fees as a countervailable subsidy.

Before examining the conclusions of the WTO Panel, it is perhaps useful to present for those not familiar with this issue a brief history of the lumber dispute between Canada and the United States.

Brief History of the Lumber Dispute

For nearly 70 years, with a short interruption during the depression years of the 1930s, Canada's exports of softwood lumber went duty-free to the United States.

Lumber I

During the 1982 recession, some lumber companies in the United States such as Pacific Northwest were faced with serious financial difficulties when lumber prices collapsed.

On October 7, 1982, the Coalition for Fair Lumber Imports (CFLI), a group of U.S. lumber producers, filed a countervailing duty (CVD) petition against softwood lumber from Canada. The petition alleged that Canadian provincial and federal governments were subsidizing softwood lumber production by selling the right to cut timber on public lands at artificially low prices. The allegations were investigated by the U.S. Department of Commerce (DOC). The case was terminated on May 31, 1983, when the DOC determined that the stumpage programs conferred no subsidies because stumpage fees were not provided to a specific industry at preferential rates.[2]

Lumber II

On May 19, 1986, the CFLI filed a second CVD petition alleging new evidence and a change in U.S. law to support its claim that Canadian and provincial stumpage

fees subsidized lumber production. In October 1986, the DOC reversed its prior determination in Lumber I, issuing a preliminary decision that stumpage fees were sold at preferential rates and benefited a specific industry. The DOC calculated a preliminary CVD margin of 15 percent, *ad valorem.*[3]

The Memorandum of Understanding

To avoid the political costs of continuing the case while starting the free trade negotiations, Canada and the United States signed a Memorandum of Understanding (MOU) before the DOC issued its final determination in Lumber II. The MOU imposed a temporary 15 percent ad valorem tariff (15 percent on the sales value) on imports of Canadian softwood lumber, in exchange for a termination of the investigation. The GATT Panel which had been established for Lumber II at Canada's request[4] ended its proceedings immediately after this "mutually satisfactory" resolution of the dispute.

Lumber III

The lumber dispute resurfaced after the announcement by Canada, on September 3, 1991, of its intention to terminate the Memorandum of Understanding, as provided in Article 9 of the memorandum. Immediately afterward, on October 31, 1991, the U.S. Department of Commerce self-initiated a countervailing duty investigation on certain softwood lumber from Canada. Once again, Canada immediately requested the establishment of a GATT Panel, since in its view stumpage fees were not subsidies within the meaning of the Tokyo Round Subsidies Code. According to Canada, the countervailing duty investigation was inconsistent with Article 2.1 of this code, which required sufficient evidence of the existence of subsidy and injury before launching a countervailing duty investigation. The GATT Panel concluded that there was a "lack of any apparent legal bar to considering Canadian stumpage as potentially a countervailable subsidy."[5] Even if the dispute before the GATT Panel concerned the legitimacy of the countervailing duty investigation itself, and not a formal determination by the DOC that stumpage fees were countervailable subsidies, the Panel tipped the scales in the sense that it considered stumpage fees potentially countervailable subsidies.

Thus, in 1992, countervailing duties were imposed on Canadian lumber (Lumber III).[6] The Canadian Government, the provinces and the Canadian lumber industry immediately took the matter before two binational panels envisaged by Article 19 of the North American Free Trade Agreement (NAFTA).[7] It is important to underline

that the mandate of these NAFTA panels was only to confirm that the United States did not contravene its own national CVD legislation. In other words, in contrast to the GATT panels, the mandate of these NAFTA panels was *not* to examine the matter in light of U.S. international obligations. Canada won its case before these two NAFTA panels and even before a subsequent NAFTA Extraordinary Challenge Committee. The United States ended the imposition of countervailing duties in 1994 and refunded $800 million which had been collected.

This outcome raised a wave a protest in the United States. Some commentators even suggested that the binational panel process envisaged by NAFTA was unconstitutional. It is necessary to say however that the nationality of the binational panel members was apparently a determining factor, since the three Canadian members voted differently from the two American members.[8] The United States tried to protect itself against this kind of misfortune by modifying its countervailing duty legislation following the Uruguay Round.[9]

In order to avoid a new legal battle, Canada and the United States signed, on May 29, 1996, a new bilateral Softwood Lumber Agreement (SLA)[10] which placed export fees on Canadian log exports above 14.7 billion board feet. This new bilateral agreement expired on March 31, 2001.

Lumber IV

On April 2, 2001, immediately after the expiration of the bilateral agreement, the U.S. Coalition for Fair Lumber Imports filed a CVD complaint with U.S. authorities. It claimed a countervailing duty of 40 percent for alleged subsidization of Canadian sawmills because of low stumpage fees and log-export restraints.

Canada had taken the log export restraints issue to the WTO early in 2000. In June 2001, the WTO Panel looking at Canada's earlier request ruled that log-export restraints could not be considered subsidies.[11] As for the question of low stumpage fees, that is the issue dealt with in this article.

The Three WTO Criteria Defining a Subsidy and the Issue of the Pricing of Natural Resources: the Case of Softwood Lumber

According to WTO texts, a practice is a subsidy if it satisfies three criteria. First, it must be "specific". Second, it must entail a governmental "financial

contribution", and third, it must confer a "benefit" to its recipient. In order to successfully challenge the U.S. countervailing duties, Canada had to demonstrate that one or more of these criteria were not satisfied in the softwood lumber case.

With regard to specificity, a program is deemed specific if it is granted selectively, in law or in fact, to a group of enterprises. In other words, if it is available for all the sectors of the economy, it is not specific and therefore not a subsidy. In the softwood lumber case, the U.S. Department of Commerce determined that "there are only two industries, sawmills and pulp mills, that use provincial stumpage programs, [so] we preliminarily determine that the provincial stumpage programs are specific."[12] The "specificity" criterion does not seem to have been a real issue between the two parties. In response to a question from the Panel, Canada stated that it was not pursuing a claim pertaining to specificity in this dispute.[13]

Regarding the governmental "financial contribution" criterion, common sense would perceive such a contribution to be a sum of money granted by a government to an industry. This common-sense perception is misleading in the context of the WTO Agreement on Subsidies and Countervailing Measures (SCM Agreement). This agreement specifies clearly that a governmental financial contribution exists not only when it provides outright financial assistance, but also in the case where "a government provides goods or services other than general infrastructure."[14] Although this provision is clear and seems to apply to stumpage rights, Canada has always hoped that the pricing of natural resources by a government was not covered by such a provision. In past lumber disputes, Canada frequently invoked arguments inspired by the idea that

> natural resource pricing is a sovereign function such that natural resource subsidies should be exempt from countervailing duties. For example ... a nation which owns its national forests may dispose of them as it sees fit; [and] that nation should not be penalized by another nation regardless of how it sells and prices its resources.[15]

In the same vein, and supposedly as a confirmation of the idea referred to above, Canada invoked in the recent lumber dispute a working paper from the time of the Uruguay Round negotiations which explicitly mentioned *harvesting rights* separately from goods or services.[16] The WTO Panel rejected the Canadian argument that the rights to exploit *in situ* natural resources are not covered by Article. 1.1(a)(iii) quoted above, which refers to "goods and services other than general infrastructure." According to the Panel, Canada was not able to point to any provision in the SCM Agreement that supports this view. In fact, in the Panel's view, the working paper

Canada invoked has little if any probative value, especially in light of the fact that the reference to "harvesting rights" as separate from "goods" was not included in the final text of the SCM Agreement.

Canada's remaining line of defense thus had to be in connection with the "benefit" criterion. According to past rulings of WTO panels, a benefit exists when the governmental financial contribution "makes the recipient 'better off' than it would otherwise have been, absent that contribution. In our view, the marketplace provides an appropriate basis for comparison in determining whether a 'benefit' has been 'conferred' …."[17] This definition is sufficient in simple cases where the free "market" to which it implicitly refers is easily identifiable. For example, if a Canadian firm receives a government loan at an interest rate that is lower than the rate charged by Canadian private banks, a benefit will have been conferred upon the recipient firm according to this definition. However, the definition becomes less certain when the free market to which it implicitly refers as a benchmark for comparison is not easily identifiable. For example, are the stumpage rights charged on Canadian *private* lands the result of a free market? It is in this context that the U.S. Department of Commerce took a risk by determining that "[s]ince stumpage fees on [Canadian] public lands are the price driver for the stumpage market in those Provinces, we conclude that the stumpage fees on [Canadian] private lands are largely derivative of the [Canadian] public land prices and are therefore distorted."[18] The DOC then inferred that it could not use as a benchmark stumpage fees on Canadian private lands, as the Canadian provincial governments would have preferred. In other words, the Department of Commerce decided that stumpage fees on Canadian private lands could not be regarded as a valid indication of free market forces in Canada and thus were not a valid benchmark. Instead, the DOC decided to use as a benchmark the prices prevailing on U.S. private lands near the Canadian border. According to the DOC, these prices constitute an adequate benchmark since "it is reasonable to conclude that U.S. stumpage would be available to softwood lumber producers in Canada at the same prices available to U.S. lumber producers."[19] After comparing U.S. private stumpage fees to stumpage fees on public lands in Canada, the DOC had no trouble finding that a benefit was conferred to Canadian softwood lumber producers.

It was obvious from the start that the method the DOC used in finding a "benefit" was its Achilles heel. The WTO Panel adopted this view and agreed with Canada that the Department of Commerce violated WTO subsidy rules by using cross-border comparisons. The WTO Panel underlined that Article 14(d) of the Uruguay Round Subsidies Agreement which deals with governmental provision of goods or services

requires that price comparisons "shall be determined in relation to the prevailing market conditions ... *in the country of provision or purchase.*" The United States tried to convince the Panel that the existence of a benefit must be determined "*in relation to* the prevailing market conditions in the country under investigation" and not necessarily "*in* the country under investigation".[20] In other words, the United States argued that the "market" benchmark may refer to the entire market available to the subsidized producers. The Panel rejected this view and found no basis in the text of the WTO Agreement on Subsidies and Countervailing Measures to conclude that the market conditions in Canada could mean anything other than the conditions in Canada, and not those prevailing in some other country such as the United States. More specifically, the Panel underlined its view that

> to adopt the U.S. approach that the market refers to the entire market available to the allegedly subsidized producers, would effectively *read out* of the SCM Agreement the explicit reference to the country of provision as the country the prevailing market conditions of which have to be used as a benchmark.[21]

Canada therefore prevailed, on the basis that the Department of Commerce did not adequately demonstrate the existence of a benefit.

The Allergy of WTO Panels to the "Distorted Price" Approach and Prospects in the Context of the Pending Second Lumber Case

There is no doubt that this ruling constitutes a partial victory for Canada. The legal advisers to the U.S. lumber industry claimed until the last minute that they were certain that Canada would fail. However, it must be underlined that the Canadian victory rests only on the fact that the *methodology* used by the Department of Commerce for finding a benefit was flawed. The victory would have been decisive if the WTO Panel had found the absence of a governmental financial contribution.

Thus, in the context of a possible new petition by the U.S. lumber industry, the present ruling leaves the door open for the United States to use another formula to find that a benefit is conferred by the Canadian stumpage programs. In such a case, all Canada will have gained is a possibly lower amount of this benefit. Moreover, although the United States signaled on November 1, 2002, that it would not appeal the present ruling relating to the *preliminary* determinations by the U.S. Department of Commerce, it is confident that the cross-border methodology will be vindicated in the pending WTO lumber case relating to the *final* determinations of the U.S. Department

of Commerce.[22] In other words, the United States hopes that the present findings relating to the cross-border methodology will be reversed or "overruled" in the pending case. Its principal argument will be that the present Panel's conclusion would allow Canada to subsidize its lumber industry with impunity. In other words, the United States will argue that a government distorting and controlling almost entirely a domestic market via its subsidies cannot benefit from its wrongdoing and then claim that its "distorted" domestic (private) prices must be used as a benchmark.

However, this strategy (or, for that matter, the use of a new methodology in possible future petitions by the U.S. lumber industry) would be difficult. One way or another, this strategy would once again be based on the rejection of using fees charged for stumpage rights on private Canadian lands as a benchmark. The stated reason would again be that the level of these fees is "distorted". It seems, however, that past WTO rulings indicate an allergy to such a "distortion" approach, since panel members do not find in WTO texts an explicit or implicit indication to corroborate it. For example, in the *Canada – Milk* case under the Agreement on Agriculture, Canada was to some extent in a position the reverse of its present one, since it objected to the use of the Canadian domestic milk price as a benchmark, arguing that this price was distorted. The last WTO Panel in charge of this case rejected this argument by underlining that "[t]he only benchmark which is stipulated [in the texts] is the price for the domestic market, *independently of* the extent of government intervention in the formation of that price"[23] [italics added by the Panel]. Another indication can be found in the *Brazil – Aircraft* case. Although the legal context of this case was slightly different from the softwood lumber case (the criterion at stake being "material advantage" and not "benefit"), there are similarities between the cases. Brazil wanted to use export credit terms offered by Canada as a benchmark for determining whether Brazil's export credit terms were conferring a "material advantage". The *Brazil – Aircraft* Panel firmly rejected this position by stressing once again that "nothing in the text[s] ... indicates that the examination of material advantage involves a comparison *with the export credit terms available with respect to competing products from other Members"* [italics added by the Panel].[24] Although the legal provisions relating to the "material advantage" criterion are somewhat different from those governing the "benefit" criterion, the two criteria are close enough to make the Panel's approach in *Brazil – Aircraft* relevant to the softwood lumber case. Indeed, the position of the United States in the softwood lumber case is reminiscent of Brazil's rejected position for finding a benchmark.

This allergy to the "distorted price" approach is once again clearly apparent in the softwood lumber panel report. In the Panel's view, the

> prevailing market conditions" of Article 14 (d) of the Subsidies Agreement do not refer to a theoretical market free of government interference…. [T]he ordinary meaning of the term "prevailing" market conditions is the market conditions "*as they exist"* or "*which are predominant"*.... [So] we are of the view that the text of Article 14 (d) of the SCM Agreement does not in any way require the "market" conditions to be those of a hypothetical undistorted or perfectly competitive market.[25]

In adopting this view, the Panel was influenced by the fact that Article 14 of the SCM Agreement deals with "benefit" *to the recipient*. The Panel inferred from this expression that in order to calculate the benefit to the recipient, an authority must compare the price the recipient paid the government with the prices in other domestic prevailing market transactions (no matter how "distorted" they are). The previous passage explains perhaps why the U.S Department of Commerce has recently tried to regain the initiative from the domestic petitioners by proposing to use policy bulletins to determine whether Canadian timber pricing is appropriately market-based.[26] This means that the DOC would use its discretionary authority to review provincial timber pricing policies and reduce or eliminate countervailing duties on exports from provinces that are found to have a market-based system.

Finally, it must be pointed out that the Panel considered that the U.S. Department of Commerce should have considered separately the case of lumber producers not related to industries benefiting from stumpage rights. Such a case is one of an "upstream" or "indirect" subsidy which necessitates the demonstration that these lumber producers benefited indirectly from the financial contribution given directly to the tenure holders.

In conclusion one can say that, although at first glance the principal U.S. argument in the pending case seems legitimate from a policy point of view, it is unlikely that it would prevail legally. The pending Panel will probably once again be receptive to the argument that the U.S. approach would effectively *read out* of Article 14 of the SCM Agreement the explicit reference to the country of provision as the country of which the prevailing market conditions must be used as a benchmark. The pending Panel will also probably be receptive to the argument that Article 14 of the SCM Agreement deals with "benefit" *to the recipient* without explicit or implicit consideration of the role of "distortion" in the analysis of this benefit.

With regard to a new bilateral agreement between Canada and the United States about softwood lumber, one can also say that such an agreement is still probable. Of course, the recent partial legal victory places Canada in an advantageous position in the negotiations of the terms of an agreement, but this victory does not replace the need for a negotiated agreement.

Endnotes

1. United States – preliminary determinations with respect to certain softwood lumber from Canada, WT/DS236/R, September 27, 2002.
2. Certain Softwood Lumber Products from Canada, 48 Federal Register, 24, 159 (U.S. Department of Commerce, 1983) (final negative countervailing duty determination).
3. Certain Softwood Lumber Products from Canada, 51 Federal Register, 37, 453 (U.S. Department of Commerce, 1986) (preliminary affirmative countervailing duty determination).
4. United States – Initiation of a Countervailing Duty Investigation into Softwood Lumber Products from Canada, Report of the Panel, June 3, 1987, (34S/194).
5. United States – Measures affecting the Export of Softwood Lumber from Canada (II), BISD, 40S/358, para. 350.
6. Certain Softwood Lumber Products from Canada, May 28, 1992, 57 Federal Register, 22, 570-01 (International Trade Administration, Final Affirmative).
7. 32 International Legal Materials, 289 (1993).
8. For more details, see Graham, J., "Re-evaluation of the Dispute Resolution Mechanism in the Canada-US Free Trade Agreement. The Sotwood Lumber Dispute", in Case Western Journal of International Law , 28 (1996), 476.
9. Uruguay Round Agreements Act, 19 U.S.C, § 1677.
10. 35 International Legal Materials 1195 (1996).
11. United States – Measures Treating Export Restraints As Subsidies, WT/DS/194/R, June 29, 2001. For more details on this case, see Benitah, M., The Law of Subsidies Under the GATT/WTO System, Kluwer Law International, 2001, p. 218.
12. U.S. Department of Commerce, International Trade Administration, Notice of Preliminary Affirmative Countervailing Duty Determination, 66 Federal Register, 43192, (Aug. 17, 2001).
13. "Canada's Answers to Questions from the Panel after the Second Meeting with the Panel," answer to question 36 from the Panel following the second meeting, Annex B-1. Although Canada did not make submissions regarding the DOC's preliminary finding of specificity, Canada, strangely, does not accept that finding as correct (Report of the Panel, para. 4.5).

14. WTO Agreement on Subsidies and Countervailing Measures (SCM Agreement), Art. 1.1(a)(iii).
15. Ragosta, J.A., "Natural Resources Subsidies and the Free Trade Agreement: Economic Justice and the Need for Subsidy Discipline", in George Washington Journal of International Law and Economics, 24(1990), 266-67.
16. Informal discussion paper: Note by the Chairman, Negotiating Group on Subsidies and Countervailing Measures, 4 September 1990 (Exhibit CDA-20).
17. Report of the WTO Appellate Body, Canada – Measures Affecting the Export of Civilian Aircraft, WT/DS70/AB/R, para. 157, (1999).
18. 66 Federal Register at 43195.
19. Idem.
20. According to the United States, "in relation to" means "with reference to" and thus, under Article 14 (d) the prevailing conditions in the country of provision are a reference point, not necessarily an end point, for the market benchmark. (U.S. First Written Submission, para. 43.)
21. United States – preliminary determinations with respect to certain softwood lumber from Canada, WT/DS236/R, September 27, 2002, para. 7.47.
22. United States: Final countervailing duty determination with respect to certain softwood lumber from Canada (brought by Canada), Case DS257 , May 13, 2002.
23. Report of the WTO Panel, Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products, WTO case WT/DS103/RW, para. 6.18, (July 11, 2001).
24. Report of the WTO Panel, Brazil – Export Financing Program for Aircraft, WT/DS46/R, para. 7.23 (Apr. 14, 1999).
25. Report of the Panel, para. 7.50. Italics added by the Panel.
26. WTO Reporter, " U.S. Proposal on Softwood Lumber Worth Pursuing, Canada's Pettigrew Says," Wednesday October 2, 2002.