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## **CANADA CONTINUES TO DISREGARD ITS OBLIGATIONS UNDER THE SOFTWOOD LUMBER AGREEMENT**

The United States and Canada entered into the Softwood Lumber Agreement (“SLA”) in October 2006. This agreement ended years of litigation and international disputes over Canadian subsidies and other unfair trade practices affecting Canadian exports of softwood lumber to the United States. Unfortunately, problems with Canadian compliance arose almost immediately after the SLA entered into force. Some of these problems have resulted in arbitration as contemplated by the SLA. Others remain the subject of continued discussions between the U.S. and Canadian governments.

By their actions, the federal and provincial governments in Canada have demonstrated that they will fully comply with the SLA only when noncompliance becomes more costly than compliance. Therefore, vigilant enforcement of the SLA by the U.S. Government is essential to the functioning of the agreement. Anything less will subject U.S. companies, mill workers, forest landowners, and thousands of forestry-reliant communities to the continuing injury that the SLA was intended to prevent.

The Coalition supports the SLA as long as it is enforced effectively against Canadian federal or provincial efforts to circumvent the Agreement. Without an effectively enforced SLA in place, the injury to the U.S. softwood lumber industry from unfair Canadian subsidy programs will become intolerable. Such a situation would risk a return to the bitter and costly countervailing duty and antidumping duty litigation that ended in 2006 with the SLA. It would seem obvious that both U.S. and Canadian producers would prefer to avoid renewed litigation, but that requires compliance with the SLA by Canada and effective enforcement of the SLA by the United States. Additionally, if Canadian producers want to extend the SLA beyond its current expiration in 2013, U.S. producers must be confident that Canada will improve its compliance record and that the U.S. Government will enforce the SLA effectively.

### **The Fundamental Premise of the SLA Is Effective Collection of Canadian Export Taxes**

The key issue that the SLA was intended to resolve is the market dislocation caused by below-market (i.e., subsidized) prices for government-owned timber in Canada. In the United States, softwood lumber producers buy timber mostly from private landowners, and even when timber is harvested from public land, it is sold in competitive auctions to the highest bidder. In most of Canada, by contrast, the vast majority of the timber is owned by provincial governments, and the vast majority of this timber is sold to lumber producers through noncompetitive, no-bid arrangements at prices well below fair market value. Thus, U.S. producers are forced to compete with producers that obtain their inputs at prices and in quantities that are dictated by Canadian government objectives rather than market forces. Because Canada has historically exported the majority of its lumber to the United States, the costs of the Canadian system are paid in lower U.S. production, lost U.S. jobs, and suppressed U.S. timberland values.

To counter the pernicious effects of the Canadian timber system on the U.S. lumber market, the U.S. lumber industry has invoked the U.S. trade laws on several occasions in recent decades. In the 2006 SLA, the U.S. industry agreed to forgo its right to invoke these laws, in return for Canada’s agreement to impose quotas and export taxes on most Canadian lumber

exported to the United States when the demand for lumber is low. In addition, the United States agreed that the Canadian provinces could continue to operate their timber pricing systems as they existed on July 1, 2006. Any changes in those systems must improve, or at least maintain, the degree to which those pricing systems reflect market forces. This is because the export tax regime is undermined when Canada collects export taxes with one hand, and then returns them to the lumber producers with the other hand through new or additional subsidies. Therefore, changes that increase the degree to which the provinces subsidize their lumber producers through lower timber prices, or otherwise increase the level of subsidies bestowed on the Canadian lumber industry, are deemed to circumvent the export taxes.

### **Canada Has Circumvented Its Export Tax Commitments Through Lower Prices for Government-Owned Timber**

Contrary to Canada's SLA commitments, several provinces have modified their timber pricing systems in ways that reduce timber prices below those that would have existed had the July 1, 2006 systems been faithfully implemented.

**BC Interior.** The most significant such violations arise from the Interior region of British Columbia ("BC"), which accounts for roughly half of Canada's total softwood lumber exports to the United States. The BC government has taken a number of steps to cut wood costs for BC Interior lumber producers, sustaining uneconomic production and significantly depressing U.S. lumber markets.

- *Huge expansion of nominal stumpage rates.* BC has historically charged only a nominal fee of C\$0.25 per cubic meter for poor quality logs deemed mostly unsuitable for making merchantable lumber (so-called "Grade 4" logs). The market value of timber that can be used to make lumber – and even the price BC charges for timber deemed to be useable for lumber – is many times this nominal "salvage" wood price. Beginning in mid-2007, however, the share of the BC Interior harvest classified as Grade 4 – and thus eligible for the nominal "salvage" timber price – has increased dramatically, from 16 percent in 2006-07 to more than 42 percent. Yet the share of the BC Interior harvest that goes into lumber production has hardly declined at all.

It is true that an outbreak of the mountain pine beetle has seriously affected lodgepole pine, the dominant timber species in the BC Interior. However, BC's own studies demonstrate that any decrease in lumber recovery from timber affected by the pine beetle outbreak is not sufficient to justify such a large increase in Grade 4 volumes. Moreover, at least part of the increase appears to be attributable to practices adopted and authorized since 2007, including changes to grading conventions and the practice of heating sample logs in kilns to produce visible cracks.

- *Additional reduction in prices for high-quality timber.* Separately, BC has dramatically reduced stumpage prices for high-value Interior sawtimber (Grades 1 and 2). The "average market price" used to calculate administered prices for government-owned Interior sawtimber fell on July 1, 2009 to C\$3.20 per cubic meter – a drop of more than 47 percent – and has fallen even further, to C\$1.68 per cubic meter in the second quarter of 2011. Although BC asserts that the price adjustment is the natural result of operation of its existing stumpage system, the magnitude of the stumpage reduction is not

consistent with market developments. Even before these latest reductions, delivered log prices in the BC Interior were more than 40% below those in similar regions just across the U.S. border – and well below those in eastern Canada. This further steep decline in BC stumpage will give BC producers an even greater cost advantage over U.S. producers, offsetting the effect of SLA export fees.

- *Other stumpage reductions.* BC has also implemented a number of short-term timber price reductions affecting individual producers or certain types of licensees in particular regions. These overt changes to the existing timber pricing policies, even if limited in effect, are manifest SLA violations.
- *Introduction of “lump-sum” pricing on administered timber sales.* BC has announced that, effective June 1, 2010, it will no longer require payment for timber harvested from many stands to be based on actual scaling and grading of the logs. Instead, a single price for an entire stand will be assessed based on an estimate of the volume and quality of the logs, derived from a cruise of the standing timber prior to harvest. The expansion of lump-sum sales to stands sold without competitive bidding would appear to provide numerous opportunities for BC Interior lumber producers to manipulate these no-bid sales and lower wood costs even more in the immediate future. At a minimum, BC has stressed its intent to implement this change in a “revenue neutral” manner, meaning that the lower timber pricing due to excessive volumes of Grade 4 in recent years will be maintained, whether or not logs continue to be graded after harvest.

BC asserts that many of these actions have been taken in order to manage the massive mountain pine beetle outbreak, which has significantly affected some portions of the Interior forest. The SLA authorizes changes to forest management systems to respond to environmental and other challenges – provided that they do not result in timber pricing moving further away from market values. It would appear that BC has used the excuse of the pine beetle outbreak to reduce Interior timber prices even further below market value since 2007, resulting in cost savings of hundreds of millions of dollars to BC Interior lumber producers, sustaining them during the worst of the recent lumber market downturn – at the expense of producers and workers in the United States. The expansion of nominal stumpage prices for Grade 4 logs is the subject of ongoing arbitration under the dispute resolution provisions of the SLA.

***BC Coast.*** Government timber prices on the BC Coast have also fallen dramatically. BC announced an average 50% reduction in January 2009, from around C\$10 to less than C\$5 per cubic meter. Prices have steadily fallen since then. A further massive reduction in Coast stumpage was implemented on March 1, 2010, with many tenure holders eligible to harvest most species, including very high-value Western Red Cedar, for only C\$0.25 per cubic meter. The BC log prices from which BC purports to derive stumpage levels fell at a far slower pace than did stumpage levels. BC asserts that these price increases result from the operation of its existing timber pricing system, but given the enormous timber price declines in current market conditions, it is difficult to give credence to these assertions.

***Quebec and Ontario.*** In late 2006 and 2007, Quebec and Ontario announced that the provinces would assume certain costs that previously had been borne by timber harvesters. In effect, the provinces reduced in-kind stumpage payments and therefore the cost of government wood to provincial lumber producers. These actions were the subject of SLA arbitration that

concluded in early 2011 with a finding that Quebec and Ontario were circumventing the SLA. An LCIA Tribunal imposed additional remedial export measures on Quebec and Ontario exports.

**Alberta.** In 2007, Alberta amended its regulations to increase the threshold lumber price, below which all lumber producers pay minimum stumpage (set at C\$1.90/cubic meter). This change in regulation will guarantee Alberta lumber producers minimum stumpage levels even if lumber prices increase much more than they already have. Moreover, while the official applied stumpage rate has not changed since the SLA came into force, Alberta's disclosures under the SLA as well as other evidence indicates that in the last two years the effective stumpage rate has fallen significantly below the official C\$1.90 minimum rate. At the same time, the Alberta industry is now claiming high profitability.

### **Canada Has Circumvented Its Export Tax Commitments Through Other New Subsidy Programs**

Subsidies not related to timber pricing, unless required to be provided under programs in existence as of July 1, 2006, also constitute violations of the SLA anticircumvention provisions, because they also offset the collection of required export fees. Many such subsidies have been announced and provided in recent years. These SLA-inconsistent subsidies have sustained large segments of uneconomical Canadian lumber production through poor market conditions.

**New Grants and Loans.** In late 2006 and 2007, Quebec and Ontario implemented plans to provide hundreds of millions of dollars in grants, subsidized loans, and subsidized loan guarantees to lumber producers. Many of these subsidies were the subject of arbitration under the SLA that concluded in early 2011 with the imposition of additional remedial export measures on exports from these two provinces. On November 5, 2010, the Honorable Denis Lebel, Minister of State (Economic Development Agency of Canada for the Regions of Quebec) stated in the federal House of Commons that "as of October 31, 2010, Export Development Canada had helped Quebec's forest industry by providing credit support, accounts receivable insurance and loan guarantees totaling [C]\$7.6 billion." Export Development Canada has also provided support to producers in other provinces.

**Company-Specific Bailouts.** Several provinces have provided specific assistance to large lumber producers that have had financial difficulties during the recent severe, prolonged market downturn. For example, Quebec has provided numerous financing guarantees, relief from pension obligations, and other assistance to AbitibiBowater, one of Canada's largest lumber producers, which has been in receivership for most of the last two years. Press reports indicate that Ontario has offered debt forgiveness to Buchanan Lumber, one of that province's largest producers, which has also been in receivership. Private sector financing for these bankrupt companies would be unthinkable without government guarantees and backing.

**Pulp and Paper Green Transformation Program.** Approximately C\$1 billion in grants has been made available under this program for capital investments in pulp and paper mills to promote energy efficiency. Many of these mills are affiliated with, and in some cases co-located with, softwood lumber producers. The SLA prohibits new subsidies to "producers or exporters of Canadian Softwood Lumber Products," unless they are "not specific to the forest products industry" – thus expressly ruling out subsidies that benefit the pulp and paper operations of Canadian lumber producers. Money is fungible – a principle confirmed by recent

announcements by large integrated Canadian producers like West Fraser and Canfor of significant capital investments almost exclusively directed to lumber mills, while the company's pulp and paper mills have received large government grants for similar investments.

***Announcements of Potential New Subsidies.*** In 2009 and 2010, many provinces, including Quebec, Ontario, and New Brunswick, announced new programs that would subsidize operating costs of lumber producers or provide loan guarantees or other subsidies to finance the reopening of closed lumber mills. When challenged, provincial authorities have indicated that these programs will be implemented consistently with Canada's SLA obligations, although in some cases it is unclear how that could be accomplished. It remains to be seen whether the announced subsidies are actually provided. Nonetheless, the caution in the statements of some provincial officials illustrates the importance of effective monitoring and enforcement of Canada's SLA commitments by the United States.

### **Canada Has Failed to Fully Impose the Required Export Measures**

In addition to circumventing substantial portions of the export measures, Canada has also in some cases simply failed to fully impose the export measures in the first place.

***Improper expansion of special treatment for independent remanufacturers.*** The SLA permits Canada to certify independent lumber remanufacturers. Certified companies are eligible for favorable treatment for purposes of export taxes. However, many of the certified companies do not meet one or more of the certification standards provided for in the SLA – such as that they produce certain remanufactured products and that they are not related to lumber producers that have rights to buy public timber. When a company is improperly certified, it pays lower export taxes than the SLA requires.

***Disregard of arbitration order to remedy past export quota violations.*** An arbitration tribunal under the SLA found in March 2008 that Canada failed to calculate correctly quota volumes for Quebec, Ontario, Manitoba, and Saskatchewan, leading to shipments in excess of permitted quota levels. In February 2009, the tribunal specified that Canada should remedy this breach by imposing an additional 10% tax on lumber exports from these provinces to the United States until it collects an additional C\$68 million. Canada failed to implement the prescribed remedy until August 1, 2010. During that time, the United States was forced to exercise its rights under the SLA to impose a duty on lumber imports from these provinces, in place of the remedy that Canada failed to implement. Although Canada has now finally complied with the decisions of a neutral arbitral panel – the dispute resolution procedure that Canada agreed to under the SLA – the lengthy delay in compliance remains indicative of the attitude behind other SLA violation issues.

### **Canada Has Failed to Comply Fully with SLA Transparency Obligations**

The SLA obliges both the Canadian and U.S. governments to exchange data crucial for monitoring compliance with the agreement. Canadian provinces have failed to provide data on provincial timber pricing systems with the required level of specificity, greatly limiting the usefulness of the data provided for monitoring compliance. For many types of data, Canada is far behind the schedule of disclosures mandated by the SLA.

