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## **Recent Developments in the US– Canadian Softwood Lumber Disputes**

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Since the United States and Canada could not resolve their contentious dispute on lumber trade, both countries approached the World Trade Organization to resolve this long-running disagreement. Each country filed three petitions covering (a) countervailing duties (CVD), (b) antidumping, and (c) material injury resulting from CVD and antidumping. This article briefly reviews the dispute, explains both countries' factual arguments submitted to the WTO, presents the WTO rulings on the three petitions, and discusses the economic implications of WTO findings.

Keywords: Canada, dispute, lumber, United States, WTO

### **Introduction**

**T**he U.S.–Canada lumber dispute is more than two centuries old and is one of the most contentious trade frictions between the two countries (Reed, 2001). The crux of this long-lasting dispute in recent years is the U.S. claim that Canadian lumber is being subsidized and Canada is dumping lumber in the U.S. market, i.e., selling at below the cost of production. The United States argues that the Canadian government charges the lumber companies artificially low prices for harvesting lumber on

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Canadian public land, a practice which enables these companies to sell at below the cost of production in the U.S. market. The United States claims that almost 94 percent of Canadian timberlands are publicly owned (Canada, 1996), which makes it possible for companies to acquire timber at a low price. In contrast, only 42 percent of the timberlands in the United States are owned by the government, and since the timber is auctioned off in the open market, its harvest is not subsidized.

Canada asserts that it grants the companies harvesting rights to standing timber in exchange for “service and maintenance obligations (e.g., road-building, protection against fire, disease, and insects); implementation of forestry management and conservation measures (including silviculture); and payment of a volumetric stumpage charge that is levied upon the exercise of the harvesting right” (WTO, 2003). The United States claims such management practices amount to subsidies even if the companies complete these activities because selling the standing timber in the open market would fetch higher prices than stumpage fees. Canada repudiates the U.S. claims by contending that the services provided by the softwood lumber companies should be taken into account in computing the stumpage fees. Canada also claims its vast endowment of forestland provides a natural competitive advantage, which helps to lower the timber price.

After the expiry of the Softwood Lumber Agreement (SLA) in 2001,<sup>1</sup> U.S. lumber producers filed a petition with the U.S. Department of Commerce (USDOC) to investigate the Canadian implicit subsidy and dumping and to impose trade restrictions. After extensive investigations and findings by the U.S. International Trade Commission (USITC) of the USDOC that Canada does provide implicit subsidy, the USDOC imposed a preliminary countervailing duty (CVD) of 19.31 percent on Canadian lumber. The USITC also found evidence of dumping, and the USDOC imposed preliminary antidumping duties ranging from 5.94 to 19.24 percent.

As soon as the USITC began its investigation, the two countries began negotiations, meeting several times in an attempt to reach a solution to this long-lasting dispute. During the negotiation period, the United States combined the preliminary CVD and antidumping duties to form a final duty of 27.2 percent. Since an amicable solution continued to elude them, both countries approached the World Trade Organization to resolve this bitter dispute.

The goal of this article is to examine and present both countries’ stands on this dispute and the WTO rulings and their implications for U.S. and Canadian softwood lumber markets. The specific objectives of this article are to:

1. Review U.S. and Canadian arguments and counter-arguments, bilateral negotiations, and outcomes of the negotiations since 2001.

2. Discuss the petitions submitted by the United States and Canada to the WTO Dispute Settlement Body (DSB) and review the arguments each country put forward in these petitions.
3. Present the findings of the WTO DSB panel.
4. Explain the economic implications of the WTO rulings, which require the United States to lower the tariffs on lumber imports from Canada.

## **Softwood Lumber Dispute and WTO Investigation**

The past 25 years of disputes and negotiations surrounding U.S.–Canada softwood lumber trade are generally classified broadly, based on their chronological development, under the titles Lumber I, II, III, and IV. Lumber I deals with disputes covering the period 1981 to 1985; Lumber II, 1986 to 1990; Lumber III, 1991 to 2000; and Lumber IV, 2001 to present. Since the focus of this study is on the recent problems, developments, and issues surrounding this dispute, we will focus on Lumber IV and the subsequent WTO investigation. For a detailed description of lumber disputes I, II, and III, refer to Rhaman and Devadoss (2002), and for a much earlier discussion of this dispute dating back to 1789, see Reed (2001).

In 2001, after the SLA expired, the USDOC received two petitions from the U.S. producers alleging that Canadian softwood lumber producers receive implicit subsidies and sell softwood lumber in the United States at prices below the cost of production (Rhaman and Devadoss, 2002). The U.S. producers wanted the USDOC to impose a CVD and an antidumping tariff on softwood lumber imports from Canada. The petitions were supported by the Coalition for Fair Lumber Imports Executive Committee; Moose River Lumber Co., Inc.; the Paper, Allied-Industrial, Chemical and Energy Workers International Union; Shearer Lumber Products; Shuqualak Lumber Co.; Tolleson Lumber Co., Inc.; and the United Brotherhood of Carpenters and Joiners. Members of these organizations produce almost 67 percent of U.S. softwood lumber production (WTO, 2003).

The major arguments put forth by the U.S. producers in their first petition was that low stumpage fees and log export restrictions implicitly subsidize Canadian softwood lumber companies, in turn allowing these companies to sell at below the cost of production in the U.S. market, injuring the U.S. lumber industry (Canada, Department of Foreign Affairs and International Trade, 2001). The log export restrictions do not permit non-Canadian lumber companies to purchase the cheaper priced logs for milling, and thus, this program helps to keep costs low only for Canadian companies. The U.S. producers suggested that various lumber policies instituted by the Canadian government amounted to a 39.9 percent subsidy to Canadian lumber producers.

Against the wishes of the Canadian government, the USITC extensively investigated Canadian forest management policies, focusing on (a) Canadian stumpage fees, (b) log export restrictions, (c) the Western Economic Diversification program, (d) the Federal Economic Development Initiative for Northern Ontario, and (e) the Industry, Trade and Economics program of the Canadian Forest Service. During this inquiry the USITC gathered input from experts who were familiar with trade and domestic policies and with these disputes. After a lengthy study of all the Canadian programs, the USITC found that Canada indeed subsidizes its domestic lumber industry to the tune of 19.31 percent. According to the GATT regulations, a country can impose a CVD on imports to safeguard its producers if these imports come from a country that subsidizes its domestic production. On this account, the USDOC imposed in August 2001 a preliminary *ad valorem* CVD of 19.31 percent.

Canada attributes its lower softwood lumber prices to its natural and vast endowments of forestlands and improved technology in harvesting and processing, which amount to higher productivity and cheaper softwood lumber. Thus, Canada argues that its stumpage programs are not countervailable.

In their second petition, the U.S. producers alleged that Canadian lumber is sold in the United States at less than fair value and asked the USDOC to impose antidumping duties ranging from 22.53 percent to 72.91 percent (*U.S. Federal Register*, 2001). Antidumping duties are generally imposed on imports if a country finds that imports are sold at below the cost of production or below the domestic market price in the exporting country (Houck, 1986). The USITC undertook an extensive and countrywide investigation to assess whether Canadian softwood lumber products are sold in the U.S. market at prices below the cost of production or below the Canadian market price. After a lengthy investigation, the USITC found that certain Canadian softwood lumber products are indeed sold below fair market prices. Subsequent to this investigation, the USDOC instituted preliminary antidumping duties ranging from 5.94 to 19.24 percent on softwood lumber imports from Canada. These preliminary duties were later finalized at 2.18 to 12.44 percent. Thus, the USDOC determined a total tariff of 31.75 percent (a CVD of 19.31 percent plus an antidumping duty of 12.44 percent), and all softwood lumber imports from Canada would incur this tariff starting in 2002.

Canada claimed that U.S. producers could not meet domestic demand in the United States; therefore, the Canadian softwood lumber industry helped to meet the U.S. demand, and the antidumping duty was unwarranted. The low price for Canadian softwood lumber arose from the inherent comparative advantage rather than from price manipulations.

In spite of polar differences, both countries tried earnestly to resolve the litigation by negotiating an amicable agreement. In fact, negotiations started as soon as the USDOC began its investigation. After the preliminary determination of antidumping duties, negotiations were held in November and December 2001 to find a durable solution to this long-standing dispute. During these negotiations, the U.S. proposal was for Canada to sell timber in an open market by auctioning. The United States also sought to eliminate the Canadian minimum cut requirements, which promote harvesting even when demand for softwood lumber is weak. Furthermore, the United States was willing to remove all tariffs if Canada made significant changes to its forest management policies. Canada and the United States were in favor of a “border tax” (export tax) that Canada would collect (*Spokesman-Review*, 2002a).

British Columbia proposed to double the amount of government softwood timber that is sold in public auction, from 6 percent to 12 percent, and eliminate minimum cut requirements, which forced softwood lumber producers to harvest timber even when market conditions would suggest otherwise. But the U.S. producers held that a higher percentage of Canadian softwood timber should be sold in a public auction in order to have a market-based system, and any public sales less than 65 percent would still constitute a protected market. Canada considered the U.S. demands to be both overreaching and unnecessary external intervention into business practices and Canada’s domestic policy. Consequently, none of these proposals materialized and negotiations broke down.

One outcome of these negotiations was that in March 2002 the USDOC reduced the combined tariff of the CVD and the antidumping duty from 31.89 percent to 27.2 percent. This tariff was to take effect from May 2002. It is important to note that in anticipation of this tariff Canadian producers increased their exports to the United States before the CVD was imposed, which depressed U.S. softwood lumber prices. This caused further stress in the U.S. softwood lumber industry (*Spokesman-Review*, 2002b). At the same time, imports from New Zealand and Chile were at an all-time high. In addition, U.S. production significantly increased during the non-tariff period. All these factors contributed to conditions of increased supply and lower prices in the United States.

Since the countries could not resolve this cumbersome dispute, each took its case to the WTO, while continuing to negotiate bilaterally to find a solution.

### **Petitions to the WTO**

Canada argues that stumpage programs do not qualify as subsidies and the United States should not impose a CVD. Canadian producers contend that the U.S.

concern is not about subsidies but about the market share of Canadian lumber in the U.S. market. Canada filed three petitions to the WTO Dispute Settlement Body (DSB):

Petition I. In August 2002, Canada requested that the WTO examine the final countervailing duty on Canadian softwood lumber as determined by the USDOC in March 2002.

Petition II. In December 2002, Canada solicited the WTO to examine the April 2002 determination by the United States that Canada was selling softwood lumber products at a price less than fair market value.

Petition III. In April 2003, Canada requested that the WTO examine the May 2002 U.S. claim that Canadian softwood lumber is subsidized and sold in the United States at a price less than fair market value, *which injures the U.S. softwood lumber industry*.

Briefly, petition I deals with countervailing duties, petition II with antidumping duties, and petition III with the material injury rationales for CVD and antidumping duties.

### *Petition I*

The discussion of petition I consists of four parts. First, we present the request for findings by each country. Second, we summarize each country's arguments and counter-arguments. Third, we discuss the WTO DSB panel's findings. Fourth, we review the appeals by each country and the findings of the Appellate Body.

While preparing the first petition and as per the rules of Article 4 of the WTO Dispute Settlement Understanding (DSU), Article XXII of the General Agreement on Tariffs and Trade 1994 (GATT), and Article 30 of the WTO Agreement on Subsidies and Countervailing Measures (SCM), which require the involved parties first to negotiate on their own to find a solution, Canada initiated the negotiation process with the United States to resolve the dispute. In June 2002, the two countries held negotiations but failed to reach an agreement. Consequently, both countries approached the WTO to resolve the dispute. In its petition, Canada requested that the WTO panel (WTO, 2003):

1. Investigate the USDOC's basis for starting the inquiry, the process of determining countervailing duties, and whether the final magnitude of the countervailing duties is in violation of the various articles of the SCM and GATT agreements.
2. Recommend that the United States use measures in line with current WTO regulations by eliminating the countervailing duty and refunding all the duties collected following the Softwood Lumber IV investigation.

The United States requested that the panel:

1. Reject all Canadian arguments and find U.S. concerns and actions in imposing the CVD are legitimate.

### Canadian and U.S. Arguments and Counter-arguments

The USDOC initiated the CVD investigation based on the fact that producers supporting the petition represented 67 percent of U.S. softwood lumber production. However, Canada argued that U.S. softwood lumber producers knew that if they supported the petition they were eligible to receive cash payments under the Dumping and Subsidy Offset Act of 2000. Canada asserted that there was a moral hazard issue in that U.S. producers had a strong incentive to support the petition even if they were not being affected by Canadian softwood lumber imports. Therefore, according to Canada, the United States should not have initiated the investigation. The U.S. counter-argument was that the investigation was initiated according to Article 11.4 of the SCM Agreement, which stipulates that an investigation can be initiated if it is supported by those domestic producers whose collective output constitutes more than 50 per cent of the total production (SCM Agreement, 2004).

In addition, Canada claimed that the United States should not have imposed countervailing duties because Canadian policy practices are not countervailable subsidies. Under the SCM Agreement a subsidy is a “financial contribution that confers a benefit.” Canada asserted, on the basis of the following arguments, that the United States had yet to prove the existence of a subsidy:

- The USDOC incorrectly considered that provincial stumpage programs “provide goods”. Provincial governments in Canada own most of the natural resources, which are used for various purposes. Canada alleged that forestry resources are carefully managed to fulfill the interests of both the Crown and timber harvesters since the system is based on tenure and licensing agreements. Thus, stumpage programs do not “provide goods”.
- “Licensing agreements are a complex bundle of rights and obligations containing at the minimum: the right to harvest standing timber on Crown land, service and maintenance obligations, implementation of forestry management and conservation measures, including silviculture, and payment of a volumetric stumpage charge that is levied upon the exercise of the harvesting right” (WTO, 2003).
- “Financial contribution” means a government providing goods and/or services other than general infrastructure. International law refers to “goods” as tradable items that are capable of bearing a tariff heading. Also, the panel that examined the U.S. Softwood Lumber III case established that the ordinary



meaning of the word “good” is a tangible or movable personal property other than money (WTO, 2002). Therefore, the definition of “goods” excludes intangible property and property rights, which are the basis of the stumpage program. Thus, Canada claimed that the USDOC erroneously considered the right to harvest the standing timber to be a “good” provided by the provincial tenure system. Canada insisted that provincial stumpage programs only provide the right to harvest, and such a right should not be considered a “good” because it is not traded across the border.

The United States refuted Canada’s argument by stating that the USDOC did correctly determine that provincial stumpage programs constitute a financial contribution. “Through their tenure systems, the Canadian provinces provide ‘an identified thing to be severed from real property’, i.e., timber” (WTO, 2003). The USDOC argued that Canada is making softwood timber available to the producers, and therefore, under the SCM Agreement’s definition, timber is a good. Providing the right to harvest the timber implies the Canadian government provides the standing timber. Furthermore, the United States claimed that a license or right to harvest timber would also constitute a good because “goods encompass all people’s legal rights of whatever description.” The United States also contended that based on previous findings by the Softwood Lumber III Panel Canadian provincial stumpage programs do benefit the Canadian softwood lumber industry.

The USDOC compared markets in the United States and Canada to determine the benefit that Canadian producers were receiving. Canada argued that in doing so the United States violated the SCM Agreement because the investigating authority should not use cross-border benchmarks and/or consider benchmarks from within the country of investigation. The United States responded that private market prices in Canada are not suitable for determining subsidy because they are significantly affected by the stumpage program. Since there were no appropriate market price data from Canada, the United States used the northern U.S. adjusted price (as benchmark) minus the stumpage fee to compute the Canadian subsidy. This reasoning relied on the commonly agreed fact that the North American market for softwood lumber is highly integrated. Canada’s counter-argument was that “international borders affect market conditions, and even if market conditions are comparable, this would be in violation of SCM.” Canada also contended that cross-border comparisons should not be used because they do not reflect the effects of natural endowments and comparative advantage.

Canada argued its stumpage program cannot be categorized as a subsidy because it is open to everyone and not specific to certain enterprises. Evidence was provided to

show there were 23 separate classes of industries, producing over 200 products, that used stumpage programs. Softwood lumber was not the dominant end use. The United States asserted that according to the SCM Agreement, which states that even if the subsidy appears to be available for everybody it is still countervailable if it is only accessed by a limited number of parties, stumpage programs constitute a subsidy because the USDOC found that the only beneficiaries were the pulp and paper mills, sawmills, and remanufacturers that produce subject merchandise.

Canada alleged that the USDOC needed to perform a pass-through analysis to conclude the extent of benefit received by softwood lumber producers. A pass-through analysis examines the extent to which upstream subsidies benefit downstream producers. The United States refuted Canada's claim by asserting that it was the production of softwood lumber being subsidized, not the production of logs. Therefore, no pass-through analysis was required.

Canada further argued that the United States overestimated the amount of benefit and thus the countervailing duty, therefore violating the SCM and GATT agreements, which note that countervailing duties may not be imposed in an amount that exceeds the subsidy. Canada claimed also that the United States included all logs entering sawmills instead of focusing on logs used for softwood lumber production, which accounted for less than 40 percent of the total logs. Canada complained that, furthermore, the United States, while conducting the investigation, did not share information and failed to give Canada a chance to defend itself.

### **WTO Findings**

In August 2003, the WTO findings with regard to the first petition were released through the DSB panel's report. This panel found that the USDOC correctly determined that Canadian stumpage programs are specific and provide a financial contribution. Consequently, the panel rejected Canadian claims of not providing the softwood lumber industry a subsidy through stumpage programs. This ruling entails that there is adequate cause for the United States to countervail. However, the panel concluded that the USDOC should have used private market prices in Canada, since the United States acknowledged that these prices did exist, and therefore there was no reason to use U.S. prices as a benchmark to determine the amount of benefit that stumpage programs provided to the Canadian producers.

In addition, the panel ruled that the USDOC should have conducted a pass-through analysis to determine the amount of benefit received by the Canadian producers. The panel recommended that the United States "bring its measure into conformity with its obligations under the SCM Agreement and GATT 1994" (WTO, 2003).

### **Appeal to the First Petition**

After the WTO presented its findings, both countries were entitled to appeal these findings. The WTO findings were not an outright win for either country, but rather a win-lose outcome for both. Consequently, in October 2003, Canada and the United States each appealed the decision of the WTO panel and wanted an appellate panel to review these findings.

### **Claims of Error by the United States**

The basis for the United States appeal was twofold. First, the United States claimed that its use of proxies for softwood lumber prices instead of Canadian private market prices was appropriate and argued that the panel ruled to the contrary because it failed to consider that prevailing conditions in Canada were not market conditions since “provincial governments control the vast majority of timber” (WTO, 2004a). Second, the United States contested the panel’s determination that the United States was to have done a pass-through analysis before it imposed countervailing duties. The United States argued that, according to the SCM Agreement, once a subsidy has been found an investigating country does not need to determine that the subsidy exists on a company-by-company basis. A pass-through analysis applies only to indirect subsidies. The United States claimed that subsidies were granted directly to softwood lumber producers. Therefore, the United States contended, no pass-through analysis was needed.

In response to both of these U.S. claims Canada requested that the Appellate Body uphold the panel’s findings and interpretations.

### **Claims of Error by Canada**

Canada’s appeal was also based on two grounds. First, Canada claimed that the panel made several errors in its legal interpretation of financial contribution. Canada argued that based on Article 1 of the SCM Agreement, the word “good” was misinterpreted by the panel. Canada alleged that the meaning of “good” should be limited to “tradable items with an actual or potential tariff classification” within the context of Article 1 of the SCM Agreement. To support this argument Canada pointed that in Article 3.1(b) of the SCM Agreement, which deals with “domestic over imported goods” issues, the word “imported” implies that goods are only those that are traded. In addition, Canada noted that in WTO agreements “products” and “goods” are used as synonymous in reference to traded items, imported or exported, but not to harvesting rights. Thus, all “goods” or “products” must be tradable and must be capable of bearing a tariff classification. Furthermore, Canada alleged that timber harvesting rights should not be considered personal property (WTO, 2004a).

Second, Canada stated that the panel erred when it determined that provincial governments “provide” standing softwood timber to Canadian producers through stumpage programs. Canada argued that stumpage programs only confer the right to harvest, which is not the same as “providing” timber.

The United States supported the DSB panel’s interpretation of the terms “goods” and “provide”, and thus requested that the Appellate Body uphold the panel’s findings and interpretations on both the points of appeal by Canada.

### **Findings of the Appeal**

Regarding the use of proxies by the United States, the Appellate Body found that an investigating authority could use a benchmark outside the domestic private market. In the case where private market prices are being distorted by the government, the alternative benchmark should relate to prevailing market conditions in the country of provision. However, the Appellate Body determined that there is not enough information either to justify the USDOC’s use of an alternative benchmark or to determine if that benchmark represented prevailing market conditions in Canada. Therefore, the Appellate Body did not rule on, in terms of consistency, the USDOC’s determination of existence and amount of benefit in the countervailing duty investigation or even if the imposition of countervailing duties is consistent or inconsistent according to the SCM Agreement.

The Appellate Body upheld the panel’s finding that the United States should have conducted a pass-through analysis of the sales of logs before it imposed countervailing duties. Since the United States failed to conduct this type of analysis, the Appellate Body found that the USDOC’s CVD determination was inconsistent with the SCM Agreement and GATT.

With regard to Canadian claims that the panel made an error in interpreting “financial contribution” and “providing timber”, the Appellate Body upheld the panel’s ruling that “Canadian provinces are providing a financial contribution in the form of the provision of a good by providing standing timber to the timber harvesters through the stumpage programs” (WTO, 2003).

### ***Petition II***

The discussion of petition II encompasses four parts: request for findings, arguments, the DSB’s findings, and the appeal, including the Appellate Body’s ruling. In September 2002, Canada wanted to further consult with the United States regarding the USDOC finding in April 2002 that Canada was selling softwood lumber products at a price less than its fair market value (i.e., dumping). In October 2002, Canada and the United States negotiated but failed to reach an agreement. Thus, in December

2002, Canada solicited the WTO to establish a panel to examine this dumping determination and antidumping measures taken by the United States. Canada's major requests to the WTO panel in this second petition were to (WTO, 2004b):

1. Find that there was not a clear justification for the USDOC to initiate the dumping investigation, since the information used by the petitioners (softwood lumber industry) was inadequate and inaccurate.
2. Find that the USDOC used flawed methodologies (i.e., the USDOC did not take into account the differences in physical characteristics and employed an incorrect procedure, zeroing, to calculate dumping).<sup>2</sup>
3. Recommend that the United States use measures in line with the WTO current regulation by eliminating the antidumping order and refunding all the duties collected.

The United States requested that the panel:

1. Reject all Canadian arguments and find that there is enough cause for the U.S. imposition of antidumping duties.

### **Canadian and U.S Arguments and Counter-arguments**

Canada claimed that the USDOC should not have initiated the investigation because there was not enough evidence of dumping by the Canadian exporters. Canada also argued that U.S. producers (the petitioners) did not provide "reasonably available" information to the USDOC; particularly, U.S. producers did not offer the USDOC any proof of actual dumping by any Canadian company, and therefore the investigation should not have begun. U.S. producers did not use Canadian producer prices or costs to support their petition even when one of the petitioners to the USDOC wholly owned Weldwood, one of the major Canadian exporters of softwood lumber to the United States (WTO, 2004b). The other Canadian exporters, besides Weldwood, that were investigated were West Fraser, Slocan, Tembec, Abitibi, Canfor, and Weyerhaeuser Canada. Although there are hundreds of Canadian exporters of softwood lumber to the United States, the USDOC used only the above-mentioned six companies' average margin of dumping to establish the dumping rate for all other exporters.

The United States assured the DSB panel that the USDOC properly initiated the investigation because the USDOC followed Article 5.3 of the Antidumping Agreement (i.e., the USDOC firmly believed that the petitioners presented "sufficient evidence", and therefore the investigation was justifiable). Also, the USDOC adequately studied the softwood lumber costs and prices of the six companies, which represent the major producers of Canadian softwood lumber, to find these companies were dumping softwood lumber to the United States (Antidumping Agreement, 2004).

Canada further argued that despite the diverse softwood lumber products covered by the U.S. producers' petition, the USDOC lumped all the products under a single category. Therefore, the investigators treated all products, which covered an extremely broad range from dimensional softwood lumber (used in home construction) to manufactured products (including mattress box-spring frame components, railroad ties, shelving, siding, decking, flooring, and moulding) and engineered wood products (such as finger-jointed flangestock), as a single category. Canadian exporters requested that the USDOC make distinctions between all the softwood lumber products being investigated in order to make a separate analysis for each product, but the USDOC "either ignored these requests or dismissed them without proper justification" (WTO, 2004b). The United States responded that Canada did not follow any provision of the Antidumping Agreement to sustain its arguments. The United States alleged that the Antidumping Agreement does not govern the way an investigating authority defines the product under investigation.

Canada stated that the USDOC used flawed methodology to determine the existence of dumping (i.e., failure to account for physical differences, zeroed negative margins of dumping, and failure to allocate reasonable amounts for selling and administrative costs). Canada alleged that the USDOC possessed information that showed that the price of softwood lumber depends on the size of the product, but that it ignored this information and compared prices of different-sized products without making the proper adjustments. The United States responded that the USDOC did not adjust its calculations based on dimensional differences because prices were not affected by these differences. The USDOC stated that the six companies studied did not "show that differences in the dimension of the softwood lumber compared in this case affected price comparability" (WTO, 2004b).

Canada argued that in a previous WTO resolution, the EC–Bed Linen case, the Appellate Body found that using the "zeroing" methodology results in "unfair comparison" between normal value and export price and therefore ruled that it is inconsistent with the Antidumping Agreement.<sup>3</sup> The U.S. rebuttal was that since it was not a party in the EC–Bed Linen dispute it cannot be bound by the report, and also the Antidumping Agreement does not require the use of a particular methodology to determine dumping margins.

Canada alleged that the USDOC computed the cost of production of only a few companies to determine "whether sales in the Canadian domestic market were made at prices below the cost of production" (WTO, 2004b). Canada also claimed that the USDOC made several erroneous computations: the USDOC included costs that were not associated with the production of softwood lumber, causing the margins of

dumping to inflate; even though Abitibi and Tembec provided the information required, the USDOC computed the costs by integrating all the operating costs of production, which covers other more capital-intensive goods such as newsprint, pulp and value-added papers, and chemicals; in the case of Weyerhaeuser Canada, the USDOC accounted for some costs related to the settlement of legal claims of the parent company, Weyerhaeuser Company, in a different product (hardboard siding) as part of the softwood lumber production costs; the USDOC failed to account for some offsetting revenue information provided by Slocan, West Fraser, and Tembec; and the USDOC chose to reject fully documented data provided by these companies. The United States rebutted Canada's claims by stating that the USDOC carefully reviewed each case and computed production costs using reasonable amounts as provided by each company. Offsetting revenues for West Fraser and Tembec were accounted for based on the information provided by these companies. Slocan's offsetting revenues were rejected by the USDOC under the argument that they were not directly related to any sales of softwood lumber.

### **WTO Findings**

The WTO panel found that the U.S. producers did not need to present any additional available information in their petition as long as they presented enough evidence for the USDOC to start the investigation. In addition, given all the information submitted by the U.S. producers to the USDOC, the WTO panel concluded that there was sufficient indication to begin the dumping investigation. Thus, the USDOC had no reason to terminate the investigation based on lack of evidence.

Regarding the Canadian claim of lumping all the softwood lumber products together, the WTO concluded that the USDOC's grouping of various products under a single category is consistent with Article 2.6 of the Antidumping Agreement. The WTO panel acknowledged that the USDOC approach might generate some discussion on whether such an approach is the appropriate one from a policy standpoint; however, it is not the panel's duty to create obligations non-existent in the Antidumping Agreement. This issue should be addressed by the members of the WTO through negotiations.

In analyzing the Canadian arguments concerning the use of flawed methodologies (price comparability being affected by physical characteristics such as the dimension of softwood lumber), the WTO panel found that, based on the information available, the USDOC approach was consistent with Article 2.4 of the Antidumping Agreement. Regarding the "zeroing" method used by the USDOC, the panel found that in utilizing this method the United States violated Article 2.4.2 of the Antidumping Agreement,

because the method does not take into account all comparable import transactions (i.e., it excludes all imports sold at above-market price).

Concerning the USDOC use of production costs and offsetting revenues of the six companies investigated, the WTO panel concluded that, given the information provided to the USDOC, the approach was not in violation of the Antidumping Agreement.

Given the above findings, the WTO panel recommended the United States bring its measures into conformity with its obligations under the Antidumping Agreement. In summary, the WTO DSB concluded that the USDOC was justifiable in initiating the dumping investigation and the USDOC's methodologies used to determine the existence of dumping were not flawed, with the exception of the zeroing method; this latter qualifier called for recomputation of antidumping tariffs.

### **Appeals to the Second Petition**

After the DSB ruled on the antidumping case, both countries appealed to the Appellate Body challenging the DSB's findings.

### **Claims of Error by the United States**

In its appeal, the United States challenged the DSB panel's finding that the zeroing method used by the United States is inconsistent with Article 2.4.2 of the Antidumping Agreement. The U.S. argument was that Article 2.4.2 does not give clear guidance concerning aggregation of the multiple comparisons when computing the margin of dumping. Article 2.4.2 identifies two methods for computing margins of dumping: zeroing and "asymmetrical comparisons", i.e., comparisons of individual export transactions and weighted-average normal value. The U.S. contention was that since U.S. and Canadian negotiators could agree only the asymmetrical comparisons, zeroing is consistent with Antidumping Agreement. The United States submitted that it made "fair comparison" in prices by allowing for differences in the level of trade, conditions of sale, and physical characteristics as per Article 2.4 of the Antidumping Agreement.

### **Claims of Error by Canada**

Canada challenged the DSB panel's finding on two grounds: the financial expenses of softwood lumber for Abitibi and the wood chip by-product revenue computation for Tembec. Canada argued that the DSB panel erred in its ruling that the USDOC need not consider the advantages and disadvantages of alternate cost allocation methodologies in computing the financial expenses of Abitibi and therefore the USDOC's use of cost-of-goods-sold method is appropriate. Canada claimed that calculating the costs requires a case-by-case examination of various products



produced by a company. Canada also disagreed with the panel's ruling that the U.S. actions were consistent with the Antidumping Agreement.

Canada took issue with the panel's conclusion that the U.S. computation of Tembec's by-product revenue is not inconsistent with the Antidumping Agreement, on the grounds that the USDOC incorrectly treated Tembec as a single corporation instead of separate entities. In doing so, the USDOC used the internal transfer value of wood chips in calculating the cost of production, which penalizes Tembec for using its own by-products rather than selling them to others.

### Findings of the Appeal

The Appellate Body rejected both countries' challenges and largely upheld the findings of the DSB, with exception of the U.S. computation of the softwood lumber cost of Abitibi Consolidated Inc. Thus, the ruling rejected the Canadian argument that the U.S. antidumping investigation was illegal. The Appellate Body confirmed the DSB panel's finding that the U.S. computation of the antidumping tariff was erroneous, as it used the zeroing method, i.e., excluding the sales of Canadian softwood lumber at above-market prices. Based on this ruling, the panel recommended that the United States recompute the level of antidumping tariff, taking into account the lumber sales at above-market price. The current level of antidumping tariff ranges from 2.18 to 12.44 percent.

With respect to the USDOC's computations of Abitibi's financial expenses for softwood lumber production, the Appellate Body reversed the ruling of the DSB panel that the USDOC need not compare the various cost allocation methods.

### *Petition III*

This section discusses three elements of petition III: request for findings, arguments and counter-arguments, and the WTO panel's findings. In December 2002, Canada again invited the United States to further the negotiation regarding the May 2002 USITC determination that Canadian softwood lumber is subsidized and sold in the United States at a price below the fair market value, *which injured the U.S. softwood lumber industry*. In January 2003, Canada and the United States tried to negotiate this issue but failed to resolve it. As a result, in April 2003 Canada filed its third petition to the WTO DSB, requesting the establishment of a panel to examine this injury claim by the USITC. Canada's major requests to the panel were to (WTO, 2004c):

1. Find that the USITC investigation and final determination of threat of material injury from softwood lumber imports from Canada violates WTO regulations. Therefore, to find that the definitive countervailing and antidumping duties imposed by the United States also violate WTO regulations.

2. Recommend that the United States align its measures with current WTO regulations by eliminating the final determination of threat of material injury, ending the antidumping and countervailing order, and refunding all the duties collected.

The United States requested that the panel:

1. Reject all Canadian arguments and find the injury determination by the USITC is justifiable.

### **Canadian and U.S Arguments and Counter-arguments**

Canada argued that the determination of Canadian softwood lumber as posing a “threat of material injury” to the U.S. softwood lumber industry violates the Antidumping and SCM agreements. Canada held that, according to these agreements, determination of injury should be based on positive evidence and objective investigation of (a) the volume of the dumped imports and the effect on prices in the U.S. market and (b) the impact of imports on domestic producers. Also, if an industry is threatened with injury due to dumping, the application of antidumping measures should be made with special care. In addition, Canada asserted that three requirements must be met to determine “threat of injury”. First, the assessment should be based on facts rather than allegations. Second, the circumstances in which dumped products would injure the domestic industry should be clearly foreseen and imminent. Third, it should be clear that “further dumped exports are imminent and unless protective action is taken, material injury would occur” (WTO, 2004c). Canada claimed that the USITC failed to fulfill these requirements.

The United States refuted Canadian claims by stating that the USITC determinations were consistent with the Antidumping and SCM agreements, as the USITC based its determination on positive evidence and objective examination of all the relevant issues with special care. Moreover, the United States argued that specifying the change in the status quo to justify its threat determination was not necessary based on the existent evidence.

Canada stated that the USITC failed to explain how prices were affected by the increment in Canadian softwood lumber exports, given that the evidence was meagre. However, the USITC finding was that though excess supply, comprised of domestic production and imports from Canada, was the reason for price declines, the increased volume of softwood lumber from Canada had a significant adverse impact on U.S. prices. As a result of the price declines, the U.S. softwood lumber industry was found to be vulnerable to injury, and above all, its financial performance suffered. Therefore, the USITC concluded that additional imports from Canada “would further increase the

excess supply in the market, putting further downward pressure on prices” (WTO, 2004c).

Canada asserted that the USITC had forecast a “strong and improving demand” due to the recovery of the U.S. economy from its recession. Canada’s contention was that its exports to the United States would be in response to increased U.S. softwood lumber demand, but would not necessarily surpass the current market share of 34 percent, which during the investigation was considered not to be an injurious level of imports. However, the United States argued that Canada focused on only one of the six major factors studied, i.e., demand in the U.S. market. The other factors covered by the USITC’s investigation were the Canadian producers’ excess production capacity; a projected increase in capacity; capacity utilization; production; export orientation of Canadian producers to the U.S. market; and softwood lumber import trends during periods when there were no import restraints, such as the SLA (WTO, 2004c). The USITC stated that, during the period of investigation, strong demand should have increased the price, but in reality prices continued to drop. This showed that imports from Canada played a pivotal role in the price decline in the U.S. softwood lumber market.

The USITC alleged that the evidence indicated that Canadian producers had excess capacity. During 1999 capacity utilization was at 90 percent and had declined by 2001 to 84 percent. Even though capacity utilization was well below the maximum, the evidence showed that both capacity and production increased during 2002 and 2003. Thus, the USITC argued, Canadian producers expected to further increase their supply to the United States.

In addition, Canadian producers had an incentive to produce more softwood lumber and export it to the U.S. market, as this market represents two-thirds of their sales. The USDOC further claimed that the Canadian annual allowable cut policy, which requires a minimum level of production even when Canadian demand is low, creates an incentive to export softwood lumber to the United States. The Canadian rebuttal was that this policy was in place even before the beginning of the investigation, and during this period Canadian softwood lumber exports to the United States did not reach the injurious level. Canada alleged that the USITC failed to explain why Canadian producers would change their behavior.

Canada noted that the USITC did not examine the significance of the SLA’s restraining effect. Canada further asserted that the increment of its U.S. market share after SLA expiration was only 0.4 percent. Canada also argued that the USITC merely explained how imports from Canada had increased between 1999 and 2001 (a 2.8 percent increment) but did not evaluate the significance of this increment.

The United States contended that the USITC evaluated evidence of increasing imports from Canada for several periods: during the investigation period, right after SLA expiration, and whenever imports were not subject to trade restrictions. The USITC findings showed that imports from Canada were already significant and had been increasing even with the restraining effect of the SLA, and that imports from Canada had substantially increased when restricting policies were not in place. In addition, the United States asserted that Canadian arguments regarding the increase in the U.S. market share held by Canadian softwood lumber were wrong. Canada's argument did not account for the preliminary countervailing duties imposed in August 2001. The USITC noted that, contrary to Canadian claims, during "true" free trade the U.S. market share held by Canadian softwood lumber increased by 11.3 percent.

Canada asserted that the USITC acknowledged that the United States is not self-sufficient in softwood lumber, and a large volume of imports is needed to fulfill the demand. Canada contended that this fact along with the prediction of a strong demand increase indicate that more imports would serve to fulfill demand that the U.S. industry could not meet. Thus, Canada argued, the reason for injury was not the imports from Canada but rather the excess supply from U.S. softwood lumber producers. On the other hand, the United States claimed that evidence proved that Canadian arguments on both fronts were wrong. Finally, Canada asserted that the USITC reviewed only the current state and not the future market conditions of the U.S. softwood lumber industry.

### **WTO Findings**

The WTO panel concluded that, based on the evidence, the USITC incorrectly determined an imminent substantial increase in imports from Canada. The panel considered that the increases in Canadian capacity of less than 1.0 percent in 2002 and 0.83 percent in 2003 were not significant. Therefore, the current capacity would be the only source for increasing exports to the United States. The share of Canadian shipments made up of exports to the United States was 57.4 percent in 1999 and 2000 and 60.9 percent in 2001. This share decreased to 58.8 percent and 58.5 percent in 2002 and 2003, respectively. Given the above figures, excess capacity did not support the likelihood of a substantial increase in exports.

The panel acknowledged that imports from Canada increased after the termination of the SLA. The panel noted that during the investigation the volume of imports increased and the USITC did not categorize the increase as significant. Also, exports from those provinces not covered by the SLA more than doubled. The panel ruled that the USITC determination did not explain why the cessation of the SLA would result in an imminent substantial increase in exports instead of a shift of supply distribution

from provinces not covered by the SLA to those covered. Moreover, the panel considered that the increase in Canadian exports after the end of the SLA might be on the one hand an indication of what the future would be like or on the other hand just a shift in the timing of exports to take advantage of the gap between the termination of the SLA and provisional measures.

With regard to the predicted strong U.S. demand, the WTO panel concluded that all the USITC found was that Canadian producers could continue to serve the U.S. market, which would be attractive to worldwide softwood lumber producers, not just to Canadian producers. The USITC reported a lack of analysis regarding third-country imports; therefore, the WTO panel did not look at third-country imports when considering the possibility of a substantial increase in imports. Furthermore, the panel concluded, if Canadian imports had increased at the same rate as U.S. demand, there would appear to be no injurious effect. The USITC did not evaluate imports from Canada increasing more than the demand.

### *Implications*

In this section we present economic implications of the U.S. tariff and the WTO rulings for both countries' producers, consumers, prices, and trade. In the technical annex, we provide a detailed graphical analysis to examine the welfare implications and determine the winners and losers. We start with the scenario of no tariffs, then examine a tariff scenario (corresponding to the 27.2 percent tariff), and analyze the effect of reduction of this tariff to 13.5 percent.

As a result of the U.S. imposition of the 27.2 percent *ad valorem* tariff, the price in the United States increased. A higher price benefited producers and hurt consumers. As a result of the price increase, production rose and producers gained. Consumption fell and consumers lost. The U.S. government received tariff revenues equal to tariff rate times price times imports. Consumers' loss less the sum of producers' gain and tariff revenues is the deadweight loss. Production inefficiency occurred as resources from other efficient uses were drawn to the inefficient lumber industry. Consumption inefficiency arose as consumers had to spend more on softwood lumber instead of on other goods.

U.S. tariffs lowered the prices in Canada as Canada reduced its exports to the United States. As a result of this price decrease in Canada, production fell and producers lost. Consumption rose and consumers gained. Producers' loss minus consumers' gain is the deadweight loss.

Since the WTO panel upheld the validity of the U.S. imposition of tariffs on softwood lumber imports from Canada but ruled that the U.S. tariffs were excessive, a preliminary decision by the USDOC has indicated that the United States is planning to

reduce the tariffs to about half of the current level, i.e., from 27.2 to 13.5 percent (*Spokesman-Review*, 2004). As a result of this tariff reduction, U.S. prices will decline and U.S. imports will increase. These price changes will affect producers and consumers in both countries. Extending the welfare analysis, we can conclude that the reduction in tariffs will reduce the U.S. producers' gain and the U.S. consumers' loss. In Canada, prices will rise, producers will regain some of their losses and consumers will lose some of their gains.

## **Conclusions**

**T**his article presents the current status of U.S.–Canadian lumber disputes and the outcomes of the WTO rulings. This trade dispute has been long lasting and contentious. A permanent solution to the impasse continues to be elusive. Since the WTO has ruled on this dispute, both countries should abide by these rulings and continue to move toward a free trade void of government intervention. Such a move will generate more efficient production and consumption decisions in both countries.

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## Endnotes

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1. In 1996, in an attempt to resolve the problem, the United States and Canada formulated the Softwood Lumber Agreement, which aimed at restricting Canadian lumber exports to the United States for five years beginning on April 1, 1996. The agreement capped Canadian duty-free exports at 14.7 billion board feet (bbf) of softwood lumber, and additional exports of softwood lumber from Canada would face a substantial amount of incremental, specific tariffs.
2. When zeroing is employed to determine dumping, the importing country does not take into account all comparable sales of imports, and in particular excludes imports sold at above-market prices.
3. Refer to the WTO Panel Report, European Communities – Antidumping Duties on Imports of Cotton-Type Bed Linen from India – Recourse to Article 21.5 of the DSU by India, WT/DS141/RW, adopted 24 April 2003, as modified by the Appellate Body Report, WT/DS141/AB/RW.

The technical annex to this paper, pages 191-194 is available as a separate document.

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