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BEFORE THE UNITED STATES
INTERNATIONAL TRADE COMMISSION

In the Matter of:

CERTAIN SOFTWOOD LUMBER
PRODUCTS FROM CANADA,
No. 701-TA-274 (Preliminary)

POST-CONFERENCE BRIEF OF THE FEDERAL TRADE COMMISSION

June 12, 1986

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Certain Softwood Lumber Products from Canada

INTRODUCTION AND SUMMARY

On May 19, 1986, the Coalition for Fair Lumber Imports, a group of United States softwood lumber manufacturers and associations representing United States lumber manufacturers, filed a countervailing duty petition with the International Trade Commission ("ITC"). The petition alleges that the domestic softwood lumber industry is threatened with material injury and is being materially injured by reason of imports of softwood lumber that have benefited from various subsidies provided by the Canadian federal and provincial governments. The major alleged subsidy concerns the level of fees ("stumpage fees") set by the provincial governments for the right to harvest softwood timber on government land ("stumpage rights").[1] The petitioners request that countervailing import duties be imposed on these products.

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1 The petition alleges that in addition to a stumpage fee subsidy, there are a variety of other subsidies to the Canadian timber industry. For example, petitioners allege that the Canadian federal and provincial governments subsidize their timber industry by purchasing equity rights, providing grants and low-interest or interest-free loans to lumber producers, and providing preferential investment tax credits for the lumber industry. (*See* Petition, at 88-90). Petitioners allege, in addition, that the Canadian government subsidizes its timber industry by paying for the reseeding of harvested timber lands and by several transportation programs. (*See* Petition, at 81-88). We do not consider, in this brief, whether the lumber industry in the United States is likely to be injured or threatened with injury as a result of these other practices. The analysis in this brief is limited to the alleged subsidy arising out of the Canadian stumpage fee systems.

The purpose of this brief is to assist the ITC in making its preliminary determination on injury. In Section I, we argue that the countervailing duty law should be applied to reduce impediments to world trade and to preserve the benefits of competition for United States consumers while protecting domestic firms from unfair practices. In Section II, we argue that the ITC should examine the causal link, if any, between an alleged subsidy and injury to a domestic industry. If a domestic industry's lost sales are not traceable to an alleged subsidy, then no injury "by reason of" such imports should be found.

In Section III, we examine a single issue that arises in this investigation. We consider whether a United States industry can be injured because the Canadian governments do not employ a competitive auction in allocating and charging for the rights to cut an administratively-determined quantity of government timber land. On the basis of the analysis by our Bureau of Economics, we conclude that, while the Canadian stumpage fee systems increase the profits of Canadian logging firms, they do not increase the quantity of logs harvested in Canada or the quantity of lumber products exported to the United States. Accordingly, we conclude that the United States lumber industry is not injured because the Canadians do not use a competitive auction to allocate the fixed quantity of timber land to be cut.

ARGUMENT

I. A Major Purpose of the Countervailing Duty Law Under the Trade Agreements Act of 1979 Is To Promote Free Trade to the Benefit of United States Consumers and Businesses.

The first United States countervailing duty law was enacted as part of a general tariff statute in 1890.[2] Over the next several decades, Congress modified the countervailing duty law several times[3] and supplemented it with antidumping laws in 1916 and 1921[4] and with an unfair practices provision of the tariff law in 1922.[5] The countervailing duty law was amended in 1979, when the Trade Agreements Act of 1979 ("1979 Act")[6] added the "injury" test that the ITC is applying in this proceeding.[7] The tests for injury under the countervailing duty law are derived from those in the 1921 antidumping law, and Congress has stated that it expects the ITC will construe injury the same way under

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2 Tariff Act of 1890, ch. 1244, § 237, 26 Stat. 584 (1890).

3 Tariff Act of 1894, ch. 349. § 182 1/2, 28 Stat. 521 (1894); Tariff Act of 1897, ch. 11, § 5, 30 Stat. 205 (1897); Tariff Act of 1909, ch. 6, § 6, 36 Stat. 85 (1909); Tariff Act of 1922, ch. 356, § 303, 42 Stat. 935 (1922).

4 15 U.S.C. §§ 71-77; Tariff Act of 1921, ch. 14, § 201, 42 Stat. 11 (1921).

5 19 U.S.C. § 1337.

6 *See* 19 U.S.C. §§ 1671-1677g, 2501 *et. seq.*, Pub. L. No. 96-39, 93 Stat. 144 (1979).

7 19 U.S.C. § 1671(b); *see* 19 U.S.C. § 1677(7). In 1974, Congress added an injury test for nondutiable imports. 19 U.S.C. § 1303(a)(2).

both laws.[8] The Trade and Tariff Act of 1984[9] further amended the countervailing duty law, including the addition of a provision that enumerated factors to be considered in determining whether an industry in the United States is threatened with material injury by reason of subsidized imports.[10]

The history of their enactment suggests that the basic purposes of these four tariff laws -- the countervailing duty law, the two antidumping laws, and the unfair practices law -- are consistent with the basic purposes of the antitrust laws. Both through these tariff provisions and through the antitrust laws enacted during the same era, Congress sought to create a legal environment that would foster an efficient allocation of resources.[11] Moreover, the legislative history of the tariff

8 See H.R. Rep. No. 317, 96th Cong., 1st Sess. at 45-46 (1979) ("H.R. Rep. No. 96-317"); S. Rep. No. 249, 96th Cong., 1st Sess. at 57, 87 (1979) ("S. Rep. No. 96-249").

9 Pub. L. No. 98-573, 98 Stat. 2948 (1984).

10 19 U.S.C. § 1677(7)(F).

11 The first countervailing duty statute was passed in the same year as the first federal antitrust law, the Sherman Act. Congress passed the first antidumping statute, 15 U.S.C. § 71-77, in 1916, two years after passing the other two major antitrust laws, the Clayton Act and the Federal Trade Commission Act. The purpose of the 1916 antidumping law was to place foreign firms selling in the United States in the same position "with reference to unfair competition" as domestic firms. H.R. Rep. No. 922, 64th Cong., 1st Sess. 9-10 (1916). In 1921, Congress passed another antidumping law, Tariff Act of 1921, Ch. 14, § 201, 42 Stat. 11 (1921); H.R. Rep. No. 1, 67th Cong., 1st Sess. 23-24 (1921). In 1922, Congress made minor changes to the countervailing duty law and enacted legislation prohibiting imports associated with unfair methods of competition. 19 U.S.C. § 1337. Senator Smoot, one of the sponsors of the 1922 tariff

laws demonstrates Congressional concern about foreign companies _unfairly_ expanding their sales in the United States at prices that United States firms of equal or greater relative efficiency could not match. That history does not show that Congress intended the tariff laws to exclude from the United States market those foreign firms that have a comparative advantage or are relatively more efficient than United States firms.

The countervailing duty law is intended to eliminate the harm resulting from "unfair" competition and to assure that United States consumers realize the benefits of "fair" competition. Thus, if the Canadian lumber industry competes successfully in the United States because the Canadian firms have a comparative advantage or are more efficient, and not because of government subsidy, then United States consumers should receive the benefits of the heightened competition engendered by those imports.[12]

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11 (footnote continued)

legislation, said that these provisions were an extension of the existing antidumping laws and the existing countervailing duty law in order to protect United States firms against "unfair competition." 62 Cong. Rec. 5874 (1922). _See_ S. Rep. No. 595, 67th Cong., 2d Sess. 2-3 (1922). _See also_ the statements of Senator Danforth and Senator Heinz in the debates on the Trade Agreements Act of 1979. 125 Cong. Rec. S. 10306, 10317 (daily ed. July 23, 1979).

12 However, domestic producers may allege they are seriously injured by an increase in fairly traded imports in section 201 escape clause proceedings. Such allegations are not at issue here.

Both the language and the legislative history of the 1979 Act establish that Congress did not intend the countervailing duty laws to be narrowly protectionist. Rather, the purposes of the 1979 Act are "to foster the growth and maintenance of an open world trading system; to expand opportunities for the commerce of the United States in international trade; and to improve the rules of international trade and to provide for the enforcement of such rules." 19 U.S.C. § 2502(2), (3), (4). _See also_ S. Rep. No. 96-249, _supra_, at 31 and H.R. Rep. No. 96-317, _supra_, at 38. In particular, Congress was concerned about "the use of practices which can distort trade or create unfair competition or trade discrimination, such as subsidies . . . ." H.R. Rep. No. 96-317, _supra_, at 11.[13] Congress has sought through the countervailing duty laws to discipline only those firms that are selling in the United States market on the basis of an unfair advantage conferred upon them by their government (or by other sources). On the other hand, Congress intended United States consumers to receive the substantial benefits that flow from

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13 In the congressional debates on the 1979 Act, Senator Heinz said that the countervailing duty and antidumping provisions of the 1979 Act are aimed at countries that do not rely on "free market principles and . . . on competition and the law of comparative advantage as arbiters of the marketplace." Cong. Rec. S10306 (daily ed. July 23, 1979). In the same debates Senator Danforth explained that the countervailing duty and antidumping provisions were aimed at "adverse distortions of free trade." _Id._ at S10317. He said that subsidized imports are not in the best interest of the United States consumer, since "the long run impact is likely to be higher prices and greater profits for the foreign producers once the domestic competition has been crippled." _Id._ at S10317.

unrestricted access to foreign firms that compete in United States markets on the basis of comparative advantage or relative efficiency.

Countervailing duties can be imposed on subsidized imports only if the ITC determines that there is material injury or the threat of material injury to a domestic industry. Trade Agreements Act of 1979, § 701(a)(2), 19 U.S.C. § 1671(a)(2). This injury standard does not indicate protectionist intent on the part of Congress. To the contrary, the injury standard was added by the 1979 Act to narrow the application of tariffs under the countervailing duty law.[14]

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14 Before 1979, there was no requirement of injury to a domestic industry in order to impose countervailing duties on subsidized dutiable imports. In the Trade Act of 1974, Congress determined that "barriers to (and other distortions of) international trade" were adversely affecting United States exports and authorized the President to negotiate international agreements to harmonize, reduce, or eliminate these barriers and distortions. 19 U.S.C. § 2112(a). The United States subsequently negotiated, as part of the Tokyo Round of Multilateral Trade Negotiations, the Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the General Agreement on Tariffs and Trade ("Countervailing Duty Agreement"). As part of this negotiation, the United States agreed to add to our countervailing duty law the requirement that such duties will be imposed only if a United States industry is injured by reason of the subsidized imports, and the countervailing duty provisions in the 1979 Act had the specific purpose of implementing "the international agreements relating to new disciplines on trade distorting subsidies and dumping practices and procedures for taking countervailing and antidumping measures." H.R. Rep. No. 96-317, supra, at 2. The requirement that an additional legal test be satisfied prior to levying a countervailing duty obviously was intended by Congress to make it more difficult for the United States to impose countervailing duties.

Congress was mindful of the potentially adverse effects on United States business of retaliatory tariffs imposed by foreign governments on United States exports, and Congress intended the 1974 Act "to expand opportunities for the commerce of the United States in international trade" by improving the rules of international trade. 19 U.S.C. § 2502. In passing the 1979 Act, Congress foresaw benefits to United States exports if the agreements it implemented were fairly carried out:

> These rules could be important in reducing the number of foreign subsidy practices, and thus the need for countervailing duties. Furthermore, _if vigorously enforced by the United States and fairly carried out by all parties, these provisions should expand the competitive opportunities of U.S. exporters who currently face subsidized competition in foreign markets._

S. Rep. 96-249, _supra_, at 38 (emphasis added). Congress realized in 1979 that, because of the precedential value of countervailing duty decisions by this country, such decisions could themselves have a significant impact on United States exports. If the ITC finds that an action by a foreign government has led to injury in the United States, and if comparable actions are regularly taken in the United States, then our exports may be impaired because of retaliatory countervailing duties, based on our own precedent. This potential impairment is relevant in determining whether Congress intended particular foreign practices to lead to the imposition of countervailing duties.

In sum, we suggest that in administering the countervailing duty law, the ITC should be guided by the legislative purpose of

the law: to reduce impediments to world trade while preserving the benefits of competition for consumers and protecting domestic firms from unfair practices.

II. The ITC Should Determine Whether the Alleged Foreign Subsidy Actually Caused Any Material Injury That May Be Found To Exist.

We suggest that the language of the Countervailing Duty Agreement, the language of the 1979 Act implementing the Countervailing Duty Agreement, and the legislative history of the 1979 Act all require the ITC to apply a sensitive causation test: countervailing duties should be imposed only if the subsidy is determined by the ITC to be a cause of material injury to a domestic industry.[15] In the instant case, the ITC should attribute to the alleged subsidy only the injury to the United States lumber industry that results from the alleged subsidy. Any harm to the domestic industry resulting from factors not attributable to the alleged subsidy should not be the basis for a finding of injury within the meaning of the countervailing duty statute.

A. The 1979 Act Is Consistent with the Countervailing Duty Agreement's Requirement To Consider the Effect of the Alleged Subsidy.

The United States statutory scheme concerning subsidies, causation, and injury is in accord with the Countervailing Duty

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15 As the petition recognizes at page 99, there are those who believe that a causal link must be established between an unfair practice and injury. At the conference, both petitioner and its counsel alleged that the Canadian stumpage fee systems were injuring the United States industry. (Tr. at 26, 70, 94, 98).

Agreement,[16] negotiated as part of the Tokyo Round of Multilateral Trade Negotiations. The article of the Countervailing Duty Agreement governing "determination of injury" provides, in pertinent part:

> It must be demonstrated that the subsidized imports are, through the effects of the subsidy, causing injury within the meaning of this Agreement.

Countervailing Duty Agreement, Article 6, Paragraph 4 (footnote omitted) (emphasis added). Several other provisions of the Countervailing Duty Agreement reinforce this provision. For example, the preamble to the Agreement recognizes that "the emphasis of this Agreement should be on the effects of subsidies." Additionally, Article 2, governing domestic procedures for conducting investigations of alleged subsidies, provides that "[a]n investigation shall be terminated when the investigating authorities are satisfied either that no subsidy exists or that the effect of the alleged subsidy on the industry is not such as to cause injury." *Id.*, Article 2, Paragraph 12.

The 1979 Act implements the Countervailing Duty Agreement, 19 U.S.C. § 2503, and adopts the requirement of a causal link between subsidy and injury by expressly authorizing the ITC, in examining an alleged threat of material injury, to consider "the effects likely to be caused by the subsidy." Act at

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16 *Reprinted in* Agreements Reached in the Tokyo Round of the Multilateral Trade Negotiations, H.R. Doc. No. 153, 96th Cong., 1st Sess., Pt. 1 (June 19, 1979).

§ 771(7)(E)(i), 19 U.S.C. § 1677(7)(E)(i); 19 C.F.R. § 207.26(d) (1981).[17] It follows that the ITC should consider "the effects likely to be caused by the subsidy" not only when there is alleged to be a threat of material injury, but also when material injury is alleged to be actually present. The 1979 Act adopts a causal link between a subsidy and alleged present injury by requiring imposition of a countervailing duty only if the ITC "determines that an industry in the United States (i) is materially injured, or (ii) is threatened with material injury . . . by reason of imports of [subsidized] merchandise or by reason of sales (or the likelihood of sales) of [subsidized] merchandise for importation." 19 U.S.C. §1671(a)(2).[18] Examining the nature and likely effect of the subsidy is especially appropriate when, as here, injury and threat of injury both are alleged. Petition, at 1, 102.

Factors other than a subsidy can cause injury, and the Countervailing Duty Agreement and the ITC's regulations are in accord that other factors should be considered. The Agreement recognizes that if "other factors" are causing injury to a

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17 Section 771(7)(E)(i) is taken almost directly from the Countervailing Duty Agreement, supra at Article 6, para. 1, n. 17, which authorizes the use of inferences when there is no direct evidence because the actual injury is as yet only threatened.

18 The 1984 Act amended this section to make explicit that the ITC may reach an affirmative injury determination if the harm is caused by sales for future delivery or by future sales. Trade and Tariff Act of 1984, § 602(a)(1), 19 U.S.C. § 1671(a)(2).

domestic industry at the same time that the subsidy is causing injury, the injuries caused by such "other factors" need not be attributable to the subsidized imports. Countervailing Duty Agreement, Article 6, Paragraph 4. The Agreement lists some of these representative "other factors." This list is incorporated _verbatim_ in the ITC's injury regulations, 19 C.F.R. § 207.27 (1981), in which the ITC states it will take into account information concerning such other factors.[19] In general, most of the ITC regulations implementing the injury requirement are the same as the language of the Countervailing Duty Agreement.[20]

The statutory language on causation and actual injury tracks the language of the Countervailing Duty Agreement, although it does not repeat _verbatim_ the Agreement's language. Nevertheless, the statutory language on injury supports an interpretation that is consistent with the language of the Countervailing Duty Agreement, and the ITC should employ an interpretation of the

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19 The "other factors" identified in the footnote to Article 6, Paragraph 4 of the Countervailing Duty Agreement, as listed in the ITC injury regulations, 19 C.F.R. § 207.27 (1981), are "volume and prices of non-subsidized imports or imports not sold at less than fair value, contraction in demand or changes in patterns of consumption, trade restrictive practices of and competition between the foreign and domestic producers, developments in technology, and the export performance and productivity of the domestic industry."

20 In the "Factors considered in determination of material injury," 19 C.F.R. § 207.26 (1981), section (a) is taken directly from Article 6, Paragraph 1 of the Tokyo Agreement; sections (b)(1) and (b)(2) from Paragraph 2; sections (b)(3) and (c)(2) from Paragraph 3; and part of section (d) from Paragraph 1 (footnote).

statute that gives recognition to this congruity.[21] It is well-settled that when a treaty and statute "relate to the same subject, the courts will always endeavor to construe them so as to give effect to both, if that can be done without violating the language of either." United States v. Lee Yen Tai, 185 U.S. 213, 221 (1902); see John T. Bill Co. v. United States, 104 F.2d 67, 74 (C.C.P.A. 1939) (construing ¶ 371 of the Tariff Act of 1930 so as to be consistent with Article VII of the 1925 Treaty between the United States and Germany).

In sum, the language of the Countervailing Duty Agreement and the 1979 Act support an interpretation that the ITC should examine the causal link between an alleged subsidy and injury to a domestic industry.

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21 While section 3(a) of the 1979 Act, 19 U.S.C. § 2504(a), states that the 1979 Act prevails if there is a "conflict" between the statute and the Countervailing Duty Agreement, Congress did not believe that there was such a conflict. S. Rep. No. 249, 96th Cong., 1st Sess. (1979) at 36. The Senate Report, in summarizing the Countervailing Duty Agreement, states that the Agreement provides for "a 'causal link' between the subsidization . . . and the injury (Article 2 of the [Countervailing Duty] Agreement)." Id. at 41. The Senate Report goes on to say that the 1979 Act "would establish the conditions for imposition of countervailing duties consistent with the [Countervailing Duty] Agreement." Id. at 44. In enacting section 3(a) of the 1979 Act, Congress was concerned that there might be a conflict in the future if the Countervailing Duty Agreement was amended. S. Rep. No. 249, at 36.

B. The Legislative History of the 1979 Act Indicates that the ITC Should Examine the Effects of the Alleged Subsidy.

The legislative history of the 1979 Act[22] also indicates that Congress intended the ITC to determine whether an alleged subsidy is the actual cause of injury to a domestic industry.[23] As discussed below, the drafters of the bill, in explaining its operation, frequently used the statutory phrase "injury . . . by reason of imports" as a synonym for the phrase "injury through the effects of a subsidy."

The President, in 1979, submitted to Congress both a trade bill and Statements of Administrative Action, which described "the manner in which the proposed legislation is to be

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22 Title VI of the Trade and Tariff Act of 1984 did not amend the portions of the countervailing duty law that are at issue here.

23 The legislative history may be used to construe a statutory phrase even when its meaning appears to be "clear." Train v. Colorado Public Interest Research Group, Inc., 426 U.S. 1, 10 (1976) (legislative history of Federal Water Pollution Control Act ("FWPCA") indicates that the Environmental Protection Agency ("EPA") does not regulate radioactive nuclear waste subject to regulation by the Atomic Energy Commission even though the FWPCA says the EPA regulates "radioactive materials"); Philko Aviation Inc. v. Shacket, 462 U.S. 406, 409-10 (1983) (legislative history of § 503(c) of the Federal Aviation Act of 1958 is a better indicator of the meaning of the statute than is the literal language of the statute); Al Tech Speciality Steel Corp. v. United States, 6 ITRD 1161, 1167-69 (Fed. Cir. 1984) (legislative history of 1979 Act indicates that "investigation" in section 776(a) of the 1979 Act, U.S.C. § 1677e(a), includes a "periodic review" under section 751 of the 1979 Act, 19 U.S.C. § 1675, even though the Department's regulations consider a "periodic review" to be a "proceeding" rather than an "investigation").

administered." Statements of Administrative Action, 96th Cong., 1st Sess., House Document No. 96-153, Part II (June 19, 1979) [hereinafter "Statements"], at 389. In its discussion of the "determination of material injury," the Statements explained:

> It is expected that in its investigation the Commission will continue to focus on the conditions of trade and development within the industry concerned. For one industry, an apparently small volume of imports may have a significant impact on the market; for another the same volume might not be significant. Similarly, <u>for one type of product, price may be the key factor in determining sales elasticity, and a small price differential resulting from the amount of the subsidy or the margin of dumping can be decisive; in others the size of the margin may be of lesser significance</u>.
>
> . . . .
>
> <u>The petitioner must demonstrate, and the Commission must satisfy itself that, in light of all the information presented, there is the requisite causal link between the subsidization or dumping and material injury</u>.

Statements, at 434-35 (emphasis added). Congress approved these Statements submitted to it by the President. Trade Agreements Act of 1979, § 2(a), 19 U.S.C. § 2503(a).

Both the House and Senate reports covering the 1979 Act indicate that Congress expected the ITC to determine the effects of a subsidy. The Senate report notes that in determining whether injury is "by reason of" subsidized imports, the ITC considers, <u>inter alia</u>, "how the effects of the [subsidy] relate to the injury." S. Rep. No. 249, 96th Cong., 1st Sess. (1979), at 57. The Senate Report elaborates on this point as follows:

> It is expected that in its investigation the Commission will continue to focus on the conditions of trade, competition, and development regarding the industry concerned. For one industry, an apparently small volume of imports may have a significant impact on the market; for another, the same volume might not be significant. Similarly, for one type of product, price may be the key factor in making a decision as to which product to purchase and a small price differential resulting from the amount of the subsidy or the margin of dumping can be decisive; for others, the size of the differential may be of lesser significance.

Id. at 88 (emphasis added). The House of Representatives Report contains nearly identical language.[24]

Accordingly, the legislative history of the 1979 Act supports the view that the ITC should evaluate the effect of an alleged subsidy on a domestic industry in order to properly determine whether the domestic industry is being injured or has been injured within the meaning of the statute.

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24 It is expected that in its investigation the ITC will continue to focus on the conditions of trade and development within the industry concerned. For one industry, an apparently small volume of imports may have a significant impact on the market; for another the same volume might not be significant. Similarly, for one type of product, price may be the key factor in determining the amount of sales elasticity, and a small price differential resulting from the amount of the subsidy or the margin of dumping can be decisive; in others the size of the margin may be of lesser significance.

H.R. Rep. No. 317, 96th Cong., 1st Sess. (1979), at 46 (emphasis added).

In sum, the statutory language and legislative history of the 1979 Act are consistent with the language of the Countervailing Duty Agreement that the ITC should examine "the effects of the subsidy." We turn now to an examination of the effects of the major subsidy alleged in the petition.

III. The Absence of an Auction for Stumpage Rights Is Likely To Have No Effect on the Price or Quantity of Exports of Softwood Lumber Products to the United States.

Economic analysis suggests that our domestic lumber industry is not injured by the system the Canadian governments use to allocate the rights to harvest the quantity of timber land that they have determined should be cut and to set the price charged for those harvesting rights -- Canadian stumpage fees.[25] This conclusion follows from a sequence of four observations: (1) A domestic industry can be injured only if the alleged subsidies increase the quantity (and decrease the price) of a commodity

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25 The United States timber industry filed a countervailing duty petition in October 1982 that is similar to the instant petition in many respects. In both petitions, the major allegation is that Canadian lumber producers are being subsidized by the methods used by the Canadian national and provincial governments to allocate and charge for the rights to harvest timber. In early 1983, Dr. David Tarr of the Federal Trade Commission ("FTC") staff conducted an economic analysis of this allegation. The results are contained in a brief that the FTC filed with the Department of Commerce on April 7, 1983, in connection with its investigation of the earlier petition. Prehearing Brief by the Federal Trade Commission before the International Trade Administration, Department of Commerce, _Certain Softwood Lumber Products from Canada_, Countervailing Duty Proceeding, April 7, 1983 (hereinafter "1983 FTC brief"). That analysis is reproduced in the appendix of this brief. The current petition does not allege that the Canadian stumpage fee system operates differently today than it did in 1983.

imported in competition with the domestic output. (2) Here, however, the quantity of Canadian timber put up for harvest each year on public lands is set by a government decision, just as it is in the United States. It is not determined by market forces and, therefore, it does not depend upon the amount of timber that might be profitably produced at a particular stumpage fee. Consequently, a low fee cannot increase the quantity of timber ultimately produced. (3) A low stumpage fee may merely increase the profits of Canadian logging companies, because their total costs are lower while the market value of their timber is unchanged. Those companies cannot increase production, however, because the Canadian national and provincial governments, not the loggers, control the rate at which timber may be harvested. (4) This situation is, therefore, quite different from an ordinary subsidy because it does not increase production and hence does not increase exports to the United States.

For this set of reasons we suggest that the domestic lumber industry has not been injured by the Canadian stumpage fee systems, and that countervailing duties based on those systems would not be appropriate. These four considerations will be discussed in sequence.

A. Only Increased Imports Will Injure an Industry in the United States.

In evaluating an alleged subsidy, it is important to recognize that a United States industry can be injured only if the alleged subsidy increases the quantity of imports coming into the United States. If the subsidy does not increase the supply of imports at any particular price, then the subsidy will not

cause the price of the product to be lower than it would otherwise have been.[26] If the price of the domestic product does not fall because of the alleged subsidy, then the alleged subsidy does not cause the output of the domestic industry to decline. This, in turn, would mean that all other measures of industry well-being, such as employment and profits, will not be adversely affected by the alleged subsidy and any observed deterioration in the domestic industry's condition must be due to factors other than the alleged subsidy. Thus, in determining whether the alleged subsidy has caused injury to a domestic industry, the ITC should consider whether the alleged subsidy has increased the quantity of the good being imported into the United States.

B. <u>The Stumpage Fee Does Not Increase Canadian Production.</u>

Canadian stumpage fee systems do not result in an increase in the quantity of Canadian lumber imported into the United States because the stumpage fee systems do not lead to an increase in the quantity of logs harvested in Canada. In general, the quantity of logs harvested under the current

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26 When the imported and domestic products are homogeneous, they will sell in the domestic market at a single price determined by total supply (imports plus domestic output) and domestic demand. Domestic supply and domestic demand are not affected by a foreign subsidy. Therefore, if the supply of imports is not increased, the domestic price must be unchanged. If the products are non-homogeneous substitutes, it will still be true that the equilibrium price of the domestic product will not be reduced unless the supply of the imports is increased as a result of the alleged subsidy. In this case, the domestic industry can be injured only if the price of the imported product declines, which in turn reduces the demand for the domestically produced good. However, the price of imports will fall only if the supply of imports is increased.

Canadian stumpage fee systems is the same as it would be if a competitive auction system like that used by the United States Forest Service ("USFS") were employed.[27]

Although the price charged for the right to harvest a tract of forest land is lower under the Canadian stumpage fee systems, a Canadian logger's ability to harvest more land is limited by the supply made available by the Canadian governments. When the amount of land made available by the Canadian governments is determined without regard to price, the number of trees cut is independent of the price paid for public timberland. A price lower than market value will not result in additional harvesting because of the governmental limitations on the supply of timber land made available.

If the national and provincial governments of Canada were willing to make as much land available for cutting at a constant price as logging companies wanted to harvest, then lower stumpage fees would lead to additional harvesting. The Canadian governments, however, determine the amount of land to be harvested and then use the Canadian stumpage fee systems to allocate the land and to collect stumpage fees.[28] This governmental limitation on the available land for timber

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27 For reasons discussed in more detail in footnote 31 below, the quantity of logs harvested in Canada might increase if the Canadian governments were to adopt a system closer to that used by the USFS.

28 If the Canadian loggers could get as much timber land as they desired at a constant price, they would not be willing to purchase other timber at prices that exceed the government rate. However, petitioners cite evidence that

harvesting is not unlike the process in the United States.[29] Here the USFS determines what land should be cut and then holds competitive auctions to allocate the stumpage rights and to determine the stumpage fees.[30] Under either system, because the

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28 (footnote continued)

Canadian mills located in Quebec purchase stumpage in Maine for several times the price of government stumpage in Quebec. Similarly they cite claims that stumpage on private lands in British Columbia sells for considerably more than the price of provincial stumpage. See Petition, at 63-65. Further, it appears that from an economic vantage point, the Canadian governments have allocated too little, rather than too much, of Canada's virgin forests for harvesting. See Western Transition (Economic Council on Canada, 1984), at 48-51 (hereinafter "Western Transition").

29 As Ken Drushka states in chapter 5 of his book Stumped, which is included as Exhibit 8 of the Petition, "our forests both in B.C. and the U.S. are administered by the name of 'even-flow sustained yield.'" (As quoted in the Congressional Record (October 10, 1985), p. S13031, column 2). "Sustained yield policies further compromise the free market. Restricting yearly harvests to an allowable cut in a particular sustained yield unit means that there is a point above which the supply cannot be increased no matter what price buyers are willing to pay." Id. See also Western Transition, at 47-49.

30 We do not address the issue of how the United States or the Canadian governments determine the quantity of timber land to make available for harvesting. Of course, Canadian government decisions concerning the quantity of timber to be cut can affect the price of lumber imported from Canada and therefore the well-being of the United States lumber industry. However, as we understand petitioners' allegations, they are claiming that the subsidy arises only because the Canadians do not hold a competitive auction or otherwise charge a competitively-determined price for the right to cut the land that they have decided to make available. The petition does not argue that the Canadians subsidize their lumber industry by the quantity of land they make available for harvesting.

land to be harvested is determined by an administrative process, the quantity will not vary with the system used to allocate the lands to specific purchasers or with the price paid under that system.[31] All of the land made available will be harvested under

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31 Indeed, there are three reasons for believing that the Canadian stumpage fee systems may actually lead to fewer logs being harvested and less lumber being exported to the United States than would be the case if the Canadians used the competitive auction system employed in the United States. First, with some versions of the Canadian stumpage fee systems, the government establishes a fixed fee for harvesting a tract rather than having a fee that depends on the costs of harvesting the tract and the quality of the timber there. In such a case the government may set the stumpage fee too high and impose a fixed fee that exceeds the profit that could be earned by harvesting the tract. Such tracts will not be cut but will remain standing. With a competitive auction system, on the other hand, some firm would enter a bid which was lower than the fee required under the Canadian system but which would make harvesting that tract profitable. Thus, under a competitive auction system, the tract would be cut.

Second, Canadian stumpage fee systems may be more likely than an auction to allocate harvesting rights to inefficient firms. It may not be profitable for the firm with the harvesting rights to cut a tract, although a more efficient firm would find harvesting profitable. Again, this can result in fewer trees sent to market.

Finally, the analysis up to this point has implicitly assumed that the fee for logging a tract of timberland is determined before the timber is cut and does not depend on the quantity of timber actually removed from the tract. (The payment would, of course, depend on an estimate of the quantity and value of the timber on the tract). However, this does not appear to be true, at least as regards timber harvested from land owned by the British Columbia provincial government. In a manner methodologically similar to the United States system, British Columbia determines the appraised value of a tract. However, instead of collecting the appraised value in a lump sum amount, British Columbia charges loggers the average appraised value of stumpage for each species on the tract on a per-log basis. That is, the

either system.[32] Thus, the total quantity of logs going to market in any period is unaffected by the stumpage fee system employed.

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31 (footnote continued)

total appraised stumpage value is divided by the quantity of timber on the tract, and the logger pays this average fee for each unit of timber removed. As a result, some trees for which the price of the logs would exceed the costs of cutting and hauling, and which therefore would be cut under a lump sum scheme, will not be cut if the average appraised value is greater than the difference between the log price and the cutting and hauling costs. See Western Transition, at 55. We note, however, that the magnitude of this effect would be limited by requirements that loggers cut a certain percentage of the allowable cut in any year and within any five year period. (Similar problems may exist with the versions of the Canadian stumpage fee systems employed in the other provinces where a fixed fee is charged per unit of timber if this fixed fee is levied on timber actually removed from the forest rather than on an estimate of the quantity of timber present in the tract. Based on petitioners' description of the stumpage fee systems in Ontario, Quebec, and Alberta, the quantity to which the fixed fee is applied is not clear. However, it appears that it may well be on the basis of timber actually removed from the forest. See Petition, at 45-48).

We also note that the USFS establishes a minimum price in the bidding for United States lands. Establishing such a minimum price may mean that the harvesting rights to some tracts are not awarded if none of the bids is high enough. The purpose of the minimum price, however, appears to be to insure that the government receives the value of the timber being auctioned and not to limit the quantity of timber auctioned. If the minimum bid values are set correctly, there would always be bids that meet the minimum and all the land made available would be harvested. If the USFS systematically overstated the value of timberlands, the quantity of land harvested could be reduced. Such a situation would represent a distortion in the United States system.

32 In order for this to be strictly true, it is necessary that, in addition to avoiding the problems discussed in footnote 31, the revenue that can be realized by selling the logs on any tract must be greater than the costs of building any

C. The Effect of the Low Stumpage Fee Is Merely To Increase the Profits of Canadian Loggers.

If the low stumpage fee does not influence the quantity of logs produced, what effects does it have? The answer is that it merely reduces the total costs and increases the profits of Canadian loggers. Economic theory suggests that Canadian loggers, like their United States counterparts, seek to maximize their profits. Therefore, the prices that they charge for logs are determined not by what the logs cost to cut but, given a fixed quantity of logs, by the demand for logs. The mere fact that loggers are permitted to harvest a tract of timber land at an advantageous price does not affect the market price at which those logs are later resold.[33]

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32 (footnote continued)

roads needed to gain access to the timber, the costs of actually cutting the trees, the costs of transporting the logs to market, and the cost of reforesting the area, if that is part of the obligation of the logging firm. If, for some tracts made available by the government, the costs of logging exceed the revenues that can be earned by selling the timber on the tract, these tracts will not be harvested under either a competitive auction or under the Canadian stumpage fee system. (For a discussion of the more general case where some tracts will not be cut, see the 1983 FTC brief in the Appendix). While all tracts may not be cut in this more general case, it is still true that there are no tracts that would be cut under the Canadian stumpage systems that would not be cut under a competitive auction system.

33 The price also would not be affected when a vertically integrated firm uses a log it has harvested because the firm would incur an opportunity cost equal to the price it would have received if it sold the log to another sawmill. See page 10 of the Appendix to the 1983 FTC brief. It would not make sense for the firm to put a log to an inefficient internal use when it could sell the log for a greater amount

In effect, Canadian logging firms are permitted to realize part of the economic rents resulting from the governmental limits on the quantity of trees available for harvesting in any period of time.[34] If the harvesting rights were sold under a competitive auction, these rents would go to the government in the form of increased stumpage fee payments. Thus, the Canadian stumpage fee systems reduce the payments received by the government for stumpage sales and increase the profits of the firms doing the harvesting.

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33 (footnote continued)

on the open market. The sawmill's production of lumber will be the same as if it was purchasing all of its logs from independent logging firms. The ITC made a similar observation in its report Conditions Relating to the Importation of Softwood Lumber into the United States, USITC Publication 1765, October 1985, at 80.

34 The payment to the government is an economic rent, and not a cost, because the availability of the land for harvesting does not depend on the price received by the government. By contrast, the price that the logger must pay for gasoline is a cost because if the price is not paid the gasoline will not be made available for harvesting timber. (For a further discussion of why the payment for harvesting rights is a rent and not a cost, see the 1983 FTC brief in the appendix.) The total economic rent resulting from the harvesting of a tract of timberland is the difference between the price for which the logs on the tract can be sold and the cost, not including a payment to the government, incurred in harvesting the logs and transporting them to market. This rent is the maximum a logger would pay for the right to harvest a tract of timber. In a competitive auction system, such as that in the United States, this rent would accrue to the government. If the stumpage fee systems in Canada result in payments less than those generated by an auction, a portion of the rent would be captured by the logging firms.

The petition itself contains information suggesting that the low stumpage fees are resulting in high profits for the Canadian logging firms rather than in an increase in the quantity of logs harvested or in a decline in the price of logs. Petitioners report that firms located in Quebec are purchasing Maine stumpage rights at an average price of $60.33 per thousand board feet at the same time that the charge for harvesting timber located on government lands in Quebec was only $11.96 per thousand board feet.[35] Similarly, the petitioners also refer to considerably higher prices being paid for timber on private lands in British Columbia than is paid for stumpage on public lands.[36] A profit-maximizing firm would only buy stumpage from private lands or from the United States at prices that exceed those charged under the Canadian stumpage fee systems if it cannot obtain additional timber at the lower price charged for harvesting timber on government land and if the prices for which the more costly logs can be sold are sufficient to cover their costs. That Canadian firms do purchase these logs is evidence that the prices charged under the Canadian stumpage fee systems are well below market prices; that the Canadian governments do not capture all of the economic rents in the sale of stumpage rights; and, hence, that the rents not captured by the stumpage fees must be appearing as increased profits for those firms given access to government forest land.

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35 See Petition, at 63-64.

36 See Petition, at 65-66 and exhibits 26 and 27.

D. The High Profits Earned by Canadian Loggers Do Not Have the Same Injurious Effects as the Grant of a Subsidy.

The high profits earned by Canadian loggers are not, in their effect on the United States industry, the same thing as a subsidy on either finished lumber or on logs harvested. The profits here are different from a subsidy because, standing alone, they will have no tendency to increase output to the detriment of the domestic industry.

First, the high profits do not have the same effect on production that a subsidy on finished lumber would have. Economic theory suggests that the supracompetitive profit is entirely captured at the logging stage, and so will have no tendency to increase output in lumber production or other downstream stages of the industry. In other words, because the quantity of logs being harvested is not affected by the Canadian stumpage fee systems, the price of logs is not affected. That the quantity of logs is the same under either an auction system or the Canadian stumpage systems means that the quantity of lumber produced from those logs will be unchanged. This in turn means that the price realized for that lumber is unchanged. The price and quantity of lumber produced in Canada are the same as if the Canadians employed a competitive auction system to allocate stumpage rights and determine the price to be paid for the right to cut that stumpage.

Because the price and quantity of lumber are not affected by the stumpage fee systems, the quantity of lumber Canadian firms

will choose to export to the United States will not be altered by the system. The choice between selling for export and selling for use within Canada will depend on the prices that can be obtained by selling in each country; and these in turn will depend on the demand for and supply of lumber in each country. Because the demand for and supply of lumber in each country is unrelated to the stumpage fee system employed in Canada, the quantity of lumber imported into the United States is not increased because the Canadian governments do not employ a competitive auction to determine the price of stumpage rights.

Similarly, the supracompetitive profit to loggers does not have the same effects as a subsidy given on logs cut. The profit brings no new timberland into production and does not increase Canadian exports to the detriment of our domestic industry.

Petitioners claim, at page 24 of the petition, that the Canadian stumpage systems are no different from a system in which a competitive price is charged for stumpage and then a subsidy of so much per log harvested is granted. It is therefore useful to consider how the two practices are in fact different.

In order to analyze this contention, it is useful to explore a slightly more complicated hypothetical situation. Up to now, we have assumed that all tracts of lumber offered by the government are logged. That is, we have assumed that the revenue that can be received for the logs on each tract is greater than the costs of harvesting those logs -- not including any economic rent paid to the government. However, some tracts made available

by the government may be unprofitable because, for example, of location or accessibility. These tracts would remain unharvested under either a competitive auction system or the Canadian stumpage fee systems.

If the government offered a payment for each log harvested, however, it might be profitable to harvest some tracts for which harvesting would not otherwise be profitable, because the revenues from selling the timber plus the payment from the government would exceed the cost of cutting. If there are tracts that are profitable to cut with the government payment but that are not profitable to cut without that payment, then payment of the per unit subsidy will increase the quantity of trees cut and reduce the price of logs. This, in turn, will lead to a larger quantity of lumber produced and a lower price and to a larger quantity of lumber being exported to the United States. As a result, the United States lumber industry could be injured.

Thus, payment of a per unit subsidy could cause injury to a United States industry because such payments could increase the quantity of imports into the United States. This, however, is not at all the same thing as the Canadian stumpage fee systems because those systems do not increase the quantity of logs

harvested and therefore cannot result in injury to the United States industry.[37]

E. Conclusion: Canadian Stumpage Fee Systems Do Not Injure the United States Lumber Industry.

In conclusion, based on our understanding of the Canadian stumpage fee systems, it does not appear that the United States logging or lumber industries are injured by reason of the methods by which the Canadian national and provincial governments allocate the timber land they have administratively-determined should be harvested or by the fees they charge for the right to harvest these lands.[38] Injury could occur only if the Canadian

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37 There is another difference between the current Canadian stumpage fee systems and a competitive auction combined with a per unit subsidy. If it is known that the subsidy will be paid before the auction is held, this will cause the competitive bids to be increased to reflect the value of the promised subsidy. As a result, the logging firms will not earn any above normal profits as a result of the subsidy. Unlike the current Canadian system, the approach that petitioners suggest is analogous would not transfer any economic rents to the logging firms. Rather, all rents would be captured by the government, just as if a competitive auction were held without a subsidy.

38 We assume that the comparison between the Canadian stumpage fee systems and a competitive auction is the only relevant comparison for purposes of determining whether the alleged subsidy injures the domestic industry. This assumption seems consistent with the petitioners' complaints.

The Canadian stumpage fee systems could lead to an increase in the quantity of timber harvested if the timber companies successfully lobbied the Canadian federal or provincial

stumpage fee systems resulted in a greater quantity of logs being cut than would be cut under an auction system. However, this does not appear to be the case. Based on the analysis of FTC staff, we conclude that the Canadian stumpage fee systems result in the same level of cutting as would a competitive auction

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38 (footnote continued)

governments to expand the quantity of cutting permitted because of the increased economic rents they would earn by cutting additional trees at the low stumpage fee.

At least one of the petitioners' exhibits suggests that this kind of behavior has occurred in the past. According to Peter Griffiths, Equity, April 1984: "[M]any mills overbuilt their capacity in relation to the actual timber supply, as a means of consolidating their domination of the resource. The British Columbia Forest Service was forced to exceed allowable cuts under pressure from politicians afraid of mill closures and lost jobs in their constituencies." (Petition, exhibit 12). This statement, if true, could imply that the low stumpage fees have, at least in the past, resulted in an increase in the quantity of timber harvested. Such behavior would not be profitable under a competitive auction system where loggers only earn a normal profit level. Evidence that sawmill capacity is being expanded beyond the level necessary to process current allowable cuts in order to convince Canadian federal or provincial governments to expand the allowable cut could suggest that the low stumpage fee charged by the Canadians could be injuring the United States timber industry.

In evaluating claims of this kind of "rent seeking" behavior, it is important to differentiate between building new capacity to justify expansions in cutting and urging that cutting levels be maintained so as to utilize existing capacity and to avoid unemployment. While the former behavior is only rational when the firm can obtain economic rents by cutting timber, the latter is rational even if no return above a normal profit is earned by harvesting timber.

system.[39] As a result, the quantity of lumber imported into the United States is unaffected by use of the Canadian systems and the domestic lumber and logging industries are not injured by the alleged subsidy.

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39 Petitioners briefly allude to a requirement that logging concerns operating under certain versions of the Canadian stumpage fee systems cut a minimum quantity of timber each year and within each five year period or lose the right to future harvesting rights. (See Petition, at 44). If, in order to maintain future rights that are expected to be profitable, this requirement is leading logging firms at present to harvest trees where the revenue received from sales is less than the costs of cutting the timber -- not including any payment that must be made to the Canadian government -- this aspect of the Canadian stumpage fee systems could be resulting in injury to the lumber industry in the United States. We have seen no evidence that such uneconomic cutting is in fact occurring. However, the International Trade Commission may wish to further investigate this aspect of the Canadian system.

CONCLUSION

For the reasons stated above, the ITC should conclude that there is no injury to the domestic industry by reason of the Canadian stumpage fee systems.

Respectfully submitted
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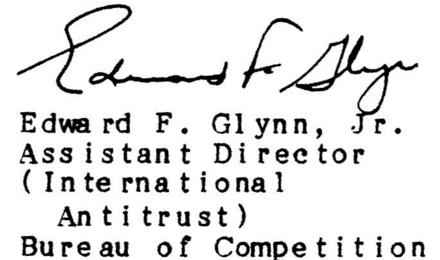

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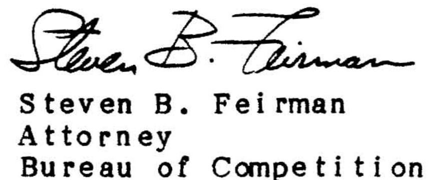

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June 12, 1986

APPENDIX

Prehearing Brief by the Federal Trade Commission

before the International Trade Administration,

Department of Commerce,

Certain Softwood Lumber Products from Canada,

Countervailing Duty Proceeding,

April 7, 1983

Before the
INTERNATIONAL TRADE ADMINISTRATION
DEPARTMENT OF COMMERCE
Washington, D.C.

In the Matter of)
)
CERTAIN SOFTWOOD LUMBER)
PRODUCTS FROM CANADA)
)
Countervailing Duty Proceeding)

PREHEARING BRIEF

BY THE

FEDERAL TRADE COMMISSION

April 7, 1983

In the matter of
CERTAIN SOFTWOOD LUMBER
PRODUCTS FROM CANADA
Countervailing Duty Proceeding

PREHEARING BRIEF
BY THE
FEDERAL TRADE COMMISSION

The Federal Trade Commission ("FTC" or "the Commission") submits this prehearing brief to assist the Department of Commerce in making its final determination under 19 U.S.C. § 1671(a) whether imports of softwood lumber products from Canada benefit from a subsidy. The Commission's analysis supports the Preliminary Determination of the Department of Commerce that no countervailable subsidy results from the methods used by Canadian Federal and Provincial governments to set a price for stumpage (standing timber that may be harvested and processed into lumber). As one of the federal agencies charged with promoting competition and consumer welfare, the Federal Trade Commission recognizes that unjustified imposition of countervailing duties on Canadian lumber would raise costs to United States lumber consumers and adversely affect other segments of the economy, including the housing industry. Moreover, the theory of subsidization presented by this petition raises significant legal and economic questions that are related to the economic and competition policy expertise of the Commission.

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STATEMENT OF THE CASE AND SUMMARY OF FTC ANALYSIS

A. Introduction.

This proceeding was initiated upon a petition by the "United States Coalition For Fair Lumber Imports,"[1/] requesting the Commerce Department to impose a countervailing duty on imports of certain Canadian softwood lumber products.[2/] Although the Petition alleged several subsidy programs, the stumpage fee[3/] subsidy asserted is by far the largest, estimated by Petitioner to be $113.78 per thousand board feet of imported Canadian softwood lumber or equivalent to 61 percent of the average unit value of imports in 1980. Petition at 97-98. Purportedly, the subsidy results from an undercharge on sales of the right to harvest government-owned stumpage, which is passed on to

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1/ Petitioner represents a group of trade associations representing U.S. lumber producers plus a large number of individual companies. Petition, App. IA-IC.

2/ If the Commerce Department determines that lumber imports are subsidized, and if in a separate proceeding the International Trade Commission determines that the producers of competitive United States products are materially injured (or threatened with material injury) by reason of the imports, then the Commerce Department would impose a countervailing duty in the amount of the net subsidy. 19 U.S.C. §1671(a).

3/ The Preliminary Determination defines "stumpage" as standing timber, 48 Fed. Reg. 10,395, 10,402 (March 11, 1982); this brief employs the same usage.

purchasers of lumber.[4] In its preliminary determination, the Department found that there is no countervailable subsidy. 48 Fed. Reg. 10395 (March 11, 1983). The Federal Trade Commission strongly endorses this conclusion.[5]

In this brief the Commission applies a competition and economic analysis to the countervailing duty statute. In making its comments, the Commission is fully aware of the importance of softwood lumber imports from Canada and of the fact that the Department's decision will have a practical, as well as legal, impact. Petitioner's request for this duty, if granted, would have a significant impact on segments of the national economy,[6] particularly the housing industry, which is a principal consumer of lumber and which has been in a severe slump.[7] In addition,

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4/ This brief refers to lumber as the critical product. To be more precise, however, lumber is only one, but commercially the most important, of a group of softwood products that are alleged to receive subsidies. This group of products is fully described in "Scope of Investigations" section of the Department's Preliminary Determination. 48 Fed. Reg. 10,396.

5/ Given the magnitude of the alleged stumpage fee subsidy, this brief focuses exclusively on this issue. The brief takes no position with respect to the other alleged subsidies, which the Department found to confer a _de minimis_ 0.32 percent benefit on imported lumber.

6/ The International Trade Commission staff has estimated that, from 1979 to 1981, the value of Canadian softwood lumber imports averaged $2.0 billion per year. _Softwood Lumber from Canada_, No. 701-TA-197 (Prelim.) (Nov. 1982) at A-16.

7/ David Stahl, Executive Vice President of the National Association of Home Builders, testified at the ITC staff conference in this proceeding that (1) the home building industry is in a depression and (2) a tariff of 65 percent "would probably raise the price of a typical single-family home built in this country by about six and a half percent." Tr. 151-153.

imposing a tariff based on the Petition's theory potentially could have an adverse impact on United States exporters, who themselves may be subjected to the application of countervailing duties by foreign countries in analogous circumstances.[8/]

B. Sale of Stumpage in the United States and Canada.

Petitioner's argument with respect to the alleged subsidization through undercharges for stumpage derives from a key distinction concerning the manner in which stumpage fees are determined in the United States and in Canada. In the United States, stumpage fees are primarily established through an auction, which sets the fee at the market price. In Canada, stumpage fees are determined administratively. Petitioner has alleged that this process results in stumpage fees being set at below-market prices.

When the U.S. Forest Service decides to sell the timber on a parcel of land, it appraises the stumpage, taking into account the quantity of recoverable wood; the various species and the

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8/ The United States owns a significant portion of the nation's resources. In 1977, the Federal Government owned 32.6 percent of the total land area of the United States, with the largest holdings in Alaska and Western states. U.S. Bureau of the Census, Statistical Abstract of the United States: 1978 237 (99th ed. 1978). Of the 742 million federally-owned acres, 482 million acres (65 percent) was used for forest and wildlife purposes, and 165 million acres (22 percent) for grazing. Id. at 238. Substantial additional land was devoted to reclamation and irrigation projects, to power development and distribution, and other economic uses. See id. at 240 for a classification of mineral and other leases. Thus, the methods for and impact of governmental sales of resources to private enterprises could be subject to scrutiny by foreign nations seeking to protect their own domestic industries.

value of each; and the estimated costs of harvesting the trees. These costs vary with forest density, terrain, accessibility, and other factors.[9/] In principle, the appraisal ascertains the residual value of the timber (i.e., the value of end products minus the costs of harvesting and producing those products) and the process also allows for a normal profit.[10/] The appraised value, adjusted for certain road-construction costs, is the minimum acceptable sales price for the rights to harvest the timber. Actual U.S. sales prices for stumpage rights are then determined in an oral auction or by sealed bid.[11/]

By contrast, Canadian stumpage fees are generally established administratively rather than through a competitive market process.[12/] For example, in British Columbia, private companies obtain long-term "tenures," giving them the privilege

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9/ For descriptions of the U.S. system, see "Joint Report Describing the Manner in Which Standing Timber is Sold in the U.S. and Canada and Stumpage Prices Actually Paid" (October 4, 1982), Petition Vol.II, hereinafter cited as Petitioner's Joint Report at 9-15 and Conditions Relating to the Importation of Softwood Lumber Into the United States, Inv. No. 332-134 at 41-44 (April 1982) [hereinafter cited as "ITC 332 Report"]. For additional detail, see John A. Combes, "Forest Service Timber Appraisal and How It Works" (April 1980) (unpublished paper available from the Forest Service). This Prehearing Brief does not offer proposed findings of fact; rather, it relies principally on the facts as set forth in Appendix B to the Preliminary Determination.

10/ Petitioner's Joint Report at 9-15.

11/ In the years 1979-1981, however, the appraised price was of little practical significance because the bid prices for stumpage exceeded the appraised value. Petitioner's Joint Report at 16a to 16f; and ITC Section 332 Report at 41-42. This has been attributed to industry expectations of a high level of housing starts and of continued high inflation. See discussion at note 62 infra.

12/ In discussing the Canadian system, we focus on the methods used by the Province of British Columbia, which, according to Petitioner's data, supplies 68% of total Canadian exports to the United States. Coopers & Lybrand, Valuation of Stumpage Subsidy 8 (1982).

of doing business in a forest area. Although there are several forms of "tenure," Petitioner and the Province both indicate that the major forms are tree farm licenses (granting up to a twenty-five year term) and forest licenses (granting up to a twenty-year term).[13] Licensees develop long-term plans, subject to Provincial Forest Service approval, for forest use. Before cutting timber, a licensee must obtain a cutting permit specifying the volume of timber that may be harvested in a designated area.[14]

The prices charged to "tenure" holders for harvesting rights in British Columbia are based on an appraisal that, in general principle, is similar to the U.S. Forest Service's appraisal. The appraisal starts with the price of an end-product -- in coastal British Columbia, the end product is logs; and in the interior, it is lumber -- and deducts harvesting, transportation, and manufacturing costs plus a normal rate of profit. The result is the appraised value of standing timber. In particular, in estimating the costs of harvesting, the appraisal considers the

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13/ Petitioner's Joint Report at 20; 48 Fed. Reg. 10,411-12 (indicating that these two procedures account for 89.6% of the annual allowable cut).

14/ An "annual allowable cut" is established, and over a five-year period the actual cut must be within plus or minus ten percent of the aggregate allowable amount. Within a single year a plus or minus fifty percent deviation from the annual allowable cut is permitted. 48 Fed. Reg. at 10,411.

location of the parcel of land in question, the species mix of trees, the timber quality, the timber density (trees per acre), the difficulty of logging, and a timber recovery factor.[15]

C. Summary of Petitioner's Argument.

Petitioner alleges that Canadian governmental sales of stumpage rights are subsidized because Canada fails to capture the full economic rent associated with its ownership of this natural resource and, by implication, suggests that this "subsidy" has an impact on lumber imported into the United States.[16] The Petition contends, in essence, that the undercharge of stumpage fees is the assumption of a cost of producing lumber. The request for imposition of a countervailing duty rests on subsection (iv) of 19 U.S.C. § 1677(5)(B), which provides that "[t]he assumption of any costs or expenses of manufacture, production, or distribution," is a subsidy if done by governmental action for a specific enterprise or industry, or a group of enterprises or industries.

15/ Id. at 10,413; see Petitioner's Joint Report at 30-35.

16/ Unless clearly specified to the contrary, the terms "Canada" and "Canadian" as used herein include the Provincial governments owning the timber at issue as well as the Federal government of Canada.

Petitioner estimates that the Provinces own 95 percent of the standing timber in Canada. Petition at 24. The International Trade Commission staff estimated that the Provinces own about 90 percent of the "economically accessible" softwood timber volume in Canada and that over one-half of this is in British Columbia. ITC 332 Report at 46.

According to the Petitioner, Canada "administratively determin[es] how much stumpage will be sold, to which mills and at what price."17/ The Petition's theory of subsidization is that the commercial value of harvesting rights is due to the timber's convertibility to lumber products; that the residual value (the sale price of lumber minus harvesting and manufacturing cost and profit) "is the 'economic rent' associated with the timber resource;" and that Canada effectively is "giving away stumpage" by not charging the full economic rent.18/ Petitioner's Brief at 18-19. The Petition does not directly analyze the economic effect of the alleged stumpage undercharge on the supply or price of imported lumber, but assumes that a reduced raw material cost will be passed through the production process to affect the price of imported lumber.

The relationship among stumpage fees, the quantity of trees cut, and the volume of exports of logs and lumber is complex. It is important for purposes of this proceeding, therefore, to identify specifically what aspects of the Canadian system are and are not alleged to be the source of unfair competitive disadvantages to domestic producers. Petitioner does not allege that government ownership of timberland is per se a subsidy. Both the United States and Canada own large tracts of timberland and sell logging rights to private enterprises, such as the

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17/ Brief concerning the Canadian Governments' Assumption of Raw Material (Stumpage) Cost of Producing Forest Products, filed in Appendix II of the Petition, at 1, 6, 22 [hereinafter cited as "Petitioner's Brief"].

18/ For a definition of this term, see note 33 infra.

petitioning U.S. producers and the Canadian lumber companies. Petitioner also does not base its claim for imposition of countervailing duties on the Canadian government's administrative determination of how much timber may be cut in a given period. Indeed, the Petition does not offer evidence that would support a finding that the administrators in Canada (or in the United States) allow too little or too much timber to be cut. Finally, although Petitioner observes that Canada prohibits, or severely restricts, the export of logs, Petitioner neither asserts that this alone creates a countervailable subsidy, nor attempts to value its benefit, if any, to Canadian producers. Petition at 28. Since the log export ban is not alleged to confer a subsidy, this Brief does not undertake a separate economic analysis of the export restriction.

D. Summary of Preliminary Determination.

In its Preliminary Negative Countervailing Duty Determinations, the Department of Commerce found that some of the subsidies alleged by Petitioner were not countervailable and the others were in the aggregate, de minimis. It therefore made a negative determination.[19] The Department relied on four main reasons for its determination with regard to the alleged stumpage subsidy.

19/ Preliminary Negative Countervailing Duty Determination, 48 Fed. Reg. 10,395 (March 11, 1983).

First, the Department concluded that the alleged stumpage subsidy is not provided to a "specific . . . group of industries" as required by the statutory definition of a domestic subsidy. 48 Fed. Reg. 10,403.

Second, the Department concluded that the setting of low stumpage fees does not constitute the "assumption of a cost" of production, because the relevant statutory language, properly interpreted, suggests the assumption of a pre-existing liability. Moreover, even if the term "assumption" is interpreted more broadly, no cost was assumed. The Department distinguished its prior precedents on the grounds that past practice did not involve the use of cross-border comparisons in setting a commercial benchmark for ascertaining the presence or absence of a subsidy; that there is no unified North American market for stumpage; and that there is no "international price" for stumpage. It determined that the residual-value appraisals are a reasonable method of valuation. 48 Fed. Reg. at 10,403.

Third, the alleged subsidy derives from Canada's purported failure to collect the full economic rent associated with its ownership of stumpage. However, the Department determined that undercollection of a rent does not produce an increase in the supply of lumber, and therefore does not interfere with the efficient allocation of resources. 48 Fed. Reg. 10,404.

Fourth, the Commerce Department found that comparison of unadjusted United States stumpage fees with Canadian prices would be "arbitrary and capricious," and not indicative of whether the Canadian prices were "subsidized." The Preliminary Determination

also questioned whether there was a rational basis for making the appropriate adjustments, given that the quality and accessibility of timber in the two countries varies widely; that Canada requires in-kind payments for harvesting rights; and that recent United States prices have been bid two to five years in advance of use and therefore have not taken into account the decline in the housing industry. In addition, the Department noted that even if there were a rational basis for adjusting for these differences, the best available evidence suggests that the stumpage prices in the two countries do not vary significantly. 48 Fed. Reg. at 10,404.

E. Summary of FTC Analysis.

1. Section I of this brief discusses the policy issues that should be considered by the Department in interpreting and applying the countervailing duty statute. It proceeds from the proposition that not every governmental payment or other benefit conferred on private parties is a countervailable subsidy. Rather, only those payments that distort trade and resource allocation by affecting the price or quantity of the good produced should be subject to countervailing duties. While the Commerce Department has authority to extend the list of subsidy practices enumerated by Congress, the legislative history is clear that the Department should do so only when the practice violates the underlying purposes of the statute. That is, the duty should be imposed only when the foreign government's program affects the output or price of the imported product.

2. Section II examines Petitioner's claims with respect to the alleged subsidy on lumber. This section asserts that even if there is an economic benefit conferred on stumpage sales in Canada, this benefit would have no effect on either the prices of logs sold to Canadian lumber mills or the prices of lumber imported into the United States. Consequently, any alleged benefit associated with lower stumpage fees does not represent a subsidy on imported lumber. The economic analysis underlying this conclusion is presented in much fuller and more technical detail in the appendix by Dr. David G. Tarr of the Commission's Bureau of Economics. This conclusion is entirely consistent with the findings and reasoning of the Preliminary Determination. This analysis supports the Department's decision by pointing out that the benefit, if any, realized by timber owners in Canada does not affect the quantity or price of lumber imported into the United States and thus does not distort trade or subject Petitioner to competitive disadvantage.

3. Section III examines the Petitioner's claims with respect to the alleged subsidy on stumpage. It concludes that the Preliminary Determination correctly held that the proper benchmark by which to determine whether or not there is a subsidy is the market-determined price for stumpage as it exists, or would exist, in Canada. If resort to stumpage prices in another country is necessary to provide a surrogate for otherwise unavailable Canadian market-determined prices, this section asserts that use of unadjusted United States prices would be legally incorrect and at variance with the economic principle of

comparative advantage. Finally, this section observes that the adjustments that must be made to use United States prices would have to account for differences not only in the relative value of stumpage in the two countries but also in the nature of the stumpage harvesting rights that each country sells.

I. THE COMMERCE DEPARTMENT SHOULD ANALYZE WHETHER THE ALLEGED SUBSIDY PRODUCES AN UNFAIR DISTORTION OF TRADE AND PROVIDES AN UNFAIR COMPETITIVE ADVANTAGE TO CANADIAN PRODUCERS.

Countervailing duties are imposed to offset an unfair competitive advantage that causes a distortion of trade by affecting the price or quantity of the good in question. Not all governmental practices and programs -- including payments made and benefits conferred pursuant to natural resource management programs -- cause such distortions.[20/] In addition, some governmental programs may have an impact on firms operating at one stage of production without affecting trade at subsequent stages of production. Sound economic analysis can help distinguish those governmental programs that distort trade from those that do not.

Section 303 of the Tariff Act of 1930, as amended, provided for imposition of countervailing duties in the "net amount of any bounty or grant" paid or bestowed on an imported product's

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20/ Some governmental practices -- depending on their details -- may affect the overall profitability that private enterprises experience in their business activities without affecting either the profitability of marginal investments or the incentives of firms to undertake those investments.

"manufacture or production or export."[21/] In 1978, the Supreme Court offered perhaps the best expression of the purpose of this section:

> This purpose is relatively clear from the face of the statute and is confirmed by the congressional debates: The countervailing duty was intended to offset the unfair competitive advantage that foreign producers would otherwise enjoy from export subsidies paid by their governments. Zenith Radio Corp. v. United States, 437 U.S. 443, 455-56 (1978) (citations omitted, emphasis added).

Thirteen months after the Supreme Court decision in Zenith, Congress passed the Trade Agreements Act of 1979, which contains the statute at issue in this proceeding. In amending the 1930 legislation, Congress was aware of -- and by implication endorsed -- the Supreme Court's view of the statute's purpose by expressly providing in the new legislation that "the term 'subsidy' has the same meaning as the term 'bounty or grant' as that term is used in section 303 of the Act." 19 U.S.C. § 1677(5).[22/] Indeed, the Senate Finance Committee's description of a countervailable subsidy echoed the Supreme Court's emphasis on "competitive advantage," stating: "Subsidies are bounties or grants bestowed (usually by governments) on the production, manufacture or export

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21/ Pub. Law No. 93-618, 88 Stat. 1978, 2049 (Jan. 3, 1975).

22/ H.R. Rep. No. 96-317, 96th Cong., 1st Sess. 21 (1979).

of products, often with the effect of providing some competitive advantages in relation to products of another country."23/

The congressional debates confirm that Congress' concern was limited to those foreign practices that distort trade and provide unfair competitive advantages. At the outset of a colloquy with Senator Ribicoff concerning the amendments to the countervailing duty statute, Senator Heinz, who was a leader in supporting the 1979 statutory amendments, stated:

> We have an international economy and cannot wall ourselves off from it. Nor should we want to -- for trade invariably means jobs and profits for Americans.
>
> At the same time, however, in our pursuit of trade expansion, we should not abandon our free market principles and our reliance on competition and the law of comparative advantage as arbiters of the marketplace . . .24/

After describing the abandonment by other countries of free-market principles and reliance on competition, Senator Heinz continued:

> It is precisely these unfair and, from the standpoint of classical economic theory, trade-restricting practices I seek to control. . . .25/

23/ S. Rep. No. 96-249, 96th Cong., 1st Sess. 37 (1979). In addition, the House Ways and Means Committee Report on the 1979 Act listed, as one of the "key" accomplishments of the international subsidies code, the "[r]ecognition that where domestic subsidies are granted on noncommercial terms, trade distortions are especially likely to arise . . ." H.R. Rep. No. 96-317, 96th Cong., 1st Sess. 43 (1979) (emphasis added).

23/ 125 Cong. Rec. S. 10,306 (daily ed. July 23, 1979).

25/ *Id.*

In distinguishing practices that are unfair -- _i.e._, trade-distorting -- from those that are not, it is important that the statute's legal interpretation and application be guided by an economic analysis to determine if any unfair competitive advantage is created by the practice in question. The statutory definition of a domestic subsidy is as follows:

> (B) The following domestic subsidies, if provided or required by government action to a specific enterprise or industry, or group of enterprises or industries, whether publicly or privately owned, and whether paid or bestowed directly or indirectly on the manufacture, production, or export of any class or kind of merchandise:
>
> > (i) The provision of capital, loans, or loan guarantees on terms inconsistent with commercial considerations.
> > (ii) The provision of goods or services at preferential rates.
> > (iii) The grant of funds or forgiveness of debt to cover operating losses sustained by a specific industry.
> > (iv) The assumption of any costs or expenses of manufacture, production, or distribution.

19 U.S.C. § 1677(5).

The Commerce Department preliminarily concluded that the statutory language, "assumption of a cost," in the fourth clause suggests the undertaking of a pre-existing liability. 48 Fed. Reg. 10,403. As a matter of pure statutory construction, the logic underlying this conclusion is impeccable. An undercharge for stumpage is, if anything, the provision of a good, and there is no claim in this case that there has been any "provision of a good _at a preferential rate_" as the second clause would require. Consequently, if an undercharge for stumpage were also considered to be an assumption of a cost, the fourth clause would

totally swallow up the second. Since Congress could have provided that all provisions of goods are subsidies, but did not do so, any interpretation of the fourth clause that, in effect, would eliminate the requirement that provisions of goods be "at preferential rates" would contravene the intent of Congress and be overly broad.

However, the parsing of the statutory language in Section 771(B)(5) of the Trade Agreements Act is not dispositive. The legislative history of the Act indicates that Congress's intent was not to set forth a comprehensive list of every possible subsidy practice, but rather to offer the four enumerated definitions as examples of subsidies. When considering a program not literally described by one of the four examples, the Congressional Committee Reports state that the Department should

make a determination based on the "principles implicit" in the enumerated subsidy practices.[26/]

In ascertaining whether imposition of countervailing duties against a program is consistent with these principles, the Department should look to the economic impact of the program on foreign sales in the United States market. In particular, the critical issue is whether the foreign program affected either the foreign producers' output of the product under investigation or the price charged by those producers. Unless a foreign governmental program affects either the supply or the price of the product in question, there can be no unfair competitive benefit or trade distortion, and hence no subsidy should be found.

As developed in Sections II and III below, there is no persuasive economic rationale or evidence compelling the conclusion that the Canadian stumpage fee system has a

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26/ The Commerce Department clearly has the authority to countervail against subsidies not specifically listed in the statute, but only to the extent that such a determination is consistent with the principles implicit in the statutory examples. As expressed by the House Ways and Means Committee Report:

> In deciding whether any other practice is a subsidy, the standard remains that presently used with regard to a "bounty or grant" under section 303. However, to the extent that the enumerations under this provision might provide a basis for expanding the present standard consistent with the underlying principles implicit in these enumerations, then the standard shall be so altered.

H.R. Rep. No. 96-317, 96th Cong., 1st Sess. 74 (1979) (emphasis added). Accord S. Rep. No. 96-249, 96th Cong., 1st Sess. 85 (1979).

subsidizing effect, i.e., that it affects the quantity or price of softwood products imported into the United States and thus distorts domestic trade. The Commission's analysis demonstrates that the undercharge for stumpage, if any, is the undercharge for an economic rent, and does not have the effect of increasing the supply of lumber or reducing its price. Furthermore, assuming hypothethically that there is a price differential between identical tracts of stumpage in the United States and Canada -- and this currently is an unsupported assumption -- this circumstance does not conclusively demonstrate subsidization. A natural Canadian comparative advantage in stumpage may explain the price differential. Petitioner assumes that the existence of a unified North American market for lumber will result in equal prices for stumpage (absent subsidization). As discussed more fully in Section IIIB, below, this economic theory is valid only under very restrictive assumptions, and Petitioner has not demonstrated that all the preconditions are present.

II. THE ALLEGED FAILURE TO CHARGE THE FULL MARKET PRICE AS A STUMPAGE FEE DOES NOT AFFECT THE PRICES EITHER OF LOGS SOLD TO CANADIAN LUMBER MILLS OR OF LUMBER IMPORTED INTO THE UNITED STATES AND IS THEREFORE NOT A COUNTERVAILABLE SUBSIDY.

As the Commerce Department recognized in its final determination in the recent Carbon Steel cases, it is not sufficient to show simply that a benefit is granted to an "upstream" producer of a product that is used as an input in a "downstream" production process. As indicated above, it is not enough that a benefit be received; in order to represent a

subsidy, the benefit must affect price or output in some relevant respect before it can be considered a subsidy to the downstream industry as well.[27/]

The Canadian stumpage fee applies to production of an "upstream" product. The analysis contained in this Section shows that any undercharge for that stumpage fee does not have an impact "downstream." In its Preliminary Determination, the Department also has adopted this view and has correctly identified the economic reason for this result.[28/] Simply stated, the stumpage fee is a payment for the right to realize part (or all) of the economic rent associated with a given parcel of timber. Economic rent in this instance represents the surplus that can be earned from the sale of logs, i.e., the revenue

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27/ Rejecting objections by domestic steel producers to the Department's effort to determine whether a subsidy on an input conferred a benefit to steel producers, the Department stated:

> Under the Act, the Department is required to determine whether respondents have received subsidies within the meaning of the Act. To do so, the Department seeks to determine whether or not respondents have received directly or indirectly an economic benefit. Whereas this is relatively easy in the case of the direct bestowal of a grant, it is quite difficult with regard to indirect subsidies allegedly conferred through the subsidization of inputs used in a final product. In this more complex area, we believe it is required for the Department to consider whether there is an economic benefit to foreign manufacturers of the final product of subsidies bestowed on manufacturers of an individual input. . . ." 47 Fed. Reg. 38,322 (Sept. 7, 1982).

28/ 48 Fed. Reg. 10,404.

realized by the sale of logs from a parcel of land minus the costs associated with harvesting, transporting, and selling these logs.[29/]

As we will discuss below, land will be logged if, and only if, it has positive economic rent associated with it. The decision to log the land will not be affected by the stumpage fee, so long as the fee is set in the range between zero and the amount by which the value of the logs exceeds the cost of harvesting them. Within that range, the amount of the fee merely determines how the surplus, or economic rent, is distributed between the Canadian government as owner of the land and the logger who removes and sells the timber. The Canadian stumpage fee system will not have any effect on the supply of logs because its operation will not induce land to be harvested that otherwise would not have been logged. Since there is no effect on the supply of logs, there also will be no effect on either the price of logs or on the price of lumber imported into the United States.

Thus, much of the Petitioner's presentation is addressed to a question about which the Commerce Department need not concern itself, that of the "correct" method for setting a stumpage fee. This question is irrelevant precisely because there can be no subsidy with respect to stumpage fees no matter how the price for the right to cut timber is set. Indeed, this conclusion

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29/ As discussed below, however, economic rent should be calculated using considerations pertinent to the buyer's decision whether or not to purchase the good (in this case, stumpage rights).

would hold even if stumpage rights were given away. The only way that the price charged for harvesting stumpage could constitute a subsidy would be if the price were negative, that is, if firms received a payment from the government for harvesting and selling the timber. No payment of this kind, of course, has been made.

Regardless of the level at which the stumpage fee is set, the price of logs is determined independently by the interaction of the demand for and supply of logs.[30/] Neither the Canadian nor the United States stumpage fee systems affect the demand for logs, which depends on the demand for lumber and other products made from logs. Demand is controlled by independent forces. Moreover, the stumpage fee system does not affect the supply (and, hence, the price) of logs. This, is true because the supply functions of the individual firms that produce logs are unaffected by the stumpage system.

The supply of logs is directly dependent upon the cost of producing them. The costs that affect the supply of logs include the costs of building any necessary roads to gain access to the

30/ Stated more precisely, the price of logs is determined by the interaction of the demand function and supply function for logs.

trees, of cutting down the trees, of transporting the logs to their markets, and of reforesting the harvested parcel.31/ These costs also include a normal profit.

On the other hand, these costs do not include any stumpage fee paid by the harvester to the owner of the timberland -- in Canada, usually the Federal or Provincial government -- for the right to harvest the logs. As Petitioner recognizes, the stumpage fee represents that portion of the trees' value, or economic rent, that is captured by the landowner.32/ By definition, an economic rent does not affect the quantity of a

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31/ The costs of logging additional parcels of land are additional or marginal costs associated with the logging operation. These additional costs would be expected to rise as the production of logs increases because, all other things being equal, progressively less-accessible parcels of timberland and/or land with less valuable species would have to be harvested. Since the product at issue is being discussed using the homogeneous term "logs," it is necessary to measure units in quality-adjusted units or efficiency units; for example, logs could be defined as a certain number of usable board feet of timber. This characterization is made for expositional ease. The analysis is not made incorrect by the fact that in reality different logs produce different amounts of lumber or differ in other ways. See, e.g., J. Robinson, The Economics of Imperfect Competition 109 (2d ed. 1969) (Chapter 8, "A Digression on Rent").

32/ Petitioner's Brief at 18-19. The Brief states:

> The maximum amount a purchaser (i.e., mill) can afford to pay for standing timber is the sale value of the products (i.e., lumber) which can be recovered from it, less logging and manufacturing costs (including a "normal" profit). This residual value of standing timber is the "economic rent" associated with the timber resource.

Id. at 18.

factor supplied.[33] Characterization of stumpage fees as part of economic rent rather than a cost that affects the quantity supplied follows from the fact that the government, which decides how much land will be made available for logging, would make the land available for harvesting and loggers would harvest the logs regardless of where the stumpage fee is set, so long as it is within the range between zero and the amount by which the value of the logs exceeds costs of harvesting them.[34]

Although the existence of this economic rent is extremely important, the allocation of the economic rent between the timber owner and the harvester will not determine whether or not a parcel of land will be logged. That will depend on whether an economic rent _exists_ and can be earned by someone if the land is logged. Whether such a rent exists depends on cost and market factors that are independent of the stumpage fee, namely, whether the anticipated revenue from sale of the logs exceeds the costs of harvesting and selling them. If so, the logger will have an

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33/ Technically, "economic rent" is defined as a surplus earned by a factor of production over and above the minimum necessary to induce that factor to remain employed in its current use. _See_ J. Robinson, note 31 _supra_, at 102-19. _See also_ T. Scitovsky, _Welfare and Competition_ 108 (1971).

34/ In contrast, compare the stumpage fee with the wage paid to a logger. The land will continue to be made available for logging regardless of the stumpage fee paid. However, if the wages of the loggers who cut the trees are reduced, some or all of them will quit working as loggers and do something else. Therefore, wages are a cost which affects supply, since the labor currently employed in the industry would not remain in the industry if the wages were not paid. Thus, a cost which affects supply is a payment which affects the quantity of the factor supplied, while a rent is a payment which does not affect the quantity supplied.

incentive to purchase the stumpage and harvest the parcel. The magnitude of the stumpage fee charged simply will determine how much of the anticipated rents the land owner and logger each will realize. As noted above, the parcel of land will be harvested regardless of where the stumpage fee is set, so long as it is in the range between zero and the amount by which the value of the logs exceeds the costs of harvesting them. This will occur because the logger will earn at least some income over and above his costs (or at a minimum, earn a normal profit) by harvesting the tract.[35/]

Conversely, suppose that for a second type of land the cost of harvesting the trees on the parcel, including a normal profit, is greater than the value of the trees as logs. In such a case

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35/ The precise level where the stumpage fee is set in the range between zero and the economic rent associated with the piece of land in question only affects the distribution of wealth between the owners of the land -- usually Canadian provinces -- and the loggers. If the stumpage fee is set equal to the economic rent, the owner of the land will obtain all of the economic rent. If the stumpage fee is set at zero, the logger will obtain all of the economic rent.

As discussed in the appendix, an appraisal system that charges stumpage fees <u>in excess</u> of possible positive economic rents associated with a parcel of land would deter development of that parcel. An excessive stumpage charge would result in a higher market price for logs and would be a cost, not a subsidy, to sawmills.

We note that the Canadian appraisal system actually could result in less timber being cut (thus contributing to higher prices) if the marginal parcel of land is not allocated to the most efficient harvester of that land. Since the marginal parcel is that parcel on which the revenues from harvesting would just cover the costs of the most efficient harvester, assigning the rights to a harvester with higher costs may mean that the available revenues are not sufficient to induce that harvester to cut the timber.

that parcel of land will not be logged even if the stumpage fee is zero. Only a positive payment by the landowner (government) could induce the logging company to harvest the timber. Indeed, this is what distinguishes the stumpage fees from a subsidy. A true subsidy would exist if, for example, the Canadian government agreed to pay loggers a specified amount for each tree that was harvested. In such a case, some tracts of timberland would be cut that otherwise would have been left standing. This would occur in instances in which the subsidy would more than overcome the amount by which the harvesting costs exceeded the predicted revenue from sale of the logs. This situation differs from the circumstances under scrutiny here because the Canadian government is not alleged to make payments to loggers for trees cut, and there is no change in the profitability of harvesting marginal tracts.

While the systems used to establish stumpage fees in the United States and Canada are different, the results are the same, namely, that the stumpage fee, so long as it is in the range described above, does not affect the quantity of timber cut. Under the United States' competitive auction system, each potential logger will compute, for each parcel of land offered for logging, the net benefits from logging that tract. The logger will do this by estimating the expected value of the logs that it expects to cut over the life of the contract and subtract from this amount the expected costs, including a normal profit of harvesting these logs. If the difference is positive, indicating that harvesting would be profitable, the firm will bid for the

right to log that tract. If the difference is negative, it will not place a bid. Under the British Columbia appraisal system, a logger will also be interested in harvesting any plot on which the expected revenue from selling the logs to be harvested exceeds the costs of harvesting them -- that is, if there is a positive economic rent associated with harvesting the plot. This would occur if the appraisal system permitted the logger to keep some portion of the economic rent. As a result, the logger makes more money if the parcel is harvested. However, if the revenue from selling the trees is less than the harvesting costs, the logger would lose money by harvesting the tract and therefore he will not harvest.

Thus, under both the Canadian and United States' systems, timberland will be logged if -- and only if -- the price that can be received for the logs is greater than or equal to the costs of logging the land, including a normal profit -- that is, if there is a positive economic rent. The only difference is that under the Canadian system, if there is "underappraisal," more of the "economic rent" will go to the loggers and less to the owners of the land.

The crucial point is that the Canadian stumpage fee system does not lead to more parcels of timberland being developed. Consequently, it does not affect the quantity of logs

harvested.[36] It therefore will not affect the price paid for logs. This is because a harvester that sells logs will sell at the highest price it can obtain. With a given quantity of logs, the maximum price for which logs can be sold is determined by the demand (more technically the demand schedule) for logs which, as discussed previously, is not affected by the stumpage fee system. Since the quantity of logs harvested also is not affected by the system at issue in this proceeding, there is also no effect on the price at which logs are sold to sawmills. Given

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[36] The typical harvesting agreement both in the United States and in Canada calls for a certain quantity of timber to be cut over a period of several years. The harvester is given latitude in deciding how much to cut in any given year but less latitude in cutting the required number of trees over the life of the contract. The analysis contained in the appendix does not consider the pattern of harvesting over the life of the contract. The length of the contract is treated as the market period and the analysis simply demonstrates that the total number of trees harvested over the term of the contract is not affected by whether an auction system or the Canadian allocation system is used.

Technically, to the extent that the Canadian system in fact amounts to a proportional division of inframarginal rents between loggers and the government, the introduction of this added intertemporal aspect should not change the results. The same harvesting pattern over the term of a contract would occur under the Canadian allocation system as under an auction system. Under an auction system, a harvester will select that pattern of harvesting that maximizes the expected present value of the stream of net benefits from harvesting trees over the life of the contract -- where the value of the net benefit at any time is the difference between the revenue received from the sale of the trees less the cost of harvesting trees at that time. Under a system in which the logger keeps a proportion of the economic rent generated by cutting a tree, the pattern that maximizes the expected value of the stream of discounted economic rents over the life of the contract will be selected. Since economic rent at any time equals revenue minus costs at that time, the same pattern of harvesting will be selected under one system as under the other.

the alleged stumpage subsidy has no impact on the sawmills' costs, it will have no effect on the sawmills' output, the quantity and price of lumber exports to the United States, or the price of lumber products in the United States.

Petitioner's belief that stumpage fees are costs that affect the price of logs may derive from the fact that for the individual firm any stumpage fee is indeed a cost. But for the industry as a whole the stumpage fees merely represent transfer payments from logging firms to landowners. The proposition that these "economic rents" do not affect the price of the product is widely and commonly discussed by modern economists.[37] Indeed, the concepts have long been established economic principles.[38]

37/ "[W]e must avoid our old enemy 'the fallacy of composition.' What appears as a cost of production to each and every small firm using a particular kind of land [tree] may, as we have seen, be to the whole community merely a derived price-determined rent expense rather than a price-determining one. More than that, suppose the land is [trees are] specialized and can be used only for the production of one industry. If a grade of land [type of tree] is inelastically supplied to one industry and, having no place to go, will always work for whatever it can earn there, its return may appear to every small firm as a cost like any other. But as scientific observers of the whole industry, we still must recognize that the land [tree] return is a price-determined rent and not price-determining cost." P. Samuelson, Economics 539 (8th ed. 1970).

38/ "Rent, it is to be observed, therefore, enters into the composition of the price of commodities in a different way from wages and profit. High or low wages and profit are the causes of high or low price; high or low rent is the effect of it. It is because high or low wages and profit must be paid, in order to bring a particular commodity to market, that its price is high or low. But it is because its price is high or low; a great deal more, or very little more, or no more, than what is sufficient to pay those wages and profit, that it affords a high rent, or a low rent, or no rent at all." A. Smith, The Wealth of Nations 145-146 (1776). See also D. Ricardo, The Principles of Political Economy and Taxation (1817) (1962 reprint).

Finally, it is important to note that the foregoing conclusion is not affected by the possibility that some or all of the firms that harvest logs may be vertically integrated into lumber production. While, on the surface, it might appear that a low stumpage fee paid by an integrated firm would give its sawmill operations access to unusually low cost logs, this does not turn out to be the case. For every log that the integrated firm uses in its sawmill, it gives up the revenue it could have received by selling that log in the market.[39] In order for the vertically integrated firm to maximize its profits, it will sell the logs it cuts or buy additional logs in the market until the value of using another log in its sawmill operations is equal to the value of selling another log, i.e., the market price of logs. In essence, the vertically integrated firm will not use an internally-produced log in its sawmill operations unless the value of that log put to that use is at least as great as the price the firm could have received by selling that log to someone else. This is, of course, the same rule that an unintegrated firm uses: it buys logs so long as the value of the log for processing in its sawmill exceeds the price it must pay to acquire that log. Thus, the processing division of the vertically integrated firm is operating in a manner fully equivalent to that of an independent sawmill regarding the quantity of lumber produced and any resulting exports to the United States. Any higher profits that the firm earns because of

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[39] In economics, this is the concept of "opportunity cost." See Appendix at 10.

the system of allocating stumpage rights are attributable to the logging division of the firm and do not affect the quantity of logs processed, the amount of lumber produced, or consequently, the export trade to the United States.[40]

The Commission agrees with the economic analysis contained in the Preliminary Determination that the alleged benefit resulting from lower stumpage fees, if it exists, would have no effect on the price of logs or lumber imported into the United States. The Preliminary Determination does not, however, follow through to state expressly what it necessarily implies, namely, that any stumpage price differential that may exist is not a subsidy to lumber producers and therefore does not warrant, as a matter of law or economics, the imposition of a countervailing duty on lumber imports.

We recognize that the Department concluded in the Carbon Steel cases that "benefits bestowed upon the manufacturers of an input do not flow down to the purchaser of that input if the sale is transacted at arm's-length."[41] The Commission agrees with the Department's approach in those cases that an assessment is required of the economic effects resulting from a benefit

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40/ It should be noted that the integrated firm may be able to enhance its profits to the extent that the integrated structure allows for increased efficiencies. Such efficiencies might arise, for example, from reduction of "transaction costs" due to the close association and coordinated management of the logging and sawmill operations. This profit, of course, is not related to the existence of the stumpage fee system and therefore has no bearing on the instant proceeding.

41/ Certain Carbon Steel Products from Belgium, et. al., 47 Fed. Reg. 39,304, 39,351 (Sept. 7, 1982).

conferred on a manufacturer of a product that is an input for the imported product examined in the countervailing duty proceeding. The Commission questions whether the presence of an arm's-length sale in the transaction is dispositive of whether an economic benefit passes from one stage of production to the next. The economic analysis of these issues generally is far more complicated than this. In the present case, however, it is clear that any benefit associated with lower stumpage fees, if it exists, will have no impact at later stages of production. Consequently, the Commission urges that the Department make an express finding on this point in the present proceeding, and hold that imported lumber does not benefit from a subsidy.

III. THE EVIDENCE AND ARGUMENTS OFFERED BY PETITIONER TO PROVE AN ALLEGED SUBSIDY ON STUMPAGE ARE THEORETICALLY FLAWED AND UNPERSUASIVE.

As discussed above, because the Canadian stumpage fee system does not affect the quantity or price of logs or lumber, it does not represent a subsidy. Hence, as the Preliminary Determination recognized, there is no basis for imposing countervailing duties on imported lumber. This conclusion is also compelled by an examination of the arguments advanced by Petitioner in support of a subsidy. As we discuss in this section, these arguments are both theoretically flawed and factually unsupported. They provide no basis to support a finding of subsidy.

A. Canadian, not United States, Market-Determined Prices for Stumpage Constitute the Appropriate Benchmark against which to Assess the Existence and Magnitude of the Claimed Subsidy.

The Petitioner's theory of subsidization is that Canada assumes a cost of producing lumber because Canadian lumber producers receive stumpage of greater value than the stumpage payment that they make in exchange. Petitioner's Brief at 16. Putting aside questions of the proper statutory construction of the term "assumption of" a cost, a problem inherent in Petitioner's theory is identifying the monetary value of the Canadian stumpage for comparison with the payments actually made. The Petitioner suggests, and we agree, that the appropriate benchmark for comparison is the amount that the stumpage would fetch in a free, commercial market.

Petitioner incorrectly asserts, however, that the relevant price is that which prevails in the "competitive United States

segment of the North American market."[42] The relevant market price instead is what the stumpage would bring in a competitive Canadian commercial market. The Department correctly resolved this issue in its Preliminary Determination by concluding that it is not reasonable to compare U.S. market prices for stumpage rights with payments for similar rights in Canada. This follows from the Petitioner's theory that the magnitude of a subsidy is the difference in value between what is given and received. The difference must be determined by reference to market-determined payments for stumpage rights in Canada, not in the United States.

Analogies to Commerce Department and judicial precedents relied on by Petitioner do not justify reference to United States prices as the commercial benchmark. The Department, for example, has decided that a foreign government's cash payments to reduce a materials cost is countervailable.[43] Since the cash amount

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42/ Petitioner's Brief at 25.

43/ See, e.g., Sodium Gluconate from the European Community, 46 Fed. Reg. 58,132 (November 30, 1981) (accepting a suspension agreement in which a foreign producer renounced E.C. cash payments); Dextrines from Corn Starch From the European Community, 45 Fed. Reg. 18,414 (March 21, 1980) (final determination that E.C. cash payments to a dextrines producer were a subsidy); Dextrines from Potato Starch from the European Community, 44 Fed. Reg. 75,135 (December 19, 1979); Lamb Meat from New Zealand, 46 Fed. Reg. 58,128, 58,130 (November 30, 1981) (preliminary) (terminated upon withdrawal of petition, 47 Fed. Reg. 1316 (January 12, 1982).

The Dextrines and Sodium Gluconate proceedings involved a government's cash payment to producers based on the quantity of a raw material purchased. In these cases, the foreign government provided a cash refund equal to the difference between the price "floor" and the lower competitive world price. While this lower world price was perhaps the European Community's motive for the payments, the Commerce Department did not undertake to measure world prices. It countervailed only against the amount of the payments and measured the subsidy on the amount of the cash payment allocated to the units produced.

could be the measure of the subsidy, however, those determinations were very simple and are not pertinent or useful to resolving the issue presented here.

In other circumstances involving the question whether a loan was made on terms "inconsistent with commercial considerations," 19 U.S.C. § 1677(5)(B)(i), the subsidy has been held to constitute the difference between the rate to the favored party versus the commercial market rate available to him.[44] In one of these cases the court looked to the lending rate available to a multinational tire producer in its home market rather than the rate available in Canada where the allegedly subsidized plant was constructed. This decision, however, does not support the use of United States prices as the commercial benchmark for stumpage

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44/ In Michelin Tire Corp. v. United States, ____ C.I.T. ____, (Slip. Op. 81-94) (October 26, 1981), the court upheld an affirmative subsidy determination, but remanded for recalculation of its value. It concluded that a loan from a Nova Scotia crown corporation at 6% interest for construction of a tire plant was preferential, and valued the subsidy as the difference between this rate and the rate Michelin would have paid a commercial lender in the lending market available to Michelin. Slip Op. at 14-20. Since Michelin could have borrowed at 7.56% in the Eurobond market, the 1.56% difference measured the subsidy. The subsidy calculation was not based on U.S. commercial lending rates.

In ASG Industries, Inc. v. United States, 82 Cust. Ct. 101, 107 (C.D. 4794) (1979), appeal dismissed, the Customs Court found a subsidy in three Italian regional development programs, consisting of (1) capital grants for new plants; (2) preferential financing at 7.5% (less than the 10.5% commercial financing then available in Italy); and (3) preferentially-reduced contributions to welfare organizations. Apart from the monetary grants, the alleged subsidies were preferential financing and reduced contributions, as measured by commercially-available lending rates or generally-imposed requirements of contribution in Italy. See also ASG Industries, Inc. v. United States, 610 F.2d 770 (C.C.P.A. 1979) (German Float Glass).

prices, because the two situations are factually quite different. The tire producer could borrow money in one country to build a plant in Canada; by contrast, a Canadian tree harvester could not shift his operation to the United States and begin cutting trees in this country to take advantage of United States stumpage prices, and remain a Canadian producer. The proper interpretation of these legal precedents is that the correct benchmark with which to identify and evaluate the magnitude of the alleged Canadian stumpage subsidy is the market-determined price in Canada for stumpage. As the following subsections demonstrate, the only proper use of United States prices in this proceeding would be as a surrogate for otherwise unestimable Canadian market-determined prices and, before such reference would be appropriate, certain adjustments to the prices are necessary to make the Canadian and United States data reasonably comparable.

B. Uncritical Reference to United States Stumpage Prices is Inappropriate Because it Does Not Account for the Principle of Comparative Advantage.

The Petition's rationale for suggesting that United States prices provide a valid proxy for Canadian market-determined prices is:

> Using data from U.S. sales to help determine true market value in Canada is appropriate because the softwood lumber, shake and shingle, and fence products made from stumpage in

> the two markets are sold into a common demand market. Product prices in this common demand market are the basis for which stumpage value is determined. Petition at 28.[45]

Because the stumpage prices differ on the average between the two countries, Petitioner concludes that there is subsidy in the amount of the difference.

Petitioner's argument, however, is theoretically flawed. The argument appears to be based on a variant of the "factor price equalization theorem," which states that, given a number of assumptions including the absence of transportation costs and the free flow of goods between nations, the factors of production that produce these goods will equalize in price, even if the factors of production themselves do not trade between nations. Petitioner apears to extend this theorem back through another stage of production and argue that not only will log prices equalize as a result of the free trade of lumber and other final products but also that stumpage fees, which are a factor in the production of logs, will equalize in price as well.

45/ The Petitioner also asserts that if North America were an unconstrained supply market for stumpage, the prices for stumpage would be consistent in the U.S. and Canada. Petition at 28. If by an "unconstrained supply market for stumpage" the Petitioner means that logs can trade freely between the United States and Canada and that as a consequence the price of logs (possibly adjusted for transportation costs) would equalize between the two nations and that this would tend, all other things being equal, to equalize stumpage fees in a competitive auction for stumpage, then the Petitioner's inference is valid. The Petitioner acknowledges, at 28, however, that the supply market is not unconstrained because Canada limits the export of logs to the United States.

The factor price equalization theorem requires a number of assumptions even when applied to a simplified two-commodity, two-country, two-factor world. In a world with more than two countries, goods, and factors, the assumptions required for the theorem to apply are more numerous, and less likely to occur. Here, in addition to logs, there are many factors that go into the production of lumber, including labor, various energy inputs, capital, and land. Under the economic theory advanced, there must be at least as many goods with equal prices as there are immobile factors of production in order to support any plausible assertions regarding equality in the prices of the factors.[46/] Given this fact, one cannot conclude that log prices are equalized between the United States and Canada and, with log price differences, one would also expect stumpage fee price differences.

In addition to the theoretical difficulties associated with Petitioner's argument, there appears to be no factual support for the assertions. The empirical test of Petitioner's theory[47/] is whether factor prices, especially log prices, equalize between the United States and Canada. Apparently, however, they do not. Data collected by the ITC staff reveal that log prices, adjusted for species and currency differences, are about 15 to 25

46/ Paul Samuelson was the most influential contributor to this literature. See A. Takayama, International Trade 552-575 (1972), for a textbook treatment of this literature. An important restriction in the many good-factor world is that there must be at least as many goods as there are factors.

47/ This is also a test of whether the factor price equalization theorem applies to these circumstances.

percent cheaper in Vancouver than in western Washington and Oregon.[48] This evidence therefore contradicts the predictions invited by Petitioner's theory, and should raise serious reservations whether the theory is validly applicable to this complex situation.

The difference in log prices is most likely explained by comparative advantage considerations. Economic theory suggests that a nation generally will have a comparative advantage in those products that intensively utilize those factors of production that it possesses in relative abundance.[49] For example, the Heckscher-Ohlin theorem of international economics states that a country will have a comparative advantage and export that product which utilizes the factor of production possessed in relative abundance, where relative abundance is measured by relative prices of the factors.[50]

48/ ITC 332 Report at 54, 55.

49/ See Bo Soderstern, International Economics 64-72 (1970). Of course, such factors would have to be relatively immobile (such as trees here) or else they would be transferred to their highest use.

50/ If relative abundance is measured in physical terms, then demand differences between the countries may result in a country importing the product that intensively utilizes the factor of production it possesses in abundance. Id. Although Petitioner asserts that the United States softwood lumber mills have a natural comparative advantage over Canadian mills (Petitioner's Brief at 2), it furnishes neither direct support for this proposition, nor offers a plausible framework of analysis from which such support may be drawn.

Assuming Canada is relatively more abundant in trees as a factor of production (where relative abundance might be measured by comparing harvestable trees per capita), then Canada should experience lower competitive market prices for logs and stumpage than the United States. Simply stated, if there is a much greater supply of trees in Canada, the market price of stumpage and logs should be lower.[51/]

The question remains, of course, how to adjust for comparative advantage considerations. If there is a segment of the Canadian market in which stumpage prices are determined by a competitive process (e.g., auction), then the Department could use sales in this market as a proxy for what Canadian market-determined stumpage prices would be on the lands currently under its appraisal system. With this proxy, the Department would avoid having to make adjustments to reflect comparative advantage. It would, however, remain necessary to make other adjustments (described in the following subsection), to account for other important differences.

If sales by competitive auction in Canada are too small to serve as the proxy, the Department would need to look to prices in another country and adjust, inter alia, for comparative advantage. In determining whether the United States is the best candidate for this purpose, the Department initially should

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51/ The Canadian export ban on logs would further tend to protect this comparative advantage and preserve it for Canadian sawmills. Lower prices for logs in Canada would imply that the marginal sawmill in Canada is less efficient than the marginal sawmill in the U.S.

evaluate the relative abundance of trees, e.g., trees per capita in the United States versus Canada. If these ratios are approximately equal for the two countries, comparative advantage adjustments may be unnecessary. However, if the ratios are significantly different, then the Department should consider whether another country would provide a better source for surrogate Canadian prices than the United States. Again, the adjustments identified below still would be required.

Thus, at a minimum, economic theory makes clear that fundamental comparative advantage considerations must be taken into account and adjustments made where appropriate. This approach is fully consistent with, and indeed necessary, in order to fulfill the purpose of the law being invoked. A countervailing duty should not be applied against, and consumers denied the benefits of, imports whose lower prices reflect another nation's comparative advantage.

C. Use of United States Stumpage Prices as a Surrogate for Canadian Market-Determined Prices Requires Adjustments to be Made Accounting for Differences Both in the Relative Value of Stumpage and in the Nature of the Stumpage Harvesting Rights Sold.

In considering prices from another country, adjustments must also be made for differences in value due to differences in the type of timber sold and in the nature of the rights granted. The market value of a plot of timberland depends on a host of variables, such as the species of timber, its density, its accessibility, its proximity to sawmills and markets, and the

difficulty of logging on the terrain. Petition at 24 note 1. In the United States, these factors are reflected in wide variations in competitive market prices paid for stumpage in different areas.[52] Even for the same species of tree, the market prices per thousand board feet of stumpage diverge widely. Moreover, the species mix in the United States Pacific Northwest tends to be more valuable than the species mix in British Columbia.[53] The Preliminary Determination recognizes the significance of these differences and, in the Commission's view, correctly concludes that appropriate adjustments to the data are necessary if cross-border stumpage price comparisons are to be made.[54] Of course, acquisition of all the necessary prices and costs for adjustments would be complicated and difficult.

52/ Petitioner furnished graphs showing that the average price for stumpage in western Washington and Oregon was bid up to the $400 per MBF level in 1979-1980, the average prices in eastern Washington and Oregon were under $200/MBF, in the Rocky Mountain area prices ranged from $25-75/MBF, in the south prices fluctuated from $100-200/MBF and in the eastern region prices were in the $25-50/MBF range. Joint Report at 16a-16f.

53/ ITC 332 Report at 51. The Report states:

> In general the species mix of the U.S. Pacific Northwest is considered more valuable than that of British Columbia. . . . Because of these and other differences, an adjustment of the average British Columbia prices must be made to put them on a comparable basis with U.S. figures.

54/ 48 Fed. Reg. 10,403-04. In addition, the Preliminary Determination observes that "it has been the Department's policy not to use cross-border comparisons in establishing commercial benchmarks." Id. at 10,403.

In addition to differences in the value of the stumpage itself, adjustments are necessary to account for differences in the nature of the stumpage harvesting rights that typically are granted in the United States and Canada. If anything, these differences are greater than the Preliminary Determination suggests.[55] For example, in the United States, along the Pacific Northwest coast, the Forest Service appraises stumpage on the basis of the value of the end-products estimated approximately at the date of sale, but the stumpage sale contracts authorize cutting during a term that may be as long as seven years.[56] In the northwestern United States east of the Cascade Mountains, the Forest Service includes an escalation clause in the stumpage contracts based on future lumber prices. The ITC staff concluded, however, that under the escalation clause, a purchaser can still realize "50 percent of any increase in timber value."[57]

By contrast, the British Columbia appraisal system, for example, adjusts for changes in end-product prices on a monthly basis.[58] Such adjustments are made if lumber prices change by $1 per cubic meter. In addition to the monthly adjustment, there

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55/ The Preliminary Determination's only observation on this specific point is that "in recent years prices in the U.S. have been bid anywhere between two and five years in advance of use, without having taken into account the decline in the housing industry." Id. at 10,404.

56/ ITC 332 Report at 43.

57/ Id. at 44 note 1.

58/ Id. at 48.

is a full reappraisal annually to reflect all changes in costs and prices.[59]

In the United States, a license operates more like a "futures" contract than does a Canadian license. In the United States, one buys the right to harvest timber over some period of time in the future for a price agreed upon today. Expectations about future prices thus are a crucial factor weighed in determining the price to offer for such a contract and stongly influence the market price. In Canada, however, one acquires the right to harvest timber according to a schedule and at a price that is adjusted over time to reflect the changing value of the timber. Risk and speculation are therefore considerably lower under the Canadian system, since one can profit (or lose) less from an increase (or decrease) in the value of timber.[60]

There is considerable evidence that United States stumpage fee prices were strongly influenced by inflationary expectations during 1977-1981; consequently, differences in the nature of the contracts probably had heightened impact during this period and account for at least part of the difference between stumpage

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[59] 48 Fed. Reg. 10,413.

[60] Given the variety and complexity of methods of awarding stumpage rights and assessing stumpage fees in the Canadian Provinces, it is possible that expectations about future timber prices affect current prices, but in a less significant manner than in the United States.

prices in the United States and Canada. [61] The evidence available, as detailed below, tends to support this conclusion.

First, in the Pacific Northwest area, reported bid prices escalated in the late 1970's to many times the appraised value of the timber under consideration.[62] The Forest Service, which administers the sales, concluded that this divergence between appraisal and market prices was due to purchasers' expectations of future trends:

61/ This conclusion is supported by the testimony of Mr. Westbrook, President of Cascade West Forest Products, given at the ITC staff conference in this proceeding. Tr. at 62. It also is acknowledged in the Petitioner's consultants' report. Petitioner's Joint Report at 15.

62/ The ITC Report of the Section 332 investigation furnished the following comparison of advertised prices (appraised values plus required road construction costs), with bid prices:

	Advertised $/MBF	Bid $/MBF	Ratio Bid to Advertised
1977	112.78	181.76	1.6
1978	120.13	214.95	1.8
1979	131.24	335.00	2.6
1980	99.42	350.46	3.5
1981	97.50	275.14	2.8

ITC 332 Report at 42.

The above ITC report reflects data through 1981 for the west side of U.S.F.S. Region 6 (Pacific Northwest). Although identical data is unavailable for 1982, a privately published report of bid and advertised prices in U.S.F.S. Region 6, west side sales indicates that the bid to advertised ratio declined further from 1981 to the period January through September 1982. Timber Data Co., Contract length Analysis, Survey, U.S.F.S., Region 6 West-Side NFS, Auction Sales. To the extent that inflationary expectations were reduced in 1981 and 1982, the decline in the bid to advertised price supports the position that these expectations influence market prices.

"Two principle causes have been a combination of the purchaser's expectations of a high level of housing starts (strong demand) and an expectation of continued high inflation rates (high prices). These expectations caused some purchasers to bid extremely high prices for longer term sales of 4, 5, or 6 years." 47 Fed. Reg. 2886 (January 20, 1982).

Second, comparisons of U.S. Forest Service bid prices and advertised prices (appraisal plus required road construction costs) that were submitted with the Petition indicate that the premium in bid prices over advertised values was much smaller in areas of the country outside the Pacific Northwest Coast. Petitioner's Joint Report at 16a-16f. Thus, where the Forest Service's sales mechanism -- *i.e.*, the inclusion of escalation clauses -- reduced the possibility of future profits, the competitive bid prices exceeded the advertised price by a considerably lower amount than in the Pacific Northwest.

In summary, United States and Canadian lumber producers are purchasing a different bundle of rights when they pay their respective stumpage fees. During an environment of inflationary expectations, such as those that characterized the 1977-1981 period, United States stumpage (of comparable quality and cost of production) would command a higher price in the market than would Canadian stumpage. If the Department were to use the United

States prices as a proxy for the Canadian market value of stumpage, it would be necessary to adjust the United States prices to ensure that the data are indeed comparable.[63]

CONCLUSION

This countervailing duty proceeding is exceptionally important. It not only involves potentially large duties on lumber that could impose significant costs on United States consumers, including the hard-pressed United States housing industry, but also rests upon a novel theory of subsidization that subsequently might be used against U.S. exports. For the reasons given above, the Commission urges the Commerce Department to determine that a subsidy exists if and only if it finds reasonably reliable evidence both that the Canadian government is undercharging for timber harvesting rights and that the "benefits" of this undercharge are passed through the various stages of production to reduce unfairly the price for imported lumber. If the Department finds that there is a subsidy on

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63/ In making this adjustment, it is also important that the Department use recent sales data. Petitioner's subsidy calculations are based on 1980 data. Even assuming *arguendo* the validity of Petitioner's averaging technique, these calculations suffer from the defect that stumpage prices in the United States have fallen dramatically since 1980. According to published reports by the U.S. Forest Service, the average price per thousand board feet for all softwood stumpage sold in National Forests has decreased from $205.17/MBF in 1979 to $58.80/MBF in the second quarter of 1982. U.S. Department of Agriculture, Forest Service, *Volume and Value of Low Timber Stumpage Sold from National Forests, By Selected Species and Region*, 1979 Calendar Year Report; 1982 Quarterly Report. Even under Petitioner's theory of the case, if there is a subsidy on 1983 imports, it should be measured on the basis of 1983 price comparisons.

lumber, it should use United States prices, if at all, only as a surrogate for the relevant Canadian market-determined prices. If this comparison becomes necessary, the Department should apply current data and adjust for differences in prices due to national differences in the values of the timber and of the harvesting rights granted.

These inquiries, although not simply accomplished, merit the Department's close attention. As the legislative history of the statute indicates, Congress intended that countervailing duties be imposed only against imports benefitting from an unfair competitive advantage bestowed on a foreign producer, thereby producing a trade distortion. United States consumers, such as the housing industry and home buyers, otherwise are entitled to the economic benefits of free and fair import trade.

By direction of the Commission.

Benjamin I. Berman
Acting Secretary

APPENDIX

ANALYSIS OF WHETHER ANY ALLEGED SUBSIDY TO CANADIAN TREE HARVESTERS IS PASSED THROUGH TO LUMBER PRODUCERS

by David G. Tarr

This appendix will show employing microeconomic analysis that, based on facts presented by the petitioner:

> Any benefits tree harvesters might accrue from the Canadian stumpage rights allocation system are not passed on to the lumber mills in the form of lower prices for logs and do not result in lower prices for lumber products sold in Canada or the United States. As such, the Canadian stumpage allocation system is not a subsidy to lumber mills.

The first section of this appendix will develop the facts upon which the analysis is based. These facts are derived from the petition. The second section derives the conclusion of this appendix from a graphical microeconomic analysis. The third section derives the same conclusion from a mathematical micro-economic model.

Factual Presentation

The principal subsidy which is alleged, by the petitioner, is that the Canadian forest products industry is allowed to cut timber on government owned lands at a fraction of the timber's actual market value. The manner in which timber is sold in the United States and Canada is described in detail in the expert's report submitted as part of Volume II of the petition.[1]

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[1] Resource Issues, Inc. and Mason, Bruce & Girard, Inc., "Joint Report Describing the Manner in Which Standing Timber is sold in the U.S. and Canada and Stumpage Prices Actually Paid," October 4, 1982, pp. 18-30. ("Joint Report")

For the purpose of assessing who receives a subsidy, if any, there are a number of essential features of the process described therein:

(1) The Canadian provinces, most importantly, British Columbia, Quebec, Ontario and Alberta, first determine through an administrative process which acreage to allot to tree harvesting and when to allocate licenses for that harvesting.[2]

(2) The right to cut timber from any such designated area is then also determined by an administrative process. These rights, known as stumpage rights, exist under a variety of names such as in British Columbia, tree farm licenses, forest licenses, timber licenses and timber sales. Petitioner states that these rights or licenses are awarded either free or at a minimal charge on criteria clearly other than profit maximization by the provinces.[3] The tree harvester then submits a plan for harvesting his acreage (or possibly the license itself stipulates a harvest plan) to the appropriate provincial officials; once the plan is approved he is free to cut within the limits of the plan.[4]

(3) The price which the harvesting company is charged for timber at the time it is harvested (the stumpage price or stumpage fee) is based, according to the petition, on a stumpage appraisal system such as the "Rothery" system used in British Columbia.[5] The Rothery system is a residual value appraisal system where the costs of producing lumber plus a normal profit are subtracted from the value of the lumber to determine the stumpage

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2 The provinces continue to own the land.

3 See Joint Report, p. 19.

4 See "Countervailing Duty Questionnaire, Appendix II, Province of British Columbia, pp. 3-7. With "tree farm licenses" he must cut within ± 10% over a five year basis.

5 We are focusing of the Rothery appraisal system, which is prevalent in British Columbia, because this was the focus of the petition and because British Columbia accounts for approximately 68% of the lumber exports to the U.S. Other provinces, may employ different systems, but these systems would be expected to have analogous effects on price, quantity and rent disposition.

fee for the timber in question. It is not a fee determined at a competitive auction. The petitioner alleges that competitive auctions more often characterize the stumpage price determination process in the United States and that competitive auctions would yield much higher prices for stumpage in Canada.

These appear to be the essential features of the Canadian tree allocation process as alleged by the petitioner. For the sake of the argument below, it is assumed that these facts are true.

What is at issue as far as the petitioner is concerned is that the lack of an auction for stumpage prices conveys a subsidy to Canadian lumber interests. The subsidy is said to equal the difference between a competitively determined auction price for trees and the appraised price actually paid. Employing microeconomic theory, however, it follows from the three facts above that any benefits that tree harvesters capture from below market stumpage fees are not passed along to the lumber mills in the form of lower prices for logs and consequently also do not result in lower lumber prices.

Graphical Economic Analysis of the Canadian Log Market

One of the most fundamental principles of economics is that the equilibrium price that prevails in the market is that price which results in equality between the quantity demanded and the quantity supplied. This is said to be the market clearing price.[6]

The demand for harvested trees (or logs) from provincial and other lands derives primarily from mills, both vertically integrated and nonintegrated, which produce wood products but also

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[6] See Paul Samuelson, Economics, 8th edition, p. 61; and Armen Alchian and William Allen, Exchange and Production: Theory in Use, 1969, pp. 86-87.

from pulp and paper mills and other industries to a lesser extent. The demand curve or demand schedule may safely be assumed to have its usual downward sloping character.[7]

The supply of logs from provincial lands, however, is specified by facts (1) and (2) above. Most importantly, the method by which stumpage prices are determined does not influence the quantity of trees the Provinces make available for cutting. That quantity is administratively determined by the provinces.

The situation described is depicted in Figure I. DD represents the demand curve for provincial logs by (both vertically integrated and nonintegrated) sawmills. MC is the aggregate of all tree harvesters marginal costs of harvesting logs,[8] not including stumpage fees. The marginal costs of harvesting less stumpage fees are the costs of labor, capital and other non-stumpage factors of production necessary to access and cut trees and deliver logs to buyers. It is usesful to understand why the marginal cost of harvesting increases with the quantity of logs. Not all parcels of land available for tree harvesting are equally accessible or valuable. Initially the easiest trees to access or most valuable could be selected, but only less accessible or valuable logs would become available as more logs are cut.[9] In

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7 See Samuelson, p. 60, ftn. 1.

8 It is drawn upward sloping, since progressively less accessible and more costly logs are available after the most accessible and cheapest logs are cut.

9 Not all logs are homogeneous in quality; different species of trees sell for different prices. A tree harvester may have to sell two logs of one variety in order to obtain the same revenue as one log of a more highly valued species. If we measure

(footnote continued on next page)

FIGURE I

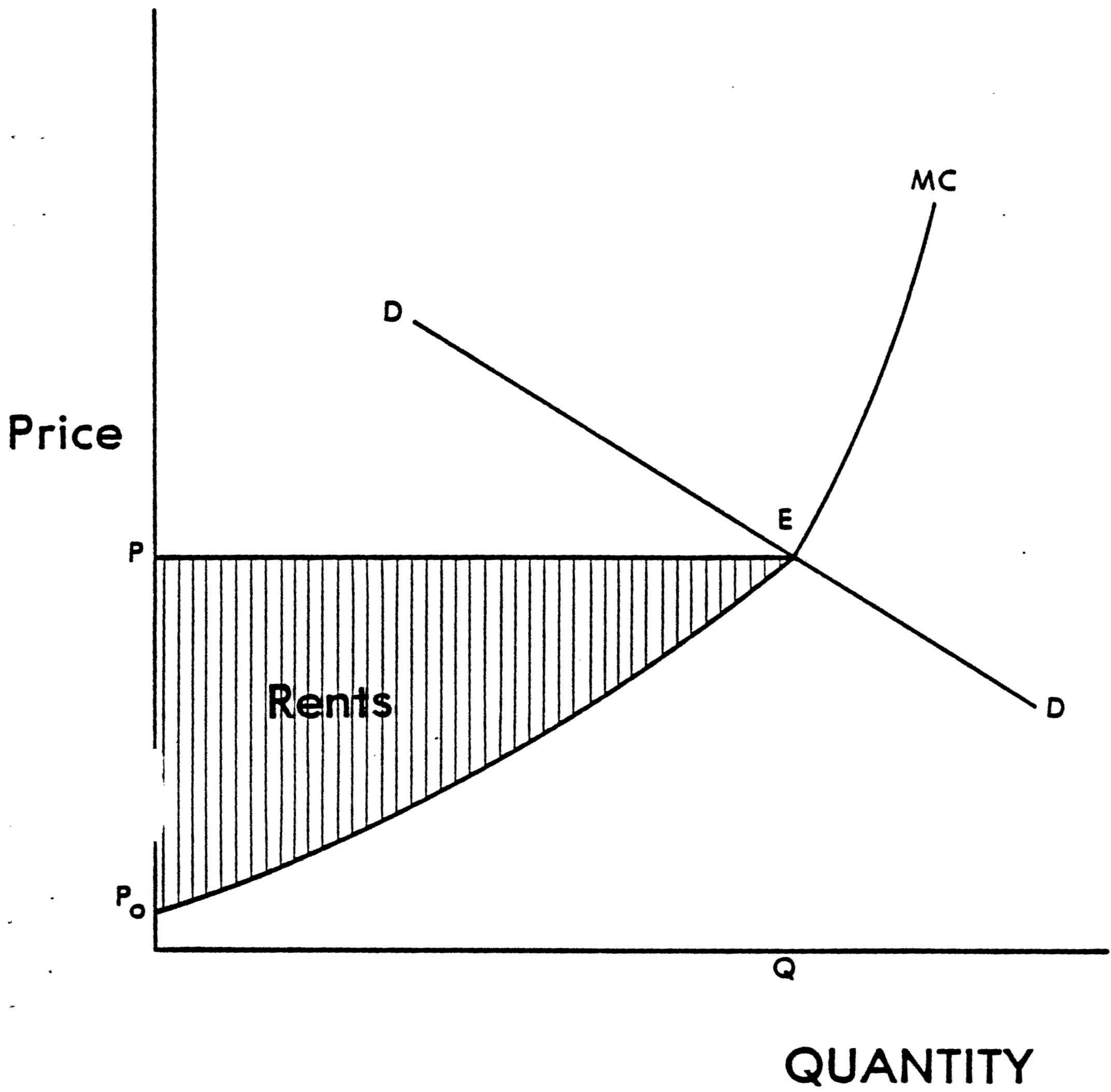

Figure I, MC, the industry long-run marginal cost curve not including stumpage fees, is drawn.[10] Depending on how much stumpage fees are, considerable intra-marginal rents may be captured by the Canadian tree harvesters.

First, consider the extreme of zero stumpage fees, that is the timber is given away for nothing by the provinces. In this event, the marginal costs of harvesting less stumpage fees are the only costs; so the MC curve is clearly the industry supply curve.[11] Then the equilibrium price and quantity are labelled P and Q where industry supply = MC = DD. The amount of rents (all intramarginal) captured by the tree harvesters would equal the area P_0PE.

Second, consider the outcome if stumpage fees for each separate parcel of harvestable timber where determined by a competitive auction. In this case an individual firm would be

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(footnote continued from preceding page)

quantity in quality adjusted units or "efficiency units" (as is necessary to refer to a homogeneous product "logs"), then the marginal costs of producing logs will increase as quantity increases in part because all other things equal the higher quality species would be taken first.

10 Since the contract period for stumpage rights generally extends over a five years or more, a long-run model appears preferable.

11 For an explanation of why the long-run marginal cost curve for a competitive industry is the long-run industry supply curve see Henderson and Quandt, Microeconomic Theory, 1971, pp. 71-79 or the mathematical section of this appendix.

willing to bid an amount on a particular parcel up to but not exceeding the price it could obtain for the logs less its marginal costs excluding stumpage, i.e. P-MC. This is the amount of rent on any particular parcel. As long as firms in a competitive market could obtain a parcel of timber for less than the rent on that parcel, some firms would be interested in bidding on it; we would expect a competitive auction to drive up the price of timber until the provinces captured all the rents. This system is equivalent to what economists refer to as a "perfectly discriminatory" fee system.[12]

Most importantly, for this discussion, we would also expect firms to continue to bid on all timber for which some rent is possible. Since some positive rent is available on all parcels until the price of logs P equals the marginal harvesting costs, expansion of output should occur to Q. That is, the competitive auction for stumpage results in the same output and price of logs as does zero stumpage fees.

<u>Third</u>, consider the "Rothery" residual value appraisal system (explained in fact (3) above). It is alleged by the petitioner that through this system the provinces fail to capture the full rent on timber. Since this system adjusts the fee in accordance with the costs of producing the logs, in principle the fee is some proportion of the difference between price and marginal cost. That is, the fee is, for any small parcel of timber, u(P-MC(Q)) where $0 \leq u \leq 1$. The fee could not be greater that P-MC, i.e. not greater

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12 See Henderson and Quardt, <u>Microeconomic Theory</u>, 1971, pp. 217, 218.

than the full rents, or no one would agree to log the timberland. In any event, the petitioner is not alleging that the Rothery system over-appraises, i.e. $u > 1$ is not at issue. If $u = 1$ the provinces collect all the rents; if $u = 0$ the provinces give away the stumpage. In between these extremes, the provinces allow the tree harvesters some of the rents that they would capture under competition and it is alleged that this situation, with $u < 1$ occurs. But analogous to the argument made under the competitive auction system, we would expect firms to continue to pay fees on parcels of timberland and harvest trees until P=MC; firms can earn positive rents up to this point. Thus, this in between case also results in the same price P and quantity $\dot{Q}$ as the previous two cases.

It should be observed that in this case if $u = 1$, i.e. the Rothery system of the provinces extracts all the rents, the price remains at P, and the quantity at Q. With $u = 1$, the Rothery system would be fully equivalent to the competitive system as far as rent disposition as well.

The crucial deduction from this analysis is that the stumpage fee system only determines the disposition of the rents between the provinces and the tree harvesters. The price at which logs trade, however, (P in the diagram) is totally independent of the stumpage fee system. That, naturally, is determined by the intersection of the supply and demand schedules. Even if the Canadian provinces set the stumpage fees at zero, the rents are captured at the tree harvesting stage of production and the sawmills receive absolutely no benefits from that government action. That is, the other extreme

of either a competitive auction or a "perfectly discriminatory" Rothery stumpage fee system (where u = 1) which allows no rents for tree harvesters (or something in between), still yields the same price for logs to the sawmills. An intermediate Rothery appraisal system, i.e. $0 < u < 1$, allows the tree harvesters to capture some but not all of the intramarginal rents (equal to P_0PE), but does not affect the equilibrium price and quantity. Thus, any subsidy through the stumpage fee system which may convey to tree harvesters is not passed along to the sawmills and therefore does not affect the price of wood products sold in the U.S.

There exist stumpage fee systems, which are not at issue in this proceeding, that would, compared with a competitive auction, result in a <u>negative</u> benefit pass-through to the lumber producers, i.e. that would result in <u>higher</u> prices for logs and <u>fewer</u> logs produced than would a competitive auction for timberland.[13] Since under such systems lumber producers must pay higher prices for logs than they would under a competitive market determined fee system, such systems impose costs on lumber producers rather than convey benefits. Thus such systems are not countervailable.[14]

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[13] In particular, if the provinces charge \$x per harvested log as a stumpage fee, then the supply curve would be the marginal cost of harvesting plus \$x, i.e. it would be a curve parallel to MC but above and to the left. It would intersect the demand curve at a <u>higher</u> price and lower quantity than the P and Q determined by the competitive auction or the Rothery system. A change in the fee from \$x to \$y will change the equilibrium price and the negative pass-through, but the sawmills are worse off with either fee than they would be with a competitive auction.

[14] The essence of the way such systems affect price and quantity is that they require a fee on marginal timberland in excess of its rent.

Vertical Integration

The conclusion that no subsidies are conveyed to the sawmills is not altered even if the tree harvester and the sawmill are part of the same company (vertically integrated). The company incurs an "opportunity cost" when it decides to use logs in its own sawmill. That opportunity cost is the price it could receive by selling the logs on the open market to an independent sawmill. Thus the true cost to the sawmill of using logs produced by the tree harvesting division of its own company is the price the logs could obtain when sold to an independent sawmill.[15]

Conclusion

If the demand for logs were significantly lower, intersecting the MC curve farther to the left, both the price of logs to the mills and the area of possible rent disposition would be significantly lower. The principles just described, however, remain unchanged. In particular, there would still be an area of possible rent capture by Canadian tree harvesters which would depend on how the stumpage fees were set. The price at which logs sell, however, would again be independent of the stumpage fee system.

The source of the petitioner's confusion may be illustrated by the following consideration. If the demand for logs shifts up or down then the price of logs rises or falls, respectively. The

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15 Samuelson (p. 449) states: "... some of the most important costs attributible to doing one thing rather than another stem from the forgone opportunities that have to be sacrificed in doing this one thing.... For these reasons, full competitive cost intimately involves _opportunity cost_."

area of possible rent disposition also increases or decreases respectively. That is, as demand shifts, price changes and possible rents change. Rents, however, are not a necessary cost that must be passed along in determining price.[16] To the vertically integrated firm in the United States who through an auctioning process pays any rents on trees, it may appear as a cost which must be passed on. But in this sense intramarginal rents are analogous to "pure" rents to which Samuelson (p. 539) refers:

> But at this point we must avoid our old enemy "the fallacy of composition." What appears as a cost of production to each and every small firm using a particular kind of land (tree) may, as we have seen, be to the whole community merely a derived price determined rent expense rather than a price-determining one. More than that, suppose the land is (trees are) specialized and can be used only for the production of one industry. If a grade of land (type of tree) is inelastically supplied to one industry and, having no place else to go, will always work for whatever it can earn there, its return may appear to every small firm as a cost like any other. But as scientific observers of the whole industry, we still must recognize that the land (tree) return is a price-determined rent and not a price-determining cost.

In summary, the price of wood products and logs determines the amount of rents that might be captured by tree harvesters if the stumpage fees are set too low. But regarding subsidies, it doesn't make any difference what the stumpage fees are, since

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[16] These rents (intramarginal) are equal to the area between the new price and the MC curve.

these only influence the distribution of the rents between the provinces and the tree harvesters and they do not affect the price of logs or wood products.

Model of Price and Quantity Determination for Canadian Logs Under Different Stumpage Fee Structures

Let $S_i(p)$ = the i-th firm's supply curve of logs, $S(p)$ = the industry supply curve of logs, $D(p)$ = the industry demand for logs and n = the number of firms in the market. Then we have:

(1) $\sum_{i=1}^{n} S_i(p) = S(p)$ and

(2) $D(p) = S(p)$

That is, equation (1) states the industry supply curve is the aggregate of the individual firm's supply curves; equation (2) states that the quantity demanded and the quantity supplied must be equal for equilbrium.

$D(p)$, the demand for logs, is not alleged to be affected by the stumpage fee system. What is at issue is how the fee system affects supply.

To determine this it is necessary to consider the individual firm and how its supply $S_i(p)$ is affected by different fee structures.

Let I_i = profits of the i-th firm; Q_i = quantity produced of the i-th firm; $C_i(Q_i)$ = total long-run costs to the i-th firm of producing Q_i, not including stumpage fees (where $C_i(0) = 0$

since costs are long-run)[16] and $F_i(Q_i)$ = stumpage fees of the i-th firm of cutting Q_i units. Then profits equal total revenues minus total costs:

$$(3) \quad I_i = pQ_i - C_i(Q_i) - F_i(Q_i)$$

where for a competitive firm p is treated as a constant (with 46 pages of firms listed by petitioner this appears reasonable) and $C_i(Q_i) + F_i(Q_i)$ equals total costs.

The individual firm wishes to maximize profits. It therefore sets:

$$(4) \quad I_i'(Q_i) = p - C_i'(Q_i) - F_i'(Q_i) = 0 \qquad i = 1, \ldots, n$$

with

$I_i''(Q_i) < 0$ to assure a maximium, where $f'(x)$ is used to denote the first derivative of the function $f(x)$ with respect to x.

From (4) the amount of fees that a competitive firm would be willing to bid on a particular parcel of timberland can be derived.

(4) implies:

$$(5) \quad p = C'(Q) + F'(Q) \qquad \text{for all firms.}$$ [17]

With the convexity assumptions of the previous sections, that $p > C'(Q)$ for all $Q \leq Q^*$ where $C'(Q^*) = p$, (5) states that the firm

[16] No generality is lost by this assumption, but it avoids a constant in the calculations.

[17] The subscript i has been suppressed for notational simplicity.

should bid on any small parcel of timberland up to the point where the price of logs equals the marginal harvesting costs plus the marginal stumpage fees.

Utilizing (5) it is possible to determine how much firms in competition would bid for the timberland. As long as the stumpage fees from an additional parcel of timberland are less than the rents a firm can earn on it, it would be interested in acquiring that parcel. That is, if a firm is producing at Q_o, where $p > C'(Q_o)$, then

$$(6) \quad \int_{Q_o}^{Q_o+\Delta Q} [p-C'(Q)]dQ$$

is the maximum amount a firm would bid for the parcel ΔQ. A firm would not pay more than this amount, since the stumpage fees would then exceed its marginal profit on that parcel. Similarly, the aggregate maximum amount of stumpage fees a firm would pay, for all of its timberland on which it produces Q units of logs is equal to:

$$(7) \quad \int_0^Q [p-C'(Q)]dQ = F(Q)$$

for $\quad Q \leq Q^*$ where $C'(Q^*) = p$

But competition from other efficient firms would drive the fees up such that firms would not be able to obtain its aggregate timberland for less than (7). Thus $\int_0^Q [p-C'(Q)]dQ$ would be the fees for a competitive firm with sufficient equally efficient competitors. If a firm had a slight efficiency edge on its competitors then it would be able to obtain its timberland for some amount slightly less than (7) since it's competitors would not offer quite as much.

Then:

$$(8) \quad u \int_0^Q [p-C'(Q)]dQ = F(Q) \qquad \text{with } 0 \leq u < 1$$

is the amount it would pay for stumpage fees.

Utilizing (8) we can return to (4) and determine the individual firm's optimal Q and its supply function. The fees are: $F(Q) = u \int_0^Q p dQ - u \int_0^Q C'(Q)dQ$

and

$$(9) \quad F'(Q) = up - uC'(Q)^{18} = u[p - C'(Q)].$$

Then (4) becomes:

$$(1-u)[p-C'(Q)] = 0$$

or

$$(4') \quad p-C'(Q) = 0 \quad \text{for } u < 1 \qquad \text{for all firms.}$$

<u>Under a competitive stumpage fee system the firm produces up to the point where the marginal harvesting costs equals price</u>. The firm's supply function is determined from (4'); given any p, the firm produces the Q that satisfies (4'). The i-th firm's supply function is the inverse function of its marginal cost function:

$$S_i(p) = C_i'^{-1}(p)$$

This is the competitive benchmark. With this analysis in mind, comparison with the Rothery system is relatively straightforward. The Rothery residual value method adjusts the fees in accordance with the marginal costs of producing logs from a particular

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[18] Refer to Taylor and Mann, <u>Advanced Calculus</u>, 2nd edition, 1972, pp. 579-580 for differentiation of an integral with respect to the upper limit of intergration.

parcel, but it is alleged that it allows considerable rents to be captured by harvesters. Accordingly, it is described by:

$$(10) \quad u \int_{Q_0}^{Q_0+\Delta Q} [p-C'(Q)]dQ$$

for any particular parcel Q where $0 \leq u \leq 1$ and u is alleged by petitioners to be considerably less than unity. The firm's aggregate fees are:

$$(11) \quad u \int_0^Q [p-C'(Q)]dQ = F(Q)$$

for $Q \leq Q^*$ where $C'(Q^*) = p$.

For the individual firm attempting to maximize profits under the Rothery system, equation (4) applies. Differentiate (11) with respect to Q and obtain an equation analogous to (9):

$$(12) \quad F'(Q) = u[p-C'(Q)]$$

Substitute (12) into (4) and obtain:

$$(1-u)[p-C'(Q)] = 0$$

or

$$(4'') \quad p-C'(Q) = 0 \qquad \text{for } 0 \leq u < 1 \text{ for all firms.}$$

(4") is the identical equation as (4'). Thus provided the stumpage fees are not fully extracted, i.e., u = 1, <u>under the Rothery system the firm will expand output until price equals marginal harvesting costs</u>. Also analogously, the firm's supply function is the inverse function of its marginal cost function:

$$S_i(p) = C_i'^{-1}(p) \quad i = 1, \ldots, n.$$

The key conclusion here is that u, the share of the rents captured by the provinces, does not effect the firm's or the industry supply curve. This is true even when $u = 0$, i.e., all rents go to the firms and none to the provinces.

The Rothery and competitive auction system yield the same industry output and price for logs. The Rothery system allows a transfer of rents (equal to $(1-u)\int_0^Q[p-C'(Q)]dQ$) from the provinces to the tree harvesters, that under a competitive system would be captured by the provinces. But any rent capture by the tree harvesters is not passed through to the sawmills in the form of lower prices for logs.

It is this latter fact that forms the basis of the Samuelson quote in the previous section and in the body of the brief. The rents are costs to the individual firms. They are not, however, passed on because the rents are a residual determined by the price and quantity. They do not help determine price and quantity.

CERTIFICATE OF SERVICE

I hereby certify that on this 12th day of June 1986, I have served the foregoing brief by causing the original and 14 copies to be hand-delivered to the Secretary of the Commission and a copy to be mailed first class, postage prepaid to the following:

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