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FROM LOG EXPORT RESTRICTIONS TO A MARKET-BASED FUTURE: TOWARDS AN ENDURING CANADA-U.S. SOFTWOOD AGREEMENT

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FROM LOG EXPORT RESTRICTIONS TO A MARKET-BASED FUTURE: TOWARDS AN ENDURING CANADA-U.S. SOFTWOOD AGREEMENT

By Eric Miller*

Welcome to "the Freddy Krueger of trade irritants".[1] The United States and Canada have been fighting over softwood lumber since the George Washington Administration. Indeed, the lumber industry has been integral to shaping the evolution of the two countries. The very border between Maine and New Brunswick was set in 1842 in the treaty that resolved the Aroostook lumber dispute.[2] Since 1982, the United States and Canada have been through four major rounds of lumber disputes with more legal twists, turns, recriminations and negotiations than one can shake a plank at.

And now this ancient feud is back. The 2006 Canada-U.S. Softwood Lumber Agreement (SLA)[3], which established a governance framework for the industry for a decade, expired on October 12, 2015. The terms of the SLA mandated that no new trade remedy case could be filed for at least one year after the expiration of the agreement. With the end of this abeyance period nearly here and little fundamental change in the positions of the players, it seems likely that the U.S. industry will file a petition with the U.S. Government seeking the imposition of countervailing duties on Canadian softwood lumber imports before the spring of 2017.

While the landscape of lumber production in both countries has shifted over the past decade, the fundamentals of Canada's lumber policies have not changed. British Columbia's log export restrictions (LERs) have long generated particular controversy. The peculiar structure of the regime guarantees B.C. wood processors access to cut-rate inputs at the expense of domestic timber harvesters. These subsidized inputs create an array of distortionary effects up and down the supply chain. B.C.'s LER regime is a strange outlier in being so much at odds with the market-based approach taken in almost every other sector of the Canadian economy. Like their spiritual cousin "supply management" in the Canadian dairy sector, many respected economists see LERs as a highly dubious policy that benefits a narrow array of interests.[4]

Just as countries such as the United States and New Zealand noisily sought an end to supply management in the Trans-Pacific Partnership (TPP) negotiations, Canada's major trading partners are also increasingly seeking reform of the B.C. LER regime. In the TPP negotiations, for example, Japan demanded a side letter with Canada on LER reform.[5] In an environment of renewed softwood lumber litigation regarding

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[1] Colin Robertson. *A Canadian Agenda for the USA: Obama and Beyond*. Canadian Global Affairs Institute, March 2016. http://www.cgai.ca/a_canadian_agenda_for_the_usa.

[2] See https://www.mainememory.net/sitebuilder/site/781/page/1190/display.

[3] See http://www.international.gc.ca/controls-controles/softwood-bois_oeuvre/other-autres/agreement-accord.aspx?lang=eng.

[4] See, for example, Jack Mintz. *TPP should raze forest protectionism*. National Post. June 29, 2015. http://business.financialpost.com/fp-comment/jack-m-mintz-tpp-should-raze-forest-protectionism.

[5] See Forest Products. http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/tpp-ptp/instruments.aspx?lang=eng. The TPP was signed on February 4, 2016 in Auckland, New Zealand. Early indications suggest that the two countries have different views about the meaning of the agreement. See Peter Mazereeuw. *Canada, Japan*

countervailable subsidies and WTO concerns about export restraints in countries such as China, LERs also will carry increased legal risks for Canada. The U.S. Lumber Coalition has previously asserted the illegality of LERs and it is not unreasonable to consider that they may form part of future softwood lumber litigation.[6]

The B.C. LER regime was not addressed in the 2006 Softwood Lumber Agreement. The SLA created an interregnum of managed trade during which the parties agreed to a "ceasefire" and to not discuss fundamental reform of Canadian lumber policies. Yet, simply agreeing not to discuss a problem will not make it go away.

With the SLA now in the history books, those in the United States that are negatively impacted by Canadian lumber policies are now especially motivated to push a long-deferred reform agenda. As the fifth round of the lumber dispute dawns – soon to be known as "Lumber V" – a key question for Canada is how to create enduring trade peace and end the "Nightmare on Log Street" once and for all. To get there, it would seem time for Canada to undertake a careful reassessment of its policies in the lumber area with a view to making them more market-oriented.

The Canadian narrative around softwood lumber typically holds that Canada is on the side of the angels and that U.S. concerns about its practices are protectionist or the work of a bully. Yet, a preponderance of evidence suggests that in some cases Canadian lumber really is subsidized and really does displace U.S. production. As will be set forth below, in the case of LERs this is almost indisputable. Faced with real damage to its domestic industry and given the law and practice of the U.S. trade remedy system, it would seem difficult to imagine the U.S. Government not imposing countervailing duties in a lumber case. There are certainly many examples across the economy of the Canadian trade remedy system providing relief to Canadian firms injured by subsidized imports. Fair enough. These processes are entirely consistent with every trade agreement that the United States and Canada have signed.

Acknowledging imperfections and carefully re-examining one's own policies and practices is an unsettling experience, but it is fundamental to countries preparing themselves for trade peace. Over the previous four rounds of lumber litigation, Canada has understandably hunkered down for the fight. It has looked to find transitory peace through market share arrangements. It has certainly not been proactive in identifying a reform path that would address the subsidies that are at the heart of U.S. concern. It therefore behooves Canada to think through how to fundamentally address areas in its lumber regime where government policies create market distortions that are injurious to its trading partners. For its part, the United States will also have to consider how it can encourage a permanent resolution of this vexing North American trade challenge. Of course, such a process would not take place in a vacuum. Politically speaking, it would likely need to be linked to a longer-term lumber agreement.

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importers at odds over TPP side deal. Embassy. November 25, 2015. https://www.osler.com/osler/media/Osler/Content/Canada-Japanese-importers-at-odds-over-TPP-side-deal.pdf.

[6] See http://www.uslumbercoalition.org/doc/log_export_restrictions.pdf.

This paper will set forth a pathway for how this reform process could be executed. After describing the key dynamics in the softwood lumber dispute, it will focus on LERs as a case study of a truly problematic measure deployed by Canada that is ripe for reform. It will then explain how reform of log export restrictions and similar distortionary policies could be synchronized in a more comprehensive package that delivers long-term lumber peace.

Part One: Softwood Lumber – The Basis of the Dispute

North America's timber industry is massive. In Canada, the forest products sector is a $58 billion industry representing 1.25% of the country's GDP.[7] In the United States, the forest products industry turns out $200 billion in products annually and accounts for 4% of U.S. manufacturing GDP.[8] Given the industry's substantial employment impacts (especially in rural areas), high dollar value outputs and cross-country geographic distribution, lumber has always been political as well.

The "lumber wars" are, at base, a series of trade remedy cases brought by the United States against what it alleges to be subsidized Canadian timber. The subsidy stems partly from different ownership structures of forests in Canada as compared to the United States, how production rights are granted and priced and directly restrictive Canadian policies.

Stumpage Subsidies

The most visible aspect of the U.S.-Canada lumber dispute has long been "stumpage fees". The vast majority of Canadian forests are publicly owned. Private companies can be authorized to harvest timber on this land through a licensing process. Governments charge them fees ("stumpage") in exchange for this right to harvest and impose a variety of conditions. The United States has long contended that these government-set fees are significantly lower than they would be in an open market environment. The under-pricing of harvest rights flows through to cheaper raw inputs for processors and low-cost outputs. The net effect of the subsidized harvest rights is that U.S. lumber and, indirectly, U.S. lumber products are displaced by cheaper Canadian outputs in the United States, Canada and third country markets. The various U.S. trade remedy cases against Canada over the past four decades have focused substantially on trying to force the Canadian Government to raise stumpage fees to reflect equivalent market conditions. In absence of a willingness to act, the U.S. has imposed import duties equivalent to the level of the Canadian subsidy.

By way of contrast, more than 70% of U.S. lumber production originates from timber harvested from private land, including almost all of the production in the east and south of the United States. Harvest rights, to the extent that they are

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[7] *Industry by the Numbers*. Forest Products Association of Canada. http://www.fpac.ca/canadian-forestry-industry/forest-products/.
[8] *Economic Impact*. American Forest and Paper Association. http://www.afandpa.org/our-industry/economic-impact.

granted to third parties, are sold on a market basis, usually by way of auction. Because NAFTA and other trade agreements endeavour to put the market at the core of resource allocation decisions, Canada has not responded with a series of trade remedy cases of its own involving U.S. practices.

OWNERSHIP OF FORESTS: CANADA VS. THE UNITED STATES

	Canada	United States
Public	94%	37%
Private	6%	63%

Source: UN Food and Agricultural Organization.

While the preponderance of Canadian timber harvesting is on public land, Canada has some significant harvesters on private land. Most production in Atlantic Canada occurs on private land based on an economic formula very similar to that in the United States. As a consequence, harvesters in this region have been excluded from U.S. trade actions, including an explicit exemption from the 2006 SLA. By contrast, in British Columbia, companies that harvest timber on private land are subject to the same U.S. trade restrictions as those harvesting on public land. This stems from the fact that harvesters on private land are subject to the same distortionary LERs as their public land-producing counterparts.

In addition to Atlantic Canada, the SLA exempted 29 Quebec and 3 Ontario companies that had previously been found not to benefit from subsidies. This suggests that the United States may be willing to work with Canadian companies and regions when they harvest and sell timber on a market basis. Policy-makers should embrace this example and seek to expand on it going forward.

2006 Softwood Lumber Agreement

As noted, the 2006 SLA did not seek to address the market-distorting elements of Canada's lumber regime. Rather, this expedient political arrangement: (1) allocated market share through the control of Canadian lumber imports; and (2) distributed approximately $5 billion in import duties paid by Canadians to the United States over the previous five years.

To control Canada's share of the U.S. softwood lumber market, the agreement allowed Canada's major lumber producing regions to choose from one of two mechanisms:

- Option A was an export charge with a surge penalty. If the given region's monthly export volume was 110% of historic levels its charge on all softwood lumber exports for that month would retroactively rise by a punitive 50%.
- Option B was a straightforward export quota with a lower-than-Option-A in-quota charge.

In short, one option provided for an indirect export limitation regime while the other was direct.

The necessity of optionality arose from Canada's complex federalist system and its lack of a comprehensive economic union. British Columbia, Canada's lumber powerhouse, was sub-divided further into its coastal and interior regions. When decision time came, Coastal and Interior British Columbia both chose Option A, as did Alberta. Quebec, Ontario, Manitoba and Saskatchewan chose Option B.

Canada Softwood Lumber Exports to the United States – 2015[9]

1	**Quantity (Cubic Meters)**	**Value (000,000 CAD$)**	**Percentage (by value)**
British Columbia	15,521,764	3,311	56
Quebec	6,419,896	1,057	18
Alberta	3,643,530	600	10
New Brunswick	2,205,848	403	7
Ontario	2,310,645	398	7
Other	986,780	165	2
Canada (Total)	**31,088,463**	**5,934**	**100**

Source: B.C. Stats with data from Statistics Canada.

An essential driver of the 2006 Canada-U.S. softwood agreement was a desire by Washington to clear the decks of key irritants between the Bush Administration and the incoming Harper Government. The White House was keen not to have the oldest of bilateral irritants sour its relationship with a new, friendly Canadian government.[10] For its part, the Canadian Government was happy for a break from expensive and extensive litigation. Given this context, deferring discussion of fundamental reforms of the market-distorting elements of the Canadian lumber regime was understandable.

The original agreement was designed to last seven years, well beyond the tenure of Bush Administration and after the next Canadian election. As the deadline approached in October 2013, the Harper Government and the Obama Administration, already in the midst of a heated debate over the Keystone XL Pipeline, agreed to extend the SLA for an additional two years through October 2015.

Despite the close personal relationship between President Obama and Prime Minister Trudeau, the pragmatism and political necessity that accompanied the original agreement is absent in 2016. Also, ten years is a long time to agree to simply not address fundamental problems. Many U.S. stakeholders want a new lumber agreement to finally address Canada's market distorting policies. Simply deferring yet again appears to be less and less of an option.

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[9] *Softwood Lumber Exports*. Exports and Imports – Data. B.C. Stats. http://www.bcstats.gov.bc.ca/StatisticsBySubject/ExportsImports/Data.aspx.

[10] From an interview with a Bush White House official substantially involved in the development of the 2006 SLA.

While the governments are negotiating, at the time of writing the likelihood of a return to litigation appears to be very high. Chief Canadian negotiator Martin Moen told a Canadian Parliamentary Committee in late August 2016 that the United States and Canada remain far apart on a number of key issues.[11]

Part Two: Log Export Restrictions

A good place for Canada to start a fundamental reassessment of its lumber regime is with British Columbia's log export restrictions. Most Canadians (let alone Americans) are unaware that the federal and British Columbia governments operate a regime for logs that is on par with the most extreme market-distorting policy frameworks in modern Canadian history. These include the above-mentioned supply management system for dairy and the National Energy Program for oil in the early 1980s. As with these initiatives, LERs prioritize the narrow interests of a small group, in this case certain B.C. wood processors, over consumers, the public purse, timber harvesters and Canada's broader trade interests.

Canada – Exports of Logs to the United States - 2015[12]

	Value (000,000 CAD$)	**Percentage**
British Columbia	65	66
Ontario	26	26
Other	8	8
Canada (Total)	**99**	**100**

Source: B.C. Stats.

It is not unusual for countries to impose log export restrictions. Indeed, all logs exported from Canada require a federal export permit. In the United States, all logs harvested from federal and state lands west of 100^0 longitude are also subject to an export licensing regime. The issue with British Columbia regime is less the concept of log export restrictions than the extraordinarily distortionary way in which it has come to be applied over time.

British Columbia – Exports of Logs by Market - 2015[13]

	Value (000,000 CAD$)	**Percentage**
China	334	50
Japan	140	21
South Korea	120	18
United States	65	10
Other	7	1
Total	**666**	**100**

Source: B.C. Stats.

[11] *Canada's Chief Lumber Negotiator Says Industry Is Gearing Up For Litigation*. Inside U.S. Trade. August 23, 2016.
[12] *Annual data for exports to the world and to the United States by province with selected commodity detail*. Exports and Imports – Data. B.C. Stats. http://www.bcstats.gov.bc.ca/StatisticsBySubject/ExportsImports/Data.aspx.
[13] Ibid.

The B.C. regime has three major components, two formal and one informal. These elements are known as 1) the surplus test; 2) "blocking"; and 3) fee in-lieu of manufacture, each of which is further described below.

i) The Surplus Test: Only in B.C.

A cornerstone of what makes the British Columbia LER regime so egregious and so in need of reform is the "Surplus Test", a procedure that the federal and provincial governments work together to apply. The Surplus Test requires that logs harvested on both private and public land in British Columbia be deemed "surplus" to the needs of the log processing sector in the province before they are eligible to be exported.

While to the layperson in Canada this may seem reasonable, it is not. By limiting auctions for logs to B.C. processors, the regime substantially reduces competition for logs and depresses prices for those that grow and harvest timber in the province. In a world of intensive international trade, British Columbia is putting one of its most attractive assets on deep discount to a small group of politically connected processors. Moreover, these cut-rate timber inputs become a bilateral trade problem when they are processed into cut-rate lumber products that are then exported to the United States.

The B.C. lumber processors that benefit from the regime decry attempts to change their special deal by claiming that an end to the Surplus Test would lead to a shortage of supply for domestic sawmills. Yet there is little evidence that this is the case as seen by British Columbia's consistent failure to reach its full sustainable annual harvest. Rather, eliminating the Surplus Test would simply allow the timberland owners to get a competitive price for their logs.

So how specifically does the regime work?

There are four major categories of land in ownership in British Columbia:

(a) Provincial Crown land;
(b) Private land granted after March 12, 1906;
(c) Federal Crown land (including aboriginal lands); and
(d) Private land granted before March 12, 1906.

The provincial government controls the first two categories of land, on which the vast majority of production occurs, while the federal government controls the latter two categories of land. In practice, the two levels of government and their Timber Export Advisory Committees (TEAC[14] and FTEAC[15] respectively) cooperate seamlessly and administer the log export restrictions in British Columbia in tandem.

[14] B.C. Timber Export Advisory Committee.
[15] Federal Timber Export Advisory Committee.

This is so much the case that the two committees have virtually identical membership.

Under the B.C. *Forest Act*, logs may be authorized for export under one of three conditions: (1) they are deemed surplus to the needs of B.C. log processors; (2) they cannot be processed economically in British Columbia; or (3) exportation would prevent the waste or improve the use of timber on Crown lands. There are strict limits on how much timber can be considered for export with each application, thereby preventing a loophole through which large volumes of exported logs could pass.[16]

Under both the federal and provincial systems, the prospective exporter must begin by advertising the logs in the provincially run "Weekly List".[17] Once listed, B.C. processors are free to make offers to purchase the logs. If no offer is made or the offer(s) are at a price less than what TEAC determines to be a "fair representation of the domestic value of the log", an export permit may then be issued. If a "fair" price is offered, TEAC will recommend that the federal government not issue the permit. The federal system largely operates on the same basis.

By virtue of these restrictions, harvesters are effectively precluded from selling their logs to foreign processors if a domestic processor makes an offer on logs which TEAC/FTEAC, not the harvester, determines to be the log's fair value in the B.C. market. Because the "benchmark domestic log value" is established with recent historic data and largely ignores factors such as supply/demand, exchange rates, and transportation costs, it tends to be less than responsive to market realities. The fact that determinations of "fairness" are made behind closed doors and with a lack of transparency does not help matters.

For the majority of the species and grades, the B.C. price is significantly lower than the value that the same log commands on the international market. For example, over the past five years, the gap between U.S. Hemlock #3 Sawlog and B.C. Hemlock/Balsam (hembal) J Grade averaged 27%. The export regime thus deprives companies harvesting the logs of obtaining full value for their product and the maximum return for their investment. In doing so, government policy forcibly requires timber harvesters to use logs from public and private lands to subsidize the domestic processing industry in British Columbia and their exports to the United States and third countries.

Proponents of the regime in British Columbia and Ottawa argue that all the government is doing is ensuring that everyone gets what is "fair". In a market economy, however, "fair" is a dubious concept when it comes to allocating natural resources. The subsidy clearly confers an unfair competitive advantage to B.C. timber processors.

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[16] Section 128 of the B.C. Forest Act. http://www.bclaws.ca/civix/document/LOC/complete/statreg/--%20F%20--/Forest%20Act%20[RSBC%201996]%20c.%20157/00_Act/96157_10.xml#section128.

[17] See B.C. Timber Sales. https://www.for.gov.bc.ca/bcts/.

ii) Blocking

Any regime that imposes substantial restrictions on where a firm can sell its products creates a power imbalance and opportunities for abuse.

British Columbia's timber processors have the ultimate leverage to stop exports by objecting to the granting of export licenses for B.C. logs. Under the regime, a processor merely has to make an offer on an export application in order to bring the process to a halt; hence the application is blocked.

So what do the timber harvesters do? They negotiate informal supply arrangements at cut-rate prices with key B.C. log processors in exchange for their agreement not to block exports.

Key timber harvesters make a substantial share of their profits from exports on which they can receive world market price. Anecdotal evidence suggests that some harvest operations are forced to sell at or below their cost of production to the domestic processors. In other words, the net effect of B.C. policy is to force timber harvesters to make next to nothing (or worse) on the domestic side of their business in order to safeguard their profitable export operations.

Because the side agreements are informal, they cannot be litigated or taken to arbitration if they are not respected. Processors can change the terms at any time, demanding more product or a different price as it suits their needs. The only leverage the harvesters have is to not cut their trees, which suits nobody's interests. The trick for the processors is to extort just enough from the harvesters to keep them producing timber. Going further runs the risk of insufficient average returns for the harvester and discontinued harvest operations.

When government policy results in such extreme distortions it really needs to be overhauled. Beyond the profitability question, one of the key impacts of the blocking threat is that B.C. timber harvesters cannot enter into long-term supply agreements with international customers. Nor can they take long positions on ocean freight solutions. Because they do not have certainty due to the constant threat of blocking, they are forced to sell on the spot market. This moves B.C. timber yet further away from receiving the true world price.

In 2002, Canada told the World Trade Organization that it granted 97% of applications to export from Crown land in British Columbia.[18] This is hardly surprising. Almost every timber harvester has negotiated side agreements to keep its exports from being blocked. If not, this number would have been substantially lower.

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[18] World Trade Organization Dispute DS 236 - *United States — Preliminary Determinations with Respect to Certain Softwood Lumber from Canada*. https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds236_e.htm.

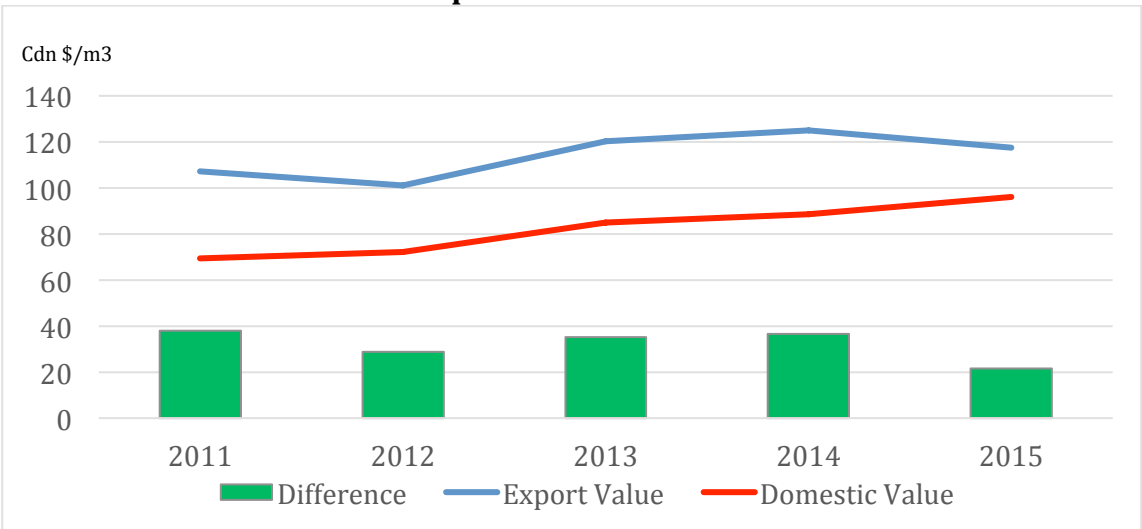
The real question is not what percentage of exports is formally approved. Rather, one should ask what percentage of B.C. timber production can be said to be legitimately available for export. Because blocking agreements between harvesters and processors are informal, one may never know precisely, but it is certainly much less than 97%.

From a U.S. perspective, the centrality of blocking to the mechanics of the B.C. lumber regime offers key insights into how subsidies are generated for domestic processors. Blocking forces timber harvesters to pay the equivalent of protection money so that they can stay in business. When government policy results in such extreme distortions, it clearly needs to be overhauled.

iii) Fee-in-Lieu of Manufacture: An Export Tax

As if the surplus test and the impacts of blocking were not obstacles enough, prior to the issuance of a permit, harvesters seeking to export logs originating on provincial Crown land (and private lands granted after March 12, 1906) must pay a "fee in-lieu of manufacture". The rates vary depending on whether the logs originate from the coast or the interior.

Coastal Fee In Lieu Multiplication Factor: The Domestic Discount[19]



Source: Government of British Columbia.

The theory is that the fee captures the "benefits" that are lost to the province when logs are exported for processing abroad. In practice, these types of export taxes are virtually unknown in North America today. The United States and Canada, through their trade agreements and their policies, have long ago deemed such charges to be highly dubious.

[19] The average gap and the data in the chart are calculated from: http://www2.gov.bc.ca/assets/gov/farming-natural-resources-and-industry/forestry/log-exports/multiplication_factor_for_coast_fil-_jul_2016.pdf.

The fee is based on the average price gap between domestic and export prices during the preceding three-month period. What makes this significant in the context of Canada-U.S. softwood lumber is that the "fee-in-lieu" is essentially the official percentage by which the B.C. Government deems its production be subsidized. Over the past five years, the B.C. Government's own data has identified a domestic discount of over 28% relative to export prices.[20]

As Dr. David Haley, Professor Emeritus at the University of British Columbia explains, the fee-in-lieu and the rest of the B.C. LER regime is akin to:

> *a transfer of wealth from the timber owners, both the Crown and the private sector, to forest products manufacturing companies. In other words, manufacturers receive a subsidy at the expense of timber growers.*[21]

By lowering domestic log prices, reducing the monies flowing to the public purse from stumpage, and reducing the returns to harvesters which sell their logs on the domestic market, it is clear the B.C.'s LER regime serves but one purpose: to substantially lower the input costs paid by domestic lumber processors. Furthermore, the regime offers an elegant means of discretely transferring the obligation to subsidize the domestic log processing industry to the timberland owner, private and public.

If British Columbia were an isolated autarkic society its log export restrictions would have little impact. Of course, British Columbia – like the rest of Canada and much of the world – depends on international trade for its prosperity. Increasingly, these trading partners, whether the United States or others, are legitimately demanding that B.C. end the one-sided LER gravy train for its log processors and embrace a lumber regime that places the market and reciprocity at its core.

Impacts and Considerations Related to British Columbia's LER Regime

In order to fully grasp the consequences of British Columbia's LER regime and the need for reform, it is useful to assess both the regime's distortionary effects and the risks that it creates for the North American economy.

Downward Pressure on Prices

The impact of LERs on log prices is clear: British Columbia domestic prices are consistently below U.S. and world market prices. While the specific gap may vary, it is widely seen across different types of logs. Take, for example, the gap between B.C.

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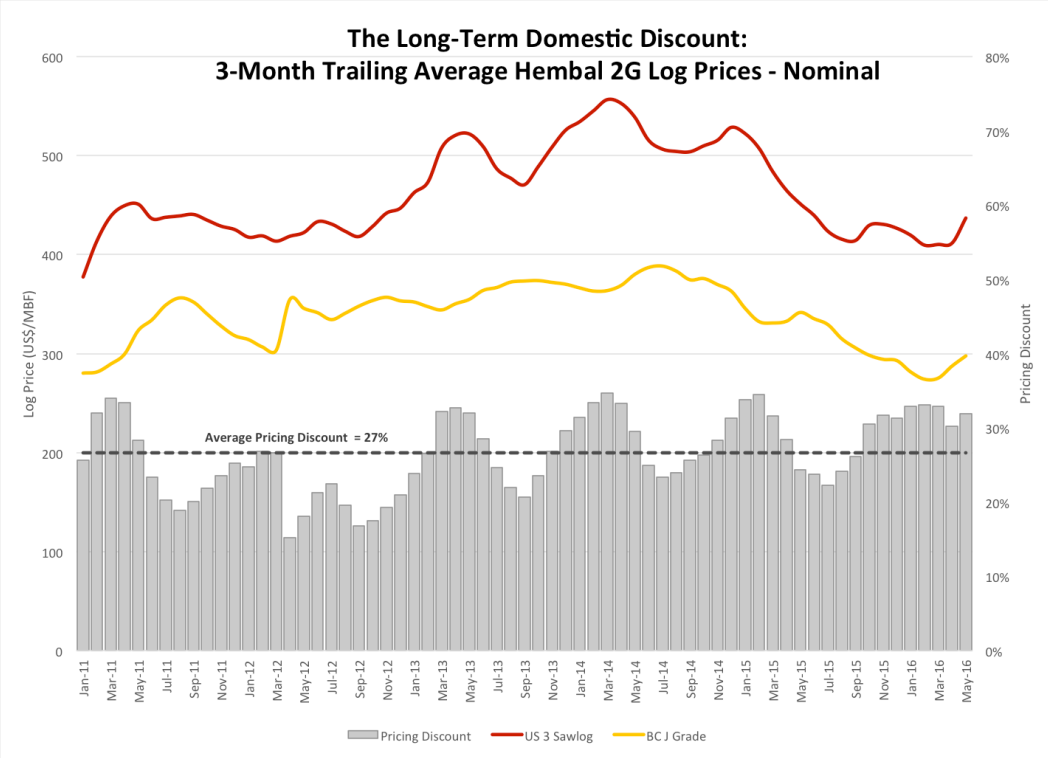
[20] Ibid.
[21] David Haley. *Are Log Export Restrictions on Private Forest Land Good Public Policy?*, 2002. https://www.rairarubiabooks.com/related-pdf-are-log-export-restrictions-on-private-forestland-good-public-policy-an-analysis-of-the-situation-in-british-columbia.html.

Hembal J Grade Logs and U.S. Hemlock #3 Sawlog – two comparable products in the market. Using a three-month trailing average, over the past five years the average pricing differential between the U.S. and the B.C. product was 27%. In other words, B.C. logs sold at an average of a 27% discount relative to their U.S. counterpart over the past five years. There is no way to rationalize away such a large gap by claiming other mitigating factors. The net effect of LERs is to push down B.C. domestic prices. The market results from these policies are stark.



Source: Author's calculations using data from B.C. Ministry of Forests, Lands and Natural Resource Operations and Washington State Department of Natural Resources.

Illegality Under Trade Law

In recent decades, international trade law has evolved in the direction of disciplining subsidies and export restrictions, and LERs are inconsistent with Canada's obligations under the WTO and NAFTA. An analysis of the illegality of LERs by Professor Michael Trebilcock is set forth in Appendix One.

There are two major areas of law that LERs violate. The first relates to subsidies. The case is clear that the B.C. LERs are countervailable subsidies.

The second pertains to export restrictions. The Surplus Test clearly constitutes a government direction to process logs in Canada. This raises the clear possibility that Canada will face a WTO challenge to British Columbia's LER regime.

LERs Undermine Canadian (and North American) Foreign Policy

While B.C.'s LER regime is bad policy and most probably illegal under international trade law, it also is hurtful to Canada's foreign economic policy and to efforts by countries across the G-7 to discipline similarly bad practices by China.

The rise of China has been a substantial source of disruption in the international trading system over the past two decades. As China becomes more powerful, many countries are debating how to respond. In December 2001, China joined the World Trade Organization, and in so doing made extensive commitments about how it would govern its economy and engage in global commerce. Consistent with the behaviour of a rising power, however, China has been keen to test the limits of what the system would tolerate.

One of the key ways that China has challenged the system is through the use of export restrictions. Over the last 20 years, China has become the global center of production for 17 types of rare earth elements. These minerals are essential to the manufacture of everything from cars to missiles to technology products. In 2010, China substantially decreased the amount of these products that it would make available for export. In 2012, the United States responded by launching a WTO case that claimed that China's restrictions on the export of rare earths, tungsten and molybdenum were illegal. Canada joined this process as a third party observer. China eventually lost the case and, in 2015, began to dismantle its restrictions.

Canada's decision to stand with the United States, the European Union and others against China's rare earth protectionism was a principled position in favour of free trade and the need to ensure respect for the WTO rules. Sadly, Canada's defence and direct support of British Columbia's export restrictions on logs puts it and its partners in a weaker position to stand against similar Chinese practices in the future. After all, LERs place Canada in the position of "do as I say, not as I do". While export restrictions are unjustified under most circumstances, one certainly could not reasonably argue that lumber is a special case. There is no timber shortage in Canada, nor could one somehow argue that B.C's LER system is essential to Canadian national security. All countries that value a robust rules-based international trading system have an interest in seeing Canada be able to fully reinforce the bulwark against those that would seek to challenge it.

Part Three: LERs and the Path to a Durable Lumber Framework

As demonstrated above, British Columbia's log export restrictions have created a variety of destructive and problematic effects. If nothing else, the price suppression impacts and blocking suggest that LERs make Canada's long-held assertion that the U.S. is merely being a bully on softwood lumber seem tenuous.

Formally, the B.C. and Canadian governments could agree tomorrow to eliminate LERs. Yet, such measures are seldom done away with all at once. After all, LERs have long been an integral part of British Columbia's and, by extension, Canada's existing lumber regime. Consequently, the path to trade peace and normalization in the Canada-U.S. lumber realm will require careful political management and a clear staging for reform measures.

Key Principle: Market Basis

If there is one clear principle that can lead to a durable lumber framework, it is that Canada must ensure that its lumber industry operates on a fully market basis going forward. Of course, defining what this looks like can be challenging, especially when navigating the tricky issue of equivalency of stumpage fees. A durable lumber agreement will therefore have to include a methodology for understanding how the United States and Canada set benchmarks and understand auction prices. The majority of Canada's timber will not suddenly migrate to private land, so the two countries will have to reach an agreement on how to determine equivalency.

Fortunately, the 2006 Softwood Lumber Agreement offers several important examples of what the two countries deem to be market-based or unsubsidized production. First, it excludes production from Atlantic Canada on the basis that it largely takes place on private land. Importantly, Atlantic production is not subject to additional government policies or measures (such as B.C.-style LERs) that would make it subsidized, either at the point of harvest or downstream.

Second, the SLA explicitly exempted 32 companies in Quebec and Ontario whose production had previously been deemed unsubsidized. At some point, there was an assessment of the practices of these companies, the market basis of their production was established and they were exempted from the agreement.

The SLA did contemplate creating an assessment mechanism that would allow regions undertaking market-oriented reforms to see their new status reflected in the form of exemptions from the agreement. Specifically, Article XII of the SLA committed to the creation of a "Working Group on Regional Exemptions", which would define:

> *substantive criteria and procedures for establishing if and when a Region uses market-determined timber pricing and forest management systems and therefore that its exports of Softwood Lumber Products to the United States qualify for exemption from the Export Measures.*[22]

Despite a commitment to establish this body within three months of the entry into force of the Agreement, the Working Group was never created. Some officials who were there at the time attributed this to U.S. foot-dragging.

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[22] *Softwood Lumber Agreement* (2006). http://www.treaty-accord.gc.ca/text-texte.aspx?id=105072&lang=eng.1

Regardless, in 2013, when Quebec established a timber marketing board system to sell lumber from Crown land by auction[23], there was no mechanism through which it could petition for these reforms to be reflected in the SLA. The province believed that the new system put its industry on a fully market basis. Yet, there was no way for the U.S. and Canada to jointly assess whether its production would be deemed as unsubsidized on a going-forward basis. Despite its bold reforms, Quebec simply had no "exit ramp" from the punitive U.S. export measures imposed by the SLA.[24]

This is not good for either the United States or Canada. Presumably, the United States is largely sincere in its desire to see market-oriented reforms in the Canadian lumber system. None of this will happen, however, if policymakers cannot identify a tangible reward from acting. Even if it is the right thing to do, policy reforms like the ones Quebec undertook are disruptive and at times costly on a political basis. If future political leaders are to be empowered to follow Quebec's lead, they will require access to a functional bilateral mechanism that can determine on as an objective a basis as possible whether the reformed regime makes lumber production subsidy-free. This same mechanism would also have the power to grant Atlantic-like exemptions from any U.S. softwood lumber measures in place at that time. Under any future agreement, the two countries should not defer the structuring and launch of a Working Group on Regional Exemptions for three months. It must be defined in the text of the deal and launched on Day One.

Step One: Eliminate LERs on Private Land in B.C.

The best path forward for reforming Canada's lumber regime would be to proceed in two stages. The first would be a pilot case that is designed to build confidence: the elimination of B.C. LERs on private land. The second stage, described in more detail below, would be the negotiation via envoys of a comprehensive and long-term accord on open and free lumber trade in North America.

As noted above, the two countervailable pieces of Canada's lumber regime have long been identified as B.C. LERs and stumpage subsidies. Both of these issues would necessitate complex reform processes. Yet, one element of the LER regime would be simple to address and could serve as both a gesture of goodwill and a genuine model for how newly subsidy-free production could be recognized or certified by the United States.

Canada and British Columbia should move expeditiously to eliminate log export restrictions on private land. British Columbia is the only jurisdiction in North America to impose LERs on private land. Arguably, it already recognizes the

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[23] *Sustainable Forest Development Act*. http://legisquebec.gouv.qc.ca/en/ShowTdm/cs/A-18.1

[24] Katie Hoover and Ian Fergusson. *Softwood Lumber Imports from Canada: Current Issues*. Congressional Research Service, May 11, 2016. https://c.ymcdn.com/sites/www.palletcentral.com/resource/resmgr/Advocacy/Softwood-Lumber-Imports.pdf.

distinction between private and public land by only charging the "fee-in-lieu of manufacture" only on the exportation of logs originating on Provincial Crown land (and private lands granted after March 12, 1906). Now B.C. should go the rest of the way and eliminate LERs on all private land.

Part of the theory of LERs is that timber that is harvested on public lands is a public resource that should be managed in accordance with the public good. While private lands like private industries are subject to regulation, their primary focus is to serve the interest of its owners who have substantial investments in timberland assets. British Columbia's log export restrictions do not do this. Rather, they have created an ugly mess that undermines the province's export competitiveness, unleashes an array of predatory activities, and creates substantial amounts of subsidized lumber that find their way into the United States and other markets.

Starting with LER elimination on private land is not only good policy, but it is also practical. Private forest land accounts for less than 2% of B.C.'s land base, or about 823,000 hectares. When one pilots a new approach, it is good to start small, but in a coherent manner.

By eliminating LERs, production on British Columbia's private lands would become as market-oriented as Atlantic Canadian production. It should therefore be exempted from present and future U.S. trade actions. Given the substantial size of B.C.'s lumber output and the long-standing controversy about this issue, eliminating LERs would send a remarkably strong signal about Canada's willingness to reform.

As noted above, the regulatory mechanics of exempting timber harvested on private land from LERs would be relatively simple. Canada would nonetheless want to be certain that timber harvested and sold under this open market regime would be deemed to be unsubsidized by the United States and therefore be free of all export measures.

The Canadian and U.S. Governments would need to coordinate policy actions on this front. Both governments, but especially that of the United States, would almost certainly want a mechanism that could certify production under the new regime as being unsubsidized. This suggests that the two countries may wish to form something like the "Working Group" contemplated by the SLA and develop criteria for how "market-oriented assessments" of policy reforms could be carried out. There would seem to be little doubt that LER-free production on B.C. private land would qualify for an exemption from U.S. trade action. This would therefore provide a good first case for assessment.

If Canada takes the first step and agrees to the elimination of LERs on private land and the two countries ensure that this production is recognized as subsidy-free in the United States, this would provide a major boost to confidence that a broader, permanent softwood lumber arrangement is possible.

Step Two: Enter the Envoys

The path to a durable lumber agreement is incredibly complicated from a political and operational perspective. Given all of the history involved in this issue, one wonders how much confidence the U.S. and Canadian sides have that their counterparts are truly negotiating in good faith. Yet, negotiate they must.

The Office of the U.S. Trade Representative and Global Affairs Canada will continue to work toward a short to medium-term agreement on managing the bilateral softwood lumber agreement. If this path is successful, the deal would likely be time-limited and focus on allocating market access and monitoring compliance. It is hard to say what in the way of policy reform would be included, but a safe bet is that anything that emerges on this front would have modest ambitions. A key reason for eschewing a major reform process is that were the Canadian Trade Minister to put, say, B.C. LERs on the table, she would be making a tacit admission that the province was somehow not on the side of righteousness at present. One of the consequences of shorter-term arrangements is that countries are nearly certain to resume their acrimony in a couple of years as the agreement winds down. While both ministries say they want a deal, the odds of avoiding litigation seem long.

Consequently, Canada and the United States need to complement the good work of their trade ministries by opening a "second track" of diplomacy. This would be done through the appointment of softwood lumber envoys that report directly to the White House and the Prime Minister's Office. Their mandate would be focused on the longer term. They would be asked to answer the question: *what steps would be required by both Canada and the United States if they were to develop a permanent framework for softwood lumber trade that would negate the perceived necessity of trade remedy actions and provide predictability to market players into the future?*

The selection of these envoys would be crucial, as would the framing of their mandates. Canada and the United States need serious and experienced individuals who are able to work through the design of an integrated package that gets everybody "in the zone" for a deal. The package would obviously be theoretical until the leaders and their ministers bless it. Because they would be tasked with working through difficult longer-term issues, the leaders should contemplate the possibility of failure. Ensuring that the envoys are isolated from the day-to-day cut-and-thrust of the trade ministers' management of softwood litigation, but nonetheless empowered to think through a long-term framework would be the challenge.

The basis for a long-term agreement would seem to be as follows: (1) Canada reforms its lumber systems on a market basis; and (2) these reforms are recognized by the United States with a guarantee of secure market access going forward. Achieving such an agreement is very complicated. Canada does not want a situation where it reforms and the United States still subjects lumber exports to countervailing duties.

A long-term lumber agreement would potentially need to address, *inter alia*, the following questions:

- What would constitute a recognized "market-oriented framework" in each of the major lumber producing jurisdictions in Canada?
- How would the staging of the reforms work, and what would be the basis of access to the U.S. market while it is in progress?
- What would be the institutional mechanism for certifying "market-orientedness", carrying out ongoing monitoring, providing guidance and resolving disputes?
- What would be the "end state" of access to the U.S. market after each Canadian jurisdiction reforms – full, unfettered access, a quota, or something else?
- What guarantees would Canada have that a future Administration would not re-impose trade remedy measures for strictly protectionist purposes?
- During a transition period, would Canadian producers be subject to a quota? How could incentives be built into such a system to provide increasing levels of reward as producers move toward the unsubsidized side of the ledger?

While pursuing a comprehensive long-term agreement is more challenging than quixotically tinkering with the 2006 SLA, it would be much more rewarding and, ultimately, conducive to long-term investment in both the U.S. and Canadian timber industries. The two countries must end the cycle of litigation that has dominated the softwood lumber trade for four decades. The unique political circumstances of 2006 are unlikely to re-emerge any time soon. The two countries should now at least try to secure an ambitious outcome on softwood.

Solving the Hard Policy Issues

LERs on Public Land

Given the market distortions, trade risks and complications to Canadian policy, British Columbia should commit to eliminating its system of LERs. In order to ensure that this shift does not radically disrupt the market for logs in B.C. and remains politically viable, it would undoubtedly be necessary to phase in a liberalized regime over time. A key question is: what would a post-LER regime look like? Perhaps the ideal path could be for the B.C. and federal governments to appoint a commission that includes both harvester and processor interests. They could instruct this group to develop a reform plan that would be fully operational in, say, five years. One idea that they could consider is a staging process that would free B.C. production from the "sell domestic" requirement, say, by 20% per year. Another would be to ensure a pricing review process for the surplus that ensures that timber harvesters actually receive a "fair" price based on true international market

fundamentals. The commission would also be charged with developing a simplified export process.

Stumpage

Given that measuring equivalence is always challenging, reforming stumpage could be a hard nut to crack. Fortunately, the new Quebec system offers a useful model that should be examined in detail. In a Canadian context, stumpage reform would necessarily require the buy-in of the provinces. If the federal government and the provinces were to designate representatives to develop a coherent approach for an auction based methodology, Canada would be in a position to approach the envoy negotiations with the United States from a position of greater strength and clarity. For its part, the United States should make clear its priorities on stumpage reform as well as its view of the Quebec model.

Part Four – A Time for Boldness

Einstein famously said: "the definition of insanity is doing the same thing over and over and expecting a different result". As "Lumber V" looms, the necessity of pursuing a substantially different approach seems clear.

Finding a permanent solution to an issue over which there has been so much acrimony can prove supremely difficult. Each side can legitimately point to instances where the other side has acted in less than good faith and history has a way of compounding these grievances. Nevertheless, history does not absolve us of the responsibility for finding a long-term solution to the Canada-United States softwood lumber dispute.

Both countries, within their own economies and internationally, have accepted the principle that markets in general should allocate scarce resources. Regardless of how unpleasant it is to hear, British Columbia's system of log export restrictions distorts its timber market beyond any semblance of normalcy. With no legitimate national security or other reason for maintaining the current system, it is time for British Columbia to move to a model that is more similar to that of other North American jurisdictions.

The appropriate place to start ensuring that Canada's timber harvesting and processing industries operate on an unsubsidized basis is to remove log export restrictions on private land in British Columbia. This policy shift should be complemented with the development and application of a mechanism that could be used to recognize its newly unsubsidized status and to provide for its exemption from U.S. import duties or export restraints.

Taking this first small step would lay the foundation for a much deeper and more complex reform process. With creativity and willingness to apply the best evidence available, Canada and the United States can achieve a durable lumber peace. After four major battles in the lumber war and a new one looming, bold action rather than tinkering around the edges is where the two countries should be heading.

APPENDIX ONE

THE ILLEGALITY OF LOG EXPORT RESTRICTIONS UNDER INTERNATIONAL TRADE LAWS

Professor Michael J. Trebilcock[25]

British Columbia's log export restrictions ("LERs") are both illegal quantitative restrictions under the General Agreement on Tariffs and Trade 1994 ("GATT"), and countervailable subsidies to Canadian lumber producers under the WTO Subsidies and Countervailing Measures Agreement ("SCM Agreement").

LERs are clear violations of Article XI:1 of the GATT. Put simply, restrictions on exportation are prohibited under Article XI:1. LERs cannot be justified under the available exemptions to the general prohibition.

LERs are also countervailable subsidies to Canadian softwood lumber producers, as the Department of Commerce has found in prior lumber CVD investigations as well as in other CVD determinations. Through the Surplus Test and Fee-in-Lieu requirements, the provincial and federal governments entrust or direct harvesting companies in BC to provide logs, to domestic producers, thus providing a financial contribution. Because the logs are provided to domestic processors at below-market prices, a benefit is conferred. And because this timber is provided only to domestic timber processing industries in BC, the log export restrictions are specific.

(1) LERs: ILLEGAL QUANTITATIVE RESTRICTIONS

LERs enable the government to control nearly all aspects of the exportation of logs, including whether the logs can be exported at all, how much can be exported, who can export, how often exports can take place, the costs related to the exportation, the purpose of all which is to help to ensure that BC log processors have continuous uninterrupted supply at all times to BC logs at suppressed domestic prices.

(a) Article XI:1 Violation

Article XI:1 of the GATT states that no prohibitions or restrictions other than duties, taxes or other charges, whether made effective through quotas, import or export licenses or other measures, shall be instituted or maintained by any contracting party on the importation of any product of the territory of any other contracting party or on the exportation or sale for export of any product destined for the territory of any other contracting party.

Canada bans the export of logs from the province of BC which do not meet the Surplus Test.[26] By refusing to grant export permits unless the Surplus Test is

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satisfied, Canada unlawfully restricts the export of logs. The effect of the LERs is to restrict the ability of landowners to sell into international markets at international prices, and to increase the supply of logs at depressed prices to the downstream lumber processing sector.

LERs are a clear violation of Article XI of the GATT:

(i) Canada and BC are not required to grant approval to applicant exporters and are authorized to impose various restrictive conditions on the export of logs. The most notable limiting condition is that log exporters are required to create a log surplus in the domestic market before they are able to obtain government approval to export logs. Both the federal and provincial governments impose the Surplus Test. BC logs are only available for export after they have first been offered for sale to local processors at discounted prices. Canada in conjunction with BC have created a government system which requires log harvesters to continuously create a surplus of logs at suppressed prices in the domestic market at all times.

(ii) The Surplus Test imposes a mandatory requirement on all exporters to submit their logs to an arbitrary government sanctioned price comparison mechanism, designed to suppress domestic log prices for the benefit of local processors. Exporters are only permitted to export logs if a domestic processor does not offer a "fair" price for the logs at issue. What constitutes a "fair" offer in relation to the prevailing market prices in BC is an arbitrary institutionally biased process administered by a government-appointed Committee of individuals, all or almost all of which have interests directly opposed to that of the applicant log exporter. There are no official, inscribed publicly-disclosed policies or requirements for determining the conditions under which an offer will be considered "fair" by the Committee or for determining the benchmark domestic market price of logs. Both such determinations are left to the arbitrary undisclosed judgement of the Committee which is subject to no effective recourse or review.

The benchmark domestic value of logs is set in an environment where the usual forces of supply and demand do not exist due to a system imposed by the Canadian and BC governments which grants domestic log processors extreme leverage to

[26] WTO panels have considered similar measures restricting exports or imports to be "prohibitions or restrictions" within the meaning of Article XI. *United States-Import Prohibition of Certain Shrimp and Shrimp Products*, Report of the Appellate Body, WT/DS58/AB/R, adopted 6 November 1998, para. 7.16.

maintain suppressed domestic market prices for the logs they purchase in the log market. This leverage is exerted by the domestic log processors through their official ability to threaten to interfere with log exporters' exporting activities if logs are not made available to them at suppressed domestic prices.

(iii) Log harvesters seeking export permits for logs are often forced to strike side deals with BC domestic log processors to induce them not to submit bids for the logs in question, but at the cost of the log exporter sharing some portion of the log export price with domestic processors that might otherwise have bid for the logs.

(iv) Restrictions prohibiting the advertising of standing timber restrict the ability to obtain an export permit until after the logs are harvested.

(v) The restrictions impede the ability of harvesters to enter into long term contracts with foreign buyers for the supply of logs.

(vi) Canada imposes severe additional mandatory costs, and procedures (such as sorting requirements) on the export of logs thereby restricting their unimpeded access to international markets.

(b) Exceptions Do Not Apply

Article XI:1 goes on to set out the various exceptions. In particular, Article XI:2(a) states that the general prohibition in Article XI:1 shall not extend to export prohibitions or restrictions "temporarily applied" to prevent or relieve "critical" shortages of foodstuffs or other products "essential" to the exporting contracting party.

In *China-Measures Related to the Exportation of Various Raw Materials*, the Panel considered the meaning of "temporarily applied". The Panel concluded that this term required that "a restriction or ban under applied under Article XI:2(a) must be of a limited duration and not indefinite.[27]

Canada cannot justify its log export restrictions under Article XI:2(a). LERs have not been "temporarily applied", but have been in place for several decades with no indication of when they will be withdrawn. There can also be no "critical" shortage

[27] *China-Measures Related to the Exportation of Various Raw Materials,* Panel Report, WT/DS394, 395, 398/R., July 5, 2011, paras. 7.256-260.

of logs in British Columbia as the volume of logs harvested has been below the Annual Allowable Cut for several years.

(c) Not Saved by GATT, Article XX

LERs are not justified under the general exception found in Article XX of the GATT because they do not meet the requirements of the chapeau to that provision: that the measures are not applied in a manner that constitutes arbitrary or unjustified discrimination or a disguised restriction on international trade.[28]

LERs discriminate between domestic and foreign users of the raw materials in question. The reason for that discrimination – a desire to favour domestic users of those raw materials – is not a reason that constitutes a "justification" within the meaning of the chapeau. The effect of the export restrictions is to favour domestic users of logs. Indeed Canada argued this very point in its support of the US complaint against China in *China-Measures Related to the Exportation of Various Raw Materials* wherein Canada stated:

> *China has not met the requirements of the chapeau of Article XX, notably because the export restrictions discriminate between domestic and foreign users of the raw materials in question. Also, the facts show that the effect of the export restrictions is to favour domestic users of the raw materials in question and this is a "disguised restriction" within the meaning of the chapeau.*[29]

(d) Illegal Export Restrictions in Other Cases

Several major Canada-US FTA, NAFTA and WTO decisions exemplify important applications of these provisions.

In 1986, the US initiated a GATT complaint against Canada's ban on the exportation or sale for export of certain unprocessed herring. In 1988, a GATT Panel found that these restrictions violated the prohibition in Article XI:1 of the GATT as they were not primarily aimed at the conservation of an exhaustible natural resource under Article XX.[30] Canada subsequently eliminated these export prohibitions and instead instituted requirements that various species of herring and salmon be landed in Canada before export, so that they could be inspected. A Canada-US FTA Panel found that the landing requirements were inconsistent with the FTA, violating the provisions of Article XI and were not justified under Article XX, given the availability of less trade-restrictive measures for monitoring and ensuring the sustainability of the fish stock.[31]

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[28] Supra, 2, *US-Shrimp*, Appellate Body Report, at para. 150.
[29] Supra, 3, Addendum, ANNEX E-3 - Executive Summary of Written Submissions and Oral Statement of Canada, at para. 10.
[30] *Canada – Measures Affecting Exports of Unprocessed Herring and Salmon*, L/6268 Panel Report, adopted 22 March 1988, BISD 35S.
[31] *West Coast Salmon and Herring from Canada*, CDA-USA-1989-1807-01. See also see Michael Trebilcock and Robert Howse, *The Regulation of International Trade* (Edward Elgar, 3rd ed., 2005), at 515-518.

Over the past several years, the U.S. and other countries have challenged several export restraint measures imposed by China for violation of Article XI of the GATT. In each case, Canada has somewhat hypocritically intervened to support the complaints notwithstanding that its own export restraints on logs violate the same provision. Arguably, logs are far less critical to Canada's national and economic security than, say, rare earth elements. Any claim that LERs are somehow essential seems highly tenuous.

In 2009, various countries, including the US, filed a WTO complaint against export restraints imposed on various raw materials from China. These included export duties, export quotas, minimum export price requirements, and export licensing requirements. In 2012, the Appellate Body largely affirmed the decision of the WTO Panel, finding that these export requirements violated Article XI of the GATT, and in particular the Panel's conclusion that China had not demonstrated that its export restrictions were "temporarily applied" to either prevent or relieve a "critical shortage" within the meaning of Article XI:2(a).[32]

Canada participated as a third party to support the complainants in this dispute. Canada argued that measures may not be applied under Article XI:2(a) for an indefinite period, but may only be applied for a fixed time; something which is clearly not the case with its own LERs which themselves have been in existence for decades.[33]

In 2012, another WTO complaint was filed by the US against various restrictions that China had imposed on the export of certain rare earth materials. While China appeared to accept that these restrictions violated Article XI of the GATT, 1994 it sought to justify the measures under Article XX(g) (the General Exceptions Provision in the GATT) as measures relating to the conservation of scarce natural resources if implemented in conjunction with measures restricting domestic production or consumption of such resources. The WTO Panel held that the terms of Article XX(g) were not satisfied, because domestic producers of products for which these rare earth materials were an import were not restricted in their access to these materials, and hence the restrictions were designed to serve industrial policy objectives in promoting domestic manufacturers by securing their preferential use of these materials and did not serve a conservation objective.[34] The Appellate Body, with some qualifications, affirmed the Panel's decision.[35]

Canada once again participated as a third party in support of the complainants, making detailed written and oral statements in opposition to the Chinese measures.

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[32] *China - Measures Relating to the Exportation of Various Raw Materials,* WT/DS394/AB/R, WT/DS395/AB/R, and WT/DS398/R (January 30, 2012).
[33] *Supra*, note 3 at 7.254 "Canada submits that measures may not be applied under Article XI:2(a) for an indefinite period, but may only be applied for a fixed time."
[34] *China - Measures Relating to the Exportation of Rare Earths, Tungsten, and Molybdenum,* WT/DS431/R, WT/DS432/R, and WT/DS433/R (Mar. 26, 2014).
[35] *China - Measures Relating to the Exportation of Rare Earths, Tungsten, and Molybdenum,* WT/DS431/AB, WT/DS432/AB, and WT/DS433/AB (Aug. 14, 2014). A number of issues raised in this case pertain to the terms of China's accession to the WTO and hence are specific to China's terms of membership.

Indeed, Canada even asked the Panel for enhanced third party rights to voice its opposition, but was denied.[36]

On July 13, 2016 the US filed a request for consultations with China relating to China's policies on the export of certain raw or rare materials, where China apparently has adopted measures that rely largely on export duties rather than quantitative restrictions.[37] The European Union filed a similar request for consultations on July 19, 2016.[38] Canada has once again requested to join both requests for consultation.

(2) LERs: COUNTERVAILABLE SUBSIDIES

Prohibited and actionable subsidies may give rise to a WTO complaint by a member government under the SCM Agreement that came into force in 1995 as a result of the Uruguay Round negotiations. In cases where subsidies of products by one WTO member result in increased volumes of exports or lower prices in the market of another WTO member, causing material injury to domestic producers of like products in the importing country, unilateral application of countervailing measures is permitted, following the filing of a petition by domestic producers of like products in the importing country before domestic trade tribunals (in the case of Canada, the US, and Mexico, subject to a binational appeal procedure set out in Chapter 19 of NAFTA).

The countervailability of LERs was a major issue in 1993 Chapter 19 binational panel proceedings under the *Canada-US Free Trade Agreement*. In 1992, the Department of Commerce (DOC) issued a preliminary determination that LERs in BC conferred a weighted average subsidy of 8.23%.[39] According to DOC, "log export restrictions in BC result in an increase in the domestic supply of logs and a decrease in the domestic log price." In its Final Determination, DOC determined that BC's LERs conferred a subsidy of 4.65% on softwood lumber producers in BC.[40]

In 1993, the FTA Binational Panel reviewing DOC's Final Determination found that log export restrictions gave rise to the existence of a subsidy to domestic timber processors by virtue of providing them with preferential access to logs harvested in Canada (in effect a captive market for these logs).[41] The Panel accepted that applying general principles of economics, it was obvious that foreclosing international competition for the purchase of raw logs indeed depressed the price of these logs in the domestic Canadian market, hence conferring a subsidy on domestic timber processors.[42]

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[36] Supra, note 3, Addendum, ANNEX C-4 Integrated Executive Summary of the Arguments of Canada.
[37] Dispute DS508: China – Export Duties on Certain Raw Materials.
[38] Dispute DS509: China - Duties and other Measures concerning the Exportation of Certain Raw Materials.
[39] *Certain Softwood Lumber Products from Canada*, 57 Fed. Reg. 8,800 (1992).
[40] *Certain Softwood Lumber Products from Canada*, 57 Fed. Reg. 22,570 (1992).
[41] *Softwood Lumber Products from Canada (Countervailing Duty*): US-Canada FTA-Article 1904: Binational Panel Review U.S.A.-92-1904-01: Decisions of the Panel, May 6, 1993 and December 17, 1993.
[42] Article 2 of the SCM Agreement provides that a subsidy is "specific" if it is specific to an enterprise or industry or group of enterprises or industries within the jurisdiction of the granting authority. The WTO Panel in *United States – Final*

As noted above, the DOC recognized the countervailability of export restrictions in its 1992 determination that Canadian softwood lumber was subsidized. The subsequent *Uruguay Round* SCM Agreement set out the criteria that must be met for a government action to be considered a subsidy. There must be a "financial contribution" which can occur if the government transfer funds directly, forgoes revenue that otherwise is due, provides a good or service *or* "entrusts or directs" a private body to carry out any of these actions. Second, the "financial contribution" must confer a benefit. In the Statement of Administrative Action[43] accompanying the U.S. implementing legislation (*1994 Uruguay Round Agreements Act*), the executive branch made clear that US law and the SCM Agreement recognized that an indirect subsidy could be provided through an export restraint scheme.[44] The DOC also confirmed that were it again to investigate situations similar to those in the 1992 softwood case, US trade law would continue to permit it to reach the same conclusion.

Given that the DOC had found LERs to be a countervailable subsidy in 1993, in May 2000, Canada challenged this policy before the WTO[45], alleging that the U.S. interpretation, as set forth in the above-cited documents, was inconsistent with US obligations under the SCM Agreement.

The WTO rejected Canada's arguments that the U.S. legislation implementing Uruguay Round on its face violated the SCM Agreement by identifying export restraints as countervailable. The Panel ruled that the law gives the DOC full discretion to decide whether or not to countervail export restraints. In effect, this means that the DOC is free to countervail BC LERs in any new trade remedy case against softwood lumber from the Canada.

The Panel did not directly address the question of BC LERs since the US did not then have measures in place to countervail those restraints. The Panel found hypothetically that a "bare" export restraint with no other government involvement would not constitute a financial contribution. The Panel was careful to limit its conclusion to the hypothetical export restraint as Canada defined it: namely, "a border measure that takes the form of a government law or regulation which expressly limits the quantity of exports or places explicit conditions on the circumstances under which exports are permitted".[46] However, the BC LERs,

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Countervailing Duty Determination with Respect to Certain Softwood Lumber from Canada, WT/DS257/R found that provincial stumpage was a specific subsidy holding at paragraph 7.121 that

> "a determination of specificity does not require a detailed analysis of the end-products produced by the enterprises involved. In our view, it was reasonable of the USDOC to reach the conclusion that the use of the alleged subsidy was limited to an industry or a group of industries. We consider that the "wood products industries" constitutes at most only a limited group of industries - the pulp industry, the paper industry, the lumber industry and the lumber remanufacturing industry - under any definition of the term "limited". We do not consider determinative in this respect the fact that these industries may be producing many different end-products. As we discussed above, specificity under Article 2 SCM is to be determined at the enterprise or industry level, not at the product level."

[43] H.R. 5110, H.R. Doc. 316, Vol. 1, 103d Congress, 2nd Session, 656 at 925-926 (1994).

[44] H. Doc. 103-316, vol. 1, at 925-926; "Countervailing Duties," 63 *Fed. Reg.* 65348, 65351(Nov. 25, 1998).

[45] *United States- Measures Treating Export Restraints as Subsidies*, Report of the Panel, WT/DS194/R, 29 June 2001. The Panel Report was not appealed to the Appellate Body.

[46] At para. 8.76.

needless to say, are far more intrusive and support a finding of "entrust or direct," unlike the "bare" export restraint presented by Canada in this case.

The Panel was also careful to place narrow limits on its ruling.[47] The Panel was clear that its decision would not apply to export restraints which also function as a direction to process the goods within the province, which is precisely what the BC Surplus Test and its concomitant web of regulatory and procedural impediments is meant to do. The restrictions governing the export of logs from BC arise from a compilation of laws and regulations that, taken together, result in a clear direction to process the logs in BC.

Since this case, the DOC has proceeded in three other countervailing duty determinations involving the export of paper products from Indonesia in 2015 (*Certain Uncoated Paper from Indonesia*[48]), 2010 (*Certain Coated Pape from Indonesia*[49]*)* and 2007 (*CFS from Indonesia*[50]) to find that log export restrictions imposed by the Indonesian government created a market distortion and confer a specific countervailable subsidy to downstream industries, including Indonesian pulp and paper processors that were given preferential or captive access to domestic log supplies. In these cases, DOC found that the Indonesian government, through the log export restriction, entrusted or directed harvesting companies to provide lower-price inputs (logs and chipwood) to companies in the pulp and paper producing industries. The DOC determined that the log export restriction provided a benefit in that the restriction allowed the purchase of inputs (logs and chipwood) at below-market prices. The subsidies have been found to be specific because they are restricted to only a limited group of industries, and because they cover only a small number of products within those industries.

These Indonesian paper cases clearly point to the existence of a countervailable subsidy induced by LERs for domestic log processors in Canada. DOC has found that the government entrusted and directed "forestry/harvesting companies to provide lower-price inputs (logs and chipwood) to companies in the pulp and paper industries.[51]

Most recently in *Countervailing Measures on Supercalendered Paper from Canada*[52], DOC initiated an investigation into the subsidies provided by BC LERs during its

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[47] At para. 8.76 the Panel was careful to limit its finding.
[48] *Certain Uncoated Paper from Indonesia: Final Affirmative Countervailing Duty Determination*, 81 Fed. Reg. 11187 (March 3, 2016).
[49] *Certain Coated Paper Suitable for High-Quality Print Graphics Using Sheet-Fed Presses from Indonesia: Final Affirmative Countervailing Duty Determination*, 75 Fed. Reg. 59209 (Sept. 27, 2010).
[50] *Coated Free Sheet Paper from Indonesia: Final Affirmative Countervailing Duty Determination*, 72 FR 60642 (October 25, 2007) (CFS Final), and accompanying Issues and Decision Memorandum (CFS IDM).
[51] *Certain Uncoated Paper From Indonesia: Preliminary Affirmative Countervailing Duty Determination and Alignment of Final Determination With Final Antidumping Determination*, 80 Fed. Reg. 3 697 1 (June 29, 2 0 1 5) and Accompanying Issues and Decision Memorandum at 22.
[52] *Supercalendered Paper from Canada: Final Affirmative Countervailing Duty Determination*, 80 Fed. Reg. 63535 (October 20, 2015).

expedited reviews of Irving and Catalyst[53]. In doing so, DOC has accepted the allegation that through the LERs both the Government of British Columbia and Government of Canada "entrust or direct" log harvesters to provide logs to the wood processing and pulp and paper industries in British Columbia thereby providing a financial contribution; that LERs provide a benefit because logs and downstream products are provided at prices that are lower than they would be without the restrictions in place; and that LERs are *de facto* specific because the actual recipients of the subsidy (users of logs) are limited in number, or, in the alternative the predominant users of the subsidy.

Finally, as the US Lumber Coalition points out in its submission of May 30, 2014, if log export restrictions were abolished in all their various forms, many of the alleged subsidy programs maintained by federal and provincial governments in Canada would be negated. For example, assuming for the sake of argument, that stumpage rates for timber harvesting on Crown lands are artificially low, domestic and foreign log harvesters could simply harvest these logs at the assumed artificially low stumpage rates and export the unprocessed logs into the US and other international markets, presumably creating an incentive for provincial governments to raise stumpage rates, given that prevailing rates would no longer confer any benefit on domestic timber processors.

In summary, LERs violate established international trade law and cannot be sustained by Canada in the long term.

[53] *Supercalendered Paper from Canada: Initiation of Expedited Review of the Countervailing Duty Order*, 81 Fed. Reg. 6506 (February 8, 2016), including: New Subsidy Analysis Memorandum (April 18, 2016), in which the US initiated an investigation into the new subsidy allegations filed by the petitioner on 16 February 2016.