

## What Should Canada Do When the Softwood Lumber Agreement Expires?

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The expiration of the [Canada-US Softwood Lumber Agreement \(SLA\)](#) at the end of March has once again led to US trade action against British Columbia and other key softwood lumber exporting provinces. The US Coalition for Fair Lumber Imports (CFLI), an organization of US lumber companies, began legal proceedings under US trade law on April 2, asserting that an array of unfair Canadian policies required the imposition of a 39.9 per cent countervailing duty on Canadian softwood to counteract provincial subsidies and an additional anti-dumping penalty of between 28 and 38 per cent to compensate American lumber mills for Canadian wood exported south below cost. That could mean a maximum penalty of 77.9 per cent. And in an apparent effort to reinforce that they meant business, the CFLI, undertook two unprecedented moves in the history of the 20-year old dispute. First, it sought a 'critical circumstances' ruling, which would see any imposed duties apply retroactively to the date of the launching of trade action. Second, the coalition also expanded its historical focus on governmental policies to company practices as well, arguing that British Columbia firms were 'dumping' their product on the US market at below cost.

The amount of the alleged subsidy caught virtually all other parties off guard. The Canadian trade minister, Pierre Pettigrew, claimed that the Americans had brought forward "absolutely ridiculously high (subsidy) allegations," and promised to fight the cases "vigorously." The American Consumers for Affordable Homes said a 40 per cent duty on Canadian softwood would add \$1,500 to \$3,000 to the cost of a new house and a coalition representing most Canadian forest companies east of British Columbia said "even for a protectionist lobby that's been at this for 20 years (the coalition) have really and truly overreached themselves. Ask yourself whether the news of an 80 per cent tax on this vital commodity is going to do anything for recovery in the United States economy. It is the worst possible message the consumer could hear." - Former Ontario premier Bob Rae, legal counsel for the Canadian-based Free Trade Lumber Council, in a Washington speech to a U.S. lumber dealers group.

In BC, where most large companies were already supporting another compromise solution that would see some sort of tax imposed, these tactics just confirmed their fears that fighting the US action was too risky a venture, with the stakes too high. David Emerson, co-chair of the B.C. Lumber Trade Council and president of Canfor Corp "This legal process will inflict enormous damage not only on companies but also on Canadian workers, their families and entire communities, as well as American consumers." With billions of dollars of exports at stake for British Columbia's most important industry, this fear is certainly understandable. Given these high stakes issues, just what should British Columbia and Canada do to address these pressures?

- Do they negotiate yet again with the United States for another “compromise deal” (known as a Voluntary Export Restraint) in order to avoid being hit with a US import duty?
- Do they fight the US lumber industry’s allegations of subsidies through the NAFTA and WTO dispute settlement processes, with a risk of losing and paying billions in duty to the US?
- Do they present a united front to the US pressure, or do they try to carve out provincial solutions that might mean criticizing other provinces for being susceptible to US allegations?

Throughout the 20 year history of the dispute, individual provinces and the federal government have responded to this pressure in different ways, from using it as a justification for increasing harvesting fees (as happened in British Columbia in 1987 and 1994), or as an illustration of why Canada needed a free trade agreement (as was Brian Mulroney’s argument for the Canada-US FTA). The Canadian government has often been caught in the middle – attempting to build productive liberal trading relations with the US while being unable to change or address most of the issues under scrutiny which fall clearly under provincial jurisdiction. The story to unfold in the next few months will provide an important chapter into Canadian inter-provincial relations, and federal-provincial relations, as well providing one of the first tests of the Canada-US relationship under President George Bush.

## The subsidy argument

At the heart of the dispute lies an allegation by US forest companies that Canadian provinces, largely focusing on British Columbia as the major softwood lumber exporter, subsidize their forest companies. Originally the argument focused on stumpage rates, or the price governments charge forest companies to harvest publicly owned timber. Unlike most US public land management agencies British Columbia and other provinces do not use a “[competitive bidding](#)” process to arrive at a price companies must pay for the wood they cut. Instead, the government, rather than the market, sets the price through a system of “administered pricing”. As a result, BC is vulnerable to allegations of subsidy. The evidence on whether stumpage has been too low has been hotly contested. What is clear is that stumpage rates in BC have increased significantly in 1987 and in 1994. Indeed, even after reductions in 1998, many argued that stumpage rates were still above what they would have been under a competitive bidding system. Certainly market analyses of the BC forest industry reveal an industry in crisis, with increasing stumpage and environmental regulations forcing up costs higher than even governmental and [industry](#) had originally estimated.

Increasing stumpage rates partly explains why US lumber interests expanded their allegations of subsidy in the early 1990s to include BC raw log export restrictions, which they claimed lowered the price for logs in the province, and thus lumber export prices. US lumber interests have also explored ways to further expand their subsidy claim to focus on BC environmental regulations, a claim which has been taken up by a number of US and British Columbia [environmental groups](#). Regardless of the merits, these new arguments have led some BC industry officials to believe that any substantive response to US subsidy allegations would simply move the argument to another policy realm.

## History of the dispute

The five-year Softwood Lumber Agreement (SLA) is only the latest temporary truce in a trade skirmish that goes back to 1982, and indeed has roots before this time as well.

Back in 1982 US forest companies argued that British Columbia's and other Canadian province's stumpage fees (what companies pay for the right to harvest publicly owned timber) were set below market value, resulting in their Canadian competitors receiving an unfair advantage. However, the US Commerce Department ruled in 1983 that no subsidy existed, and Canadian governments and forest companies celebrated what they felt had been an unfair intrusion on Canadian sovereignty.

Yet three years later, after changes in US trade law had made it easier for US forest companies to assert a charge of subsidy, the US Commerce Department reversed itself, now finding that Canadian stumpage fees did amount to a subsidy. The stage was set for a never ending battle over what Canadian provinces said was their right to determine Canadian forest policies, and US lumber companies claims that they were losing market share unfairly. The 1986 "Memorandum of Understanding" (MOU) saw a settlement in which Canada agreed to impose an 15% export fee on lumber it sent to the United States, in lieu of the US imposing an import tax. By 1991 British Columbia was paying no export fees under the MOU, as the US agreed that its replacement measures (largely stumpage rate increases) more than offset the taxes it had been paying. Partly as a result, the Canadian government terminated the MOU, and the US immediately launched yet another trade action, known as a "countervail proceeding". This time, Canada was in no mood to negotiate. Once again the US Commerce Department found that a subsidy did exist, though this time it placed most of the "blame" on BC raw log export restrictions, finding them to confer a 3.6 percent subsidy, with stumpage policies deemed to have only created a 2.9 percent subsidy. Armed with the dispute settlement provisions of the FTA's (Now NAFTA) Chapter 19, Canada appealed the US ruling.

The binational panel processes permitted another arena in which detailed and highly complex theories regarding economic rent, the actions of perfectly competitive markets, and advanced econometrics techniques were presented before panelists. One of the key issues was an argument raised by Canada through Harvard economics professor, Mike Scherer, back in 1986. Scherer's argument, in a nutshell, was that the market for softwood lumber in North America is perfectly competitive, and as a result, all companies are "price takers" (the market predetermines the prices they get). The logic of this position was that even if stumpage rates were below what they would get using a system of competitive bidding, this was show up as increased profits for British Columbia producers, rather than as lower prices. The US Commerce Department gave Scherer's arguments little attention.

William Nordhaus of Yale University advanced and developed Scherer's 1986 position for the binationals. The Canadian government believed that there was finally an audience that would spend time considering all arguments. In response, the US coalition advanced a competing theory which asserted, in short, that a perfectly competitive market did not exist as low stumpage rates could lead to a higher volume output of lumber being produced, and that this volume would distort markets.

The competing and complex theories gave panelists considerable discretion in interpreting the evidence before them. Initially both NAFTA panels both found the US decisions questionable, both with respect to the stumpage and raw log export allegations, and sent them back for further justification and refinement. The US confirmed their decisions, indeed the US *revised* upward its subsidy findings. Once gain the two Binational panels' considered the US responses, and once again they remanded them back, finding that the rulings were not in accordance with US trade law. However this time the panels were divided along national lines. Since Canadians outnumber the American panelists 3-2, Canada temporarily prevailed.

## Birth of the SLA

Canadian companies and governments had barely time to savor its victory when the US Congress passed legislation that specifically changed/or clarified those parts of US trade law the Binational panels used in their rulings, trying to ensure that future Binational panels would no longer “misinterpret” US trade law. With the threat of a fourth countervail action looming, the SLA was born. The SLA differed from the MOU because it used a “quota” system in which the first 14.7 billion board feet (BBF) of softwood lumber exports from British Columbia, Alberta, Ontario and Quebec would be able to enter the US market but any amount above this figure would be subject to an export fee. The first 650 million board feet over this amount is subject to a \$50 tax per each thousand board feet (MBF), while any further exports are subject to a \$100 tax MBF. In exchange, key US forest companies and their association, the Coalition for Fair Lumber Imports, agreed not to launch a countervail or other legal action for five years, the Commerce Department agreed not to proceed with any softwood countervail petition.

Administering the SLA proved to be a bureaucratic nightmare for the federal government, which had never been happy with the deal. Quota had to be allocated among provinces, as well as among companies within provinces. Understandable internal Canadian squabbles resulted, which were exacerbated by the Asian economic collapse. Owing to the quota system, each company’s volume of softwood lumber exports to the United States had been “locked in” before the Asian collapse occurred. In normal times, BC companies could simply redirect their lumber to the US market, but the quota system made this a costly option, because any additional exports would be subject to the taxes noted above.

Dispute settlement provisions of the SLA also led the US CFLI to argue that changes to the BC forest practices rules and subsidy reductions in the late 1990's contravened the SLA. Before a final determination was made, the US and BC [agreed to a deal](#) in which BC lumber exports would pay higher fees on exports beyond their quota.

At the same time Alberta, Ontario and Quebec were increasingly frustrated about their share of quota, which they believe did not reflect future trends in the Canadian softwood lumber production. That is, while BC remains the dominant supplier to the US market of [softwood lumber](#), the years before the SLA saw incremental relative shifts away from BC to Alberta, Quebec and Ontario. Yet, the quota system locked in market share to each province, thus stopping any additional shift in market share that might have occurred.

## Death of the SLA and political manoeuvrings

Recognizing that it was highly unlikely the SLA would be extended, Canadian governments and industry have been positioning themselves for the next round of conflict. Initially two associations were formed – the BC Lumber Trade Council, and the [Free Trade Lumber Council](#) representing mostly companies from Alberta, Ontario and Quebec. The organizations were split over strategic choices: the BC Lumber Trade Council originally argued it was best to achieve another [compromise deal](#), while the FTLC believed they should fight US pressure directly. The Free Trade Lumber Council immediately sought linkages to [traditional US allies](#) – home builders and lumber dealers who had never supported the SLA, as well as retailers such as the [Home Depot](#). A new association was formed, the [American Consumers for Affordable Homes](#), which, in a break from the past, has taken a more proactive role in Congress in presenting the

Canadian position and countering claims of the US Coalition for Fair Lumber Imports (CFLI).

Not to be outdone, the CFLI has launched a two-pronged strategy. It has been proactive in raising concern among US landowners and forest companies about the [impending doom](#); and is once again reaching out to environmental groups critical of British Columbia's environmental practices, forging a "[bootleggers and Baptists](#)" alliance. Both efforts are geared toward shoring up political support in the US Congress, where, like the ACAH, the CFLI has spent [considerable resources](#).

Environmental groups have long argued that BC's stumpage rates have been too low, and despite massive increases in stumpage pricing in BC in the 1990s, have steadfastly maintained this claim. It thus came as no surprise that the BC Sierra Legal Defence Fund released a [report](#) in late January that charged BC companies with "cheating" on their stumpage fees. Though quickly challenged by industry analysts, this report is sure to become a best seller in the US congress, as each sides attempts to sway legislators toward their side. In related moves, the US [Natural Resource Defense Council](#) - long concerned about BC forest policy, has argued British Columbia's forest practices rules amount to a subsidy, and submitted a report this year to the office of the [US Trade Representative](#) on the softwood lumber dispute slamming the BC government for subsidizing its forest industry. Likewise the [World Resources Institute](#) issued its own [report](#) documenting what it claims are numerous subsidies employed by the BC government. On the U.S. side of the border the US Forest Service released a [report](#) in March 2001 on their Timber Sales program showing heavy subsidies to U.S. timber companies cutting in US National Forests. [Taxpayer advocacy organizations](#), among others, quickly condemned the program.

The environmental issue is a thorny one. Environmental groups are unhappy with implementation of the [BC Forest Practices Code](#) and what they feel are broken promises by the provincial NDP government on the environment. As a result, the softwood lumber dispute represents to them [another tool with which to wage their campaigns](#). But British Columbia forest companies and the BC government argue that the environmental complaints are unfair - pointing out that, in comparison with forest practices rules governing harvesting on private lands in most US states, BC's rules are more severe. To support a claim of subsidy on environmental issues, one would have to demonstrate that BC's rules set weaker standards than those faced by their competitors in the US.

## **Countervail IV**

As expected, on April 2<sup>nd</sup>, 201, the US Coalition presented the US trade adjudication bodies with a massive document outlining their allegations of unfair Canadian lumber policies. Traditional arguments centering on provincial stumpage pricing and raw log export restrictions were now joined with allegations that firms were "dumping" their product on US market- charging less for their product in the US than they were in Canada. These actions come at a sensitive time - North American lumber prices have reached their cyclical low, and the US forest sector appears to be joining British Columbia's industry in an economic downturn. There are few jobs and landowners across the US are concerned about their returns on investment. And to add salt to their wounds, the global strength of the US dollar has pushed Canadian dollar to near historical low vis-a-vis the US dollar, making Canadian lumber more competitive in the US market. While none of these conditions have anything to do with allegations of subsidy, they are crucial for understanding the political context in which the dispute is playing out.

Indeed, in a strategic coup, US forest companies managed to convince Jimmy Carter to write an opinion piece in the New York times on the dispute in which he blamed Canadian timber pricing and other forest policies for an array of US woes – including unemployment in the US forest sector, overharvesting, and even global warming!

And in a case of deja-vu all over again, key US senators have held back fast track approval to President Bush for any Free Trade in the Americas agreement, unless it deals with the softwood issue.

## Where to go from here?

So, where should Canada go from here? There is no easy choice. Some sort of compromise deal would represent a short-term solution that would take away the risk of letting the dispute play out in the US trade adjudication process. At the same time, such a short term deal would once again put off any long term resolution. Indeed, there is increasing evidence that federal governmental officials and forest companies East of the BC border are so fatigued with short term solutions that they are more committed than before to fight this dispute under US trade law, under the bi-national panels, and the WTO. Indeed, to expedite matters there has been talk of going directly to WTO, bypassing NAFTA processes altogether.

At the end of the day it will come down to whether the British Columbia and Canadian government can stomach the huge risks that come with fighting this through all legal means. Obtaining a ruling from the WTO would do much to help frame the context for a long-term resolution to the issue.

What is important to recognize however, is that the political economy of the softwood lumber dispute makes it difficult to talk about “US” and “Canadian positions. All of the four provinces under the dispute have administered pricing, but the details are quite different, with Quebec and others arguing that theirs are more closely related to market factors. As well, those provinces exempt from the agreement have actually benefited from the current deal vis-à-vis the four leading provinces. Similarly, the United States forest companies are divided on the issue – while some such as Georgia Pacific have taken a lead in this dispute, because they know that a victory will push up the price of lumber and give them a greater market share. Others, like Weyerhaeuser, are officially on the sidelines because of their extensive operations in both Canada and the US. Nonetheless, the real losers in this dispute is neither Canadian or US forest companies – rather it is the [US consumer who is hardest hit](#) and who, given the constraints of US trade law, have virtually no standing during US trade adjudication procedures.

One thing is clear is that in the months and years to come intensive pressure will be put on British Columbia and the federal government to settle the dispute, from BC companies, US lumber companies, and even President Bush. Whether initial entrenched positions will hold out is uncertain – certainly the history of the dispute is one in which short-term solutions have ultimately one the day, leading crises every five years like the one we are now experiencing.

In the meantime, there are other initiatives the BC and Canadian governments could undertake innovative initiatives. Some ideas might include:

- the creation of a North American Commission on Forestry. Such a commission could present nonpartisan objective information and research on environmental, economic and social aspects pertaining to sustainable forestry in North America.

At the very least such an organization would assist Canadians and Americans in analyzing claims on all sides, and might build to a more productive dialogue on common issues and more fundamental issues facing both countries in their forest sectors. Indeed, it could provide a more productive atmosphere with which to address legitimate environmental concerns within and across both countries.

- a specific mutual recognition agreement (MRA). This idea would focus US and Canadian efforts toward a specific agreement on policies that would no longer be countervailable, versus those that would continue to be. Such an agreement might acknowledge the rights of both governments to limit log exports, and that such policies could not be subject to trade sanctions.
- A move toward a more-market oriented competitive bidding system in British Columbia and elsewhere. The idea has been raised in the [past](#) and a year and a half ago was gaining steam as a new way out of the dispute. However recognition that such a response would involve massive changes to long-term harvesting agreements, governments and industry have shied away from this option. And given that the US lumber industry is focusing as much on log export restrictions as stumpage rates, this, alone, would arguably fail to provide a long-term solution.

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