Proposed Policies Regarding the Conduct of Changed Circumstance Reviews of the Countervailing Duty Order on Softwood Lumber from Canada (C-122-839)

Introduction

In evaluating the proposed Policy Bulletin and anticipating changes to Canadian provincial systems that may emerge subject to its structure, the Coalition for Fair Lumber Imports highlights three general principles:

First, Congress established the changed circumstances review ("CCR") mechanism to address unusual post-order developments. 19 U.S.C. § 1675(b)(1) (2000). The context of a CCR, through which a foreign interested party seeks revocation of an existing countervailing duty order, is fundamentally different than an investigation: the Department has found after complete examination of relevant information that a foreign government has provided countervailable subsidies to its domestic industry. Thus, a CCR does not begin from a "clean slate."
[1]

Rather, it starts from a finding of subsidization. The applicant must demonstrate that these practices have ended and that the industry no longer receives benefits. While any interested party can request a CCR at any time, it must "show{ } changed circumstances sufficient to warrant a review;" "good cause" is required for the Department to conduct a review within two years of the final determination. Id. §§ 1675(b)(1) and (4).

Second, the Department found during the investigation that Canadian provincial systems incorporate numerous non-market supply and pricing mechanisms, which collectively confer countervailable benefits on the production of softwood lumber.

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[1] Avesta AB v. United States, 689 F. Supp. 1173, 1181 (Ct. Int'l Trade 1988) ("{T}he party seeking revocation bears the initial burden of showing the existence of such circumstances.")

[2] As the Department explained:

> {T}here is substantial evidence that Provincial government stumpage fees are not set to reflect market prices. Rather, these fees are often set with a view towards traditional government economic policy goals, such as job creation, rather than with a view toward obtaining a fair market price.

Final Determ. at 37. The structures of current provincial systems distort signals to tenureholders and generate over-harvesting as they were designed primarily to provide social goods.

[3] These "soviet style"

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[2] For example, the Department found that the following provincial practices distorted provincial timber markets: mandatory mill ownership requirements, long-term tenure arrangements, Issues and Decision Memorandum: Final Results of the Countervailing Duty Investigations of Certain Softwood Lumber from Canada, No. C-122-839 at 55, 97 (Mar. 21, 2002) (final determ.) ("Final Determ."); minimum cut requirements. Certain Softwood Lumber Products from Canada, 66 Fed. Reg. 43,186, 43,195 (Dept't Commerce Aug. 17, 2001) (prelim. determ.) ("Prelim. Determ."). The International Trade Commission found that provincial mandatory cut requirements and rules requiring processing affect the market. Softwood Lumber From Canada, Inv. Nos. 701-TA-414 and 731-TA-928 (Final), USITC Pub. 3309 at 40-41 (May 2002). Record information also demonstrates that provinces maintain numerous mandates including: appurtenancy and minimum processing requirements, including log export restrictions. E.g., BC Forest Act §§ 35, 127, 128 app. to BC Questionnaire Response ("BCQR") (June 28, 2001); BC TFL Template § 15.01 app. to BCQR Exh. BC-S-62; BC FL Template § 14.01 app. to BCQR Exh. BC-S-63; Alberta Forest Act § 31(1) app. to Alberta Questionnaire Response ("ABQR") Exh. AB-S-9 (June 28, 2001); Alberta FMA § 36(1) app. to ABQR at Exh. AB-S-21; Ontario Crown Forest Sustainability Act §§ 30(1-4), 54 app. to at Ontario Questionnaire Response ("ONQR") at Exh. ON-GEN-18 (June 28, 2001); Quebec Forest Act §§ 159, 160 app. to Quebec Questionnaire Response ("QCQR") at Exh. QC-S-16 (June 28, 2001); Quebec Sample TSFMA Art 6.6 app. to QCQR at Exh. QC-S-30; New Brunswick CLFA § 68; Newfoundland Forest Act § 37.

[3] As a BC union leader recently stated, "Historically, the government has taken rent partly in the form of timber-harvesting fees, called stumpage, and partly in the form of jobs, economic opportunities and economic security for resource-based communities." "New forest policy called dangerous by IWA head," Campbell River Mirror, Apr. 11, 2003.

[4] systems have significantly reduced provincial revenue streams, delivering valuable timber to lumber producers at the expense of Canadian taxpayers, indigenous peoples, the environment, the U.S. lumber industry, U.S. workers and U.S. timberland owners.

Third, there is a simple and transparent way for Canadian provinces to establish timber sales systems that would ensure that the government receives adequate remuneration: establish 100% fully open and competitive timber markets. Yet, no province has adopted this approach. Instead, some provinces seem to propose "policy reform" primarily as a means to settle the current dispute over subsidized Canadian softwood lumber with as little disruption to their social engineering as possible. In the absence of true markets, significant conditions must be imposed on provincial systems to ensure that they generate adequate remuneration on timber sales, thereby eliminating the subsidy.

The goals of the Policy Bulletin and any CCR are clear, consistent with this context and the applicable legal standards:

> The Department expects that reforms introduced by the Canadian provinces . . . will result in a North American market in which lumber producers and timber markets in Canada and the United States operate under similar competitive conditions and that timber valuations would equilibrate, subject to the normal qualifications based on geography, species, and other factors that normally apply in the case of timber markets in either country.

Proposed Policies Regarding the Conduct of Changed Circumstances Review of the Countervailing Duty Order on Softwood Lumber from Canada, 68 Fed. Reg. 37,456, 37,547 (Dep't Commerce June 24, 2003) ("Draft Policy Bulletin"). While provinces have flexibility in developing reforms appropriate to their internal conditions, they must, as a matter of law, demonstrate that reforms

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[4] "BC Hints at Move to Free-Market Forestry," Wood Technology (June 1999) (quoting former BC deputy premier) app. to Petition Exh. IV I-1 (Apr. 2, 2001).

generate market-consistent results and do not confer countervailable subsidies to achieve revocation of the order. 19 U.S.C. § 1675(b).

If a province implements reforms that generate results equivalent to what would obtain in truly open and competitive timber and log markets and documents these changes through a CCR, the Department both could and should lift the countervailing duties under U.S. law. At the same time, "reforms" that only create the appearance of competition or market prices without achieving the necessary structural change cannot satisfy the legal standard and would effectively leave Canadian parties with their unfair advantage. The Department must ensure that a final Policy Bulletin and any future CCR produce economically and legally adequate results.

Finally, as the draft Bulletin recognizes, the Department provides this policy guidance "to serve as the basis for a long-term, durable solution to the ongoing dispute." Draft Policy Bulletin, 68 Fed. Reg. at 37,457. This reflects the understanding of all parties that a comprehensive negotiated solution would be preferable to ongoing litigation over Canadian unfair trade practices. Thus, the governments of Canada and the United States must also seek an interim measure to bridge the gap until policy reform can be implemented and tested through a CCR. Unless and until this comprehensive solution is attained, the Department should not promulgate a final Policy Bulletin. Providing the Canadian provinces an agreed roadmap toward ending trade remedy discipline on unfair imports would be appropriate only in the context of a comprehensive settlement agreement. Of course, in the absence of a finalized Policy Bulletin, provinces would retain the right under the statute to request a CCR.

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The Coalition supports the Policy Bulletin initiative as an important effort to encourage long-term, policy-based reform of provincial timber systems in Canada and to remove impediments to an interim agreement. These comments highlight a few important issues that the Department should consider prior to promulgating a final Policy Bulletin at the appropriate time.

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5 The Department's regulations also provide for revocation through the normal administrative review procedures. 19 C.F.R. § 351.222(c) (2003). These rules provide for the possibility of revocation if programs have been terminated for at least three years or if companies have not applied for or received benefits for a period of at least five consecutive years. Id.

I.A. Policies and Practices That Inhibit Market Response

Summary of Comment

A final Policy Bulletin should clarify that provinces must eliminate formal appurtenancy requirements and implement rules designed to reduce their lingering impact. A final Policy Bulletin must require the elimination of market-distortions caused by existing minimum processing restrictions. Finally, the Department should clarify that it will examine tenure transfer rules and harvesting requirements to ensure that these policies do not generate new subsidies or negate the impact of other reforms.

Comment

As the Department recognized in both the Draft Policy Bulletin and the Final Determination, Canadian provincial systems incorporate regulatory mechanisms that inhibit the industry's ability to respond to changes in the marketplace. One basic requirement of the CCR inquiry will be a showing by the applicant province that it has eliminated such policies. Draft Policy Bulletin, 68 Fed. Reg. at 37,457. The Coalition agrees that elimination of market-distorting regulatory policies must be a prerequisite for entry to the CCR process. Provinces must remove government practices that inhibit the ability of harvesters to respond to market signals free of artificial constraint. These rules distort provincial timber markets and compound the impact of artificially low-priced government timber.

The Department lists six practices embedded in provincial systems that must be addressed, including: 1) appurtenancy requirements, 2) minimum cut requirements, 3) mill closure restrictions, 4) minimum processing requirements, 5) long-term, non-transferable tenure and 6) offsetting provincial actions. Through these rules, provinces have crafted a mutually-reinforcing regulatory web that has en-

gineered continual harvest and processing of Crown timber. In general, the draft Policy Bulletin accurately describes the market distortions caused by these regulations; however, the Department should clarify several points in a final Policy Bulletin.

Appurtenancy

Appurtenancy rules require licensees to process timber harvested from provincial tenures in specific mills and "limit{ } the ability of tenure holders to rationalize their harvesting operations, log purchase and sale operations, and lumber production in response to changing market conditions." Id. at 37,458. Indeed, true appurtenancy actually prevents tenureholders from conducting "log purchase and sale operations" with respect to Crown timber. Id. As Quebec (the province with the purest appurtenancy rules) reported during the investigation, "there have been no sales of logs from the public forest, either for the domestic market or for the export market." 9 QCQR at 13.

Appurtenancy is inconsistent with competition. It inextricably links the benefit of under-priced timber to Canadian lumber production. These rules reinforce minimum cut requirements, mill closure restrictions and minimum processing requirements. If a tenureholder harvests, the company must process in the designated mill, meaning that the mill will be open; further, the need to keep the mill in operation would tend to encourage harvesting when the market would not. Thus, failure to end (or substantially reform) appurtenancy would undermine commitments to reform other mandates.

The Department should also recognize that existence of appurtenancy requirements over time has already caused substantial damage to provincial timber structures. Rules required companies to build processing plants in order to gain access to fiber; these plants are already built and the fiber allocated. Structures established by these legal requirements are entrenched; simply removing the legal

rule may be insufficient to decrease the vertical integration of the industry. Provinces should not only end such legal restrictions but implement specific measures to eliminate their lingering effect and result in the reallocation of fiber. One measure that would have this impact is substantial tenure takeback, discussed in greater detail below.

Minimum Processing

As the draft Policy Bulletin recognizes, minimum processing requirements constrain "the impact of market forces in public and private timber markets." Draft Policy Bulletin, 68 Fed. Reg. at 37,458. Combined with other provincial mandates such as appurtenancy, minimum harvest requirements and mill closure restrictions, these rules have generated continual processing of Crown fiber by tenureholders. Minimum processing requirements restrict public harvests and usage of Crown timber in nearly all Canadian provinces.

[6] Log exports from private lands in BC are jointly controlled by the province and Canadian federal government; private log exports from other provinces are controlled by federal permitting requirements. [7]

Given their demonstrated price impact, the Department has previously found export restrictions

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[6] E.g., BC Forest Act § 127; Alberta Forests Act § 31(1); Manitoba Forest Management License § 26; Ontario Crown Forest Sustainability Act § 30 (1-4), Quebec Forest Act §§ 159, 160. While Saskatchewan does not appear to maintain a formal minimum processing requirement, restrictions in individual agreements with tenureholders require mills to process continuously on pain of default, which operates as a minimum processing requirement. 1 SKQR at SK-30. In addition, many of the Maritime provincial rules include minimum processing requirements on timber harvested from Crown lands. E.g., New Brunswick Crown Lands and Forests Act § 68; Newfoundland Forestry Act § 37.

[7] E.g., Notice to Exports Under the Export and Permits Act, Serial No. 102 at 3-8 (Apr. 1, 1998) available at http://www.dfait-maeci.gc.ca/trade/eicb/notices/ser102-en.asp.

to confer countervailable subsidies.

[8] Thus, continuation of minimum processing rules that significantly depress the price of domestic logs would be inconsistent with the legal standard for revocation of the order.

[9] Of course, this is not to say that there would be substantial volumes of log exports. Transportation costs for logs are significant, and local processors will always have a significant advantage. In an unrestrained market (with prices at fair market value), a relatively small volume of logs would be purchased by foreign buyers, but these buyers would increase the overall level of demand for provincial logs.

Numerous Canadian academic and industry sources confirm the price impact of current log export restrictions. Even the government of British Columbia recently acknowledged that these rules generate distortions: "Overall, mandatory links between logging and processing impair the ability of licensees to make decisions based on economics or market demand."

[10] BC Forestry Professor David Haley concluded, for example, that coastal hemlock logs for the

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[8] Certain Softwood Lumber Products from Canada, 57 Fed. Reg. 22,570 (Dep't Commerce May 28, 1992) (final CVD determ.). Congress and the Administration have clearly indicated that such restrictions, as indirect subsidies within the meaning of 19 U.S.C. § 1677(5)(B)(iii) (2000), should continue to be countervailable. Uruguay Round Agreements Act, Statement of Administrative Action, H.R. Doc. No. 103-316, at 926 (1994). At the same time, the WTO dispute settlement panel's decision regarding countervailability of export restraints was extremely limited and confirmed that certain types of export restraints, as part of a domestic processing scheme, could be actionable under WTO rules. United States — Measures Treating Export Restraints as Subsidies, WT/DS194/R (adopted Aug. 23, 2001).

[9] Log export restraints are one type of minimum processing requirement. Any rule that requires a "minimum amount of processing of the timber harvested" Draft Policy Bulletin, 68 Fed. Reg. at 37,458, would have the same impact.

[10] "B.C. Heartlands Economic Strategy-Forests: The Forestry Revitalization Plan" (2003) at 17, available at http://www.for.gov.bc.ca/mof/plan/frp/frp_lr.pdf ("Forestry Revitalization Plan").

Japanese market (net of additional costs) are priced 65% higher than for the domestic market; hemlock logs from the BC Interior fetch double the price in the United States than in Canada (at similar hauling distances).

[11] Other sources, including renowned B.C. forest analyst Peter Pearse, the Northwest Ecosystem Alliance, columnist Ken Drushka and the U.S. Forest Service, have all reached similar conclusions.

[12] BC private landowner, major Crown tenureholder and lumber manufacturer, TimberWest, not only recognizes this price depression, but has actively called for the removal of log export restrictions.

[13] Clark Binkley (former Dean of Forestry at the University of British Columbia) summarized the matter succinctly: "Canada's log-export restrictions devalue the forest."

[14] Again, the purpose of easing restraints is to ensure full and fair demand and pricing, not necessarily to see substantial volumes of export shipments.

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[11] David Haley, "Are Log Export Restrictions on Private Forestland Good Public Policy? An Analysis of the Situation in British Columbia," Dec. 2002, at iv.

[12] Peter H. Pearse, Ready for Change: Crisis and Opportunity in the Coast Forest Industry at 24 (Nov. 2001); Northwest Ecosystem Alliance, "Log Price Comparisons in the Vancouver Log Market," Dec. 31, 2001, at vii; Ken Drushka, "Log-Export Policy is Unfair and Counterproductive," Vancouver Sun, Dec. 6, 2000, at D2 ("{E}xport restrictions reduce log values in B.C. This is not an accidental consequence, but the whole point of the exercise."); and Christine L. Lane, "Log Export and Import Restrictions of the U.S. Pacific Northwest and British Columbia: Past and Present" at 38 (Aug. 1998) (USDA Forest Service: PNW-GTR-436) ("The overall purpose of the {log export restrictions} has been to maintain and enhance Provincial development, provide jobs, {and} ensure that all aspects of the timber industry remain solvent during the ups and downs of the economy.").

[13] TimberWest Forest Corp 2002 Annual Report at 20 ("Forcing private landowners to sell logs to domestic sawmills at prices lower than international prices transfers the value from the tree grower to the processor, provides some sawmills with an unfair competitive advantage and restricts competition. It impairs the value of private timberlands in coastal BC and depresses pricing on Crown logs as well.").

[14] "Free the trade in logs and sell the forests," National Post, Apr. 5, 2001.

Despite this demonstrated effect, provinces have resisted commitments to end log export restrictions, in part because of political sensitivities. Many constituencies including environmentalists and labor interests support reasonable restrictions on the export of raw logs as a policy mechanism, to favor value-added industries that further develop the resource. Further, U.S. objections have been criticized as hypocritical because some restrictions apply to harvests from U.S. public land in certain western states.

In recognition of these concerns a final Policy Bulletin could establish a legally adequate standard without requiring wholesale repeal of these rules. What is needed is a reform adequate to ensure that market conditions prevail by: bilaterally lifting export restrictions, reforming Canadian restrictions such that a substantial share of Crown harvest is subject to export or requiring that timber used as a "price benchmark" is subject to export, etc. This type of bilateral reform would not be expected to result in a log exodus, particularly if province sold timber for fair market value.

[15] Canadian governments should, as a first step, eliminate all limitations on and regulations governing the export of logs harvested from private lands.

A final Policy Bulletin should require elimination of export restrictions on reference market timber for another reason: to provide some additional confidence in domestic timber pricing for provinces using internal sales. Lifting restrictions on at least some portion of the harvest would ensure

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[15] Domestic purchasers should normally have lower costs associated with log delivery (a very substantial share of raw material cost) and should be willing to pay a higher price for the log (all else being equal). Transportation costs should thus ensure that a high volume of logs does not move. In the Pacific Northwest, annual log exports have never exceeded 17% of harvest, and most of those have been to Japan. Production, Prices, Employment and Trade in Northwest Forest Industries (USFS; 4th Qtr. 1990, 2000).

that domestic log prices achieve the result that would obtain in an unrestricted market, by increasing demand for available timber. In this way, log export bids could partially validate internal market prices. Using limited raw log exports to test newly-created competitive bidding systems has previously been suggested by Canadian experts.

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Long-term, non-transferable tenure

The draft Policy Bulletin recognizes that long-term, non-transferable tenures create entry and exit barriers, limit competition and complicate the issue of adjustments. Draft Policy Bulletin, 68 Fed. Reg. at 37,458. Long-term tenures, and the control they create, have an enormous impact on all aspects of provincial timber sales.

While independent rules, such as processing requirements, currently establish other barriers to entry, the removal of these barriers will do very little to increase competition absent fundamental tenure reform. A large majority of provincial timber is allocated to long-term tenureholders through evergreen arrangements granted to large, integrated harvesting and processing operations.

17 Provincial timber allocation decisions have caused near paralysis; with very little available fiber,

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16 "The Future Use and Value of the British Columbia Forests" at 32 (Mar. 1992) available at http://www.for.gov.bc.ca/hfd/pubs/Docs/Mr/Rc/Rc021/RC021_4.pdf (study by SRI International, on behalf of the BC Forest Resources Commission).

17 In BC, over 50% of provincial AAC is allocated to the 10 largest tenureholders; the 25 largest companies hold nearly 70% of total AAC. "Provincial Linkage AAC Report" (July 11, 2003) available at http://www.gov.bc.ca/for/. In Ontario, the eight largest tenureholders (Section 26 licensees) accounted for roughly 50% of harvest. Memorandum from the Department of Commerce Regarding Certain Softwood Lumber Products from Canada Verification Responses Submitted by the Government of Ontario at 9 (Feb. 15, 2002). In Quebec, a very small amount of tenureholders harvest the majority of

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provinces have not been able to satisfy commitments to indigenous peoples nor foster the development of communities and entrepreneurs. To create functioning internal markets without compounding existing subsidies, provinces will have to engage in substantial tenure takeback. Without tenure takeback, there will be insufficient volume to create viable, undistorted markets.

Commitments to allow unrestrained tenure transfer and subdivision may have little impact on timber distribution in practice, and could raise additional concerns. Tenureholders may not engage in substantial sub-division and sale if it would generate increased competition for localized auction timber and affect benchmark pricing on the remaining portions of the original license. Further, if sales occur, who would receive any premiums these sales generate? These premiums, reflecting the value of secured, long-term supply, could result in increased subsidies to existing tenureholders.

[18] As the Natural Resources Defence Council ("NRDC") recently explained:

> What cannot be forgotten is that BC, and other Canadian provinces are starting from a situation where cutting rights are virtually fully allocated. To lock in this situation by commodifying long-term tenure would be a huge windfall benefit to the small group of companies who currently control tenure.

(...continued)
softwood harvest. 6 QCQR at Exh. S-40. Large tenureholders in Alberta (holding FMAs) accounted for about 60% of softwood harvest during the investigation. Memorandum from the Department of Commerce Regarding Certain Softwood Lumber Products from Canada Verification Responses Submitted by the Government of Alberta at 3 (Feb. 15, 2002).

[18] According to press reports, sales of existing tenures command a significant premium, reflecting this value. E.g., John Greenwood, "Doman may sue over timber cutting reforms: 'It is going to impact the value of some of our major assets.'" Financial Post (Apr. 9, 2003) (worth at least C$100/$m^3$). Recent tenure transactions apparently incorporated values in the range of C$71-C$118/m^3. Gordan Hamilton, "Too many trees for stock investors," Vancouver Sun (Apr. 2, 2003). Vaughn Palmer, "Economic thorns lurk in timber regulations," Vancouver Sun (Apr. 1, 2003) (companies estimate tenure value between C$75-C$100 m^3).

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The 1991 Forest Resources Commission in BC also recognized that allowing companies to keep "unearned" profits from tenure sales would result in a "windfall" to the tenureholder.

[20] Provinces should also develop mechanisms to collect data on the value of tenure transfer amounts.

If tenureholders assign part of their holdings, they could also seek to influence downstream use. For this reason, provinces should enact rules that prevent tenureholders from imposing restraints on alienation of the fiber from tenure sales, such as rights of first refusal on logs harvested from transfer areas. Such restrictions imposed by tenureholders would impede the operation of log markets. In addition, they would compound difficulties with collecting and measuring the value of the timber.

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19 Letter from National Resource Defence Council, *et al.* to Under Secretary Grant Aldonas (Feb. 14, 2003).

20 A. L. (Sandy) Peel *et. al.*, "The Future of Our Forests" at 53 (April 1991).

Finally, as the draft Policy Bulletin recognizes, long-term tenures provide a secure supply to licensees.[21] As Weyerhaeuser publicly acknowledged, "forest tenure is a valuable asset."[22] Long-term, guaranteed access to supply lowers input costs and the cost of capital.[23] Companies frequently secure financing transactions with timber provided under tenures.[24] Tenures have distorted the investment decisions of Canadian producers and fueled their subsidy-induced capacity growth over time. The continuation of long-term tenures will require provinces to adjust for this value if comparing to short-term auction sales.

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21 The final determination did not include an adjustment for the value of tenure security and thereby understated the actual amount of the subsidy; the Department acknowledged that there could be value but declined to adjust because of insufficient data. Final Determ. at 160. As the BC Minister of Forests recently indicated, "There is value associated with the harvesting rights." House of Assembly Hansard at 5682, 27 Mar. 2003 ("Testimony of Hon. Michael de Jong"). Recent press reports confirm the enormous value associated with long-term tenures. See *supra* note 18.

22 Weyerhaeuser, "Coastal Competitive Reform: A Proposal for Market-based Stumpage and Tenure Diversification for Coastal B.C.," at 10 (Oct. 2001) ("Coastal Competitive Reform").

23 "Without a secure, long term supply of wood fibre, the risk is much higher, and so, correspondingly, is the cost of financing the investment." "The Future of Our Forests" at 39. As one mill rebuilding from fire damage in the Maritimes recently indicated, "'What we need is a guaranteed supply' . . . {as} accessing enough timber is crucial to securing funding through government agencies and private investors to help restart the business." Gary Kean, "Mill needs help, co-owner says, The Western Star (June 12, 2003).

24 L. Ward Johnson, "The More Things Change," Madison's, Apr. 4, 2003, at 6.

Offsetting Provincial Actions

The draft Policy Bulletin specifies that the Department will examine whether a province maintains or introduces requirements that would offset or undercut the operation of market forces. Draft Policy Bulletin, 68 Fed. Reg. at 37,458. Provincial timber supply rules could have this impact. Existing systems do not set the total quantity of timber available for harvest consistent with market principles.

[25] Provinces do not apply a commercially-reasonable reservation price that would signal that certain timber may be uneconomic to harvest. BC also maintained generous harvest bands: companies were required to maintain harvesting of at least 50% and up to 150% of their annual allowable cut ("AAC") in any given year and within 90-110% band over five years. Rules that tolerate long-term harvesting well-above the so-called maximum level make no sense and cannot be maintained. If a province allows uneconomical harvesting, ecological sustainability may also be compromised. As the draft Policy Bulletin recognizes, these actions could offset the impact of other reforms. Setting timber supply at an artificially high level will generate an artificially low price.

Rules that prescribe harvesting within a set band can interfere with market signals in complex ways. If companies must harvest a certain percentage of AAC within a set time period, they may harvest and process timber that would otherwise remain off market. With an internal reference market, these bands could allow tenureholders to manipulate auction prices through selective participation. With any significant flexibility, a company could completely withdraw from reference markets in

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[25] Tom Green, Cutting for the Economy's Sake 154-58 (2000).

particular periods in the attempt to keep auction prices low, choosing to bid at auction only when conditions were optimal for low prices and offsetting years with higher administered harvest against years with low administered harvest. Harvest banding on administered volumes also affects a company's need to participate in the reference market.

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A province must ensure that these rules do not influence participation in the reference market. One way of reinforcing this requirement would be to test whether all market participants source from competitive markets on a consistent and ongoing-basis. While the Department does include the level of competitive sourcing as one of the levers subject to examination, Draft Policy Bulletin, 68 Fed. Reg. at 37,459, it should also specify that harvesting bands cannot encourage non-competitive behavior. The Department must ensure that these rules do not allow companies to engage and withdraw from reference markets on a selective basis and thereby manipulate prices.

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[26] For example, in 2001, BC tenureholders were harvesting less than 97% of their AAC. Under the then applicable AAC utilization rules, 12% of tenure could have been withdrawn from harvesters without changing historical production levels or requiring tenureholders to source in competitive markets for any additional volume. 3 BCQR at Exh. BC-S-1, Att. E-1

I.B.1. Reference Prices

Summary of Comment

The Department should consider carefully what level of reform is necessary to ensure that a reference market will properly reflect fair market value, particularly given current conditions in provincial timber markets. The Department should also specify that the Department would examine all circumstances in which administratively priced timber could affect pricing conditions in the reference market, not just whether tenureholders have the ability to manipulate pricing through administered volumes. A final Policy Bulletin should specify that the Department will examine all barriers to entry and exit in the provincial timber market as a whole, including whether pre-existing conditions function as de facto *restraints on competition.*

Comment

The Coalition agrees, as a theoretical matter, that a market could exist in which less than a majority of the total volume is sold through competitive mechanisms and yet generated a fair market price. The Department's discussion of "Reference Prices" seems to relate to this type of theoretical market. Draft Policy Bulletin, 68 Fed. Reg. at 67,458-459. Yet, consistent with U.S. law, the Bulletin must guide policy reform of current provincial timber systems, which are deeply distorted, which exhibit and are controlled by non-competitive factors, and in which major licensees have enormous market power. In describing and applying the pre-conditions for adequate reference market,

the Department must 1) ensure that the prices generated eliminate the subsidy, i.e. fully reflect market

forces; 2) establish that the burden is on the applicant province to demonstrate that reforms have resulted in non-subsidizing timber prices; 3) take into account its regulations; and 4) ensure that key evidence is accounted for.

First and most fundamentally, for a province to qualify for revocation through a CCR, the Department must ensure that policy reform eliminates the countervailable subsidy. If the government sells goods for adequate remuneration, e.g., fair market value, no countervailable benefit exists. 19 U.S.C. § 1677(5)(E)(iii). Thus, the reference market must yield fair market prices.
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Second, in any CCR, the statute allocates the burden of persuasion to the applicant party. 19 U.S.C. § 1675(b)(1). A province must overcome the finding that its timber pricing mechanism generates less than adequate remuneration. Thus, the reference market must not only generate fair market prices, it must be sufficiently robust that a province can demonstrate this result. The definition of reference market must incorporate this burden.

Third, the definition of the reference market must be consistent with Department practice and regulations. Only market-determined prices can establish the adequacy of remuneration. 19 C.F.R. § 351.511(a)(2) (2003). Normally the Department employs internal market prices in this calculation.

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[27] Sales will generate adequate remuneration only if competitive segments are viable and undistorted. A viable market is characterized by a sufficient number of buyers, sellers and transactions in every relevant region and time period so that the observed price and quantity exchanged can be relied upon as being representative of the good's economic value. Newly created markets must also be relatively undistorted: free of manipulation through supply, demand or both, as can occur, for example, through the overhang of large administratively priced volumes. E.g., Robert D. Stoner and Matthew G. Mercurio, "Economic Analysis of Price Distortions in a Dominant-Firm/Fringe Market" at 9 (Jan. 2002).

Yet, significant government participation renders internal benchmark prices unusable if significant distortions (shifts in market behavior, supply or demand) result. Countervailing Duties, 63 Fed. Reg. 65,348, 65,377 (Dep't Commerce Nov. 25, 1998) (final rule) ("Preamble"). For ease of administration, and based on sound economics, the Department normally presumes that prices are unusable if the government supplies more than 50% of the market on non-competitive terms:

> While we recognize that government involvement in a market may have some impact on the price of the good or service in that market, such distortion will normally be minimal unless the government provider constitutes a majority or, in certain circumstances, a substantial portion of the market. Where it is reasonable to conclude that actual transaction prices are significantly distorted as a result of the government's involvement in the market, we will resort to the next alternative in the hierarchy.[28]

In Lumber IV, the Department properly determined as a matter of U.S. law and economics that internal benchmarks could not be used because of the overwhelming dominance of government timber sales. Final Determ. at 37-38. As the Department explained:

> Where the market for a particular good or service is so dominated by the presence of the government, the remaining private prices in the country in question cannot be considered independent of the government price. It is impossible to test the government price using another price that is entirely, or almost entirely, dependent upon it.

Id. at 38. Thus, a reference market must be sufficiently robust such that it is not dependent upon current or previous government pricing systems. The Department's practice and regulations suggest that at least 50% of sales must occur in open and competitive markets to generate this result.

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[28] Preamble, 63 Fed. Reg. at 65,377 See also Certain Hot-Rolled Carbon Steel Flat Products from Thailand, 66 Fed. Reg. 20,251, 20,259 (Apr. 20, 2001) ("{I}n the preamble, we made clear that if the government provider constitutes a majority of the market, we would have to resort to other alternatives, including world market prices.").

Fourth, the definition of reference market must take into account available evidence concerning the minimum conditions necessary to create competition in Canadian provincial timber markets. Many independent sources conclude that 50% of harvest would be the bare minimum necessary to create open competition. For example, Professor Peter Pearse, a leading Canadian forest economist who has led numerous timber investigations and commissions for the BC government, indicated that, "To establish a market-based stumpage system many in the industry believe about 50 per cent of the coastal harvest would have to be sold on the open market."

[29] The BC Forest Resources Commission recommended selling more than 50% of the total crown harvest through competitive sales.

[30] Independent and secondary processors understand that for them to have a fighting chance in a market at least half of all sales must be truly competitive.

[31] Canadian environmental groups confirm that "A substantial majority of tenure in Canada must be reallocated to create the basis for competition."

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29 Gordon Hamilton, "Coast Forest Prober Pearse Decries Gov't 'Tinkering,'" Vancouver Sun, Sept. 25, 2001, at C10.

30 "The Future of Our Forests" at 40-41.

31 According to the BC Central Interior Wood Processing Association, "{I}f British Columbia is going to create a market-based timber pricing system, at least 50 per cent of Crown timber needs to be put up for public auction, and preferably 100 per cent." Gordon Hoekstra, "Forest Sector Open to U.S. Proposal," Prince George Citizen (Jan. 9, 2003); Gordon Hoekstra, "Planting forestry's future," Prince George Citizen (Mar. 29, 2003). Accord "Market-based timber pricing possible," Canada.com (Sept. 19, 2002) (secondary manufacturers say at least 50 percent must be bid to create a market system); Gordon Hoekstra, "Interior logging rights could be part of forest policy reform, De Jong says," Prince George Citizen, (May 13, 2002) ("{L}oggers, the value-added wood sector, some communities and environmentalists have said in order to create a true log market, more than 50% of the province's timber must be auctioned.").

[32] Further, the practices of many countries (including Australia, England, France and Ireland) confirm that 50% government sales is a minimum threshold for creating adequate competition.

[33]

The legal standard and available evidence must inform the application of the Department's proposed definition. While the draft Policy Bulletin has not adopted a presumption about the share of sales necessary to satisfy the definition, given current provincial systems, a reference market without a substantial majority of volume may not satisfy the two basic criteria: (1) operate as a market, and (2) function independently of the administered portion of the harvest. Draft Policy Bulletin, 68 Fed. Reg. 37,458.

In evaluating whether a reference market "functions" as a truly competitive market, the draft Policy Bulletin proposes to examine the number of participants, market access, volume of timber, restraints on buyers and sellers and access to market information. Id. To ensure adequate and consistent participation in reference markets, provinces must ensure that tenureholders are forced into the market for a significant volume of fiber; this requires a significant volume of fiber be allocated to reference markets.

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[32] Comments from Natural Resources Defence Council, *et al*. on U.S. Department of Commerce Softwood Lumber Draft Policy Bulletin at 8 (Feb. 2003).

[33] State of Victoria, Department of Natural Resources and Environment, "Timber Pricing Review Discussion Paper," Appendix 3 at 3-11 (June 2001).

In fact, even Canadian industry sources – MacMillan Bloedel/Weyerhaeuser – have proposed taking back tenure and increasing competitive sales to a level that could be within striking distance of a substantial majority of competitive sales. MacMillan Bloedel "A White Paper for Discussion: Stumpage & Tenure Reform in B.C." at 1-2; Weyerhaeuser "Coastal Competitive Reform" at ii.

[34] Another key factor relating to market function is the potential market power of participants and their ability to game market structures.

[35] As the draft Bulletin acknowledges, no single participant should be able to influence the sales price; thus, the Department must exercise particular caution in evaluating a reference market that incorporates opportunities for manipulation.

[36]

Absent a substantial majority of competitive sales, provinces may be tempted to intervene, which could prevent the reference market from functioning. Large administered volumes will leave provinces vulnerable to lobbying for exceptions and special deals, including pressure to adopt policies that would interfere with market operations.

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[34] Draft Policy Bulletin, 68 Fed. Reg. at 37,459 ("the greater number of market participants who must participate in the reference market or other competitive markets for a sizeable share of the furnish for their mills, the stronger the evidence that the reference market is open, competitive and functioning independently of the administered portion of a province's harvest"). This requirement has reinforcing benefits and ultimately would encourage companies to incorporate competitive pricing signals into their cost structures and develop efficiencies.

[35] "If they are good at nothing else, Canadian forest companies are masters of fiddling administrative systems. They have been doing it for 140 years and will have no trouble subverting whatever systems American bureaucrats put into place." Ken Drushka, "Market forces a better driver than bureaucrats," The Interior News (Feb. 12, 2003).

[36] One example of "gaming" was the widespread BC industry practice of "grade-setting" reduced stumpage collections, particularly on high-valued, highly-subsidized species. Through "grade-setting" a tenureholder harvests only the low quality wood from a cutblock then has stumpage reappraised based on the low scaled values and harvests the remaining high-quality wood at lower, rescaled rates. Tom L. Green and Lisa Matthaus, "Cutting Subsidies, Or Subsidized Cutting?" at 6 (July 12, 2001). Under prior rules, even if the BC Ministry of Forests discovered the manipulation, it did not have authority to retroactively assess higher stumpage, basically making the practice no-risk.

[37] Existing systems tie tenureholders and provincial policy makers and allow companies to bend policy makers to their needs. Provinces have a demonstrated history of "giving back" to industry as a result of lobbying efforts: for example BC's 1998 stumpage reduction due to alleged higher costs associated with complying with the Forest Practices Code and Quebec's 1999 and 2000 reductions from stumpage increases indicated by the parity technique.

[38] The Department must also insist that a province make adequate commitments not to change its practices in ways that result in offsetting or passing-back subsidies, including relief from environmental regulations, discussed with reference to Part III, below.

To ensure that the reference market operates independently of the administered portion of the harvest, we believe that a substantial majority of competitive sales is required. A large volume of sales will ensure that reference markets incorporate an adequate level of demand. It would be nearly impossible to isolate a small reference market from the overhang of surrounding administered volumes for several reasons. Even assuming that all competitors within the small reference are required to participate, the level of demand may still remain low. Logs may be economically hauled long distances

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[37] As TimberWest CEO Paul McElligott explained, "It is difficult for government to resist the special interests clamouring for exemptions from the market." "Creating win-wins in BC's forests . . . Taking on sacred cows," (Apr. 4, 2003) available at http://www.timberwest.com. Further, BC industry groups such as the powerful Council of Forest Industries ("COFI") have already begun lobbying BC for delays in implementing market-based stumpage. Greg Sakaki, "Group wants changes delayed," 100 Mile House Free Press (May 21, 2003).

[38] "Cutting Subsidies, Or Subsidized Cutting?" at 5; Michel Corbeil, "Quebec steps back, the projected 23 % increase has been reduced to 6.8 %" Le Soleil (Apr. 2, 1999) (translated) app. to Petition at Exh. IV I-2; Minister of Natural Resouces, "Forest Dues," (Mar. 28, 2000) (translated) app. to Petition at Exh. IV I-2. Various BC governments have practiced "'sympathetic administration.'" "The Future of Our Forests" at 41.

and mills from surrounding areas would have participated in bidding in an open and competitive market.

[39] Further, if provinces create small reference markets, tenureholders will retain access to large administered volumes and will not need to compete for supply.

[40] This reduces demand in the reference market and would likely allow tenureholders to participate selectively, to avoid driving up prices that would then apply to administered volumes. If tenureholders have the ability to withdraw from reference markets when conditions are poor, prices would likely plummet to artificial lows.

[41] As discussed above, if a province retains generous harvest banding rules, this could encourage such

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[39] During the investigation Quebec reported an average log haul of 142 km. Supplemental Questionnaire Response from the Government of Quebec Exh. QC-S-73 at 22 (Aug. 26, 2001). Ontario reported logging distances of up to 800 km for SPF timber. Charles River Associates "An Economic Analysis of the Appropriateness of Relying on Ontario's Private Timber Sales" (Dec. 14, 2001) at 17-18 app. to Ontario Second Supp. Questionnaire Response at Exh. ON -2ndSUPP-12 (Dec. 17, 2001).

[40] Draft Policy Bulletin, 68 Fed. Reg. at 37,459. Even with a substantial majority of competitive sales, reference markets will remain open to manipulation on the supply side. Provinces could selectively increase AAC, allow abnormal levels of silviculture, etc. Any artificial supply expansions will have long-term effect on market prices. For example, the very substantial additional volumes BC has made available to address the mountain pine beetle epidemic is likely to reverberate through the market for years to come. BC recently reported that it has increased AAC by more than 5.5 million cubic meters to address the beetle problem, "The Forestry Revitalization Plan" at 16. Further, BC has "created incentives for forest companies to remove beetle-infested trees, including lowering the rate it charges them to cut in infested areas." John Greenwood, "New Ally in Softwood War: Voracious Beetles," National Post (July 12, 2003). The presence of substantial, unutilized administered supply in the form of unused AAC impacts the prices that may be obtained on competitive supply. Final Determ. at 96 (discussing impact of unused AAC on Ontario private markets). Of course, one should keep in mind that the paradigm on which evaluation is based is fully open and competitive markets.

[41] This potential also underlines the need for provinces to establish a commercially reasonable reservation price based on commercial criteria such as fully allocated replacement costs and expectations of the future value of the timber. Even in low markets, private landowners would

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distortions. A two-tiered market, with large, integrated tenureholders sourcing primarily from the administered segment and smaller operators forced to compete, would not satisfy the conditions outlined in the draft Policy Bulletin.

The administered segment may influence individual participants' decisions to bid on competitive timber in other ways, including the allocation of fixed costs. Tenureholders will attempt to rely on administered supply whenever possible to the extent that fixed costs associated with forest management obligations such as forest planning and major roadbuilding exist.

[42] Tenureholders will seek to avoid the marginal costs of participating in the competitive segment, such as bid preparation. This suggests that a reference market must account for an even larger percentage of overall harvest to ensure adequate participation. With a larger volume of competitive sales, all companies must prepare bids in light of estimated timber value, lest they be left with no supply at all.

Finally, the draft Policy Bulletin could be read to suggest that there may be a direct trade-off between a province's willingness to eliminate market distortions generated by mandates and the

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(...continued)

not sell timber for less than replacement cost as they would instead withdraw from the market until prices improve. A species-specific reservation price, such as that employed by the USFS, must be implemented.

[42] By deducting the per-cubic-meter equivalent of certain fixed costs of forest management from competitive prices, systems will build in tenureholder preferences to harvest from administered volumes in order to recoup these amounts, which must be paid regardless of where the tenureholder harvests. E.g., Robert D. Stoner and Matthew G. Mercurio, "Economic Analysis of Price Distortions in a Dominant-Firm/Fringe Market" at 1, 9-11 (Jan. 4, 2002). As the Department found, "Because the majority of timber consumers in the Province are mills that have large sunk costs in their own tenures, there will be a marked preference for mills to consume timber from their own tenures before going to market, which would further distort prices." Final Determ. at 97.

necessary size of a reference market. Draft Policy Bulletin, 68 Fed. Reg. at 37,458. Removing these policies should be a prerequisite regardless of the size of the reference market. In a competitive market, no market distorting regulations would impede competition and all of the volume would be sold competitively. Provinces should implement significant reforms addressing both levers: the elimination of rules that impede the market and ensuring that an adequate volume of timber underlies competition. We agree, however, that once a province has achieved this minimum level, there could be tradeoffs involving the degree of reform to achieve the necessary overall conditions of competition. For example, the danger that tenureholders will be able to avoid participation in the competitive segment is greater if a province maintains rules that permit harvesting above AAC within significant bands. And the necessary volume of timber sold in a reference market might be somewhat less if a province completely eliminates minimum processing requirements, prohibits long-term harvests above AAC and significantly restricts short-term harvests above AAC. Overall, the Department should test the level of competition in the reference market, for which, an adequate volume remains the paramount concern.

In considering whether a province has established an adequate reference market, the Department would need to evaluate data presented to determine whether the market generates the expected price equilibration. Draft Policy Bulletin, 68 Fed. Reg. at 37,457. Nevertheless, the Department's regulations, current practice and economic analysis suggest that a substantial majority of timber sales must be allocated to reference markets in order to generate adequate competition. Any reforms should be evaluated, but the necessity of substantial reform should not be underestimated.

Direction of the Causal Link

The draft Policy Bulletin recognizes that a province must demonstrate that prices in the

reference market drive prices for administered volumes and not the reverse. Draft Policy Bulletin, 68 Fed. Reg. at 37,459. "{F}irms or individuals with significant long term tenures cannot artificially force down prices in the private market to lower stumpage charged on the administered portion of the harvest." Id. This requirement also applies to a province that uses competitive sales of public timber as its reference market.

[43]

But the inquiry should not be limited to this condition. The Department already found after extensive investigation, briefing and argument that significant, low-priced administered volumes distorted existing minority competitive markets in Canadian provinces. For example, with respect to Ontario, the Department concluded:

> There is one significant participant in the market for stumpage in Ontario that is a price setter -- namely, the Province of Ontario itself. In Ontario, the stumpage market is driven by the provincial government's ownership and control of forest land and the government's practice of setting stumpage charges administratively.

Final Determ. at 98. Thus, the mere presence of enormous administered supply can drive prices in a smaller competitive segment. This is clearly the case in Canada where, in almost all of the provinces, harvest levels are below AAC.

[44] The Department also found that administered sales significantly distorted private prices in Quebec,

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[43] For clarity, the Department may want to strike "private" from this paragraph.

[44] During the POI, BC harvested at 94.8% of AAC (all timber) (BCQR at Exh. BC-S-1, Att. E-1), Quebec at 90.9% of AAC (softwood timber) (QCQR at Exh. QC-S-1 and QC-S-43), Ontario harvested 92.4% of AAC (softwood timber) (ON-Stats-1 and ON-TNR-5). Of the major provinces, only Alberta met or exceeded AAC, harvesting at 112.6% of AAC (softwood timber) (AB-S-64, amended tbls. 1 and 16).

based on careful examination of applicable economic theory and record evidence. Id. at 58-60. While these findings directly pertain to internal private markets, the reasoning applies with equal force to internal competitive segments. As the Department found, independent private sellers (seeking to maximize revenue) were unable to overcome the dominant force of administratively-priced government sales. Id. at 59 and 98. There should be even greater concern for governments' "competitive" sales.

A province must demonstrate that prices in the reference market are not effectively dictated by the administered segment. This is particularly a concern if the size of the competitive market is comparatively small. Ability to use administered volumes to manipulate the competitive price is but one part of the necessary inquiry.

Barriers to Entry and Exit

The draft Policy Bulletin also focuses on whether there are entry and exit barriers in the reference market. The Coalition agrees that express barriers such as nationality requirements, mill ownership rules or log trade restrictions distort the market. Draft Policy Bulletin, 68 Fed. Reg. at 37,459. The Department should also examine whether there are barriers to entry or exit in the provincial timber market as a whole and whether rules require participation in the reference market.

As almost all Crown timber is already allocated in long-term tenure arrangements, major barriers to entry are built into existing systems, even if legal rules that restrict transferability are removed. Large, integrated operations dominate provincial harvesting and processing in all provinces. For this reason, existent provincial systems have been criticized for their failure to foster participation by smaller stakeholders, indigenous peoples and value-added processors. Without substantial tenure takeback, access will remain in the hands of a few integrated processors. The Department should

examine whether provincial reforms generate new entrants to the market as a whole. The "entry" barrier inquiry must include the distribution of provincial tenure.

Provinces should structure markets so as to ensure participation by tenureholders, not merely refrain from barring them from competition. Tenureholders have numerous incentives to refrain from competing for reference market timber, e.g., to keep administered prices low and recover fixed costs from tenures.

Safeguards Against Collusive Behavior

The draft Policy Bulletin proposes to examine whether provinces have established safeguards against collusive behavior. The Coalition agrees that provinces should develop and implement rules to ensure that timber markets are free from collusion. Previous provincial timber auction systems were reportedly characterized by widespread anticompetitive behavior.

[45] The concentration of provincial administered timber in the hands of relatively few large producers creates the danger of coordinated action. Particularly in remote areas, large tenureholders can be expected to attempt to divide markets for mutual benefit. A commercially reasonable reservation price will also provide some protection against coordinated underbidding.

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45 "The More Things Change" at 6. ("Intimidation and collusion were common auction strategies. One anecdote was told of a large contractor who went around the auction with a pocket full of envelopes. Every time he handed one out, the recipient left the room. By the time the bidding started, he was the only serious bidder left.").

46 A commercially reasonable reservation price is appropriate for all auctions sales and mimics the behavior of private timber owners, who would not sell timber without receiving a price that exceeds the present value of any future expected timber price. G. Robinson Gregory, Resource Economics for Foresters 199 (1987).

I.B.2 Transparency

Summary of Comment

A final Policy Bulletin should direct provinces to apply market-generated costs in adjustments wherever possible and update adjustments on a regular basis. The system must be transparent and verifiable.

Comment

As the draft Policy Bulletin recognizes, "transparency is a key feature" of markets. Draft Policy Bulletin, 68 Fed. Reg. at 37,459. The Department must ensure that provincial reforms are open and known to all participants for several reasons. Provincial timber systems have entrenched non-market features. Equally as important, Canadian lumber companies have a long-standing history of manipulating these administered systems to their advantage.

The Vancouver Log Market ("VLM") is one example of the failure of previous "market" mechanisms in BC. Numerous authoritative analysts have concluded that the VLM does not function as a true market but is characterized by "backroom" deals by a small number of integrated operators.[47] Transactions are largely structured as log "swaps" without a cash price.[48] Even if other entrants could open up backroom dealings, the VLM currently generates insufficient public information about market values and conditions.

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47 E.g., Pearse, "Crisis and Opportunity" at 24 ("Five large companies account for most of the sales, three of them for the majority of purchases."); Letter from Northwest Ecosystem Alliance to Secretary Donald L. Evans, Case No. C-122-839 (Jan. 5, 2002).

48 Id. ("Most transactions are not independent purchases or sales, but trades of one type of logs for another, enabling integrated companies to adjust their log supply to better fit their mill requirements.").

[49] As the draft Policy Bulletin indicates, Draft Policy Bulletin, 68 Fed. Reg. at 37,459, an exchange that operates on swaps could not serve as a reference market: prices must result from a competitive process open to all interested buyers and sellers and generate public information about individual transactions to foster competition in provincial log sales. Of course, simply publishing information about existing trades would not fix the VLM's underlying structural issues and generate "transparency." Publishing data is only one step in making the VLM function as a competitive, transparent exchange.

Transparency is particularly critical with respect to adjustments made to account for differences in the terms of sale between transactions in the reference market and administered volumes. Adjustments must be based on publicly available, objective and verifiable information. Draft Policy Bulletin, 68 Fed. Reg. at 37,460. Adjustments should be limited to differences in terms quantifiable based on market-generated data. Otherwise cost inefficiencies built into existing systems will influence results. For example, if an adjustment were required for harvesting costs, a province should use arm's-length harvest and haul contracts, rather than internal company data from industry surveys. Limiting the overall number of adjustments will also ensure that a close link remains between market conditions and administered pricing as the draft Policy Bulletin recognizes. A complicated system of adjustments, such as is applied in Quebec's parity system (which generates negative stumpage in some instances), would be unacceptable.

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[49] Id. ("{I}ndependent log producers complain that there are insufficient buyers for truly competitive marketing and pricing.").

[50] As, the Department verified, Quebec's parity technique generates negative values associated with harvesting timber in certain tariffing zones (C$-4.42 for zone 917). Memorandum from the (continued...)

Consistent with the overall allocation of burdens in a changed circumstances review, applicant provinces must bear the burden of demonstrating and quantifying *bona fide* differences in the level of requirements, particularly when proposing adjustments that reduce administered stumpage prices. Importantly, adjustments cannot be a one-way street. As the draft Policy Bulletin recognizes, long-term tenures also confer important advantages, such as security of supply, which must be balanced against their burdens, such as forest management obligations.

Adjustment data must be market-generated as existing systems incorporate numerous inefficiencies. For example, the Quebec system adjusts for costs associated with transportation of timber from the forest to the mill, thereby reducing any incentive mills have to choose the most efficient location. Instead, the company will locate its mill to reduce other costs, such as transportation to market (although the Quebec system accounts for this too) -- in essence the provincial government compensating its mills to offset a natural U.S. comparative advantage.[51]

The Ontario system provides another example. As part of its administered stumpage fee it

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Department of Commerce Regarding Certain Softwood Lumber Products from Canada Verification Responses Submitted by the Government of Quebec ("QCVR") at 13 (Feb. 15, 2002). Quebec instead charges its minimum stumpage rate in this zone, C$3.53/$m^3$. As harvesting still occurs in these zones at the minimum rate, the adjustment mechanism necessarily and grossly undervalues timber.

[51] QCVR at 11 (discussing how Quebec's system adjusts based on distance from forest to mill). In fact, comparing the costs of transportation built into the parity technique, public costs are much higher on a per cubic meter basis for forest-to-mill transportation, likely a result of the effective reimbursement built into the stumpage estimation. The Quebec Wood Producers Federation has complained about this intervention, calling such adjustments "a form of subsidy." Report on Bill 136 at 19, Petition Exh. IV F-16.

currently incorporates a partial residual value charge. That charge is based on inflated costs that: 1) are determined by an industry survey (known to be for the purpose of setting the stumpage adjustment);

[52] 2) incorporate a mandatory 20% profit allowance;

[53] and 3) result in a province-wide average adjustment (rather than a marginal-cost based ability-to-pay assessment as would occur in a market).

[54] Further, as Canadian producers recognized, mandates such as appurtenancy, minimum harvest rules and mill closure restrictions imposed additional costs.

[55] It would be highly inappropriate for any province to make adjustments based on cost data inflated by these restrictions. An appraisal method that deducts inefficient costs results in undervaluation; "the actual value of a stand of timber is not related to cost inefficiencies in the industry that harvests it."

[56]

Adjustments may also generate unintended incentives. By adjusting for fixed costs associated with forest management obligations, systems could encourage producers to harvest from tenures rather than participate in reference markets. This problem also reflects the need for provinces contemplating newly created internal reference markets to allocate sufficient volumes to administered sales so that no

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52 This methodology creates incentives to inflate costs. "A Results Based Forest and Range Practices Regime for British Columbia," Submission from the Sierra Club of British Columbia at 2 (June 2002) (KPMG cost study in BC flawed based on survey of companies that knew the government could use the results to lower stumpage charges).

53 5 ONQR at Exh. ON-S-3.

54 In a competitive market, the most efficient producer would pay the good's marginal value, which would become its market price. E.g., Peter H. Pearse, Introduction to Forestry Economics 31, 45-46 (1990).

55 E.g., "Coastal Competitive Reform" at 14 (ending appurtenancy will lower costs).

56 "The Future Use and Value of the British Columbia Forests" British Columbia Forest Resource Commission at 6 (Mar. 1992) (emphasis original).

tenureholder will be able to withdraw from auctions completely, as is discussed above.

Whatever limited adjustments are necessary should be updated on a quarterly basis. Changes in market conditions should be accounted for in administered pricing systems. Further, provinces should endeavor to minimize lag in adjustment data wherever possible.

II.A Auctions

Summary of Comment

A final Policy Bulletin should indicate that the Department will closely examine rules governing tenure transfers. The Department should examine supply conditions in a province over time, including distortions that could result from present supply allocation decisions. The Department should clarify that it will examine the overall share of volume purchased as well as the number of market participants and will primarily focus on purchases in the reference market; the example should also clarify how Province A proposes to "reinforce" log markets.

Comment

First, Province A proposes to make "its tenures freely divisible and transferable."

[57] The Coalition supports this proposed reform, in principle. Still, the Department should inquire further into how tenure transfers would be structured. Some "restrictions" on tenure transfer in provinces actually were designed to increase diversity in timber allocation. For example, prior rules in BC provided for transfer with government consent, subject to a 5% volume takeback. This provision, while a "restriction" on transfer, allowed the province to reallocate volumes to new entrants, communities and indigenous peoples, which had pro-competitive impact. Maintaining the 5% tenure takeback rule would be consistent with policy reform goals and encourage progressive liberalization.

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[57] Draft Policy Bulletin, 68 Fed. Reg. at 37,460. The Coalition's general comments with respect to the necessary size of the reference market, rules to require participation by tenureholders, barriers to entry and the need for substantial easing of minimum processing requirements and other mandates apply with equal force to the examples. These comments are not repeated here.

Of course, the rule could be applied only to remaining administered volumes.

In addition, the Department should clarify how tenure sales should be structured, particularly treatment of proceeds from these sales. If the existing tenureholder keeps the profit, it would, in effect, be receiving a new subsidy equal to the cash value of the benefits associated with long-term tenure. Mechanisms should be developed to encourage tenure transfers that do not result in massive new subsidies.

The draft Policy Bulletin includes a commitment not to manage harvests in a way that artificially expands supply. Draft Policy Bulletin, 68 Fed. Reg. 37,460. The Coalition supports this requirement. The Department should require applicant provinces to provide full and complete data on timber supply in the CCR process. Supply distortions could influence competitive markets (particularly small, competitive markets) over time. If a Province allocates additional volumes to tenures, even before the creation of competitive markets, this could reduce the need of tenureholders to participate in the reference markets and artificially reduce demand for competitive timber. Alternatively, if a province allocates substantial volumes to the reference market itself, without commensurate tenure take-back, it could drive prices below what would obtain in a market-driven equilibrium. The Department should examine whether allocations result in harvest levels above long-term AAC. As a general matter, no system which permits long-term harvests above AAC should be permissible.

The Department should ensure that competitive markets also include a commercially reasonable reservation price.

[58] If the value of a stand to a harvester is below the reservation price, the economically marginal timber will not be harvested, as would occur in a competitive market. Reservation prices also help to ensure environmentally-damaging over-harvesting does not occur. In measuring whether provincial reforms generate adequate remuneration, the Department should examine both the demand and supply portions of the equation.

Province A has committed to "locate its auctions in a manner best designed to maximize participation and competition for the fiber." Id. One key concern must be selection of timber for auction. Auction timber must generate a representative sample if it is used to value remaining administered volumes. The Department must examine the process through which benchmark timber is selected. When benchmark timber is created through tenure takeback, licensees will seek to relinquish relatively lower quality volumes wherever possible, to keep higher quality wood for processing. This could create a situation in which lower quality timber prices would be used to set the price for relatively higher quality timber (as was done in the BC "grade-setting" scandal). Alternatively, tenureholders could propose takeback volumes located in relatively less accessible areas of their existing tenures, so as to reduce the potential demand for these volumes. Province A will have to document an appropriate benchmark timber selection process to ensure against these distortions.

In Province A, tenure reforms would "result in the need for all, or virtually all, market participants to, obtain a significant share of their fiber from the reference market or competitive log markets on an ongoing basis." Id. This obligation could help to ensure adequate competition, although

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[58] BC's C$0.25 per cubic meter cannot qualify as a commercially reasonable reservation price. Provinces must develop species-specific reservation prices or utilize USFS reservation prices.

it requires clarification in key respects.

First, this practice could have little or no actual impact because it focuses on the number of participants rather than the volume of timber. The major provinces all have hundreds of tenureholders, but the vast majority harvest only a very small volume each year. If 480 small operators bid in the market, yet the 20 large tenureholders accounting for 80% or more of harvest do not participate, the rule would be meaningless. Absent a requirement that all participants receive a substantial share of their fiber competitively, the Department must focus on both number and distribution of participants to ensure that large tenureholders also face this requirement.

Second, to the extent that participants satisfy this pledge by sourcing from competitive log markets rather than reference markets, the benefits from the participation rule would be limited to incorporating competitive signals into its cost curve. Participation in a log market does not ensure that there is adequate demand in the reference market itself. In evaluating this commitment, the Department should focus primarily on whether manufacturers obtain a significant share of supply from the reference market.

Province A will also encourage "the operation of log markets within the province on the basis of price rather than fiber swaps." Id. It is not clear what Province A proposes -- to ban log trades? To require sales be made on a cash basis subject to tax (and audit)? Simply to collect and publish additional information on log transactions? The Department should clarify what this commitment addresses. Additional reforms may be necessary for these markets to begin to function as a competitive fiber exchange, considering non-competitive practices in existing markets, including domination by a few large suppliers.

While any CCR would require detailed testing and evaluation as the draft Bulletin indicates, id. at 37,462, the initial package of reforms proposed by BC appears insufficient to satisfy the legal standard for revocation. Although testing of the system will provide a more definitive answer, BC may need to develop additional competitive mechanisms to satisfy its burden. We include just a few examples of the apparent limitations of proposed reforms.

First, the volume of tenure takeback is likely insufficient to create adequate competition. [59] About half of the very small volume proposed to be removed from tenures would be sold competitively; the remaining volume would apparently be reallocated to community forests and indigenous peoples. Volume that is not sold through direct competition cannot count. Creative accounting by the Ministry of Forests suggests that the province recognizes that the actual volume allocated to competitive sales is insufficient.

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It has also been reported that BC will permit tenureholders to assign harvesting rights as long as

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[59] While BC has stated plans to takeback about 20% of volume from major tenureholders, the actual volume involved is somewhat smaller. The first 200,000 m^3 for each tenureholder is exempt from takeback, making the actual volume closer to 16%. The number appears to be an arbitrary figure. The takeback volume necessary to result in market competition should be assessed on a regional basis, given local conditions. Further, the province has not yet implemented any tenure takebacks. Given controversy over proposed compensation, BC may actually implement a much smaller plan. Bill 28 "Forestry Revitalization Act" § 2 (March 2003) available online at http://www.legis.gov.bc.ca/37th4th/3rd_read/gov28-3.htm#section2 (harvesting rights reduced); see also Testimony of Hon. Michael de Jong at 5682 (takeback exempts the first 200,000 m^3 of wood).

[60] E.g., "Timber Reallocation Creates Opportunities for Entrepreneurs," B.C. Ministry of Forests (Mar. 26, 2003), available online at http://www.for.gov.bc.ca/mof/plan/timberreallocation.htm (the program will result in up to 45 percent of timber available for indigenous peoples, new entrepreneurs, etc., combines all takeback volumes with existing auctions).

the tenureholder maintains responsibility for forest management obligations. If a tenureholder were able to assign harvest for a premium over costs, this profit could constitute evidence of an additional subsidy. It would also tend to demonstrate a problem with either the prices generated in the reference market or how those prices were translated to the administered sales. No mechanism exists to capture this "market value" for future benchmarking. The Department would have to examine rules that allow tenureholders to attach conditions such as right of first refusal to see whether they allow licensees to fix prices.

Finally, current proposals to compensate for tenure takeback are deeply disturbing and appear simply to be additional, actionable subsidies. The Department would have to account for such new subsidies in the CCR process. They could ultimately sabotage policy reforms that might otherwise qualify for revocation. In principle, tenureholders could be compensated for the un-depreciated value of capital improvements made on areas subject to takeback. BC has publicly relied on this rationale to justify compensation, but the plan as announced was not so limited.

[61] Further, the BC government has claimed that such compensation is required by law but relevant authority indicates that cash payments are not necessary.

[62] BC Forest Minister De Jong said that payment "is the right thing to do," rather than a legal constraint.

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61 E.g., Testimony of Hon. Michael de Jong at 5682 (discussing investments made by licensees).

62 Forestry Revitalization Plan at 10-11. Expropriation by statute does not require compensation. NRDC Comments at 10, citing British Columbia v. Tener, {1985} 3 W.W.R. 673, 681 (S.C.C.) ("Where expropriation or injurious affection is authorized by statute the right to compensation must be found in the statute."). Companies could also simply agree not to pursue these rights to ensure a successful CCR.

[63] Instead, the removal of mandates or other in-kind compensation could suffice, as Weyerhaeuser proposed.

[64]

The plan "set{s} aside one-time funding of $200 million" ($Can) for compensation, which has been estimated at C$24 for each cubic meter of takeback.

[65] Legislation does not cap the value and the final amount could be subject to arbitration.

[66] Certain BC tenureholders have already announced plans to seek additional amounts, with tenure values estimated at C$75-C$100/m^3.

[67] The Department should examine this issue carefully in any CCR.

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63 Testimony of Hon. Michael de Jong at 5682. As one industry source stated, "It's important to remember that most of the timber in B.C. is Crown timber . . . which makes me wonder why we are buying back something we already own." "The More Things Change" at 1.

64 "Coastal Competitive Reform" at 10.

65 "Forestry Revitalization Plan" at 11.

66 Forestry Revitalization Act § 6 (appropriation for compensation).

67 E.g., Greenwood, "Doman may sue"; Gordon Hamilton, "Too many trees for stock investors: Not enough details in B.C. forest policy announcement to help or hurt firms' market value," Vancouver Sun, April 2, 2003, at D6; Vaughn Palmer, "Economic thorns lurk in timber regulations," Vancouver Sun, April 1, 2003, at A16.

II.B. Comparison with Prices Established in Markets in Other Jurisdictions.

Summary of Comment

A final Policy Bulletin should direct Province B to provide a comprehensive explanation with complete supporting data of its price transmission mechanism and all accompanying adjustments. Province B should utilize market-generated cost data for adjustments. A final Policy Bulletin should provide additional explanation as to Province B's commitments pertaining to its private market.

Comment

The principal issue with respect to Province B is whether the province can "establish the validity of the mechanism or calculation it uses in translating the prices from the adjacent jurisdiction to Province B's harvest." Draft Policy Bulletin, 68 Fed. Reg. at 37,462. The mechanism "must be transparent in the sense that it is publicly available and that the potential adjustments are known and appropriate to the task." Id. Consistent with the Department's guidelines on adjustments, the mechanism must be fully and economically justified and maintain a close and accurate link between market-determined and administered prices. Id.

The Department must ensure that Province B provides a comprehensive explanation with complete supporting data of its price transmission mechanism and all adjustments. This explanation should detail how the mechanism or calculation was developed. One issue likely to require particular attention is selection and weighting of benchmark jurisdictions. In addition, Province B must show the validity of each adjustment. The Department must carefully examine any claimed quality adjustment.

Adjustments must be based on market-determined costs. The Department should ensure that

Province B does not attempt to default to pricing or cost structures already employed in its timber pricing systems, particularly to the extent these adjustments rely on residual-value type adjustments. Further, the issue of cost incentives must be considered. Fundamentally, the default principle must be, consistent with the allocations of burdens in any CCR proceeding, that an adjustment is not acceptable unless based on transparent, verifiable market-based cost data and has been fully justified.

The Coalition urges the Department to evaluate the rules by which the province provides for divisibility and transfer of tenure. As with Province A, this issue cuts in multiple directions: restrictions create barriers to entry, but unconditionally allowing sales could increase subsidies.

Finally, the Department should clarify what is meant by the condition, "Province B reinforces the operation of the private market for standing timber within the province through the changes in conditions applicable to tenures on provincial lands." Id. at 37,461. The explanation is also unclear, "It also ensures that a greater volume of timber or logs will enter the private market for fiber within the province." Id.

III. Changed Circumstances Reviews Burden & Testing

Summary of Comment

The Department should maintain clear instructions as to required data and the evidentiary burden that must be satisfied. Further, a final Policy Bulletin should include pass-back, timing and snap-back commitments.

Comment

To achieve revocation, a province must demonstrate that its system no longer provides a countervailable subsidy within the meaning of the law. Thus, the province bears a dual burden: first, to present sufficient evidence to show circumstances warrant initiation of the CCR and second, to persuade the Department that these circumstances warrant revocation of the order.

[68] Congress intended this process to be available on a limited basis.

[69] A CCR does not begin from a "clean slate" but, rather, starts from the prior finding of subsidization.

[70]

A province may submit a request for a CCR at any time even though the statute discourages the

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[68] AG der Dillinger Hüttenwerke v. United States, 193 F. Supp. 2d 1339, 1347 (Ct. Int'l Trade 2002); Eveready Battery Co. v. United States, 77 F. Supp. 2d 1327, 1329 (Ct. Int'l Trade 1999); Avesta, 689 F. Supp. at 1181 (Ct. Int'l Trade 1988) ("{T}he party seeking revocation bears the initial burden of showing the existence of such circumstances.").

[69] Jia Farn Manuf. Co. v. Secretary of Commerce, 817 F. Supp. 969, 974 (Ct. Int'l Trade 1993); Avesta, 689 F. Supp. at 1182.

[70] Avesta, 689 F. Supp. at 1182.

Department from undertaking a CCR within two years of the final determination. 19 U.S.C. § 1675(b)(4). Whenever a province applies, it must demonstrate and document the implemented reforms. Accordingly, we support the requirement in the draft Bulletin that the Department would only initiate a CCR if the applicant province provides detailed information satisfying each of the listed evidentiary requirements. If the Department declines to initiate a review, it should provide the applicant province with a written explanation of what additional material would be required.

As the detailed list of materials in section III.B of the draft implies, an applicant province must have adequate documentation to show the resultant market outcomes, including timber price equilibration. This list, in and of itself, urges caution: provinces must develop and assemble adequate data. The Coalition supports the list of material included in this part. The focus on the reference market, the means to transfer prices from the reference market to the administered harvest and evidence pertaining to pre- and post-reform stumpage charges are needed. Evidence that establishes how the reformed stumpage prices relate to prices in other open and competitive markets for similar timber sales is also critical. Only by providing detailed, empirical evidence that document the operation of the policy reforms can a province demonstrate that its new system operates in reality as it purports to do on paper. Given the Canadian industry's demonstrated history of gaming rules, comprehensive data must be provided.

[71] To ensure that countervailable practices have ended, the Department must examine subsidy

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[71] E.g., Ken Drushka, "Market forces a better driver than bureaucrats," The Interior News (Feb. 12, 2003) ("If they are good at nothing else, Canadian forest companies are masters of fiddling administrative systems.").

programs, regulatory cost reductions and the failure to enforce provisions, such as environmental laws. [72]

The Coalition also supports the evidentiary standard detailed in paragraph III.C. A CCR is a legal process, established by statute and governed by the Department's regulations. 19 U.S.C. § 1675(b) and 19 C.F.R. § 351.216 (2003). The statute specifies that a request must "show{ } changed circumstances sufficient to warrant a review of such determination." 19 U.S.C. § 1675(b)(1). As the draft Bulletin indicates, the "burden is on the province to establish that those circumstances have changed such that revocation of the order with respect to the province is warranted." Draft Policy Bulletin, 68 Fed. Reg. at 37,462. This burden extends to both the policy prescriptions of Part I and the specific example chosen under Part II. The combination of the evidentiary standard and content of request make clear that the evidentiary burden on the applicant province is quite high and will be subject to rigorous testing by the Department in the changed circumstances process. Certain provinces may find it difficult to satisfy this burden even with respect to basic data underlying their current systems. [73]

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[72] For example, the Canadian government has failed to enforce requirements of its environmental protection laws, such as the Federal Fisheries Act, with respect to the timber industry. Testimony of Defenders of Wildlife at 3 (Feb. 13, 2002).

[73] For example, press reports indicate that Quebec does not even know the actual volume of timber harvest. Louis-Gilles Francoeur, "The Fox Is Counting the Chickens," Le Devoir (Monteral), Dec. 7, 2002), at A1; Perry J. Greenbaum, "Clear-cutting seen as economic issue," Canada.com (Jan. 25, 2003) ("Quebec's Natural Resources Department has no idea how many trees are being cut in the forestry sector. As a result, the ministry is not able to determine if allowable annual-cut calculations are over-evaluated, and consequently, if there is overcutting of timber in public forests."); Kevin Dougherty, "Province has no clue how many trees are cut," (continued...)

Revocation should also be subject to several commitments. First, the applicant province must agree to maintain reforms for a reasonable period of time. Second, the province must agree not to "pass-back" increased revenues or otherwise increase subsidies to the industry; this commitment should extend to operating regulations, such as forest practices codes.

[74] The formal revocation should provide for a set provisional period, during which the order would snapback in the event of demonstrated circumvention of commitments. These requirements are necessary to achieve results consistent with the Department's practice governing revocation.

[75] A final Policy Bulletin should also encourage provinces to implement reforms using a principle of progressive liberalization. Provinces should commit to increase the percentage of competitive sales over time and establish periodic review of any retained policies that may impede the exercise of market resources.

Finally, the Coalition notes that revocation of the order with respect to companies located in an

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(...continued)

The Gazette (Montreal) (Dec. 2, 2002). These reports suggest that the actual per-cubic-meter stumpage payment collected during the period of investigation by Quebec may have been far less than what the Department examined -- and the subsidy far higher. A province would need to provide accurate data on amount harvested and charges collected to show subsidies have ended. 68 Fed. Reg. at 37,462.

[74] The U.S.-Canada Softwood Lumber Agreement included this requirement. Art. VII, ¶¶ 2, 3 (1996).

[75] 19 C.F.R. § 351.222(c)(3)(i) provides that in considering partial revocation of a countervailing duty order, the Department examines whether the company agrees in writing to the immediate reinstatement of the order if the Department finds that the company received new subsidies after revocation. The Department explained, "The underlying assumption behind a revocation based on the absence of . . . countervailable subsidization is that a respondent, by engaging in fair trade for a specified period of time, has demonstrated that it will not resume its unfair trade practice following the revocation of an order." Antidumping Duties; Countervailing Duties, 62 Fed. Reg. 27,296, 27,326 (Dep't Comm. May 19, 1997) (final rule).

individual province would present a highly unusual (perhaps unique) circumstance under the statute. If an individual province applies for revocation, the Department should issue a proposed methodology for comment, including a proposed mechanism for the revocation and discussion of proposed measures to ensure proper enforcement of the amended order. This would allow interested parties an opportunity to comment and the Department to develop a robust mechanism that could be implemented as soon as the applicant province cleared the CCR process.