UNITED STATES – MEASURES AFFECTING THE PRODUCTION AND SALE OF CLOVE CIGARETTES: RECOURSE TO ARTICLE 22.6 OF THE DSU

(DS406)

Responses of the United States of America
to the Questions by the Arbitrator
in Advance of the Substantive Meeting with the Parties

March 11, 2014

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1 COMPLIANCE WITH DSB RECOMMENDATIONS AND RULINGS - GENERAL ISSUES

1.1 Question for the United States

1. With respect to the allocation of the burden of proof in these proceedings:

(a) Does the United States agree that, in an Article 22.6 proceeding, the responding Member bears the burden of proving that the level of suspension of concessions requested by the complaining Member is not equivalent to the level of nullification or impairment of benefits accruing to it? (Indonesia's First Written Submission, para. 35)

1. The United States agrees that it carries the burden to establish a *prima facie* case that Indonesia's proposed level of suspension of concessions is not equivalent to the level of any nullification or impairment of benefits accruing to Indonesia. It would then be up to Indonesia to provide sufficient evidence and argument to rebut that case.[1]

(b) If the United States agrees that it carries the burden of proof in these Article 22.6 proceedings, does that extend to the issue of whether the United States has implemented the recommendations and rulings of the DSB?

2. The Appellate Body has recognized that the burden of proof rests with the party who asserts the affirmative of a particular claim or defense, [2] and that as a general matter, the Member asserting a WTO-inconsistency bears the burden of proof. [3] In this proceeding, the United States claims that the level of suspension proposed by Indonesia – $42.9 million – is not equivalent to the level of any nullification or impairment of the benefits accruing to Indonesia under the *Agreement on Technical Barriers to Trade* ("TBT Agreement"). If the Arbitrator finds that the United States has established a *prima facie* case and Indonesia has not rebutted that case, the U.S. objection would be established, and the Arbitrator would then need to calculate the accurate level of nullification or impairment. In the context of this determination, it would be up to each party to substantiate its position with respect to that determination.

3. The United States submits that, in fact, Indonesia's benefits under the TBT Agreement are not being nullified or impaired at all. First, the United States has taken measures that result in compliance with the recommendations and rulings of the DSB; second, the level of exports of clove cigarettes from Indonesia would not increase under any reasonable compliance scenario

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[1] *EC – Hormones (US) (Article 22.6 – EC)*, para. 9.

[2] *US – Wool Shirts and Blouses (AB)*, p. 14 ("[I]t is a generally accepted canon of evidence in civil law, common law and, in fact, most jurisdictions, that the burden of proof rests upon the party, whether complaining or defending, who asserts the affirmative of a particular claim or defence. If that party adduces evidence sufficient to raise a presumption that what is claimed is true, the burden then shifts to the other party, who will fail unless it adduces sufficient evidence to rebut the presumption."); *US – FSC (Article 22.6 – US)*, para. 2.11.

[3] *EC – Hormones (US) (Article 22.6 – EC)*, para. 9.

because the United States would not take a measure contrary to its public health objective; and, third, the level of exports of clove cigarettes from Indonesia would not increase even under an *unreasonable* compliance scenario, such as a scenario assuming that clove cigarettes are permitted in the U.S. market. This is because Indonesian exporters are already meeting the demand in the clove tobacco product market by marketing and distributing essentially the same product as clove cigars.

4. Therefore, on any one of these bases, the United States has met its burden of showing, in the first instance, that Indonesia's proposed level of suspension is not equivalent to the level of any nullification or impairment. Indonesia's submissions have made apparent an additional reason that the Arbitrator need not make a determination concerning U.S. compliance in order to conclude that Indonesia's proposed level of suspension of $42.9 million is not equivalent to the level of any nullification or impairment – Indonesia's misguided "multiplier" effect. If the Arbitrator considers that the level of nullification or impairment is not based on a so-called "multiplier" effect, then the Arbitrator would have found Indonesia's proposed level of suspension (which Indonesia has revealed relies on a "multiplier" effect) *not* to be equivalent to the level of any nullification or impairment. On this basis, the United States would also have met its burden, and it would then be up to each party to substantiate its position on the correct level.

1.2 Question for Indonesia

2. At paragraph 57 of its First Written Submission, the United States refers to the statement by the panel in US – Gambling (Antigua and Barbuda) that compliance "could conceivably be achieved through changes to the factual or legal background to a measure at issue, without a change to the text of the measure itself." Does Indonesia agree that there are situations in which a WTO-inconsistent measure could be brought into conformity with DSB recommendations and rulings without a Member withdrawing or modifying that measure?

2 COMPLIANCE WITH DSB RECOMMENDATIONS AND RULINGS – ARTICLE 2.1 OF THE TBT AGREEMENT

2.1 Questions for the United States

3. At paragraph 2 of its First Written Submission, the United States submits that it "has complied by undertaking a new, comprehensive evaluation of the public health effects of menthol cigarettes, resulting in new findings (unavailable during the original proceeding) that demonstrate a distinction between the products that the Appellate Body erroneously assumed did not exist".

(a) How does the United States respond to Indonesia's argument that an arbitration under Article 22.6 "is not an opportunity for a Member to re-litigate the underlying facts of the Panel or Appellate Body determinations"? (Indonesia's First Written Submission, paras. 34, 43-55)

5. Indonesia is incorrect that the United States seeks to re-litigate the underlying facts in this dispute. The United States has taken several measures to implement the recommendations and rulings of the DSB, and the question for the Arbitrator is whether the U.S. measures – including, and taken together – Section 907(a)(1)(A); the adoption of new findings in the FDA Menthol Report; the issuance of an Advanced Notice of Public Rulemaking (ANPRM) concerning menthol cigarettes; and public education initiatives that reduce the use of menthol cigarettes – are consistent with the treatment of flavored and menthol cigarettes required under Article 2.1 of the TBT Agreement.

6. Indonesia insists that the *only* way for the United States to implement the recommendations and rulings of the DSB is to remove Section 907(a)(1)(A). This is incorrect. The Appellate Body reasoned, and the DSB consequently found, that even if Section 907(a)(1)(A) results in a detrimental impact on the competitive conditions of Indonesian clove cigarettes compared to domestic menthol cigarettes, the measure is nevertheless consistent with Article 2.1 if the detrimental impact stems exclusively from legitimate regulatory distinctions.[4] Therefore, to comply, the United States is required to ensure that any detriment to the competitive conditions of Indonesian clove cigarettes stems exclusively from legitimate regulatory distinctions, and not for other reasons. It is not "re-litigating" underlying facts to determine whether subsequent actions mean that Section 907(a)(1)(A) is now in conformity with the TBT Agreement, and in particular that the United States has addressed the DSB's finding that the regulatory basis for taking a different regulatory approach to clove cigarettes than to menthol cigarettes was inadequate.

(b) With respect to the statement that the FDA's July 2013 Menthol Report contains "new" findings which were "unavailable during the original proceeding", please clarify the following:

(i) As a legal matter, please explain whether and if so why it is legally relevant if the FDA's 2013 Menthol Report contains "new" findings that were "not available" during the original proceeding? Is it the United States' view that the Arbitrator can revisit the question of whether Section 907(a)(1)(A) is consistent with Article 2.1 of the TBT Agreement provided there is "new" information which was not available during the original proceeding, but that it could not revisit this question based on the same information that was already before the panel and the Appellate Body in the original proceeding? In other words, is it the United States' view that DSB recommendations and rulings must be treated as fixed and final, except insofar as a party can adduce new information and evidence that was not available to the panel and/or the Appellate Body in the original proceeding? If so, what is the basis for this distinction?

[4] *US – Clove Cigarettes (AB)*, para. 225; U.S. First Written Submission, paras. 70-71.

7. As an initial matter, the DSB recommendations and rulings in this dispute are taken as a given. And as the Appellate Body has explained, "The DSB recommendations and rulings from the original proceedings remain in effect" until the Member concerned "brings itself into substantive compliance."[5]

8. And those DSB recommendations and rulings have called on the United States to bring its measure into conformity. As past arbitrators, panels, and the Appellate Body have recognized, a Member "generally has the discretion to determine the means through which it will comply with adverse DSB rulings, provided that such measures are consistent with the covered agreements."[6] In this dispute, one option for doing so is to ensure that any detrimental impact on imports stems exclusively from legitimate regulatory distinctions. And one means to ensure this is to review the basis for those distinctions, including seeking evidence and making relevant determinations.

9. In this way, the means for compliance is similar to the means for compliance in situations where the basis for a measure has been found to be deficient, for example due to the lack of a risk assessment in the case of a finding of a breach under Article 5.1 of the *Agreement on the Application of Sanitary and Phytosanitary Measures* (SPS Agreement) or the lack of an adequate explanation or appropriate factual findings in the case of a finding of a breach with respect to the *Agreement on Implementing Article VI of the General Agreement on Tariffs and Trade 1994* (AD Agreement) or the *Agreement on Subsidies and Countervailing Measures* (SCM Agreement). There have been a number of instances in which a WTO panel has been called to examine compliance with these types of recommendations and rulings.

10. For example, in *US – Oil Country Tubular Goods Sunset Reviews (Article 21.5 – Argentina)* , the Appellate Body determined that the United States could bring its measure into compliance with the AD Agreement concerning an anti-dumping determination by providing a new evidentiary basis, even though the applicable duty rate did not change. The Appellate Body stated:

> The requirement in Article 19.1, first sentence, to "bring the measure into conformity" does not indicate that the choice of means of implementation is confined to withdrawal of the measure that was found to be WTO inconsistent. Article 19.1, second sentence, confers authority on panels and the Appellate Body to suggest "ways in which the Member concerned could implement the recommendations", which implies that several "ways" of implementation may be

[5] *EC – Bananas III (Article 21.5 – US) (AB)*, para. 273. Of course, this also means that there are situations where some or all of the original DSB recommendations and rulings could no longer be in effect, for example a Member has complied in whole or in part. The determination of compliance could, for example, be by agreement of the parties or by means of subsequent DSB rulings pursuant to a proceeding under Article 21.5 of the DSU, or by an arbitrator as contemplated in Article 23.2(c) of the DSU.

[6] *US – Gambling (Article 22.6 – US)*, para. 3.24; *Australia – Salmon (Article 21.3(c))*, para. 30; *Korea – Alcoholic Beverages (Article 21.3 (c))*, para. 45.

> possible. The obligation under Article 21.3 that the Member concerned "inform the DSB of its *intentions* in respect of implementation" also suggests that alternative means of implementation may exist and that the choice belongs, in principle, to the Member. This implies that an investigating authority would not seem to be precluded from gathering additional facts relating to the review period in order to implement the recommendations.[7]

11. In a similar example concerning a U.S. countervailing duty deemed inconsistent with certain provisions of the SCM Agreement, an Article 21.5 panel agreed that the United States brought its measure into compliance by adjusting an aspect of its subsidy calculation, even though the new calculation did not change the resulting determination.[8]

12. In no instance has a panel found that it is "re-litigating" the DSB recommendations and rulings to examine the new determination or other basis for the measure that the Member concerned considers to bring the measure into compliance. Nor has a panel found that it is precluded from examining the new determination or other basis due to the underlying DSB recommendations and rulings. In fact, it would be expected that the Member concerned would consider as one option for compliance ensuring that whatever deficiency had been found in the basis for its measure is cured such that the measure is no longer inconsistent with the relevant provision. In this instance, the United States may implement the recommendations and rulings of the DSB by presenting subsequent further analysis by public health authorities relevant to the treatment of products at issue that demonstrates that any remaining detriment to the competitive conditions for clove cigarettes compared to menthol cigarettes stems exclusively from a legitimate regulatory distinction.

13. Thus, as a legal matter, it is appropriate for the Arbitrator to consider subsequent scientific findings from U.S. public health regulators that bear upon the question of whether there is a legitimate regulatory distinction between menthol cigarettes and clove cigarettes.

14. We recall that the DSB found that Section 907(a)(1)(A) is inconsistent with the TBT Agreement because the detrimental impact on the competitive conditions for clove cigarettes did not appear to stem exclusively from a legitimate regulatory distinction.[9] The Appellate Body

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[7] *US – Oil Country Tubular Goods Sunset Reviews (Article 21.5 – Argentina)(AB)*, para. 173.

[8] *US – Countervailing Measures on Certain EC Products (Article 21.5 – EC)*, paras. 7.157-7.171. Specifically, in this dispute, the panel found that the United States had taken a measure to comply with the SCM Agreement with respect to the calculation of a subsidy determination on Certain Corrosion-Resistant Carbon Steel Flat Products from France because the United States applied a different methodology to assess privatization – even though the new methodology did not change the resulting subsidy determination or reduce the applicable countervailing duty rate, and thus did not change the treatment accorded to the product at issue. *See also Australia – Salmon (Article 21.5 – Canada)*, paras. 7.91, 7.93 (determining that Australia brought its measure into conformity with the SPS Agreement by providing a new risk assessment that was not available during the original proceeding to justify the differing treatment of salmonids and non-salmonoids.).

[9] *US – Clove Cigarettes (AB)*, para. 225.

reached this finding without citing to the factual record, which indicates that it could not identify an evidentiary basis to conclude that there was or was not a legitimate regulatory distinction. The Appellate Body instead based its finding on an apparent *assumption* as to the likely behavior of menthol smokers in the event their preferred product were to become unavailable.[10] It is consistent with this DSB finding that the United States would conduct further scientific analysis addressing the likely behaviors associated with use of menthol cigarettes that bear directly upon the question of whether there is a legitimate basis to take a different regulatory approach to menthol cigarettes. The resulting FDA Menthol Report was adopted subsequent to the DSB's adoption of its recommendations and rulings in this dispute.

15. In instances where the DSB finds that a Member lacks a sufficient basis for a particular measure, it is within a Member's rights to comply by conducting further analysis related to that basis. If the results of that analysis are that the treatment accorded by the challenged measure is justified, then the measure would no longer be inconsistent with the relevant covered agreement. Doing so is in no way inconsistent with the principle that DSB findings are fixed and final.

(ii) As a factual issue, please respond to Indonesia's contention, at paragraphs 56-60 of its First Written Submission, that virtually all of the studies regarding dependence and cessation that the FDA reviewed in its July 2013 Menthol Report were "available" at the time of the original consideration of the case by the panel and the Appellate Body and could have been provided by the United States to substantiate its claims regarding the premise that there are factors specific to menthol cigarettes that may affect dependence and cessation. In this regard, please comment in particular on the relevance of the fact that the March 2011 TPSAC report appears to have already concluded (i.e. prior to the FDA's July 2013 Menthol Report) that "cessation is less likely to be successful among smokers of menthol cigarettes", and that this conclusion was quoted by the original panel at paragraph 7.227 of its report?

16. As a factual matter, the United States had not concluded or adopted findings, prior to the DSB's adoption of its recommendations and rulings in this dispute on April 24, 2012, that the presence of menthol in cigarettes likely is associated with increased addiction and difficulty with cessation. The Tobacco Products Scientific Advisory Committee ("TPSAC") is an independent body that developed a report concerning menthol cigarettes at the direction of the U.S.

[10] *US – Clove Cigarettes (AB)*, para. 225.

Congress.[11] The TPSAC report, and the findings included therein, do not constitute findings of the U.S. government.[12]

17. The March 2011 TPSAC report was included among the sources of information that U.S. public health authorities examined in producing the FDA Menthol Report. The FDA Menthol Report also takes into account scientific literature that post-dates the TPSAC report,[13] and additional secondary analyses of existing data and information.[14]

18. Paragraph 7.227 of the panel report cites to the TPSAC report as evidence for its finding that, as with clove and other flavored cigarettes, "the availability of menthol cigarettes increases initiation among youth, i.e., the number of smokers[.]"[15] As noted by the Arbitrator, the paragraph from the TPSAC report includes a sentence related to difficulty with cessation. However, it appears that the panel cited to the TPSAC report here to support its findings related to menthol cigarettes and initiation, and it did not make specific findings concerning menthol cigarettes and addiction or cessation. As a result, when the Appellate Body articulated its assumption as to the likely behavior of menthol smokers in the event their preferred product became unavailable, it did not have any factual findings related to addiction or cessation, nor did it cite to any findings related to addiction or cessation to support its assertion.[16]

(c) With respect to the proposition that the United States has complied with DSB recommendations and rulings because the FDA's July 2013 Menthol Report

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[11] U.S. First Written Submission, para. 32.

[12] *See* 21 Code of Federal Regulations 14.5 (An advisory committee is utilized to provide advice and recommendations to the FDA Commissioner, who has sole discretion concerning action to be taken on any matter considered by an advisory committee); available at: http://www.fda.gov/advisorycommittees/committeesmeetingmaterials/tobaccoproductsscientificadvisorycommittee/ucm247605.htm ("The report submitted by TPSAC will undergo a thorough review by experts within the FDA Center for Tobacco Products. . . . The FDA will then make a determination about what future regulatory action(s), if any, are warranted."; http://www.fda.gov/advisorycommittees/aboutadvisorycommittees/committeemembership/ucm117646.htm ("Advisory committees provide FDA with independent advice from outside experts . . . . Although the committees provide advice to the Agency, final decisions are made by FDA.")

[13] *See, e.g.*, Caraballo, R.S. and Asman, K., Epidemiology of Menthol Cigarette Use in the United States (Center For Disease Prevention and Control, 2011); Blot, W.J., Cohen, S.S., Aldrich, M., McLaughin, J.K., Hargreaves, M.K. and Signorello, L.B., Lung Cancer Risk Among Smokers of Menthol Cigarettes (National Cancer Institute, 2011); levy, D.T., Blackman, K., Tauras, J., Chaloupka, F., Vilanti, A., Niaura, R., Vallone, D.M., and Abrams, D.B., Quit Attempts and Quit Rates Among Menthol and Nonmenthol Smokers in the United States (Legacy, 2011). Cited in the Tables of References and Sources for Dependence and Cessation of the FDA Menthol Report.

[14] U.S. First Written Submission, para. 36.

[15] *US – Clove Cigarettes (Panel)*, para. 7.227.

[16] *US – Clove Cigarettes (AB)*, para. 225.

contains findings that "demonstrate" an important distinction between menthol and regular cigarettes, please clarify the following:

(i) Does the United States interpret the Appellate Body report and/or DSB recommendations and rulings in this dispute to suggest that the United States could bring Section 907(a)(1)(A) into conformity with article 2.1 by obtaining more information to demonstrate that its measures meet the requirements of Article 2.1 of the TBT Agreement?

19. The United States has brought Section 907(a)(1)(A) into conformity with Article 2.1 in three ways: (1) by undertaking further scientific evaluation of the public health implications of menthol cigarettes and presenting the results of that analysis in a report that demonstrates that there is a legitimate regulatory distinction between menthol cigarettes and clove cigarettes; (2) by continuing to develop its understanding of the public health implications of menthol cigarettes by issuing an Advanced Notice of Public Rulemaking ("ANPRM") designed to advance possible appropriate regulatory measures affecting menthol cigarettes; and (3) by applying measures to reduce youth smoking – including Section 907(a)(1)(A) and a public education campaign that targets menthol cigarettes – in an even-handed manner, in light of the different regulatory challenges posed by menthol cigarettes and clove cigarettes.

20. The United States has not merely "obtained new information." It has addressed the insufficiency addressed by the Appellate Body by conducting further scientific analysis, the results of which demonstrate that the regulatory distinction between clove and menthol cigarettes is legitimate. And the United States is applying measures to clove cigarettes and menthol cigarettes consistent with the status of available science on the public health implications of each product.

(ii) If so, what is the basis for that interpretation of the Appellate Body report and/or DSB recommendations?

21. Please see the U.S. response to question 3(b)(i).

(d) With respect to the proposition that the FDA's July 2013 Menthol Report demonstrates that the Appellate Body "erroneously assumed" something, please clarify the following:

(i) Is the United States asking the Arbitrator to rule that Section 907(a)(1)(A) has been brought into conformity with Article 2.1 of the TBT Agreement on the basis that the United States has demonstrated that the Appellate Body erred in finding that Section 907(a)(1)(A) is inconsistent with Article 2.1?

22. No. It is the U.S. position that the Appellate Body identified an insufficient basis for the challenged U.S. measure on the basis of an assumption related to the behavior of menthol smokers if menthol cigarettes were banned. Further analysis conducted by U.S. public health

authorities demonstrates that assumption to be unjustified. The "erroneously" in the quoted paragraph was referring to the fact that the assumption has proven erroneous in light of subsequent analysis of the scientific evidence.

(ii) If so, what is the legal basis for the view that a Member can bring a measure into conformity with DSB recommendations and rulings by demonstrating that those DSB recommendations and rulings are wrong?

23. This is not the position of the United States; please see the explanations above.

4. At paragraph 78 of its First Written Submission, the United States indicates that "[t]he findings in the FDA Menthol Report demonstrate that there likely are factors related to menthol cigarettes other than the presence of nicotine which affect addiction and cessation. This finding directly addresses what the Appellate Body apparently considered to be a logical flaw in the U.S. public health rationale concerning the risks of banning menthol cigarettes. Contrary to the Appellate Body's assumption, menthol smokers appear to be more addicted than non-menthol smokers and have a harder time quitting, which might make them more likely than regular smokers to seek medical treatment for cessation assistance or illicit cigarettes if their preferred type of cigarette were no longer available." In the accompanying footnote, the United States indicates that "This does not mean that such concerns *necessarily* would materialize. Rather, the Appellate Body's finding was that they *would not* materialize." (emphasis original) With respect to the existence of a contradiction between the new findings in the FDA's July 2013 Menthol Report and the Appellate Body report, please clarify the following:

(a) It appears that when the FDA refers to "increased dependence" it is referring to "*nicotine* dependence and/or craving", and the FDA explains that the finding of "reduced success in smoking succession" is "consistent with the observation that menthol smokers appear to be more *nicotine* dependent than nonmenthol smokers" (FDA's July 2013 Menthol Report, pp. 5-6 (emphasis added)) How does this contradict the Appellate Body's finding that "the addictive ingredient in menthol cigarettes is *nicotine,* not peppermint or any other ingredient that is exclusively present in menthol cigarettes" (emphasis added)?

24. The United States does not contend that the FDA Menthol Report contradicts the Appellate Body's observation that nicotine is the addictive ingredient in menthol and other cigarettes. Rather, the U.S. point is that the findings of the FDA Menthol Report are consistent with what is well understood by public health regulators – that is, that banning certain tobacco products can pose different public health challenges than banning other tobacco products, depending on a range of factors that impact consumer tastes, habits, prevalence of use, addiction level, and demographics of use. The FDA's finding is that the presence of menthol in cigarettes is likely associated with *increased* addiction and difficulty with cessation: menthol smokers, more than other smokers, are likely to experience increased addiction and difficulty quitting. This suggests that the presence of *menthol* is a factor affecting addiction and cessation.

25. This finding also is consistent with the conclusion that, if their preferred product were to become unavailable, smokers of menthol cigarettes – more than smokers of other cigarettes – may be more likely to require cessation services and/or to seek a replacement cigarette through the illicit market. If menthol cigarettes were to be banned, addicted menthol smokers would have three choices: (1) attempt to overcome the addiction and quit, (2) seek out a different legal product to satisfy their addiction, or (3) seek out an illegal menthol tobacco replacement.

26. With respect to option (1), it is axiomatic that if smokers of menthol cigarettes suffer greater addiction and tend to have a harder time quitting, they are more likely to require cessation services if they choose to try to quit. Accordingly, the new finding by the FDA contradicts the Appellate Body assumption that banning menthol cigarettes could not and would not result in an increased strain on the U.S. healthcare system. To the contrary, the finding directly supports the conclusion that menthol smokers appear to be more addicted than non-menthol smokers and have a harder time quitting. This might make them more likely than regular smokers to require medical treatment for cessation assistance or illicit cigarettes if menthol cigarettes are banned.

27. With respect to options (2) or (3), it is also logical that because menthol smokers likely suffer increased addiction, if they choose to continue smoking, they may be more likely to seek a replacement menthol cigarette through the illicit market to satisfy their particular craving than merely to switch to an alternative supply of nicotine. FDA is thus seeking to better understand, including through the ANPRM, the impacts such a ban could have on the public health, such as whether it could produce significant increased strain on the U.S. healthcare system.

28. Therefore, the U.S. rationale for its different regulatory approach for menthol cigarettes, supported by the FDA Menthol Report, is that there may likely be more complications and different public health considerations associated with banning menthol cigarettes than with banning other flavored cigarettes. The FDA Menthol Report therefore shows that, based on further evidence and analysis, these public health considerations are a legitimate possibility warranting further consideration, even though it is nicotine that is the addictive ingredient in tobacco products.

(b) Why does the finding that the presence of menthol in cigarettes likely increases menthol smokers' dependence on nicotine, which in turn reduces their success in quitting smoking, suggest that many addicted menthol smokers would not switch to regular cigarettes to satisfy their addiction to nicotine if menthol cigarettes were banned?

29. Please see the U.S. response to question 7(a). In determining whether to ban menthol cigarettes, it would be important, from a public health perspective, to consider information regarding to what extent menthol smokers would attempt to quit and seek cessation services; seek out menthol cigarettes through the illicit market; or switch to regular cigarettes or other tobacco products. U.S. public health authorities must assess these and other possible outcomes

as part of their due diligence. Prior to the implementation of the characterizing flavor ban, approximately 88 billion menthol cigarettes were consumed annually in the United States, compared to approximately 400 million clove cigarettes.[17] The difference in the magnitude of use, coupled with the fact that the presence of menthol in cigarettes likely increases users' level of addiction and difficulty with cessation, demonstrates that the difference in treatment of menthol and clove cigarettes is a legitimate regulatory distinction.

(c) At paragraph 71 of its First Written Submission, the United States emphasizes the Appellate Body's finding that "it 'is not clear' that such possible negative consequences would materialize, insofar as regular cigarettes, which also contain nicotine, would remain on the market". With reference to the different formulation of the Appellate Body's finding that the United States sets forth in the footnote accompanying paragraph 78 of its First Written Submission, is it the United States' position that the Appellate Body's finding was that the risks in question "would not" materialize, or rather that it "is not clear" that the risks in question would materialize? If the Appellate Body's finding was that it "is not clear" that such risks would materialize, and if the United States' position is that the possible implication arising from the new findings in the FDA's July 2013 Menthol Report "does not mean that such concerns necessarily would materialize", how does that Report contradict the Appellate Body's report?

30. The Appellate Body, based on an assumption, concluded that the risks of countervailing effects could or would not materialize. The FDA Menthol Report, with its finding that menthol is likely associated with increased addiction and difficulty with cessation, shows that upon further review, the Appellate Body's assumption is not supported by scientific evidence.

31. Given this uncertainty about these risks, it would be important, from a public health perspective, to consider information regarding to what extent menthol smokers would attempt to quit and seek cessation services, seek out menthol cigarettes through the illicit market, or switch to regular cigarettes or other tobacco products. The public health response to these risks constitutes a legitimate regulatory distinction between menthol cigarettes and clove cigarettes (because the very small size of the clove cigarette market in the United States and other factors made it a virtual certainty that banning clove cigarettes would *not* result in any such countervailing effects to any significant degree). It is not uncommon that the public health consequences of a particular measure (in this case, banning menthol cigarettes) are not entirely certain and require additional analysis and management through the regulatory process (as the United States clarified in the footnote accompanying paragraph 78). Scientific conclusions are not expressed with absolute certainty.

[17] Exhibit US-4, Exhibit IND-11 (Orig. panel).

32. By contrast, the implicit uncertainty expressed through the Appellate Body's phrase, "is not clear", is that the countervailing effects identified by the United States are *so unlikely* to occur that they could *not* warrant further regulatory consideration and thus do *not* constitute a legitimate regulatory distinction. The Appellate Body's equivocal finding reflects the fact that it was not derived from any evidentiary basis in the record.

33. The Appellate Body apparently assumed that the possible negative consequences associated with banning menthol cigarettes were not likely to materialize because menthol smokers would still have access to regular cigarettes.[18] From the fact that the Appellate Body did not cite to any evidence from the original proceedings to support its findings, one can only conclude that the Appellate Body did not identify evidence on the record bearing upon the issue. The Appellate Body apparently adopted the logic that a menthol smoker addicted to nicotine would use another cigarette if their preferred product were unavailable (rather than engage in the behaviors suggested by the United States), and therefore it was "not clear" (*i.e.*, not very likely) that the consequences identified by the United States would materialize.

34. Subsequent to the DSB recommendations and rulings, the United States conducted additional scientific review and analysis, and concluded in the FDA Menthol Report that the presence of menthol in cigarettes likely is associated with increased addiction and difficulty with cessation. This additional assessment of the particular health consequences of smoking menthol cigarettes provide an additional basis for the U.S. position that banning menthol cigarettes presents different, more complicated public health challenges than banning clove cigarettes. These additional challenges constitute a legitimate regulatory distinction for purposes of Article 2.1 of the TBT Agreement.

35. The United States understands the Appellate Body's finding to be that – absent evidence to the contrary – such consequences are *so unlikely* to materialize because of the availability of regular cigarettes that they do not warrant further regulatory consideration. The findings in the FDA Menthol Report demonstrate that the evidence does *not* now support the Appellate Body's assumption and thus that any detrimental impact stems solely from a legitimate regulatory distinction.

5. At paragraph 81 of its First Written Submission, the United States indicates that it has taken measures that ensure that it is "regulating … in an even-handed manner within the meaning of the Appellate Body's findings". Which findings on "even-handedness" is the United States referring to, and what does the United States understand the Appellate Body to have meant when it referred to "even-handed" treatment?

36. The findings of the Appellate Body Report include that:

> 95. We thus understand the sixth recital [of the Preamble of the TBT Agreement] to suggest that Members have a right to use technical regulations in

[18] *US – Clove Cigarettes (AB)*, para. 225.

> pursuit of their legitimate objectives, provided that they do so in **an even handed manner** and in a manner that is otherwise in accordance with the provisions of the *TBT Agreement*.[19]
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> * * *
>
> 182. Accordingly, where the technical regulation at issue does not *de jure* discriminate against imports, the existence of a detrimental impact on competitive opportunities for the group of imported vis à vis the group of domestic like products is not dispositive of less favourable treatment under Article 2.1. Instead, a panel must further analyze whether the detrimental impact on imports stems exclusively from a legitimate regulatory distinction rather than reflecting discrimination against the group of imported products. In making this determination, a panel must carefully scrutinize the particular circumstances of the case, that is, the design, architecture, revealing structure, operation, and application of the technical regulation at issue, and, **in particular, whether that technical regulation is even handed**, in order to determine whether it discriminates against the group of imported products.[20]
>
> * * *
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> 215. Where the technical regulation at issue does not *de jure* discriminate against imports, a panel must carefully scrutinize the particular circumstances of the case, that is, the design, architecture, revealing structure, operation, and application of the technical regulation at issue, and, **in particular, whether that technical regulation is even handed**, in order to determine whether the detrimental impact on imports stems exclusively from a legitimate regulatory distinction rather than reflects discrimination against the group of imported products.[21]

37. The Appellate Body's findings make clear that, even where a technical regulation has a detrimental impact on a group of imported like products compared to a group of domestic like products, there is no inconsistency with Article 2.1 of the TBT Agreement where the difference stems exclusively from a legitimate regulatory distinction. The inquiry as to whether there is a legitimate regulatory distinction is based on the particular facts and circumstances of the particular measure, and is designed at least in part to distinguish measures that are applied in an "even-handed" manner as opposed to those that are applied so as to reflect discrimination against the group of imported products.[22] The United States understands that the Appellate Body uses

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[19] *US – Clove Cigarettes (AB)*, para. 95.

[20] *US – Clove Cigarettes (AB)*, para. 182.

[21] *US – Clove Cigarettes (AB)*, para. 215.

[22] *US – Clove Cigarettes (AB)*, para. 215.

the term "even-handed" in accordance with its ordinary meaning of not favoring one side or group over another.[23] This understanding is reflected in the Appellate Body's contrast between a measure applied in an "even-handed" manner versus a measure applied in a way that reflects discrimination based on the origin of the product.

38. In the context of this dispute and the measures taken by the United States, it is clear that U.S. measures are applied in an even-handed manner and not to discriminate on the basis of where the like products are manufactured. The United States is treating domestic menthol cigarettes and clove cigarettes in a manner reflecting the status of the scientific understanding of the public health effects of each product.

39. At the same time that the United States is advancing the regulatory process concerning menthol cigarettes – including by conducting scientific analysis of available information[24] and issuing an ANPRM to evaluate possible restrictive measures[25] – the United States is moving forward with an unprecedented investment and commitment to target the pervasive use of menthol cigarettes.[26] In fact, the United States has already invested $115 million to educate at-risk populations, the direct effect of which is to reduce demand in the United States for menthol and other domestically produced cigarettes.[27] Since the period of 2006-2008, consumption of menthol cigarettes in the United States has declined by 6.3 percent, representing a loss in sales to domestic menthol producers totaling approximately $52 million.[28] It is simply not the case that U.S. tobacco regulatory measures are based on any form of favoritism for U.S. products or discrimination against foreign products.[29] U.S. measures to reduce youth smoking are driven by the status of the science and on proven methods to combat the pervasive problem.[30] In other words, because the U.S. measures seek to reduce smoking regardless of the underlying origin of the products being targeted, they are even-handed.

6. With respect to the FDA's July 2013 Advanced Notice of Proposed Rulemaking (ANPRM) concerning menthol cigarettes, please clarify the following:

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[23] *Merriam-Webster's Collegiate Dictionary* (10th ed.) (1997), p. 401 ("even-handed: fair, impartial"), 417 ("fair: free from favor toward either or any side…impartial stresses an absence of favor or prejudice") (Exhibit US-24); *see also The Oxford English Dictionary*, p. 475 (1989) ("[S]howing no partiality") (Exhibit US-25); *The American Heritage College Dictionary* (3d ed.), p. 454 ("[O]n equal terms; also without either gain or loss") (Exhibit US-26); *Encarta World English Dictionary* (1999), p. 617 ("[T]reating everyone fairly, without favoritism or discrimination.") (Exhibit US-27).

[24] U.S. First Written Submission, paras. 32-36, 76-80.

[25] U.S. First Written Submission, paras. 37-39.

[26] U.S. First Written Submission, paras. 40-46.

[27] U.S. First Written Submission, paras. 31, 82.

[28] Exhibit US-4.

[29] U.S. First Written Submission, paras. 83-84.

[30] U.S. First Written Submission, paras. 44-46.

(a) Is the United States arguing that the ANPRM is a measure that brought Section 907(a)(1)(A) into conformity with Article 2.1 of the TBT Agreement? If so, please elaborate the basis for that view. If not, what is the relevance of the ANPRM to the Arbitrator's analysis?

40. The United States is arguing that the ANPRM is one of several actions taken by the United States consistent with current scientific understanding of the public health effects of menthol cigarettes. Thus it treats menthol cigarettes consistent with a legitimate regulatory distinction between menthol cigarettes and clove cigarettes. The ANPRM is relevant because it demonstrates that the United States is treating menthol cigarettes and clove cigarettes in an even-handed manner, which as described in the U.S. response to the previous question, means a manner based on scientific evidence of the public health challenges associated with each product, and not based on the national origin of the products.

(b) Does the ANPRM propose that menthol cigarettes be banned, and/or commit the United States to banning menthol cigarettes?

41. No. The ANPRM advances the regulatory process by soliciting information regarding possible restrictive measures affecting menthol cigarettes, including a possible ban.

7. At paragraph 83 of its First Written Submission, the United States indicates that "[t]hese U.S. measures with respect to menthol cigarettes are reducing (and should continue to reduce) demand for the product, and therefore constitute treatment that is even-handed in comparison to the treatment accorded to imported clove cigarettes."

(a) When the United States' refers to "these U.S. measures", is the United States referring to all of the various initiatives referenced at paragraphs 40-46 and 82 of the United States' First Written Submission?

42. Yes.

(b) What does the United States mean by these measures "with respect to menthol cigarettes"? Are any of these measures specifically and exclusively targeted at menthol cigarettes, or are they targeted at youth smoking more generally (including but not limited to menthol cigarettes)?

43. The measures described in paragraphs 40-46 of the U.S. First Written Submission are targeted specifically, though not exclusively, at menthol cigarettes.

(c) With respect to paragraphs 83-85 of the United States' First Written Submission, is it the United States' argument that imported clove cigarettes are being accorded even-handed treatment with respect to competitive opportunities in the US market as compared with menthol cigarettes?

44. The argument is that U.S. public health measures to reduce youth smoking accord to domestic menthol cigarettes and imported clove cigarettes treatment that is even-handed, taking

into account relevant scientific evidence related to the public health challenges associated with each product. Thus, any remaining detrimental impact on the competitive opportunities of Indonesian clove cigarettes stems exclusively from a legitimate regulatory distinction and is therefore consistent with Article 2.1 of the TBT Agreement.

45. The legitimate regulatory distinction stems from the complicated public health challenges associated with banning menthol cigarettes that are not associated with banning clove cigarettes. These complications arise from the fact that there is a huge disparity in the number and demographics of menthol smokers versus clove smokers in the United States, and the fact that the presence of menthol in cigarettes likely is associated with increased addiction and difficulty with cessation (see U.S. response to question 4). The measures taken by the United States to implement the recommendations and rulings of the DSB – including further analysis resulting in new findings in the FDA Menthol Report, the issuance of an ANPRM concerning menthol cigarettes, and public education initiatives that reduce the use of menthol cigarettes among youth – are consistent with the U.S. public policy objective of reducing youth smoking and with current scientific understanding of the possible public health challenges associated with menthol cigarette smoking and possible measures to restrict availability.

2.2 Questions for Indonesia

8. What is the relevance of the United States' response to question 37 from the panel in the original proceeding, which Indonesia cites at footnote 24 of its First Written Submission and submits as Exhibit IND-2?

9. At paragraph 42 of its First Written Submission, Indonesia states that "should the Arbitrator feel it necessary to evaluate the information on menthol cigarettes raised by the United States", the Arbitrator should reject the United States' argument on the grounds that, inter alia, the information is not "new".

(a) Is it Indonesia's position that the Arbitrator should not engage in any evaluation of the FDA's July 2013 Menthol Report?

(b) Does Indonesia consider that DSB recommendations and rulings must be treated as fixed and final, regardless of whether a disputing party obtains and provides new information and evidence which was not available to the panel and/or the Appellate Body in the original proceeding?

10. At paragraph 71 of its First Written Submission, Indonesia submits that the FDA's July 2013 Menthol Report "does not prove with certainty" what the United States claims it does. Please clarify what, in Indonesia's view, is the applicable evidentiary standard of proof on this issue? What level of "certainty" would the United States have to establish in order to demonstrate compliance?

3 COMPLIANCE WITH DSB RECOMMENDATIONS – ARTICLES 2.9.2 AND 2.12 OF THE TBT AGREEMENT

3.1 Question for the United States

11. How does the United States respond to the following arguments by Indonesia concerning Articles 2.9.2 and 2.12 of the TBT Agreement:

(a) the United States has taken no measures to comply with these provisions (Indonesia's First Written Submission, paras. 82-87);

46. The recommendations and rulings of the DSB do not require the United States to come into conformity with Articles 2.9.2 or 2.12 by taking action with respect to Section 907(a)(1)(A), because the DSB recommendations and rulings do not find Section 907(a)(1)(A) to be inconsistent with those articles. The findings in the Appellate Body and panel reports distinguish between where the United States *acted* inconsistently with Articles 2.9.2 and 2.12, and where *Section 907(a)(1)(A)* or the *measure* is inconsistent with Article 2.1. Specifically, paragraph 298(a)(v) of the Appellate Body Report upholds the Panel Report finding that "Section 907(a)(1)(A) is inconsistent with Article 2.1 of the *TBT Agreement*." By contrast, paragraph 298(b)(ii) upholds the panel finding that "the United States acted inconsistently with Article 2.12 of the *TBT Agreement*" and paragraph 8(f) of the panel report finds that "the United States has acted inconsistently with Article 2.9.2 of the *TBT Agreement*."

47. The DSB found that the inconsistencies with respect to Articles 2.9.2 and 2.12 stemmed from U.S. acts – and not from the measure. Paragraph 299 of the Appellate Body Report recommends that:

> the DSB request the United States to bring *its measure* found in this Report, and in the Panel Report as modified by this Report, to be inconsistent with the *TBT Agreement*, into conformity with its obligations under that Agreement." (emphasis added).

When the DSB recommends that the United States bring "*its measure*" into conformity with the obligations under that Agreement, it is not referring to Articles 2.9.2 and 2.12, because the measure (Section 907(a)(1)(A)) was *not* found to be inconsistent with those articles.

48. Indonesia's First Written Submission mischaracterizes the DSB recommendations and rulings when it states that the DSB recommended that the United States bring Section 907(a)(1)(A) into conformity with Articles 2.9.2 and 2.12.[31] Rather, the DSB found U.S. acts, and not Section 907(a)(1)(A), to be inconsistent with those articles. Thus, Indonesia's assertion that the United States can only comply with Articles 2.9.2 or 2.12 by removing Section 907(a)(1)(A) rests on an erroneous reading of the recommendations of the DSB.

49. Moreover, Indonesia's arguments in paragraphs 82-106 of its first written submission fundamentally mischaracterize the analysis required under Article 22.4 and 22.7 of the DSU.

[31] Indonesia's First Written Submission, paras. 107, 132.

Articles 22.4 and 22.7 require the arbitrator to determine whether Indonesia's proposed level of suspension is equivalent to the level of nullification or impairment. The starting point in this inquiry is Indonesia's proposed level of suspension. In this instance, Indonesia has failed even to propose that there is *any* level of nullification or impairment of its benefits under the TBT Agreement resulting from U.S. actions that were inconsistent with Articles 2.9.2 and 2.12.

50. Indonesia does not propose a level of suspension with respect to Articles 2.9.2 and 2.12 of the TBT Agreement, and instead "urges the Arbitrator to reject the United States' claim that no nullification or impairment of benefits exists and to authorize Indonesia to suspend concessions with respect to the United States."[32] However, as explained in the U.S. response to question 15, arbitrators in Article 22.6 proceedings have been clear that the presumption of adverse impact under Article 3.8 of the DSU does *not* constitute evidence of nullification or impairment for purposes of evaluating a complaining Member's proposed level of suspension, and does *not* imply that a complaining Member is automatically entitled to suspend concessions.[33]

51. The suspension of concession is prospective, meaning it should reflect the current and ongoing level of nullification or impairment. For example, the arbitrator in *US – Act of 1916 (Article 22.6 – US)* determined that, to be equivalent, the level of suspension must reflect "ongoing" nullification and impairment.[34] This meant that the level would not be "frozen in time" but would reflect the actual level of nullification or impairment experienced by the EU as a result of the Act of 1916.[35] The arbitrator determined that the level thus should reflect any nullification or impairment resulting from specific applications of the Act, *i.e.*, amounts equivalent to U.S. court judgments or settlements pursuant to the act.[36] At the time of the Arbitrator's award, there were no such applications, and so the effective level of nullification or impairment – and of suspension – was zero.[37] The arbitrator considered that its approach "[struck] an appropriate balance between" the EU's right to apply its qualitative suspension in response to the WTO-inconsistent measure, and the U.S. right to ensure that the EU applied its suspension "only up to the level of nullification or impairment."[38]

52. In this dispute, Indonesia has not even alleged that there is *any* ongoing nullification or impairment of benefits accruing to it under Articles 2.9.2 or 2.12 of the TBT Agreement. The reality is that no nullification or impairment exists.

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[32] Indonesia's First Written Submission, para. 106.

[33] *EC – Bananas III (US) (Article 22.6 – EC)*, para. 6.10; *US – Offset Act (Byrd Amendment) (Brazil) (Article 22.6 – US)*, para. 3.54.

[34] *US – 1916 Act (EC) (Article 22.6 – US)*, para. 6.14

[35] *US – 1916 Act (EC) (Article 22.6 – US)*, para. 6.14

[36] *US – 1916 Act (EC) (Article 22.6 – US)*, paras. 6.14, 8.2.

[37] *US – 1916 Act (EC) (Article 22.6 – US)*, paras. 6.14, 8.2.

[38] *US – 1916 Act (EC) (Article 22.6 – US)*, para. 7.10.

53. With respect to Article 2.9.2, the panel found that, as a technical matter, the United States acted inconsistently by not notifying other Members through the WTO Secretariat of the products to be covered by the proposed Section 907(a)(1)(A).[39] The question for the Arbitrator is whether, and to what extent, benefits accruing to Indonesia currently are being nullified or impaired as a result. This obligation under Article 2.9.2 attaches to *proposed* measures, and it is not clear how Indonesia reasonably could maintain that benefits accruing to it under this provision are nullified or impaired even now, after the measure has been in effect for more than four years. And this is particularly true where, as here, the proposed measure was publicly available and Indonesia participated in the legislative process, which it has not denied in these proceedings.[40]

54. With respect to Article 2.12, the Appellate Body upheld the panel's finding that the United States acted inconsistently by failing to allow an interval of not less than six months between the publication and the entry into force of Section 907(a)(1)(A).[41] Again, the question is whether, and to what extent, benefits accruing to Indonesia under this provision currently are nullified or impaired. Article 2.12 requires a reasonable interval between publication and entry into force "in order to allow time for producers in exporting Members, and particularly in developing country Members, to adapt their products or methods of production to the requirements of the importing Member." The Appellate Body found that it may require a "significantly longer" period than three months for Indonesian producers to adapt their cigarettes to Section 907(a)(1)(A).[42] However, Indonesia cannot reasonably maintain that its producers should have more than four years to adapt their products. By this point in time, any trade effects from having less than six months to adapt their products will have long since dissipated. Moreover, as evidenced by Kretek's July 2009 national sales meeting presentation[43] and U.S. import and sales data,[44] Indonesian producers have already adapted their product and continue to export cloves to the United States. Therefore, there is no basis to conclude that the benefits accruing to Indonesia under Article 2.12 are currently being nullified or impaired.

(b) accepting the United States' position "would effectively read out of existence every provision that calls for a Member to perform an obligation within a specified period of time by allowing Members to violate these obligations, fail to take measures to comply, and then escape retaliation for failing to come into compliance" (Indonesia's First Written Submission, para. 89);

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[39] *US – Clove Cigarettes (Panel)*, paras. 7.541, 8.1(f).

[40] *US – Clove Cigarettes (Panel*), para. 7.541

[41] *US – Clove Cigarettes (AB*), para. 298(b)(ii).

[42] *US – Clove Cigarettes (AB*), para. 294.

[43] Exhibit US-9.

[44] Exhibit US-5 and Exhibit US-8.

55. Again, Indonesia's assertion misconstrues the analysis required under Article 22 of the DSU. As noted in the U.S. response to questions 11(a) and 15, the existence of a WTO-inconsistent measure does not automatically entitle a complaining Member to suspend concessions or other obligations. The level of suspension must be equivalent to the level of nullification or impairment, which "connotes a correspondence, identity or balance between two related levels."[45] Therefore, a Member may only obtain authorization to suspend concessions or other obligations to the extent that the Member's benefits are currently being nullified or impaired.

56. Applying this required standard to Indonesia's request for suspension with respect to Articles 2.9.2 and 2.12 of the TBT Agreement does not "effectively read out of existence" any provision under the covered agreements, or allow a responding Member to "escape retaliation." To the contrary, Indonesia's approach to Article 2.9.2 and 2.12 – *i.e.*, that the Arbitrator must authorize suspension of concessions so that the United States does not "escape retaliation" – would be inconsistent with Articles 22.4 and 22.7 of the DSU and would constitute a punitive countermeasure against the United States. Whatever purpose an arbitrator may consider to be reflected in provisions on suspension of concessions (such as to rebalance concessions or induce compliance), any such purpose cannot override the requirement in the DSU that the level of suspension be equivalent to the level of nullification or impairment. Arbitrators have acknowledged that granting a level of suspension beyond the level of nullification or impairment would constitute an unjustified punitive countermeasure.[46] In this instance, Indonesia has failed even to specify a level of suspension, and it is clear that no nullification or impairment of Indonesia's benefits under Articles 2.9.2. or 2.12 of the TBT Agreement exists.

(c) the United States' position runs counter to the TBT Committee's emphasis of the importance of complying with notification obligations in the TBT Agreement (Indonesia's First Written Submission, paras. 91-92);

57. The U.S. position is that the authorized level of suspension of concessions or other obligations must be equivalent to the level of nullification or impairment of Indonesia's benefits under the relevant articles of the TBT Agreement. It is unclear how this position has any bearing, one way or another, on the TBT Committee's commitment to transparency and to compliance with the notification obligations in the TBT Agreement. The United States shares the TBT Committee's commitment to transparency, and in fact has notified more technical regulations under the TBT Agreement than nearly every other WTO Member.[47]

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[45] *EC – Bananas III (US) (Article 22.6 – EC)*, para. 4.1.

[46] *EC – Bananas III (US) (Article 22.6 – EC)*, para. 6.3; *US – Gambling (Article 22.6 – US)*, para. 3.24.

[47] According to the TBT Information Management System, the United States had notified 916 "regular" technical regulations under the TBT Agreement as of February 2014, second only to China, which had notified 986. Indonesia had notified 66. The TBT Database is available at: http://tbtims.wto.org/.

(d) there are a number of cases in which panels or the Appellate Body rejected a responding Member's argument that its failure to comply with certain notification requirements constituted "harmless error" and did not result in any "nullification or impairment" of benefits within the meaning of Article 3.8 of the DSU (Indonesia's First Written Submission, paras. 93-105); and

58. Please see the U.S. responses to questions 11(a), 11(b) and 15. The United States has not asserted in these proceedings, or in the original proceedings, that actions inconsistent with Articles 2.9.2 or 2.12 constitute "harmless error." The examples in paragraphs 95-105 of Indonesia's First Written Submission demonstrate the principle that, for purposes of determining whether a WTO-inconsistency exists or whether a Member has a right to bring a claim under the DSU, a complaining Member is presumed under Article 3.8 to have suffered an adverse impact, and need not show actual nullification or impairment.[48] However, these examples are not relevant to the Arbitrator's analysis in this proceeding. The presumption under Article 3.8 of the DSU is not a presumption of ongoing nullification or impairment, and it is a rebuttable presumption. The United States has shown that Indonesia itself does not assert any ongoing nullification or impairment and that Indonesia's benefits under these provisions are not currently being nullified or impaired.

(e) because Articles 2.9.2 and 2.12 "are procedural provisions with temporal requirements, any reasonable compliance scenario must include withdrawal of the measure" (Indonesia's First Written Submission, para. 112).

59. The fact that Indonesia considers that Articles 2.9.2 and 2.12 have temporal requirements only further supports that there is no current nullification or impairment, since the temporal period at issue in those provisions is now well in the past.

60. Furthermore, there is no basis for interpreting these Articles to mean, as Indonesia asserts, that in this dispute and as a general matter, a Member can come into compliance with respect to breaches of "procedural provisions with temporal requirements" *only* by removing the implicated measure and starting over.[49] As explained in response to question 11(a), the DSB recommendations and rulings do not require the United States to take any action with respect to Section 907(a)(1)(A) in order to come into compliance with Articles 2.9.2 or 2.12 of the TBT Agreement.

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[48] Paragraphs 95-105 of Indonesia's First Written Submission cite *Guatemala – Cement I (AB), US – Petroleum Taxes (GATT Panel), Guatemala – Cement II*, and *Argentina – Ceramic Tiles (Panel)* for the principle that an assertion of "harmless error" or lack of "adverse impact" is not a defense as to the consistency or inconsistency of a challenged measure. Paragraph 95 of Indonesia's First Written Submission (22.6) cites to *EC – Poultry (AB)* for the finding that just because the EU notified tariff-rate-quotas to the WTO Committee on Agriculture does not excuse the EU from meeting the notification requirements under Article 1.4(a) of the *Agreement on Import Licensing*. This finding is similarly irrelevant to the arbitrator's determination of nullification or impairment.

[49] Indonesia First Written Submission, para. 112.

61. Finally, Indonesia's position would create uncertainty as to the status of dozens of technical regulations currently in force in different Members, where Members, including Indonesia, have not allowed six months between publication and entry into force of the measure.[50]

3.2 Questions for Indonesia

12. At paragraphs 88-89 of its First Written Submission, Indonesia indicates that it disagrees with the United States' argument that because "there is no ongoing breach," there is "neither nullification nor impairment of benefits, and there is no need to address this matter further." Is Indonesia arguing that there actually is an "ongoing breach"? Or is Indonesia arguing that while there is no ongoing breach, that does not mean that there is no ongoing nullification or impairment of benefits, and/or obviate the need to address this matter further?

13. Could Indonesia please clarify whether and if so why it would be necessary for the Arbitrator to address whether the United States has also failed to comply with Articles 2.9.2 and 2.12 of the TBT Agreement in the event that the Arbitrator agrees with Indonesia that the United States has not brought Section 907(a)(1)(A) into conformity with Article 2.1 of the TBT Agreement. What would be the implications of such additional determinations in respect of Articles 2.9.2 and 2.12 for the Arbitrator's assessment of the level of nullification and impairment, if the Arbitrator were to agree with Indonesia that the United States has not brought Section 907(a)(1)(A) into conformity with Article 2.1?

4 CALCULATION OF THE LEVEL OF NULLIFICATION OR IMPAIRMENT – GENERAL

4.1 Questions for both parties

14. Please clarify whether you agree that, in the event that it considers Indonesia's proposed level of suspension not to be "equivalent to the level of nullification or impairment", the Arbitrator should proceed with a calculation of a level of suspension that would be "equivalent".

62. Yes, the United States agrees.

15. Article 3.8 of the DSU provides that:

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[50] *See, e.g.*, Indonesia notification, G/TBT/N/IDN/78, dated 30/07/2013, which appears to provide **23 days** between publication and entry into force; Indonesia notification, G/TBT/N/IDN/67, dated 1/11/2012, which appears to provide **two days** between publication and entry into force; and Indonesia notification, G/BT/N/IDN/65, dated 22/10/2012, which appears to provide **three days** between publication and entry into force. Indonesia did not notify these technical regulations under the TBT Agreement as "urgent." Notifications are available at the TBT Information Management System: http://tbtims.wto.org/.

> **In cases where there is an infringement of the obligations assumed under a covered agreement, the action is considered prima facie to constitute a case of nullification or impairment. This means that there is normally a presumption that a breach of the rules has an <u>adverse impact</u> on other Members parties to such agreement, and in such cases, it shall be up to the Member against whom the complaint has been brought to rebut the charge. (emphasis added).**

Please explain whether and if so, how, the notion of "adverse impact" referred to in Article 3.8 informs the meaning of the concept of "nullification or impairment" in Articles 22.4, 22.6 and 22.7 of the DSU.

63. Article 3.8 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* ("DSU") establishes that, where a measure of a Member is found to be inconsistent with a covered agreement, there is a rebuttable presumption that such inconsistency has an adverse impact on the complaining Member(s).[51] As a general matter, Article 3.8 informs the concept of "nullification or impairment" in Articles 22.4, 22.6, and 22.7, by establishing a rebuttable presumption that the benefits accruing to the complaining Member under the relevant covered agreement(s) are nullified or impaired by the inconsistency. Because the presumption is rebuttable, the Article acknowledges that there may not be *any* level of nullification or impairment resulting from an inconsistent measure.

64. More specifically, however, a distinction must be drawn between the interpretation of "adverse impact," as it has been interpreted in applying the presumption in Article 3.8 in proceedings to determine the WTO-consistency of a measure, and the interpretation of "nullification or impairment," as it concerns the analysis of a proposed level of suspension, once an inconsistency with a covered agreement has been established. In the first instance, panels and the Appellate Body have explained that a Member is generally presumed to have an interest in other Members adhering to their trade obligations. Thus, in this context, a complaining party need not demonstrate any actual, quantifiable nullification or impairment and is presumed to have suffered an "adverse impact" pursuant to Article 3.8.[52]

65. Quantifying the level of the adverse impact is appropriate only once an inconsistency has been established. At that point, arbitrators in Article 22 proceedings have interpreted "nullification or impairment" to require a demonstration of an actual, quantifiable adverse impact caused by an inconsistent measure.[53] Each of these proceedings cited by Indonesia in paragraphs 95 to 105 of its first written submission concerned the WTO-consistency of the challenged

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[51] *EC – Bananas III (Article 21.5 – US) (Panel)*, para. 7.49 ("Article 3.8 of the DSU provides that nullification or impairment is normally presumed if there is an infringement of the obligations of a WTO agreement.")

[52] *EC – Bananas III (Panel)*, para. 7.5; *see also EC – Bananas III (AB)*, para. 254.

[53] *EC – Bananas III (US) (Article 22.6 – EC)*, para. 6.10; *US – Offset Act (Byrd Amendment) (Brazil) (Article 22.6 – US)*, para. 3.54.

measure, [54] and none were brought pursuant to Article 22.6 to determine whether the proposed level of suspension was equivalent to the level of nullification or impairment.

66. In proceedings under Article 22.6 where a Member is challenging the proposed level of suspension, arbitrators must determine whether the proposed level is equivalent to the level of nullification or impairment, and so have calculated the actual, quantifiable adverse impact. In *EC – Bananas III (US) (Article 22.6 – EC)*, the arbitrator stated:

> The review of the level of nullification or impairment by Arbitrators from the objective benchmark foreseen by Article 22 of the DSU, is a separate process that is independent from the finding of infringements of WTO rules by a panel or the Appellate Body. As a result, a Member's potential interests in trade in goods or services and its interest in a determination of rights and obligations under the WTO Agreements are each sufficient to establish a right to pursue a WTO dispute settlement proceeding. However, a Member's legal interest in compliance by other Members does not, in our view, automatically imply that it is entitled to obtain authorization to suspend concessions under Article 22 of the DSU.[55]

In the original *EC – Bananas III* proceeding, the panel and Appellate Body considered as a general matter that Members have an interest in other Members adhering to their trade obligations, and noted that, even though the United States did not export bananas to the EU, it might possibly export bananas in the future, or might suffer other indirect economic harm.

67. By contrast, in the Article 22.6 proceeding, the *EC – Bananas III* arbitrator rejected the notion that possible or remote impact, other than or beyond a direct impact on current trade, could constitute part of the calculation of the level of nullification or impairment. The arbitrator determined that U.S. exports of goods or services between the United States and third countries did not constitute nullification or impairment of even indirect benefits accruing to the United States under the GATT or the GATS, and that U.S. content incorporated into Latin American Bananas also must not be part of the calculation.[56] The arbitrator determined that "the benchmark for the calculation of nullification or impairment of US trade flows should be losses in US exports of goods to the European Communities and losses by US service suppliers in services supply in or to the European Communities."[57]

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[54] Indonesia's First Written Submission, paras. 95-10 (citing *EC – Poultry (Panel)*, *Guatemala – Cement I (AB)*, *Guatemala – Cement II*, and *US – Petroleum Taxes (GATT Panel)*).

[55] *EC – Bananas III (US) (Article 22.6 – EC)*, para. 6.10; *See also US – Offset Act (Byrd Amendment) (Brazil) (Article 22.6 – US)*, para. 3.54 (This implies, in our view, that no assimilation can be made between, on the one hand, a violation or the right breached and, on the other hand, the benefit nullified or impaired as a result of that violation.).

[56] *EC – Bananas III (US) (Article 22.6 – EC)*, para. 6.12.

[57] *EC – Bananas III (US) (Article 22.6 – EC)*, para. 6.12. Guided by the same principle, arbitrators in similar circumstances have limited the calculation of nullification or impairment only to loss of the current export

68. In sum, contrary to Indonesia's assertion in paragraphs 94-106 of its first written submission, a reliance by a panel or the Appellate Body on the normal presumption of an "adverse impact" does not influence in any way a subsequent analysis under Article 22, of whether, and to what extent, a Member's benefits actually have been nullified or impaired.

69. Finally, as noted above, in Article 22.6 proceedings, the responding Member may demonstrate that, in fact, the benefits accruing to the complaining Member are not nullified or impaired at all – that is, the "level" is zero. The analysis in each instance must be guided by the particular facts and circumstances pertaining to the alleged ongoing nullification or impairment and situation of compliance. In this dispute, the benefits accruing to Indonesia under the TBT Agreement, including Articles 2.1, 2.9.2, and 2.12, are not being nullified or impaired.

16. Both parties have referred to various notions such as "lost export opportunities" (United States' First Written Submission, para. 96), "trade flows" (Indonesia's First Written Submission, paras. 114 and 115), "trade effects" (Indonesia's First Written Submission, para. 116) or "competitive opportunities" (Indonesia's First Written Submission, para. 107) or "trade opportunities" (United States' First Written Submission, para. 100) in describing what is to be assessed in a determination of the level of nullification or impairment of benefits. Please clarify what, in your view, is the proper basis for determining what is to be reflected in a determination of the level of nullification or impairment for the purposes of Articles 22.4, 22.6 and 22.7 of the DSU.

70. As an initial matter, one can determine that the level of nullification or impairment is zero since the United States has brought its measures into compliance. However, even aside from this basis, the level of nullification or impairment of Indonesia's benefits under the TBT Agreement is zero as the level would be equal to the estimated level of exports of clove cigarettes to the United States in a reasonable compliance scenario.[58] In this case, there is no reasonable compliance scenario in which clove cigarettes would be permitted in the U.S. market.

71. And even under Indonesia's unrealistic counterfactual that assumes clove cigarettes are re-admitted to the market, Indonesia still would see no change in its level of exports. This is because Indonesia has managed to maintain, nearly dollar-for-dollar, the same level of exports it had before Section 907(a)(1)(A) took effect by offering its clove cigarettes as clove cigars. By marketing its products as clove "cigars," Indonesia continues to satisfy the U.S. market for cloves. Thus, there would be no additional level of Indonesian clove exports even presuming the ban in Section 907(a)(1)(A) were to be lifted.

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level. *See, e.g.*, *EC – Hormones (US) (Article 22.6 – EC)*, paras. 72-77 (rejecting the notion that exports would have increased due to marketing efforts and calculating only "the total value of exports under the counterfactual, the current value of U.S. exports.").

[58] *EC – Bananas III (US) (Article 22.6 – EC)*, para. 6.12; *EC – Hormones (US) (Article 22.6 – EC)*, paras. 72-77; *US – Offset Act (Byrd Amendment) (Brazil) (Article 22.6 – US)*, para. 3.55.

5 INDONESIA'S COUNTERFACTUAL

5.1 Question for both parties

17. Please clarify what, in your view, is the benchmark for assessing the acceptability of a counterfactual scenario for the purposes of calculating the level of nullification or impairment under Article 22.6 of the DSU and why? To the extent that such counterfactual must be "reasonable", as both parties have suggested in their submissions (see for example Indonesia's First Written Submission, para. 113, United States' First Written Submission, para. 89), how is this to be assessed? To what extent should the "plausibility" of the proposed compliance scenario be taken into account? If this consideration is relevant, how is this to be assessed?

72. Please see the U.S. response to question 18. The benchmark for assessing the acceptability of a counterfactual is whether the counterfactual is reasonable.[59] The reason for this benchmark stems from an arbitrator's mandate under Articles 22.4 and 22.7 of the DSU to determine whether the proposed suspension is equivalent to the level of nullification or impairment of the benefits accruing to the complaining Member. The task of determining equivalence requires the arbitrator first to determine the level of nullification or impairment. To do so, arbitrators have considered what would be the level of exports in a reasonable situation of compliance.[60]

73. It is the implementing Member's prerogative to determine the manner in which it will comply.[61] There is no requirement under the DSU that a Member implement the recommendations and rulings of the DSB in such a way as to result in the resumption of trade for the complaining Member. Where the product at issue is inherently harmful and addictive, and the objective of the measure found inconsistent is to reduce its availability and use among youth, the overwhelming likelihood is that a Member will *not* comply by taking measures that would *increase* the access of youth to that product.

74. Therefore, to result in an accurate assessment of the level of nullification or impairment, an acceptable counterfactual must at least be reasonable, meaning that, minimally, it must be a compliance scenario that the defending Member plausibly would undertake. An *implausible* counterfactual – *e.g.*, a scenario that assumes that a Member takes a measure that is directly contrary to its policy objective, harmful to the public health, or otherwise highly unlikely – is not a counterfactual that will result in an accurate assessment of the nullification or impairment of the benefits accruing to the complaining Member.

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[59] *US – Gambling (Article 22.6 – US)*, para. 3.26; *EC – Hormones (US) (Article 22.6 – EC)*, paras. 41-43.

[60] *US – Gambling (Article 22.6 – US)*, paras. 3.24-3.30.

[61] *US – Gambling (Article 22.6 – US)*, para. 3.24; *Australia – Salmon (Article 21.3(c))*, para. 30; *Korea – Alcoholic Beverages (Article 21.3 (c))*, para. 45.

5.2 Questions for the United States

18. Please comment on Indonesia's argument that the complete withdrawal of the measure is the only compliance scenario capable of reflecting the trade flows necessary to estimate a level of nullification or impairment of benefits upon which a level of suspension of concession likely to induce compliance may be established (Indonesia's First Written Submission, para. 115).

75. At paragraph 115 of its first written submission, Indonesia insists that the only way the United States can comply with the recommendations and rulings in this dispute is to remove Section 907(a)(1)(A) and states that "the United States' proposed counterfactual would result in a level of nullification or impairment of benefits of zero, which would frustrate *the purpose of these proceedings (i.e., to induce compliance from the offending Member)*."[62]

76. Indonesia fundamentally misstates the purpose of the current proceedings. The purpose of these proceedings is to determine whether Indonesia's proposed suspension is consistent with the requirements of the DSU – that is, whether the proposed suspension is *equivalent* to the level of nullification or impairment. Article 22.4 of the DSU states that the level of suspension authorized "shall" be "equivalent" to the level of nullification or impairment – not more, not less. Article 22.7 of the DSU mandates that an arbitrator "shall determine whether the level of suspension is equivalent to the level of nullification or impairment." Accordingly, to determine equivalence, the task of the arbitrator is to identify the level of nullification or impairment of benefits accruing to Indonesia – the first variable in the equation.

77. It is not the task of the arbitrator to determine a level of nullification or impairment "upon which a level of suspension of concession likely to induce compliance may be established," which would be a speculative exercise divorced from the requirement of equivalence. Indonesia's mistaken approach is exactly backward; it would have the Arbitrator start by considering a level of suspension that it considers might induce compliance, and then consider a counterfactual that would result in a level of nullification or impairment to match that level. Aside from there being no basis under Article 22 to support this approach, one can easily see how such an approach quickly (and indeed necessarily) would spiral into pure speculation.

78. Guided by the mandate to determine equivalence, the arbitrator in *US – Gambling (Article 22.6 – US)* applied the correct approach by determining a counterfactual that would accurately reflect the level of nullification or impairment. The arbitrator stated as follows:

> In determining whether this proposed level is "equivalent", we must take care to ensure that the level of suspension is neither reduced to a level lower than the level of nullification or impairment of benefits accruing to the complaining party, such as to adversely affect the party's rights, nor exceeds the level of nullification or impairment of benefits, such that it would become punitive. This is the key

[62] Indonesia's First Written Submission, para. 115 (emphasis added.).

> consideration that must, in our view, guide our assessment of the US challenge to Antigua's choice of counterfactual."[63]

In that dispute, the arbitrator determined that it need not necessarily speculate as to the "most likely" compliance scenario,[64] but that it must adopt a counterfactual that reflects "at least a plausible or 'reasonable' compliance scenario."[65] The arbitrator acknowledged that where certain assumptions must be made, such assumptions "should be reasonable, taking into account the circumstances of the dispute, in order for the proposed level of suspension to *accurately reflect* the benefits accruing to the complaining party that have actually been nullified or impaired."[66] In this regard, the arbitrator placed an emphasis on the fact that United States had consistently demonstrated a "public morals" and "public order" policy objective in both the original proceedings and again in the compliance proceedings.[67] Accordingly, the arbitrator rejected Antigua's proposed counterfactual, which assumed that United States would provide unlimited market access for cross-border remote betting and gambling services to consumers in the United States.[68]

79. The arbitrator in *US – Gambling (Article 22.6 – US)* agreed with the United States that a "reasonable" compliance scenario would be one reflecting its policy objective.[69] In particular, the arbitrator adopted a counterfactual that would continue to restrict access to the cross-border supply of remote betting and gambling services, with the exception of one sector, remote horseracing betting and gambling. The arbitrator concluded that the counterfactual reflects a "reasonable assumption as to a situation in which the United States would have complied with the recommendations and rulings of the DSB *in the circumstances of this dispute, and thus can be considered to accurately reflect the benefits accruing to Antigua that have been nullified or impaired*."[70]

80. In *US – Offset Act (Byrd Amendment) (Brazil) (Article 22.6 – US)*, the arbitrator similarly applied a strict standard of equivalence, and refused to adopt an approach that would result in a higher level of suspension, as Indonesia suggests the Arbitrator should do here. The arbitrator rejected the proposal that a complaining member's benefits were nullified or impaired at a level corresponding to the value of the identified subsidy, finding instead that the level "corresponds

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[63] *US – Gambling (Article 22.6 – US)*, para. 3.24.

[64] *US – Gambling (Article 22.6 – US)*, para. 3.25.

[65] *US – Gambling (Article 22.6 – US)*, para. 3.26.

[66] *US – Gambling (Article 22.6 – US)*, para. 3.30 (emphasis added).

[67] *US – Gambling (Article 22.6 – US)*, para. 3.41.

[68] *US – Gambling (Article 22.6 – US)*, para. 3.16.

[69] *US – Gambling (Article 22.6 – US)*, para. 3.41.

[70] *US – Gambling (Article 22.6 – US)*, para. 3.61 (emphasis added).

to the value of exports from Brazil 'replaced' by the United States' domestic production."[71] In its finding, the arbitrator implied that its mandate under Article 22.7 to apply a standard of "equivalence", as opposed to a more flexible standard, precluded a calculation that might lead to a level that exceeds the actual nullification or impairment[72] and that "it would be difficult […] to conclude that any disbursement pursuant to an illegal measure automatically causes nullification or impairment at least equivalent to the total amount disbursed."[73] The arbitrator further stated that "we recall that past arbitrators under Article 22.6 of the DSU have deemed that benefit to correspond to the trade directly affected by the maintenance of the illegal measure."[74]

81. In this dispute, the United States has been consistent throughout the dispute settlement process that its policy objective is to reduce youth smoking and thereby reduce the number of smokers in the United States. The DSB acknowledged that this is a legitimate objective and rejected Indonesia's claim that less trade-restrictive alternatives are available. It therefore is entirely *unreasonable* to assume that the United States would comply with the recommendations and rulings of the DSB by removing Section 907(a)(1)(A) to allow the distribution of clove and other flavored cigarettes within the United States. Withdrawing the measure would harm the public health and run contrary to U.S. efforts to reduce youth smoking.

82. In order to be reasonable, any counterfactual must take into account that U.S. compliance will continue to protect the public health at the level at least the same as under Section 907(a)(1)(A). A counterfactual that involves permitting the sale of clove cigarettes would not be one that safeguards the public health, and therefore would not be reasonable.

83. It should be noted that Indonesia does not propose that a counterfactual involving the "complete withdrawal" of the measure actually reflects a *reasonable* compliance scenario, taking account of U.S. public health objectives. Rather, Indonesia proposes this counterfactual on the basis that it will result in a level of nullification or impairment, and corresponding level of suspension, that it deems is "likely to induce compliance." However, as mandated by Articles 22.4 and 22.7, the question for an arbitrator is what is the accurate level of nullification or impairment – not what is the level that might induce compliance.

84. As explained in the U.S. response to question 17, an implausible counterfactual is not reasonable and will not result in an accurate assessment of the level of nullification or impairment.

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[71] *US – Offset Act (Byrd Amendment) (Brazil) (Article 22.6 – US)*, para. 3.41.

[72] *US – Offset Act (Byrd Amendment) (Brazil) (Article 22.6 – US)*, paras. 3.47-3.52.

[73] *US – Offset Act (Byrd Amendment) (Brazil) (Article 22.6 – US)*, para. 3.49.

[74] *US – Offset Act (Byrd Amendment) (Brazil) (Article 22.6 – US)*, para. 3.55; *see also US – 1916 Act (EC) (Article 22.6 – US)*, para. 7.10 (explaining that the EU must apply a level of suspension "only up to the level if nullification or impairment.").

19. You argue that under any reasonable counterfactual, sales of clove cigarettes would not be permitted (United States' First Written Submission, para. 95). Please clarify whether this implies that, in any dispute in which it has been found that the objective pursued through the challenged measure is legitimate but the measure has been found to be applied in a discriminatory manner, the complaining Member would not be entitled to any level of suspension of obligations under the DSU?

85. The circumstances of this dispute do not imply that in any dispute in which it has been found that objective pursued through the challenged measure is legitimate but the measure has been found to be applied in a discriminatory manner, the complaining Member would not be entitled to any level of suspension of obligations under the DSU. The question of the level of nullification or impairment of benefits accruing to a complaining Member – and, the corresponding level of suspension of concessions or other obligations – is specific to every dispute and is a factual inquiry to determine the level of actual nullification or impairment.

86. The United States considers that, in this particular dispute, there is no reasonable, plausible compliance scenario under which the United States would weaken its protections that reduce youth smoking. A finding of inconsistency does not automatically entitle a Member to suspend concessions or other obligations.[75] The Arbitrator's determination in this dispute would not dictate determinations in future Article 22.6 proceedings, involving different measures, facts, and circumstances.

5.3 Questions for Indonesia

20. At paragraph 112 of your First Written Submission, you argue that "[b]because Articles 2.9.2 and 2.12 are procedural provisions with temporal requirements, any reasonable compliance scenario must include withdrawal of the measure." (emphasis added). At paragraph 115 of the same submission, you suggest that "it is true that the United States may not need to repeal Section 907(a)(1)(A) in order to come into compliance with its obligations under the TBT Agreement". Please clarify whether Indonesia considers that the withdrawal of the inconsistent measure is the only option available to the United States for the implementation of the DSB recommendations and rulings in this case.

21. Please clarify what is, in your view, the relevance of the fact that the objective of the challenged measure was recognized in the underlying proceedings to be legitimate, in determining what may constitute a "reasonable" or "plausible" counterfactual scenario (see United States' First Written Submission, para. 92)?

6 CLOVE CIGAR AND CIGARILLO EXPORTS

6.1 Question for both parties

[75] *EC – Bananas III (US) (Article 22.6 – EC)*, para. 6.10.

22. In paragraph 18 of its First Written Submission, the United States refers to Kretek's plan to "satisfy its U.S. market for clove cigarettes with a product marketed as a clove cigar". Reference is made to Exhibit US-9, a presentation prepared by Kretek with information based on "pilot testing and research". What is in your view the "U.S. market for clove cigarettes" referred to in paragraph 18? Does it matter for your answer that the research referred to on Exhibit 9, p. 1339 is based on survey replies of "adult consumers".

87. For purposes of the Arbitrator's mandate under Articles 22.4 and 22.7 of the DSU – that is, to determine whether Indonesia's proposed level of suspension is equivalent to the nullification or impairment of the benefits accruing to Indonesia under the TBT Agreement caused by the (alleged) inconsistency of the U.S. measures – the only relevant issue with respect to the U.S. market for Indonesian clove cigars is whether it is essentially the same as the previous U.S. market for clove cigarettes. To the extent that Indonesian exporters of clove cigarettes have maintained their level of exports by selling essentially the same product to the same market by packaging and marketing the product as a "clove cigar" instead of a "clove cigarette" (in an attempt to fall outside the scope of Section 907(a)(1)(A)), Indonesia's benefits under the TBT Agreement are not being nullified or impaired.

88. Company documents from Kretek International ("Kretek"), which occupied 97 percent of the market for clove cigarette imports in the United States, substantiate that the current market for clove cigars is the old market for clove cigarettes. Kretek's July 2009 National Sales Meeting Presentation makes clear that clove cigars fulfill the exact same market as clove cigarettes. The presentation details how Kretek will effect a "seamless conversion to clove cigars as cigarettes are depleted."[76] Kretek's presentation explains that the company will offer clove cigars in the "other tobacco product" ("OTP") category[77] – with the intent of putting them in a category currently not subject to Section 907(a)(1)(A). Slides 1330-31 illustrate Kretek's plan to phase in sales of clove "cigars" in mid-2009, at the same time that sales of clove "cigarettes" are winding down. By December 2009, sales of clove products marketed as cigars would (and did) completely replace sales of clove cigarettes at just over 4500 cases.[78] Indeed, this plan is borne out in the import data, which shows that imports of Indonesian cigars replaced the level of imports of clove cigarettes by the end of 2009.

89. Indonesia is not tapping a new or different market in the United States for clove cigars. The fact that there is one U.S. market for "cloves" – *i.e.*, clove cigarettes or clove cigars – is provided by Kretek. As the company details in its July 2009 presentation, the key to a smooth "conversion" to clove cigars is to deliver essentially the same product to the same consumers through the same distributors and marketing.

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[76] Exhibit US-9, p. 1332.

[77] Exhibit US-9, p. 1334 ("A replacement product for Djarum Clove Cigarettes. OTP category penetration at retail."); p. 1335 (Managing the move to OTP is critical to success.").

[78] *See also* Exhibit US-9, p. 1336 ("Roll-out plan to be executed at national scale beginning July 30. Major distributor listings already in place. All seven styles by Sept. 15.").

1. Same product. Kretek makes clear that its goal is to replace clove cigarettes with a product that consumers will recognize as basically the same and which will meet their expectations:

   - Djarum clove cigars are a "replacement product for clove cigarettes" that deliver the "rich smooth taste clove smokers expect."[79]

2. Same consumers. Phasing in clove cigars is not designed to tap a new market, but "necessary […] to satisfy 1.3 million clove smokers."[80] Kretek consumer research confirms that the product meets the company's objective, showing that:

   - "[I]t's the clove rather than the product format. Cigar/cigarette choice is secondary";

   - a "strong majority of clove smokers state they will transition to new cigar product"; and

   - "[C]love smokers are looking for their 'clove moment' and recognize the taste and aroma of clove are nearly the same."[81]

3. Same distributors and marketing. Kretek's presentation details how it will achieve its "conversion" to clove cigars through its existing distributor customers and marketing displays:

   - A company official explained that "we are number one in cloves and we want to stay that way – continuing to provide our distributor customers with a solid source of business." [82]

   - Kretek links the goal of "seamless conversion to clove cigars as cigarettes are depleted" to its ability to "maintain the continuity of our relationship with each distributor."[83]

   - "Maintaining continuity" includes, with respect to merchandising, a "zero sum transfer of existing specialty display space to cigars."[84] Pages 1344-1346 describe the different types of in-store display cases through which Kretek will

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[79] Exhibit US-9, p. 1334.

[80] Exhibit US-9, p.1335.

[81] Exhibit US-9, p. 1339.

[82] *See, e.g.*, Exhibit US-8 (Email from John Geoghehan to "Kretek Sales" and "Kretek Manager," May 14, 2009).

[83] Exhibit US-9, p. 1332.

[84] Exhibit US-9, p. 1337.

> realize its "zero-sum trade-out"[85] of point-of-sale display of clove cigarettes for clove cigars.

There is no reason to doubt what Kretek expressly confirms – that imports of clove cigars from Indonesia replaced imports of clove cigarettes. This fact is corroborated by the trend in U.S. import and retail data,[86] which shows that this complete replacement of clove "cigars" for clove cigarettes took place by the end of 2009.

90. Finally, for purposes of determining the level of nullification or impairment, it does not matter whether the market in the United States for "cloves" is composed of "adult consumers." What matters is that the market has remained consistent during the "conversion" from clove cigarettes to clove "cigars." Indonesian exporters are delivering essentially the same product to the same market at nearly the same level, meaning there is no loss in trade.

91. However, several points are worth emphasizing with respect to the presentation's focus on "adult consumers." First, as Kretek's slide presentation notes on page 1326, the legal smoking age in the United States was and remains 18 years old. The United States finds it difficult to believe that any company, including Kretek, would commission consumer studies or surveys for marketing purposes that target a population that legally cannot use the product at issue. Therefore, it is not surprising that a presentation for a national sales meeting of a major cigarette manufacturer would present data drawn from research and surveys among consumers who legally could use the product. This does not mean, however, that the U.S. market for cloves is not primarily composed of young people who are just beginning to smoke, including underage youth.

92. Second, as the United States stated during the original proceedings, the "window of initiation" for smoking (*i.e.*, the age range when more than 96 percent of addicted smokers first started smoking) is 12 to 26 years of age. Accordingly, it would be consistent with this "window of initiation" that Kretek's survey of "adult consumers" consisted of the population of consumers ages 18-26 who are "at-risk" of using "starter" products and becoming addicted smokers.

6.2 Questions for the United States

23. At paragraph 88 of your First Written Submission, you state that "the guiding principle in determining the level of nullification or impairment should be to determine what would have been the <u>value of Indonesia's clove cigarette exports</u> to the United States in the situation of compliance" (United States' First Written Submission, para. 88, emphasis added). Please explain how you reconcile this with your argument that the level of benefits accruing to Indonesia must take account of the fact that Indonesian clove

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[85] Exhibit US-9, p. 1347.

[86] *See* Exhibit US-5 and Exhibit US-6.

manufacturers "have not been economically impacted" by the US measure (United States' First Written Submission, para. 97).

93. In paragraph 88 of its first written submission, the United States sets out the benchmark for determining the level of nullification or impairment, which is to determine what would be the value of Indonesia's clove cigarette exports to the United States in a reasonable situation of compliance.[87] In this dispute, the level is zero. There is no compliance scenario under which clove cigarette exports to the United States would increase.

94. In paragraph 97 of its first written submission, the United States responds to Indonesia's unrealistic compliance scenario under which the United States would re-admit cloves cigarettes to the U.S. market. Because clove cigarette manufacturers have not been economically impacted by Section 907(a)(1)(A), there would be no change in the level of Indonesian exports to the United States even in this compliance scenario. As Kretek's July 2009 national sales meeting presentation confirms, the market for clove cigarettes and clove cigars is one market: a single market for "cloves." In 2009, there was a zero-sum conversion from one product to the other. Therefore, the evidence shows that exports of one product merely take the place of exports of the other. In other words, clove cigarette manufacturers have not been economically impacted by Section 907(a)(1)(A).

95. Whether Indonesian firms export cloves marketed as "clove cigarettes" or "clove cigars," the level of exports would be the essentially same either way. Therefore, one must expect that re-admitting clove cigarettes would not result in any increase in exports of clove cigarettes because the same manufacturers are already meeting demand with an identical, slightly more attractive product.

24. In paragraph 99 of your First Written Submission, you provide evidence regarding the revenue accrued to Indonesian manufacturers from sales from clove cigarettes and from 'cigars, cheroots, and cigarillos'. Could you complement this information with information on US consumer spending on clove cigarettes and on clove cigars and cigarillos by consumer group (e.g. by age group, by gender, by geographical location of consumption).

96. The United States is able to provide evidence of the volume of consumption of clove cigarettes and clove cigars in the United States based upon U.S. import data.[88] However, the U.S. Government does not have access to U.S. consumer spending on clove cigarettes or clove cigars by consumer group, and therefore has not been able to identify the specific information requested. The Nielsen Company provided retail sales by flavor and brand going back to 2009, which demonstrates that nearly all clove cigars sold in the United States are imported from

[87] *See also* U.S. Responses to Arbitrator's Advance Questions, questions Nos. 17 and 18.

[88] Exhibit US-5.

Indonesia, and nearly all cigars imported from Indonesia are clove-flavored,[89] but the United States has not been able to obtain from the Nielsen Company information responsive to the Arbitrator's request.

97. As noted in the U.S. response to question 22, for purposes of determining the level of nullification or impairment, the composition of the market in the United States for clove cigarettes and clove cigars is only relevant to the extent that it is the same. Kretek's internal communications[90] and July 2009 presentation[91] demonstrate that the market is the same. Indonesia has not rebutted this evidence. If Indonesian exporters are exporting essentially the same product to the same consumers at the same level, then the benefits accruing to Indonesia under the TBT Agreement are not being nullified or impaired.

25. Please comment on Indonesia's argument that the United States confuses the issue of "to whom benefits are owed under the WTO Agreements" (Indonesia's First Written Submission, para. 110).

98. The United States does not disagree with Indonesia that "the benefits and obligations of treaties accrue to the government signatories, not their respective nationals."[92] However, Indonesia's argument misses the point. To determine the level of nullification or impairment, every Article 22.6 arbitrator in the past has examined the export level of the complaining Member's private industry. Indeed, there is no way to quantify the level of nullification or impairment without reference to the export activity among the complaining Member's industry, which, it should go without saying, is generally made up of private parties, who are not the Member itself, and are not legally bound by, or legal beneficiaries of, the covered agreements. Even Indonesia's calculation of the level of nullification or impairment is based on the level of its private industry's exports of clove cigarettes. Therefore, Indonesia's observation that the benefits and obligations of the WTO Agreement accrue to the government signatories does not contradict the U.S. argument that there is no nullification or impairment of the benefits accruing to Indonesia under the TBT Agreement because Indonesian clove exporters are maintaining their level of exports.

6.3 Question for Indonesia

26. Please comment on the information presented by the United States at paragraphs 14-20 and 97-100 of its First Written Submission.

7 VALUE OF US CLOVE CIGARETTE IMPORTS

[89] Exhibit US-6.

[90] Exhibit US-8.

[91] Exhibit US-9.

[92] Indonesia's First Written Submission, para. 119.

7.1 Questions for both parties

27. The United States argues that Indonesia's speculation about trade values where actual numbers exist constitutes an "unreasonable assumption" (United States' First Written Submission, para. 104). Indonesia responds that its 2009 estimated imported data is not "unreasonable" (Indonesia's First Written Submission, para. 121). Do the parties agree that the Arbitrator should accept Indonesia's calculation of the annual average of US clove cigarettes imports unless it is unreasonable?

99. The U.S. position is not that the Arbitrator should use Indonesia's calculation unless it is unreasonable. Rather, the United States believes that the Arbitrator should use the most accurate methodology available, which may be Indonesia's calculation unless the arbitrator determines that a different calculation would be more accurate, and therefore more reasonable. Consistent with the Arbitrator's mandate under Article 22.7 of the DSU, in determining if the requested level of authorization is equivalent to the level of nullification or impairment, an arbitrator generally will determine the actual level of nullification or impairment. When determining the actual level of nullification or impairment, it is appropriate to use the most accurate methodology available.

100. Even assuming Indonesia's unrealistic counterfactual, the Arbitrator still would need to assess the level of nullification or impairment *as accurately as possible*. Indonesia proposes to determine the level of nullification or impairment based on an annual average of trade flows during the three year period preceding the ban.[93] The United States does not object to this approach. However, in practice, Indonesia uses an annual average of trade flows based on the *two-and-a-half years* preceding the ban, and replaces the value of exports for 2009 with a guess, including a hypothetical level for the three-month period *after* Section 907(a)(1)(A) went into effect. As the United States stated in paragraph 110 of its first written submission, "Indonesia provides no rationale as to why it would be more accurate to guess at monthly totals rather than to use the actual totals for the full three years (or more) preceding the ban." The United States objects to Indonesia's calculation because it does not most accurately reflect trade flows in the three years preceding the ban – Indonesia's own proposed benchmark for determining the likely future level of annual trade flows. It is inaccurate, and therefore unreasonable, to calculate the average based on these hypothetical trade levels.

28. In its methodology paper, Indonesia indicates that it uses data from "the three-year period". In its First Written Submission, the United States indicates that using a longer historical reference period would yield a lower annual average, but appears not to object to the use of a three-year reference period. Is the Arbitrator correct in its understanding that, although the parties disagree on the date from which the three-year period should be calculated (and on whether that calculation may be based on estimates), the parties agree that the calculation could be based on a three-year reference period?

[93] Indonesia's Methodology Paper, p. 1.

101. Yes.

7.2 Question for the United States

29. Please comment on Indonesia's argument that the United States fails to offer due consideration to the fact that demand for clove cigarettes was impacted prior to the implementation of Section 907(a)(1)(A) (Indonesia's First Written Submission, paras. 110, 122).

102. Each party bears the burden of providing evidence to substantiate its claims. Indonesia asserts, but provides no evidence, that clove cigarette retailers were "dissuaded" from importing additional clove cigarette inventories "long before" Section 907(a)(1)(A) took effect. It is unclear how Indonesia intends for this unsubstantiated assertion to support its contention that the partial, manipulated import data from 2009 is more reliable and accurate for purposes of determining an average annual level of imports than actual data for the three years preceding the implementation of Section 907(a)(1)(A).

103. Moreover, Indonesia does not specify in its first written submission exactly when – for example, which month in 2009 – it believes that retailers began to be dissuaded from importing clove cigarettes. Indonesia's methodology paper suggests this supposed decline occurred in July 2009.[94] However, the United States *did* offer a calculation accounting for this alleged occurrence. In paragraphs 112 and 127 of its first written submission, the United States provides a calculation incorporating import data for the first six months of 2009 – that is, from January through June, up to the time that Indonesia claims that imports started to "drastically drop."[95] In other words, the United States accommodated Indonesia's wish to incorporate 2009 data, and to exclude the data from the months supposedly affected by the impending measure. Therefore, it is simply not the case that the United States failed to offer due consideration to Indonesia's undocumented assertion that demand began to decline before Section 907(a)(1)(A). took effect.

104. The fact remains that Indonesia's calculation for the average annual value of clove cigarette imports needlessly invites the arbitrator to speculate. Indonesia acknowledges that a proper benchmark would be the average of the annual value of imports in the three years preceding when Section 907(a)(1)(A) went into effect. However, contrary to this position, Indonesia then derives an average based on the two-and-a-half year period before Section 907(a)(1)(A) went into effect, and unreasonably adjusts this average upward for July-September 2009 and for the remainder of the year (if Section 907(a)(1)(A) were not in effect). The result is not an accurate average, but a speculative one. By replacing the actual import level for 2009 with a hypothetical level (based on a contrived and unsubstantiated notion of what would have occurred but for the ban), Indonesia's calculation is not actually based on three full years of data.

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[94] Indonesia's Consultant Report, p.1.

[95] Indonesia's Consultant Report, p.1; U.S. First Written Submission, paras. 112, 127.

105. Additionally, adopting this approach artificially inflates the three-year average by excluding 2006 import data – which was significantly lower than 2007 and 2008 – from the calculation. Indonesia has not explained why it has manipulated the calculation in this way. However, if Indonesia believes that this is somehow necessary because it does not consider the 2006 data to be an accurate representation of its normal trade flows, it should account for this by expanding the time period over which imports are examined rather than to contrive a hypothetical level that includes a period of time after the measure took effect.

106. However, an average based on five or five-and-a-half years (to include the first six months in 2009 before imports purportedly started "drastically dropping") illustrates that Indonesia's selection of only three years is actually favorable to Indonesia. The more years included in the average, the lower the average becomes.[96] While the United States is not objecting to the use of a three year period instead of a period of five years or more (even though the longer period provides more data and is thus arguably more accurate), it is manifestly unreasonable to rely upon contrived import levels where actual import levels are available.

7.3 Question for Indonesia

30. Please comment on the accuracy of the yearly values provided by the United States at paragraph 112 of its First Written Submission. Please clarify whether you agree with the United States that, where available, actual trade data should be preferred as the basis for calculating the level of nullification or impairment of benefits?

8 CALCULATION METHODOLOGY – THE USE OF A "MULTIPLIER" IN DETERMINING THE LEVEL OF NULLIFICATION OR IMPAIRMENT

8.1 Questions for Indonesia

31. Article 22.3(d)(ii) of the DSU refers to "the broader economic elements related to the nullification or impairment and the broader economic consequences of the suspension of concessions or other obligations".

(a) Please comment on the US argument that this provision distinguishes nullification or impairment from "the broader economic elements related to the nullification or impairment " (United States' First Written Submission, para. 116), and on the implications of this distinction for the inclusion of a "multiplier" in the calculation of the level of nullification or impairment;

(b) Please comment on the relevance of "the broader economic consequences of the suspension of concessions or other obligations" (emphasis added) to the

[96] *See* U.S. First Written Submission, para. 127 (illustrating that average annual value of imports of clove cigarettes for the five (or five-and-a-half) year period before Section 907(a)(1)(A) went into effect is lower, $12.6 million and $12.8 million, respectively).

equivalence between the level of suspension and the level of nullification or impairment.

32. Please comment on the US argument that Indonesia's proposed multiplier is included to reflect effects on internal transaction within the Indonesian economy, and as such, are not Indonesian lost exports properly included in a measurement of Indonesia's nullification or impairment of trade benefits under the covered agreements (United States' First Written Submission, para. 119).

33. Please comment on the US argument "that to the extent that the level of nullification or impairment is increased by a multiplier to reflect broader economic effects on Indonesia of the U.S. measure, the corresponding level of suspension would need to be decreased by an appropriate divisor to account for the broader economic effects on the U.S. economy of the suspended trade (that is, through the 'multiplier effect' of the suspension of concessions)". (United States' First Written Submission, para. 121).

34. Please clarify how the elements identified at paragraph 117 of your First Written Submission support the choice of a multiplier effect of 2.5.

9 CALCULATION METHODOLOGY – INFLATION AND DECLINING DEMAND FOR CIGARETTES

9.1 Questions for the United States

35. With reference to footnote 139 of the United States' First Written Submission, please clarify whether and if so how the Arbitrator should take inflation into account in setting the level of nullification or impairment.

107. It is unclear how inflation would factor into any reasonable calculation of nullification or impairment. Assuming Indonesia's counterfactual – and not taking into account the effect that Indonesian exports of clove cigars would have on the level of exports of clove cigarettes – the level of nullification or impairment would be equal to the level of exports of clove cigarettes during the benchmark period (presumably, the three years preceding when Section 907(a)(1)(A) took effect), adjusted to reflect demand.

36. Regarding the question whether "the declining demand for regular or menthol cigarettes is dispositive of a declining demand for clove cigarettes" (Indonesia's First Written Submission, para. 123), please comment on the relevance of the figures in Exhibit US-5 regarding annual consumption of clove cigarettes over the period 1998-2009.

108. With respect to the import data for clove cigarettes and clove cigars reflected in Exhibit US-5, the United States notes that the average annual value of Indonesian clove cigarette imports from 2006-2008 (the period Indonesia proposes as a benchmark) is $13.8 million. When adjusted to reflect reduced demand from the benchmark period to 2012 (the last year for which complete data is available), the figure is reduced to $**11.06 million**, as explained in paragraph 127 of the U.S. First Written Submission.

109. In 2009, clove imports switched from "cigarettes" to "cigars." The average annual value of clove cigar imports in the four years after Section 907(a)(1)(A) took effect was **$12.5 million** – lower than the benchmark before accounting for decreased demand.[97] While clove cigars appear to be consumed at a slightly higher volume than clove cigarettes were consumed, this data corroborates that clove consumption is generally tracking the decline in cigarette consumption in the United States.

110. In addition, Indonesia is incorrect that it is "mere speculation" that demand for clove cigarettes would decline along with overall demand for cigarettes in the United States. As an initial matter, Indonesia asserted throughout the original proceedings that the market share for clove cigarettes "has remained *generally flat* at around 0.1 percent" for at least the last decade.[98] At the First Meeting of the Panel in the original panel proceedings, counsel for Indonesia sought to make the point that – unlike U.S.-produced flavored cigarettes – Indonesian clove-flavored cigarettes were not, and had never been, heavily marketed, and instead had always occupied a small sliver of the U.S. market.

111. Therefore, Indonesia has no basis to claim now that clove cigarettes (which, according to Indonesia, were never marketed as heavily as other flavored cigarettes) would somehow defy the downward trend resulting from U.S. efforts to curb youth smoking. The United States' serious and substantial commitment to continue to reduce smoking – in particular by targeting the youth demographic that was attracted to clove and other flavored cigarettes – would undoubtedly have an impact on clove and other flavored cigarettes, if they were permitted back on the market.

112. The United States continues to develop tighter and more effective tobacco regulation, and the twenty-year trend of decreasing consumption will only continue and accelerate. Clove cigarettes would not be exempt from measures affecting the demand of all types of cigarettes. Any authorized suspension of concessions that does not take into account this shrinking demand would not be equivalent to the level of nullification or impairment of the benefits accruing to Indonesia under the TBT Agreement.

37. Please clarify your argument that under a methodology looking prospectively to a current level of nullification or impairment, "any level would need to be adjusted annually to reflect further decreases or increases in demand" (United States' First Written Submission, para. 128, emphasis added). How should the Arbitrator take into account continually decreasing demand that is projected for a given product? Is the United States suggesting that the Arbitrator should set different levels of nullification or impairment for different years, i.e. one figure for 2014, another lower figure for 2015, and so on?

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[97] Exhibit US-28 (update to Exhibit US-5, including recently available import data for 2013).

[98] Indonesia's Responses to Orig. Panel's Questions, question 16 (emphasis added). *See also* Indonesia's Orig. First Written Submission, paras. 7, 40; Indonesia's Orig. Second Written Submission, para. 88; Indonesia's Opening Statement at the First Meeting of the Orig. Panel, para. 54.

113. No. Rather, the United States is suggesting that the Arbitrator should follow the approach used by a number of other arbitrators of prescribing a formula to determine the level of suspension after some period where there is a specified level.

114. For example, if the Arbitrator were to determine for the remainder of 2014 a level of nullification or impairment corresponding to the average value of annual imports over a benchmark period (*e.g.*, 2006-2008, the three years preceding the ban), then the Arbitrator should apply a formula, such as the example provided in paragraphs 125-128 of the U.S. First Written Submission, to adjust the authorized level of suspension by the percentage of decreased or increased demand for cigarettes in the United States reflected in the most recent available annual data. So, as noted in response to question 88, the level for 2013 would be $11.06 million, which is equal to the benchmark ($13.8) reduced by 19.7 percent, which is the percentage of decline in demand from the benchmark period to 2012. To calculate the level for 2014 or 2015, the Arbitrator would adjust $11.06 million by the percentage of increase or decrease in demand reflected in the most recent available annual data on consumption.

9.2 Questions for Indonesia

38. Indonesia accounts for inflation in the context of a multi-step calculation of the level of nullification or impairment based on a "multiplier effect" (Indonesia's Methodology Paper, pp. 3-4). Without prejudging the issue of whether a multiplier should be included in the calculation, please clarify what the level of nullification or impairment would be in 2014 dollars, i.e. taking inflation into account, without including a multiplier as a step in the calculation.

39. At paragraph 123 of its First Written Submission, the United States, citing the prior decisions in EC – Hormones (US) (Article 22.6 – EC) and US – Gambling (Antigua) (Article 22.6 – US), argues that the counterfactual level of cigarette exports "would need to reflect any increase or decrease in demand for the product in the United States after the measure went into effect". Does Indonesia agree with that proposition as a general premise?