

In the LCIA

No. 111790

THE UNITED STATES OF AMERICA,

Claimant,

v.

CANADA,

Respondent.

UNITED STATES STATEMENT OF CASE

NON-CONFIDENTIAL VERSION

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NON-CONFIDENTIAL

1. Pursuant to paragraph 2.1.f of Procedural Order No. 1, claimant, the United States, respectfully submits this Statement of Case, together with evidence and authorities.

INTRODUCTION

2. Since early 2007, Canada's largest softwood lumber exporting province has systematically underpriced timber harvested from Crown forests and sold it to Canadian lumber producers in breach of the 2006 Softwood Lumber Agreement ("SLA" or "Agreement"). In the SLA, Canada promised the United States one of two things regarding "stumpage" fees that British Columbia ("BC" or "the BC government") charges lumber producers for Crown timber: BC either would apply its newly-reformed timber pricing system to reflect its suitability for producing lumber, or if BC modified its system, it would do so in a way that maintained or improved the extent to which its stumpage fees reflect market conditions. BC did neither of these things. Instead, it ran in the opposite direction from market conditions by selling large volumes of lumber-quality timber for C\$0.25 per cubic meter, the fixed minimum price generally reserved for "reject" logs incapable of producing lumber. This was a breach of the SLA.

3. Over 90 percent of the forests in BC are owned by the provincial government. Under its timber pricing system, BC charges lumber companies a fee, known as "stumpage," for timber harvested from Crown forests. Stumpage fees are based on the timber's "grade"—an evaluation of the timber's suitability for manufacture into lumber. Before April 2006, the BC system had automatically graded *all* timber affected by the mountain pine beetle ("MPB timber") as lumber "reject" priced at the minimum stumpage fee, even though most beetle-affected timber can be used to produce

merchantable lumber. This, of course, was a tremendous competitive advantage for Canadian lumber companies harvesting MPB timber for the manufacture of their lumber products.

4. While Canada and the United States were negotiating the SLA in 2006, BC agreed to reform its pricing system to address predicted increases in MPB timber. Under the reforms, BC would sell its timber at prices that reflect whether the timber could be used to make lumber, not whether the timber was affected by the mountain pine beetle. The reforms recognized that the mountain pine beetle does not impair the quality of timber, which still can be used to produce lumber, and therefore recognized that BC should not sell all MPB timber for the minimum stumpage fee. BC anticipated that most MPB timber would be sold as lumber-quality. The calibrated new system, which also adjusted the timber price to reflect the effects of the mountain pine beetle, was a critical component of the SLA and of great importance to the United States, which had been concerned for years about BC's pricing system.

5. In April 2006, BC reformed its timber grading rules with the stated intent of pricing MPB timber in a way that reflects its suitability for use in making lumber. Shortly thereafter, Canada announced that the two governments had reached an agreement on the general terms of the SLA.¹

6. The SLA, effective as of October 2006, grandfathered the reforms made part of BC's timber pricing system. Although the SLA permitted BC to change the

¹ See C-61, <http://news.gc.ca/web/articleeng.do?crtr.sj1D=&crtr.mnthndV1=8&mthd=advSrch&crtr.dpt1D=&nid=209789&crtr.lc1D=&crtr.tp1D=&crtr.yrStrtV1=2006&crtr.kw=softwood%2Blumber&crtr.dyStrtV1=26&crtr.aud1D=&crtr.mnthStrtV1=2&crtr.page=1&crtr.yrndV1=2006&crtr.dyndV1=6> (visited Aug. 8, 2011).

system, any changes had to maintain or improve the extent to which timber prices reflect market conditions for BC to avoid a breach.

7. But after reforming its system in 2006, BC quickly abandoned the new reforms beginning in early 2007, almost exactly when the North American housing and softwood lumber markets began to precipitously decline, driving the price of lumber down. BC resumed selling MPB timber for the minimum stumpage fee, to the enormous benefit of BC lumber producers and exporters, and in breach of the SLA.

8. Canada acknowledges that MPB timber can be used to manufacture merchantable lumber. The province's own commissioned studies of lumber recovery from MPB timber uniformly demonstrate this. More recently, Vancouver showcased MPB lumber during the 2010 Winter Olympic Games by constructing its speedskating venue using one million board feet of lumber made primarily from MPB timber.² Yet soon after BC enacted its reformed system, and just months after the two governments entered into the SLA, BC restored the windfall that it previously had given BC lumber producers and exporters for MPB timber under the pre-April 2006 system. When those producers and exporters then sell lumber made from the cheaply-purchased timber, they recover substantially more money than they could have had they purchased the timber under the reforms grandfathered by the SLA. By its actions, BC has provided its lumber industry benefits approaching C\$500 million. Because these benefits breach the SLA, the United States has brought this arbitration proceeding to require Canada to remedy its breach.

² See C-89, <http://www.nrcan.gc.ca/com/olymp/vidoval-eng.php> (last visited Aug. 6, 2011).

I. Relevant Provisions Of The SLA

A. The United States Negotiated For A System Of Export Measures

9. The SLA entered into force on October 12, 2006, and resolved the decades-long series of disputes over Canadian softwood lumber exports into the United States. As part of the SLA, the United States agreed to cease collection of antidumping and countervailing duties imposed under its domestic laws and to refund US\$5 billion in deposits of duties that it had collected on Canadian softwood lumber entering the United States since May 2002.³

10. In exchange, Canada agreed to apply Export Measures – export charges and volume limitations – to shipments of softwood lumber from Canada into the United States when the price of lumber products falls below a certain level.⁴ The price of lumber products has remained low since the inception of the Agreement in October 2006, and thus the Export Measures have been in effect almost every month in which the SLA has been in force.

11. The Agreement gave Canada's different lumber producing regions, including BC Interior, a choice regarding the types of Export Measures to which they would be subject. Regions selecting Option A chose to pay only an export charge and would not be subjected to a volume restraint.⁵ Regions electing Option B chose to pay a

³ C-1, SLA, arts. III-IV.

⁴ *Id.*, arts. VI-VIII.

⁵ *Id.*, art. VII, ¶ 1.

smaller export charge in combination with a volume restraint.⁶ BC Interior chose Option A, meaning that it has never been subject to a volume restraint. Rather, BC Interior may export as much softwood lumber to the United States as it wishes, so long as it pays the required export charges.

12. The Export Measures are a critical part of the benefit for which the United States bargained in the SLA. The United States agreed not to exercise its right to apply most of its own domestic trade remedy laws in return for Canada's agreement to self-regulate the production and export of softwood lumber, within the agreed-upon parameters. The Parties agreed to exchange certain information to ensure that the Agreement functions as intended.⁷ As part of that exchange, Canada is required to provide the United States information regarding exports of lumber to the United States, so that the parties can reconcile Canada's export information with the United States' import information. Canada is also required to notify the United States of any change to provincial timber pricing systems, together with an explanation, including any evidence showing how the change improves the statistical accuracy and reliability of the system, or how the change maintains or improves the extent to which the prices reflect market conditions.⁸

⁶ *Id.*

⁷ *Id.*, art. XV.

⁸ *Id.*, art. XV, ¶¶ 13, 14.

B. Canada Agreed Not To Offset Or Circumvent The Export Measures

13. Canada further agreed not to offset or circumvent the Export Measures.

This commitment is memorialized in Article XVII of the SLA and applies to Canada and all of its provinces, including BC.⁹

14. The Anti-circumvention article prohibits a party from taking any “action to circumvent or offset the commitments under the SLA 2006, including any action having the effect of reducing or offsetting the Export Measures or undermining the commitments set forth in Article V.”¹⁰ “Grants or other benefits” that Canadian federal, provincial, or local governments provide *de jure* or *de facto* to softwood lumber producers are deemed to circumvent the Export Measures, unless they fall within certain limited exceptions.¹¹ In other words, benefits that are provided on a *de jure* or *de facto* basis *per se* circumvent the Agreement, unless an exception applies.

15. The SLA’s Anti-circumvention article contains two pertinent exceptions to the general prohibition on grants or other benefits provided to producers or exporters of Canadian softwood lumber.¹² First, the SLA provides that “measures that shall not be considered to reduce or offset the Export Measures in the SLA 2006 include without limitation”:

⁹ *Id.*, art. XVII, ¶ 2.

¹⁰ *Id.*, ¶ 1.

¹¹ *Id.*, ¶ 2.

¹² To be clear, the United States does not concede that any of the provision’s exceptions are pertinent. Rather, in its response to our Request for Arbitration, Canada invoked two exceptions, which we address here.

{P}rovincial timber pricing or forest management systems as they existed on July 1, 2006, including any modifications or updates *that maintain or improve the extent to which stumpage charges reflect market conditions, including prices and costs.*¹³

This is a grandfathering provision that permits Canada and its provinces to continue to apply provincial timber pricing or forest management systems or, if Canada wishes to change the system, requires that Canada maintain or improve the extent to which stumpage fees generated under these systems reflect market conditions.¹⁴

16. Second, the Agreement provides that “measures that shall not be considered to reduce or offset the Export Measures” in the SLA include:

{A}ctions or programs undertaken by a Party . . . for the purpose of forest or environmental management, protection, or conservation . . . provided that such actions or programs do not involve grants or other benefits that have the effect of undermining or counteracting movement toward the market pricing of timber[.]¹⁵

17. Read together, the Anti-circumvention provisions contemplate that any grant or other benefit provided by BC (or any Canadian province or governmental entity) circumvents the SLA if the grant or other benefit is provided to producers or exporters of

¹³ *Id.*, ¶ 2(a) (emphasis added).

¹⁴ *Id.* The SLA identifies BC’s Market Pricing System (“MPS”) as a “provincial timber pricing or forest management system.” SLA, art. XVII, ¶ 4. The BC provincial timber pricing system in the Interior, including the MPS, was reformed in the months before the SLA went into effect, and the definition of the MPS in the SLA reflects the MPS as it existed on July 1, 2006. *Id.*, ¶ 4(a), XXI, ¶35. Article XVII, ¶ 4(a) specifically provides that “[a]ny action that conflicts with the measures in the documents listed in Article XXI(35) may constitute circumvention.” *Id.*, art. XVII, ¶ 4(a). These BC-specific provisions clarify that any action that conflicts with the measures in the MPS as it existed on July 1, 2006, may constitute circumvention.

¹⁵ *Id.*, ¶ 2(c).

Canadian softwood lumber. There are limited exceptions to this rule, but, in general, these exceptions do not permit any grants or other benefits that are inconsistent with a movement toward the market pricing of timber, or, minimally, with maintaining the *status quo*.

C. The SLA Provides For A Dispute Resolution Process

18. The SLA also provides for dispute resolution procedures, including the referral of an unresolved dispute to arbitration for resolution by an arbitral tribunal.¹⁶ If the Tribunal finds a breach, the SLA provides that the Tribunal “shall” make two determinations: first, it determines a reasonable period of time for Canada to cure its breach; and, second, it determines appropriate compensatory adjustments to the Export Measures in an amount that remedies the breach if Canada fails to cure the breach within the reasonable period of time.¹⁷

II. Governing Law

19. The SLA and applicable international law, including customary international law applicable to the interpretation of treaties, govern this arbitration. Article 31 of the Vienna Convention on the Law of Treaties, May 23, 1969, 1155 U.N.T.S. 331 (“VCLT”) codifies customary international law on the interpretation of international agreements between state parties.¹⁸ Article 31(1) of the VCLT provides that

¹⁶ *Id.*, art. XIV, ¶ 6.

¹⁷ *Id.*, ¶¶ 22-23.

¹⁸ CA-1. Canada ratified the VCLT on October 14, 1970, and the treaty entered into force on January 27, 1980. While the United States is not a party to the VCLT, it has recognized since at least 1971 that the Convention is the “authoritative guide” to treaty law and practice. *See* CA-8, Letter from Secretary of State Rogers to President Nixon Transmitting the Vienna Convention on the Law of Treaties, Oct. 18, 1971, *reprinted in*

“[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.” In discussing Article 31, the International Court of Justice has recognized that “[i]nterpretation must be based above all upon the text of the treaty.”¹⁹

20. The VCLT permits use of:

supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31: (a) leaves the meaning ambiguous or obscure; or (b) leads to a result which is manifestly absurd or unreasonable.²⁰

III. Previous Disputes Under The SLA

21. This is the fourth arbitration brought under the SLA. The first proceeding was brought by the United States. In *United States v. Canada, LCIA No. 7941*, the Tribunal held that Canada breached the SLA by failing to perform a particular calculation

65 DEP'T OF ST. BULL, 684-89 (1971). The International Court of Justice has determined that Article 31 of the VCLT is reflective of customary international law. *See, e.g., CA-2, Kasikili/Sedudu Island (Bots. v. Namib.)*, 1999 I.C.J. 1045, 1059 (Dec. 13).

The VCLT applies by its terms to “treaties between States.” CA-1, VCLT, art. 1. The Convention defines a “treaty” as “an international agreement concluded between States in written form and governed by international law.” VCLT, art. 2, ¶ 1. Although the Agreement is not a “treaty” for purpose of Article II, § 2 of the United States Constitution, the cited provisions of the VCLT nonetheless should be used to interpret the Agreement because they reflect customary international law on the interpretation of international agreements.

¹⁹ CA-3, *Territorial Dispute (Libyan Arab Jamahirya v. Chad)*, 1994 I.C.J. 6, 20 (Feb. 3).

²⁰ VCLT, art. 32.

as of January 2007,²¹ and that Canada must compensate for the breach by collecting an additional 10 percent export charge upon softwood lumber shipments from Option B regions until the total amount of C\$63.9 million plus interest (totaling C\$68.26 million) was collected.²²

22. Importantly, the 7941 Tribunal also determined that both a cure and compensatory measures under the Agreement share the same goal: to wipe out the consequences of the breach, both past and present.²³ In other words, whether by acceptable cure or by imposition of the compensatory measures, Canada must wipe out all consequences of the breach, including retroactive consequences. The Tribunal relied on both the terms of the SLA and the general principle that a state is to provide full reparation for an injury caused by a wrongful act of that state—referring to the principle as reflected in Article 31 of the ILC Articles on State Responsibility.²⁴

23. The compensation in *United States v. Canada, LCIA No. 7941*, was straightforward—to the extent that Option B regions had paid lower tariffs on a particular volume of lumber exported to the United States, the compensation was an adjustment to the export charges.²⁵

²¹ CA-4, *United States v. Canada, Award on Liability*, LCIA No. 7941 Mar. 3, 2008).

²² CA-5, *United States v. Canada, Award on Remedies*, LCIA 7941, Feb. 23, 2009).

²³ *Id.*, ¶¶ 284, 295-96.

²⁴ *See id.*, ¶¶ 273-306.

²⁵ *Id.* at ¶¶ 330-31.

24. Shortly after the 7941 Tribunal issued its award, Canada brought its own proceeding. It requested that the 7941 Tribunal be reconstituted to decide the question of whether Canada had cured its breach when it failed to impose the compensatory export measures required by the Tribunal and instead conditionally offered to pay the United States through a check in the amount of US\$34 million. In its Award, the Tribunal held that its previous Award on Remedy did not contemplate that an offer to pay a lump sum, particularly a lump sum that was conditional and not accepted by the United States, could be a “cure.”²⁶

25. The United States also brought a second arbitration, this time alleging that six Canadian government benefit programs had breached the SLA by providing grants and other benefits to softwood lumber producers in violation of the Anti-circumvention article. The 81010 Tribunal determined that many of the programs breached the Agreement.²⁷ Regarding remedy, the 81010 Tribunal agreed with the 7941 Tribunal that “the remedies system of the SLA covers past effects,”²⁸ but relied exclusively on the SLA’s terms to reach that conclusion, rather than on other principles of international law.²⁹ Thus, two separate Tribunals have now agreed that the SLA requires both retrospective and prospective remedies.

²⁶ CA-7, ¶ 162, *Canada v. United States*, Award, LCIA No. 91312 (Sept. 21, 2009).

²⁷ CA-6, ¶¶ 157, 259, 283, 317, *United States v. Canada*, LCIA No. 81010 (Jan. 28, 2011).

²⁸ *Id.*, ¶ 324.

²⁹ *Id.*, ¶¶ 324-329.

ARGUMENT

I. The SLA Grandfathered The 2006 BC Interior Timber Pricing System, Which Graded Logs For Their Suitability For Lumber

26. BC reformed its grading and pricing system in April 2006 specifically to address the significant pricing imbalance in its old system. Under the old system, lumber producers paid a low, flat fee of C\$.25 for all MPB timber, regardless of whether the timber was suitable for manufacture into lumber. This system provided a windfall to producers purchasing MPB timber because they were able to buy cheap timber and make merchantable lumber out of it. At the same time, BC lumber producers were paying much higher prices for non-MPB timber. The April 2006 reforms drastically reduced this windfall, which, in turn, moved BC's pricing system toward the market pricing of Crown timber—a move that was critically important to the United States during the SLA negotiations because the windfall the BC lumber producers received for MPB timber put U.S. lumber producers at a competitive disadvantage.

27. This dispute arises from BC's abandonment of the April 2006 reforms. Although BC implemented the new system at first, portions of the BC lumber industry appear to have become quickly disillusioned with the system and, as the housing market in the United States tumbled in early 2007, put increasing amounts of pressure on BC to lower the price of MPB timber and BC conceded. By 2007, BC lumber producers were once again benefitting from the windfall they had enjoyed before the 2006 reforms, netting these producers benefits of nearly C\$500 million. These benefits received during the term of the SLA are the direct result of BC's actions. The background and history of Canada's breach are discussed below.

A. Canada's Response To The Latest MPB Outbreak Recognized That MPB Timber Is Largely Suitable For Lumber

28. During consultations and in response to the United States' Request for Arbitration, Canada suggested that the mountain pine beetle has rendered affected timber unsuitable for lumber and essentially worthless.³⁰ Canada's contention runs contrary to overwhelming evidence that MPB timber largely retains its quality and capacity to produce lumber, and contrary to BC's own assessment of the scope and severity of the MPB infestation when it instituted the reformed system in April 2006. In short, the mountain pine beetle cannot explain the dramatic increase in timber graded and priced at the minimum stumpage rate. A bit of background on the mountain pine beetle is useful to understanding the context of Canada's breach.

29. According to the BC Ministry of Forests, Lands, and Natural Resources Operations (formerly the Ministry of Forests and Range) (the "Ministry"), the mountain pine beetle is a natural part of the pine forest ecosystem in Interior BC and "play[s] an important role . . . by attacking older or weakened trees that are then replaced by healthy new pine forests."³¹ There have been numerous recorded mountain pine beetle outbreaks over the last century. The beetle bores into the tree bark of various pine species, including lodgepole pine, where it lays its eggs. After hatching, the larvae burrow in the layer between the bark and the wood, cutting off the flow of water and nutrients to the tree, and the tree eventually dies.³² While under the bark, the beetle transmits a fungus

³⁰ Can. Req. for Arbitration at ¶ 2.

³¹ C-3, CAN-037151-177 at CAN-037154.

³² C-90, http://www.for.gov.bc.ca/hfp/mountain_pine_beetle/facts.htm; *see also* C-4, CAN-032842-59 at CAN-032844.

that stains a tree's sapwood blue. The fungus has no effect on the integrity or structural soundness of the wood: BC states that "comprehensive testing has confirmed that the blue stain caused by the beetle has no effect on wood's strength properties."³³

30. The effects of the MPB have been divided into three "attack stages" identifiable by color.³⁴ The "green attack" stage is when the adult beetles have found a new host tree and bored underneath the bark to lay their eggs. The needles stay green and the tree appears healthy for a number of months after infestation. About one year after infestation, the "red attack" stage begins when the needles start turning red, a sign that the tree is dying. At this stage, which can last three to four years, the beetles have left the tree after mining the layer between the bark and the wood. Finally, the "grey attack" stage is when the needles have fallen off of the tree and only the bare branches remain.³⁵ Because the activity of the beetle does not affect the quality or structural integrity of the wood, lumber from MPB timber can be manufactured and put to the same uses and purposes as lumber from timber unaffected by the beetle.³⁶

31. In the 1990s, BC concluded that the increasing spread of mountain pine beetle would affect its forests far more significantly than earlier outbreaks. It created the "Mountain Pine Beetle Emergency Task Force" to further assess and develop methods to

³³ C-4, CAN-032842-859 at CAN-032844.

³⁴ *Id.*

³⁵ C-91, http://www.for.gov.bc.ca/hfp/mountain_pine_beetle/Updated-Beetle-Facts_Apr2011.pdf.

³⁶ C-92, <http://woodworkingnetwork.com/Denim-Pine/2003-0512/Article.aspx?oid=934721>; C-94, <http://www.theglobeandmail.com/globeinvestor/investment-ideas/little-beetle-a-big-puzzle-for-canadian-lumber/article1311993/>; C-93, [http://www.journalofcommerce.com/article/id35078\(Vancouver\)](http://www.journalofcommerce.com/article/id35078(Vancouver)).

mitigate any damage.³⁷ By 2005, the Ministry had estimated that the mountain pine beetle would kill up to 50 percent of mature lodgepole pine by 2008, and up to 80 percent by 2013.³⁸

32. In response, BC developed an action plan to address the problem, seeking to maximize the economic recovery from beetle-affected trees, among other things. BC projected that implementation of the action plan would reduce the share of MPB timber that would be sold at the minimum stumpage price.

B. Before April 2006, BC Automatically Graded And Priced All MPB Timber At The Minimum Stumpage Rate

33. The BC Interior timber pricing system assigns essentially one of two stumpage prices to any given stand³⁹ of trees: a variable price generated through a complicated economic model, or the flat minimum stumpage rate of C\$0.25 per cubic meter. Because the variable price is higher than the minimum price – usually significantly higher – the grading rules used to determine which logs are eligible for each price are a central component of the provincial timber pricing system.⁴⁰ The log grading

³⁷ C-6, at 3.

³⁸ C-7, CAN-000490-516 at CAN-000490.

³⁹ A stand is a group of trees with similar characteristics, such as age and species composition, that make the group distinguishable from the surrounding forest, and is officially defined as a “community of trees sufficiently uniform in species composition, age, arrangement, and condition to be distinguishable as a group from the forest or other growth on the adjoining area, and thus forming a . . . management entity.” C-13, p. 98, March 2008, available at <http://www.for.gov.bc.ca/hfd/library/documents/glossary/Glossary.pdf>.

⁴⁰ Although Canada owns the land on which timber is harvested, it does not inspect every tree to determine the proper grade. Rather, the companies that harvest timber hire “scalers” to inspect or “scale” the timber to determine the proper grade. BC then employs “check scalers” who randomly assess the accuracy of the scalers’ work. C-

system in place before April 2006 automatically assigned all MPB timber to a grade corresponding to the minimum stumpage fee, regardless of whether it could be used to produce merchantable lumber. The pre-April 2006 BC Interior scaling rules recognized six grades of logs:

Grade “Blank” – Sawlog

Grade 3 – Dead and Dry Sawlog

Grade 4 – Lumber Reject

Grade 5 – Dead and Dry Lumber Reject

Grade 6 – Undersized

Grade Z – Firmwood Reject

34. Under this system, the four most commonly-used grades were Blank, 3, 4, and 5.⁴¹ Among the four principal grades, the primary distinction was between “sawlog” (Grades Blank and 3) and “lumber reject (Grades 4 and 5).⁴² A “sawlog” was priced at the variable stumpage rate and “lumber reject” was priced at the minimum stumpage rate, *with one important exception*: “sawlogs” harvested from “dead and dry” trees – Grade 3 logs – were assigned the minimum stumpage price, as if they were “lumber reject.” Accordingly, logs assigned Grades 3, 4, and 5 were sold for \$0.25 per cubic meter, and only logs assigned Grade “Blank” were priced at the variable stumpage rates. The only

42, CAN-010667-677 at CAN-010671. Scalers are governed by the BC Scaling Manual and BC scaling regulations.

⁴¹ Grade 6 was reserved for “undersized” trees that were harvested despite being too small to meet the minimum diameter requirements, and Grade Z was for logs that were so defective as to be virtually unusable for any commercial purpose. C-8, at §§ 6.6.3, 6.6.7, and 6.6.12.

⁴² C-8, at § 6.6.

difference between logs classified as Grade “Blank” and logs classified as Grade 3 was that the latter came from trees that were dead at time of harvest.

35. To determine whether a log should be classified as a sawlog or “lumber reject,” BC developed what is known as the “50/50 rule.” The 50/50 rule defined a pine “sawlog” as a “log or slab 2.5 m or more in length and 5 cm or more in radius where . . . at least 50% of the gross scale can be manufactured into lumber, and at least 50% of the lumber will be merchantable.”⁴³ BC defined “merchantable” lumber as “good, strong, general purpose lumber graded as better than utility or number 3.”⁴⁴

36. Accordingly, under the old system, Grade 3 “dead and dry” sawlogs met the standard for a sawlogs harvested from live trees in terms of their capacity to produce lumber, but were nonetheless assigned the minimum stumpage price. In other words, the system then in place before April 2006 priced *all* “dead and dry” timber (Grades 3 and 5) at the minimum stumpage rate of C\$0.25 per cubic meter. That is, BC sold all logs from trees that were dead when harvested at the minimum stumpage rate, regardless of whether those logs could be used to produce merchantable lumber.

C. The April 2006 Reforms Anticipated A Rising Volume Of MPB Timber And Priced Timber According To Its Lumber Suitability

37. In the early 2000s, BC realized that it needed to address continuing mountain pine beetle outbreaks and reform its grading and pricing system. Given that increasing amounts of pine would be harvested from beetle-affected trees, and that the majority of this timber would be suitable for lumber, BC recognized that its system [

⁴³ *Id.* at § 6.6.3.

⁴⁴ *Id.* at § 6.6.5. “Utility” and “number 3” are lumber grades, not timber grades.

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],⁴⁵ and that the C\$0.25 per cubic meter price for Grade 3 sawlogs did not [] and posed []

] ⁴⁶ As early as 2001, BC recognized that the pricing of “dead, dry sawlog quality logs” should “be addressed” as part of a “broader review of timber pricing” occasioned by the mountain pine beetle outbreak.⁴⁷

38. As “dead and dry” logs – *i.e.*, beetle-affected logs – began to account for an increasing share of the timber used to produce lumber in the BC Interior, []

] ⁴⁸

39. To reform the grading and pricing system and specifically to address the pricing of MPB timber, BC turned in 2005 to the Interior Scaling Advisory Committee (“ISAC”), a joint industry and government group tasked to review and recommend changes “from both a government and industry perspective.”⁴⁹ BC directed an ISAC Subcommittee, also composed of a mix of government and industry representatives, to propose revisions to the province’s grading system.

40. The ISAC proposed grading changes that would end the practice of assigning all “dead and dry” logs the minimum stumpage price, and instead would grade and price logs according to the portion of the log that could be made into lumber. The

⁴⁵ C-9, CAN-019761-778 at CAN-019762.

⁴⁶ *Id.* at CAN-019762-769.

⁴⁷ C-6 at 9.

⁴⁸ C-9, CAN-019761-778 at CAN-019762.

⁴⁹ C-15, CAN-007126-129 at CAN-007126.

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heart of these reforms – and of this case – is the “50/50 rule.” The 50/50 rule is the standard applied in BC Interior to determine whether a log is capable of being used for the manufacture of lumber. It requires that a log be graded as a “sawlog” if it is a certain size, and if 50 percent of it can be made into lumber, and if 50 percent of that lumber is of “merchantable” quality (*i.e.*, able to be sold as lumber). A sawlog, therefore, is a log deemed suitable for the manufacture of softwood lumber. On the other hand, logs that do not meet the 50/50 rule are deemed unusable for lumber and referred to as “lumber reject.” The point of the ISAC proposals, and the April 2006 reforms that implemented them, was to move the BC system in the direction of market pricing by assigning all sawlogs (*i.e.*, logs that meet the 50/50 rule) to the variable price, and reserving the minimum stumpage price only for logs that are deemed “lumber reject.” BC stated at the time that it wished to []⁵⁰

41. The ISAC proposed eliminating the two grades that identify “dead and dry” logs, Grades 3 and 5. The elimination of Grades 3 and 5 would mean that logs would no longer be graded based on whether they were harvested from trees that were living or dead.⁵¹ Instead, a log would be assigned a “sawlog” Grade 1 or 2 if it was capable of being manufactured into lumber or, if not, the log would be assigned the proposed “lumber reject” grade, Grade 4.

42. The ISAC proposed and defined sawlog Grades 1 and 2 based on projected lumber yields. Grade 1 was for sawlogs for which at least 75 percent of the gross volume was suitable for manufacture into lumber, and at least 75 percent of the

⁵⁰ C-16, CAN-019779-788 at CAN-019780; *see also* C-17, CAN-030070-71.

⁵¹ C-17, CAN-030070-71 at CAN-030070.

lumber would be merchantable. Grade 2 was for sawlogs that met the existing 50/50 rule from the existing system – at least 50 percent of the gross volume is suitable for manufacture into lumber, of which at least 50 percent would be merchantable.⁵² The Grade 4 “lumber reject” category would be reserved for logs that could not meet the 50/50 rule, that is, for logs that could not produce a sufficient percentage of merchantable lumber and, therefore, would be priced at the minimum stumpage rate of C\$0.25 per cubic meter. The proposed changes are shown in the following table.⁵³

Grade Under April 2006 Reforms	Lumber yield	Pre-April 2006 Grade
1	75/75	“Blank” and 3
2	50/50	“Blank” and 3
4	< 50/50	4 and 5
6	< 50/50	6
Z	< 50/50	Z

43. The proposed reforms retained the same “50/50 rule” for separating sawlogs from “lumber reject” logs, but eliminated the standard that assigned “dead and dry” sawlog the minimum stumpage price.⁵⁴ Instead, the standard was suitability for lumber: only logs that were unsuitable for lumber would be sold at the minimum stumpage price.

⁵² C-12, CAN-000001-13 at CAN-000005.

⁵³ See C-12, CAN-000001-13 at CAN-000010 (derived from a table describing lumber yields under 2006 reforms as compared to previous system).

⁵⁴ C-12, CAN-000001-13 at CAN-000007; C-9, CAN-019761-778 at CAN-019764.

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44. Under the proposed reforms, most of the logs formerly classified as Grade 3 would now be assigned Grades 1 and 2 because they would meet the 50/50 rule.⁵⁵ Application of the April 2006 reforms would mean that substantial quantities of timber from beetle-affected trees would be graded as sawlogs, and BC would sell them for the first time at sawlog stumpage prices. The proposed changes would eliminate the windfall enjoyed by the lumber industry, which long had been paying the minimum stumpage fee for lumber-quality MPB timber.

45. The ISAC Subcommittee reported in July 2005 that it had conducted comprehensive tests of the draft grading rules on actual logs and compared the results to results obtained by grading under the existing rules. “Senior industry and ministry scalers” participated in tests spanning the entire Interior.⁵⁶ In those tests, “18.8 percent of the Grade 3 sawlog volume went to Grade 1, 0.3 percent went to Grade 4 due to checks and whorls, and the majority went to Grade 2.”⁵⁷

46. Although it is unsurprising that almost all of the logs formerly assigned Grade 3 would meet the 50/50 standard or better for Grades 1 and 2 under the new grading rules, some members of the Subcommittee expected “the lower quality Grade 3 . . . to be downgraded or fall into the lumber reject Grade 4.”⁵⁸ The ISAC Subcommittee advised that “further discussion and potentially further testing is required to establish

⁵⁵ C-96, CAN-029620-48 at CAN-029625.

⁵⁶ C-12, CAN 000001-13 at CAN-00008.

⁵⁷ *Id.*, at CAN-000010-12.

⁵⁸ *Id.* at CAN-000013; *see* C-18, CAN-007146-64 at CAN-007148 ([

D.

threshold levels that will ensure most fibre is correctly graded.”⁵⁹ When the new grading rules were adopted less than a year later in April 2006, the rules and standards were nearly identical to the rules that the ISAC Subcommittee had proposed and tested.

47. When BC announced reforms on April 1, 2006, it emphasized that the purpose of the new grades was “to better reflect the quality of timber affected by the mountain pine beetle.”⁶⁰ BC expected and intended that the majority of timber previously characterized as “dead and dry” Grade 3 would be assigned to Grades 1 and 2. BC publicly represented that the majority of MPB timber would now be graded and priced as sawlogs: “Under the new grades, the majority of this timber will be assessed as saw logs, recognising their potential to produce good quality lumber. Sawlog stumpage will apply.”⁶¹ Further, under the new system, “[l]ogs not capable of producing lumber will be charged minimum rates.”⁶² That is, BC fully expected that the majority of beetle-affected logs would be of a quality sufficient to produce lumber, and lumber producers would have to pay regular stumpage rates for MPB logs.

48. BC reiterated its expectation in its comprehensive 2005-2010 mountain pine beetle planning document, which explained that a primary goal for 2005-2006 was to ensure that timber pricing takes account of the economic value of beetle-affected sawlogs because “[t]he damaged timber retains most or all of its ‘green’ value for some

⁵⁹ C-12, CAN-000001-13 at CAN-000013.

⁶⁰ C-22, CAN-000420.

⁶¹ *Id.*

⁶² *Id.*

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time before beginning to split and decay.”⁶³ In enacting the April 2006 reforms, BC announced that “{t}imber will be priced in a manner that reflects its market value, providing revenue to the province and encouraging a competitive industry.”⁶⁴

49. When BC implemented the new Interior grades on April 1, 2006, it understood, intended, and had verified that the vast majority of timber that previously was graded as Grade 3 and had been sold at the minimum stumpage rate could be used to produce merchantable lumber, and therefore would be sold at sawlog rates. As a result, BC lumber producers would no longer obtain these beetle-affected sawlogs for the low, fixed minimum stumpage rate of C\$0.25 per cubic meter.⁶⁵

D. The April 2006 Reforms Considered And Accommodated All Effects Of The Mountain Pine Beetle

50. The April 2006 reforms were specifically designed to anticipate and accommodate the effects of the mountain pine beetle in the BC Interior both as those effects were experienced in 2006 and as they would be for the next decade. In the mid-2000s, when BC was developing its pricing reforms, it was well aware of the mountain pine beetle epidemic. By 2005, the Ministry had estimated that the mountain pine beetle would kill up to 50 percent of mature lodgepole pine by 2008, and up to 80 percent by 2013.⁶⁶ BC had spent years studying the beetle’s damage and likely effect on future

⁶³ C-23, CAN-037128-49 at CAN-037138.

⁶⁴ *Id.*

⁶⁵ *See* C-20, CAN-000442 ([

]).

⁶⁶ C-7, CAN-000490-516 at CAN-000490.

lumber production. The spread of the mountain pine beetle, and the trajectory and effect of the outbreak, was a primary element that BC considered and accommodated in the April 2006 grading reforms and in the variable prices for logs graded Grade 1 or Grade 2.

51. The evidence shows that, while the mountain pine beetle does eventually have an adverse effect on logs, the primary effect initially is *not* to diminish the quality of even grey-stage timber for purposes of manufacturing merchantable lumber. Even if the majority of a beetle-affected log is still of merchantable lumber *quality* and passes the 50/50 rule, certain factors nevertheless may diminish the *value* of the produced lumber compared to that from logs harvested from live trees. As demonstrated in studies commissioned by BC discussed below, the primary loss of value from processing beetle-affected logs is neither the loss of volume of lumber production nor a lack of merchantability of lumber production – the two criteria under the 50/50 rule that defines a sawlog. Rather, the beetle’s effect is to reduce modestly the quality of lumber *within* the definition of “merchantability.”

52. The April 2006 grading and pricing system explicitly accounted for these potential differences in log value by making adjustments to the Grade 1 and 2 sawlog prices. Although the 2006 system provides for only two prices on any given stand – one price for sawlogs that at least meet the 50/50 rule and another price (C\$0.25) for timber that does not – this does not mean that the system is indifferent to factors, including beetle damage, when setting the sawlog price. Instead, the prices for Grades 1 and 2 were designed to reflect forms of damage affecting the value of the timber and other costs associated with the mountain pine beetle. Indeed, the April 2006 reforms specifically accounted for any reduced value of beetle-affected sawlogs as compared to other logs.

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Although BC expected that the vast majority of MPB logs formerly assigned to Grade 3 would be suitable for lumber and graded as Grade 1 or 2 under the new system, the system was still adjusted to reduce the price of Grade 1 and 2 timber in a stand to account for the amount and severity of the beetle attack in the stand.⁶⁷ By design, then, the new system established a variable price for sawlogs that is sensitive to the effects of the mountain pine beetle.⁶⁸ And because the new reforms were a subject of SLA negotiations, BC also understood that these changes had to be in place by July 1, 2006, the grandfathering date in the SLA.⁶⁹

E. The April 2006 Reforms Were A Condition Of The SLA

53. It is important to understand the April 2006 grading reforms in the context of the negotiations that led to the SLA. The discussion, testing, and announcement of the April 2006 reforms coincided with negotiations between Canada and the United States

⁶⁷ BC addressed the differences in Grade 1 and 2 sawlog value caused by the mountain pine beetle by issuing two amendments to the BC Cruise Compilation Manual (called “Amendment 2” and “Amendment 3”), in which it revised its calculation for how much lumber could be recovered from timber. The amendments accounted for varying degrees of recovery (called the “lumber recovery factor” and priced timber accordingly. C-24, at 24, 37; *see also* C-26, CAN-028602-19, at CAN-028606 (step 2.3: adjusted species LRF is the cruise species LRF for each “mark” or stand plus a regional LRF adjustment); *id.* at CAN-028609 (step 2.16 and 2.17: lumber selling price of a stand is the adjusted species LRF times the prevailing lumber price for that species and chip recovery for a stand increases when adjusted species LRF decreases); *id.* at CAN-028610 (step 2.22: “selling price” or stand value for a species is lumber selling price plus adjusted chip selling price); *id.* at C-CAN028611 (step 2.34).

⁶⁸ C-27, CAN-052412-414 ([

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⁶⁹ *See id.* at CAN-052413-414.

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for a new softwood lumber agreement to resolve the continuing trade disputes related to the Canadian softwood lumber industry.⁷⁰

54. During the SLA negotiations in 2006, the United States was very concerned about BC's longstanding practice of grading and selling large volumes of Interior MPB timber for the minimum stumpage fee. The United States viewed the April 2006 Interior grading changes as a movement toward a more market-driven system in the province. The Canadian and BC governments also understood that reforming the flawed Interior pricing system was critical to the parties' ability to reach an agreement. BC's Forest Service's Chief of Resource and Regulatory Economics explained in March 2006 that the new reforms [

] ⁷¹

55. Less than one month after BC formally announced the new grading and pricing system on April 1, 2006, the United States and Canada reached agreement on broad terms of the SLA, including a term that would permit BC to maintain its timber pricing system.⁷²

56. The April 2006 reforms were clearly tied to the language of the SLA, which expressly permits and grandfathers the provincial timber pricing systems in effect as of July 1, 2006. With respect to BC, the timber pricing system in effect as of July 1,

⁷⁰ SLA, Annex 2A, Settlement of Claims Agreement (listing many of the disputes in existence before the SLA, and that the SLA settled.

⁷¹ C-20, CAN-000442.

⁷² C-61, <http://news.gc.ca/web/articleeng.do?ctr.sj1D=&ctr.mnthndVI=8&mthd=advSrch&ctr.dpt1D=&nid=209789&ctr.lc1D=&ctr.tp1D=&ctr.yrStrtVI=2006&ctr.kw=softwood%2Blumber&ctr.dyStrtVI=26&ctr.aud1D=&ctr.mnthStrtVI=2&ctr.page=1&ctr.yrndVI=2006&ctr.dyndVI=6>.

2006, includes the timber grade definitions and rules implemented in April 2006. Canada thus committed in the SLA to apply the new grading and pricing system enacted by BC in April 2006, or to ensure that any changes or modifications maintained or improved the extent to which stumpage charges reflect market conditions. Moreover, two of the documents specifically identified in Article XXI(35) of the SLA as forming part of the BC system in effect as of July 1, 2006, reference the new grading rules. These documents acknowledge that the vast majority – 95 percent – of former Grade 3 timber is expected to fall into new Grades 1 and 2, and only 5 percent into new Grade 4.⁷³

57. When entering into the SLA, the United States viewed the April 2006 grading and pricing reforms in BC Interior not as part of a market system, but rather as a movement *toward* a more market-driven system. Canada warranted as much in the SLA: “Canada warrants that the central purpose of the MPS {in BC} is to implement a system that is more sensitive to market-forces than pre-existing systems.”⁷⁴ Indeed, the very purpose of the 2006 reforms was to recognize that most MPB timber is generally sawlog quality, and to price MPB timber based on its suitability for lumber, a concept closer to a market system than the previous system of automatically pricing MPB timber at the flat minimum rate.

⁷³ C-25, CAN-028636-649 at CAN-028646 (Interior Market Pricing System: Tenure Obligation Adjustments, June 5, 2006) (if historical data based on the pre-2006 timber grades are used in the MPS calculations, 95 percent of the earlier Grade 3 should be assigned to Grades 1 and 2 and only five percent of that timber should be assigned to Grade 4). *Id.* at CAN-028639 (Interior Market Pricing System: Average Market Price, June 5, 2006) (stating that “95 percent of the former Grade 3 are saw logs under the new grades”).

⁷⁴ SLA art. XVII, ¶ 4(b).

F. BC Applied The April 2006 Reforms Until Early 2007

58. Shortly after BC adopted the 2006 grading and pricing reforms, the percentage of timber classified as Grade 4 and sold for the minimum stumpage fee dropped as BC expected. Between April 2006 and early 2007, BC lumber producers for the first time paid the variable sawlog prices for beetle-affected timber.

59. To illustrate this: in the six months before BC enacted the new grading reforms in April 2006, the percentage of lodgepole pine in Interior BC that was assigned Grade 3 and priced at C\$0.25 per cubic meter varied between 43.1 percent and 52.3 percent. Adding logs from the two other reject categories (Grade 4 “lumber reject” and Grade 5 “reject dead/dry”) to these Grade 3 figures, the percentage of Interior BC lodgepole pine sold at the minimum price of C\$0.25 per cubic meter in the six months before the April 2006 grading changes varied between 50.9 and 63.6 percent.⁷⁵ By contrast, in the six months immediately after the April 2006 reforms went into effect, the percentage of lodgepole pine in Interior BC that was assigned the Grade 4 “lumber reject” grade and sold at a price of C\$0.25 per cubic meter, dropped to between 5.7 and 19.2 percent. The Grade 4 share of the harvested timber remained at between 16.0 and 18.4 percent over the subsequent six months, a period ending with April 2007. The new reforms largely worked to grade and price MPB timber according to its suitability for producing lumber and in line with BC’s representations at the time it announced the grading changes.

60. The overall share of the harvest that was graded as “lumber reject” Grade 4 during this period was generally consistent with the overall share of the harvest not

⁷⁵ C-2 Ex. 3.

used for lumber. BC data show that in 2006, 84.5 percent of the Interior harvest went to lumber mills. This figure is little changed from earlier years, but this time BC appears to have charged sawlog stumpage fees for the large majority of the timber used in lumber mills.⁷⁶ This was exactly what was expected when the April 2006 reforms were introduced, consistent with the modification to Interior grading and pricing system reflecting that 95 percent of historic Grade 3 timber would be assigned to new grades 1 and 2 and only 5 percent to new Grade 4. In other words, Canada's own statistics show that it has always been using MPB timber to make merchantable lumber. At least at first, the new reforms confirmed that the grading system better reflected the reality of what was coming out of the lumber mills.

II. British Columbia Circumvented The SLA By Selling Lumber-Quality Timber For The Minimal Stumpage Price

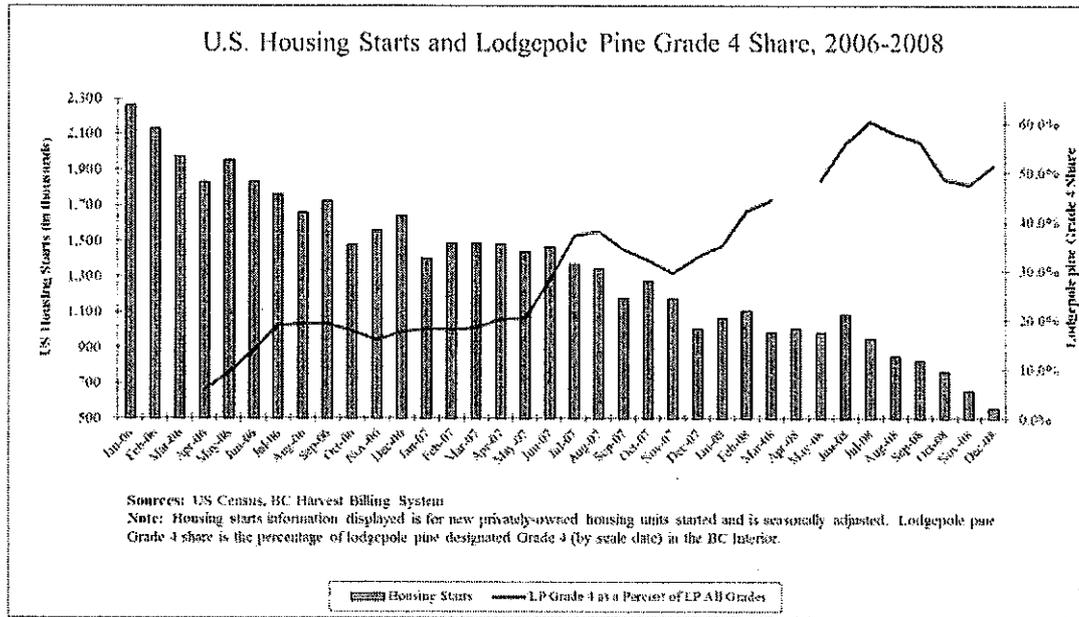
61. BC's commitment to the new grading and pricing reforms did not last. As the downturn in the housing market in the United States and the accompanying decrease in lumber prices accelerated, the volume of timber assigned Grade 4 and sold for the fixed minimum stumpage fee began to rise dramatically. Over the course of one year, the amount of Grade 4 lodgepole pine more than doubled, beginning at 20.2 percent in April 2007 and rising to 44.4 percent by March 2008.⁷⁷ From 2008 through 2010, about 55 percent of the BC lodgepole pine harvest was classified as Grade 4 "reject" timber.⁷⁸ The remarkable speed with which the share of timber sold for the minimum stumpage rates

⁷⁶ C-28, at 6.

⁷⁷ C-2 at Ex. 3.

⁷⁸ *Id.*

returned to pre-April-2006 levels highlights Canada's failure to honor its obligations under the SLA.



62. This graph vividly shows the rapid rise in the share of Grade 4 lumber, a rise that has largely paralleled the decrease in the market for softwood lumber. The troubles in the industry were well-known at the time. The following are from Random Lengths industry references:

A sharp downturn in the housing market and resulting weak prices for lumber and panel products marks the year. Analysts projected U.S. housing starts to contract to about 1.5 million units in 2007, but the declines is much steeper and hits a 14-year low in November at a seasonally adjusted annual rate of 1.19 million. Loose lending practices contribute to the downturn as foreclosures increase rapidly. Prices of many key items dip to levels not seen since previous troughs in 1981 and 1991, but on an inflation-adjusted level trump even those depressed markets. The Random Lengths Framing Lumber Composite Price averages its lowest level since 1991.⁷⁹

First quarter sets tone for somber 2007 outlook

⁷⁹ C-10.

Lumber prices as measured by the various Random Lengths composites turned in one of their lowest first-quarter showings in years. A review of Random Lengths' composite price data back to 1995 shows that many lumber prices – not adjusted for inflation – were akin to prices in the first quarters of 2003 and 2001, both low-water periods.⁸⁰

A. Evidence of Constant Lumber Yields And Quality Data Confirms BC's Underpricing

63. Canada's failure to correctly grade and price MPB timber is confirmed by the lumber yields coming out of BC's Interior in and after 2007. If the large increase in Grade 4 since 2007 were the result of the correct application of the 50/50 rule, the increase would necessarily correlate with a large increase in either the share of logs that were unsuitable for lumber production; an increase in the share of lumber produced from these logs that was not merchantable; or a combination of the two.⁸¹ In other words, a significant increase in Grade 4 timber, if BC were grading the timber correctly, would necessarily result in a corresponding, measurable, and likely substantial decrease in either the quantity or quality of lumber produced in BC. But the data on timber harvest and lumber production in the BC Interior for this period demonstrate exactly the opposite, namely that BC has been misgrading large volumes of lumber-quality timber, in breach of the SLA.

64. Canada's own evidence further demonstrates this unequivocally. Canada provides monthly data under the SLA for lumber volumes and export charges, from which the average unit value (price per fixed unit of lumber) can be calculated for each

⁸⁰ C-21.

⁸¹ *Id.*

region.⁸² A large-scale decrease in lumber quality would be expected to result in a noticeable decline in BC lumber unit values relative to the overall market. Yet there is no such decrease in Interior unit values relative to the overall market.⁸³

65. Moreover, if BC Interior, the largest lumber-producing region in Canada, had begun to produce increasing quantities of low-quality lumber, this would have resulted in an increased supply of low grade, non-merchantable lumber in North America.⁸⁴ As a matter of simple economics, this increased supply would have increased the price spread between merchantable lumber and non-merchantable lumber.⁸⁵ In reality, however, the actual spread between merchantable and non-merchantable lumber in North America has been decreasing, suggesting no such increase in the supply of low quality lumber.⁸⁶

66. A true decrease in log quality would have resulted in a decrease in the quantity of lumber manufactured from those logs.⁸⁷ But, once again, the evidence does not support this. The ratio of lumber production to harvest has not declined over time.⁸⁸

67. Tellingly, a comparison of lumber unit prices from Interior BC and lumber unit prices from Alberta also shows no increase in low quality logs in BC.⁸⁹ Alberta

⁸² C-2 at ¶ 21.

⁸³ C-2 at 21, Ex. 7.

⁸⁴ C-2, at 21.

⁸⁵ *Id.*

⁸⁶ C-2 at 21-22, Ex. 8 and 8a.

⁸⁷ C-2 at 22.

⁸⁸ C-2 at 22-23, Exh. 9.

neighbors BC, has similar timber species, and has carried out little MPB timber harvesting. Yet the average unit value of lumber from BC did not decline compared to that of lumber from Alberta.⁹⁰

68. Finally, a true drop in log quality would have been expected to have increased the percentage of logs going to non-lumber uses, such as pulp mills, instead of sawmills.⁹¹ Once again, the evidence shows that the opposite is occurring. The share of logs that went to sawmills in BC actually increased from 89 percent in 2007 to 91 percent in 2010, with only a small decline in between.⁹²

69. The evidence in the harvest and other data does not show the necessary decrease in BC Interior lumber quantity or quality that would have to accompany an increase in correctly graded Grade 4 timber. Rather, BC was misgrading and selling logs that met the 50/50 rule for only C\$0.25 per cubic meter. Canada thus circumvented the SLA because BC abandoned its provincial timber pricing system as it existed on July 1, 2006, in order to provide a benefit to Canadian softwood lumber producers in the form of underpriced timber. SLA, art. XVII, ¶ 2.

70. The preponderance of the evidence shows that sawlogs identical to those classified as Grade 1 and 2 in 2006 and early 2007 started to be classified as Grade 4 “lumber reject” after April 2007, even though they were capable of producing merchantable lumber in line with the 50/50 rule. In short, BC abruptly reverted to its old,

⁸⁹ C-2 at 23.

⁹⁰ *Id.* at Exh. 10.

⁹¹ C-2 at 23.

⁹² *Id.*

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pre-April 2006 practice of selling lumber-quality MPB timber for the minimum stumpage fee.

B. The Mountain Pine Beetle Does Not Explain The Sharp Rise In The Share Of Grade 4 Timber

71. Since early 2007, the United States has repeatedly asked Canada to explain the substantial rise in Grade 4 timber, and specifically why BC has abandoned the grading and pricing reforms that it put into place in April 2006. The United States has made these requests both informally and in formal consultations. To date, however, Canada has provided no plausible explanation for BC's reversion to the pre-April 2006 grading and pricing practices, or the resulting windfall that BC has bestowed on lumber producers by selling them lumber-quality timber at the minimum stumpage fee.

72. In Canada's response to the United States' Request for Arbitration, Canada attributed the increases in Grade 4 timber to "the explosive growth" of the MPB "epidemic." Canada Resp. at ¶ 3. [

] ⁹³ There are at least three flaws in Canada's attempt to attribute the rapid increase in the share of Grade 4 timber to the mountain pine beetle. First, BC enacted the April 2006 grading and pricing reforms specifically to address a predicted increase in the mountain pine beetle outbreak, so the occurrence of that predicted event cannot possibly explain BC's abandonment of the same reforms, especially when they were a primary basis of the United States' agreement to grandfather the BC Interior pricing system in the SLA. Second, Canada's claim that the growth in the mountain pine beetle population was "explosive" seems to imply that the size or effects of the outbreak were unanticipated and unplanned for. Not only does

⁹³ See, e.g., C-30, CAN-028450.

this miss the point, but it is also an inaccurate account of the history of the beetle outbreak in BC. Third—and to the point—what really matters is the *quality* of the timber, not how the trees from which it was harvested died. BC *expected* an increase in MPB timber when it enacted its new system in 2006—a new system that acknowledged that MPB timber was lumber quality. Even if Canada is correct that an increase occurred, an increase does nothing to explain the huge increase in Grade 4 timber.

73. As an initial matter, there has been nothing unanticipated about the mountain pine beetle's presence or spread in BC Interior since the SLA entered force. BC has aggressively monitored the mountain pine beetle's presence in the province for years. As early as 2004, BC projected that the mountain pine beetle epidemic could peak in 2008 and could "kill more than 80 per cent of the merchantable pine in B.C.'s interior."⁹⁴ A 2005 Canadian government report "project{ed} that the annual volume of pine killed will peak during the 2006 flight at more than 90 million m³ {cubic meters} of merchantable pine in the timber harvesting landbase" and predicted that "significant volumes of pine will continue to be killed at least until 2015."⁹⁵ BC's 2005 "Mountain Pine Beetle Action Plan" similarly estimated that "50 per cent of the mature pine will be dead by 2008 and 80 per cent by 2013."⁹⁶

74. If anything, BC's estimates regarding the effects of the mountain pine beetle outbreak were too pessimistic. By 2007, the rate of mountain pine beetle

⁹⁴ C-31, CAN-015200-01 at CAN-015200.

⁹⁵ C-32, CAN-037178-228 at CAN-037205.

⁹⁶ C-23, CAN-001437-60 at CAN-001441. The 2006 "Mountain Pine Beetle Action Plan" predicted that over half of merchantable pine would be dead by the summer of 2007 and 80 percent killed by 2013. C-34, CAN-047191-213 at CAN-047193.

expansion was slowing down, not speeding up.⁹⁷ In 2008 – in the midst of the sharp increase in Grade 4 timber – a team of government and government-sponsored researchers concluded that the worst year of infestation had been 2004.⁹⁸ For several years, these researchers compared actual rates of red- and grey-attack (timber at the more advanced stages of beetle-attack) with predicted red- and grey-attack rates. During each relevant year, the researchers adjusted their predictions downward, indicating either that the infestation was slowing, not quickening, or that their initial predictions had overestimated the rate of attack.⁹⁹

75. Thus, even if it were accurate to characterize the post-SLA mountain pine beetle attack as “explosive,” BC’s April 2006 reforms anticipated and accounted for the spread of the beetle and predicted that the majority of affected timber would be lumber-quality Grade 1 or 2. Indeed, that is precisely why BC instituted grading and pricing reforms intended to, on one hand, move the vast majority of MPB-affected timber to Grades 1 and 2 and, on the other hand, adjust the Grade 1 and 2 pricing downward to account for the effects of the beetle. Nothing has occurred since the SLA went into effect that would alter the premises and predictions of the BC Interior timber pricing grandfathered by the SLA.

76. If the level of MBP timber experienced in 2007 truly rendered most MBP timber worthless, then BC would not have projected, with strong evidence about the

⁹⁷ C-35, at (i) (“{T}he rate of infestation expansion has slowed considerably over the past four years.”).

⁹⁸ C-36, CAN-014690-700 at CAN-014692.

⁹⁹ Compare *id.* at CAN-014699 and C-37, CAN-009532-46 at CAN-009542, with C-38, CAN-014671-80 at CAN-014679.

infestation's trajectory in hand, that 90 to 95 percent of the old Grade 3 would receive a grade of 1 or 2 under the new system. Canada cannot reconcile this projection with its current excuse, because the evidence and data supporting the projection remains valid.

77. Both BC and Canada have had ample opportunity to allay the United States' concerns of circumvention of the SLA by providing evidence that the post-2007 increases in Grade 4 were legitimate. They have failed to do so, instead contending that the United States "surmises, and only surmises, that the mere increase in percentage of Grade 4 timber" violates the SLA.¹⁰⁰ The United States has, in fact, identified more than a "mere" increase in the amount of Grade 4 timber. The United States has identified an unanticipated and unjustified rise in Grade 4 timber resulting from the underpricing of lumber-quality timber in breach of the SLA.

C. BC's Mill Studies Show That Beetle Attack Has Not Unexpectedly Diminished The Volume Or Quality Of MPB Timber

78. Canada's own documents demonstrate that the increase in Grade 4 has no relationship to increases in mountain pine beetle damage. These documents, in the form of a series of studies commissioned by BC agencies, were conducted and released during the very time at which Canada alleges a drastic change in the beetle outbreak. They confirm what Canada's harvest, export, and production data already establish—there was no decline in the lumber produced from BC logs, and no decline in the volume of merchantable lumber. Therefore, there was no true increase in Grade 4 timber.

79. BC's Forestry Innovation Investment Ltd. ("FII"), a provincial government agency, commissioned a series of post-SLA studies addressing the difference in volume and value of lumber of grey-stage logs (which are dead as a result of mountain

¹⁰⁰ Can. Response to Request for Arbitration, ¶ 3.

pine beetle infestation) compared to fresh green logs (which are not).¹⁰¹ The results of these studies demonstrate that even grey-stage timber dead for five or more years can produce lumber of comparable volume with only a small loss of value. In other words, the basis and expectations for the April 2006 grading rules turned out exactly as expected—most MPB timber in these studies actually fell within Grades 1 or 2. If anything, these studies show that a correct application of the 50/50 rule should direct *less* MPB timber to Grade 4 than BC had predicted in 2006. It is critical to note that all of these studies analyzed actual lumber coming out of real lumber mills. Thus their conclusions are not merely hypothetical—they provide concrete evidence to support the export, harvest, and production data discussed above.

1. The Princeton Mill Study

80. The 2009 Princeton mill study is the most recent of the four studies. Its stated purpose was to “determine the difference in lumber recovery and lumber value from processing grey-stage (5+ years) Mountain Pine Beetle attacked lodgepole pine when compared to processing green lodgepole pine.”¹⁰²

81. The study sample at the Princeton mill was large: 1,726 grey-stage logs and 1,300 green logs.¹⁰³ The logs were individually scaled before testing.¹⁰⁴ The

¹⁰¹ C-39, CAN-029325-61; C-40, CAN-029247-66; C-41, CAN-029267-91; C-5, CAN-007000-31.

¹⁰² C-5, CAN-007000-31 at CAN-007006.

¹⁰³ *Id.* at CAN-007007.

¹⁰⁴ *Id.* at CAN-007011.

researchers then milled the logs into three standard sizes of dimension lumber.¹⁰⁵ The input volume of the logs and the output volumes of lumber were measured to determine a lumber recovery factor (“LRF”).¹⁰⁶ LRF measures the amount of lumber that can be recovered from a particular log. The lumber was then graded for quality.¹⁰⁷

82. The study found that the lumber recovery for grey-stage logs was 98.5 percent that of the green logs.¹⁰⁸ That is, the volume of lumber that could be manufactured from grey-stage logs was almost exactly what could be manufactured from the green logs.¹⁰⁹

83. The study further determined that, after grading the manufactured lumber, the value of the lumber from the grey-stage logs was 85.9 percent of value of the lumber from the green logs.¹¹⁰ Moreover, much of the difference in value resulted from differences in quantities among merchantable grades (Grades 2 and better), as opposed to differences between the quantities of merchantable vs. non-merchantable lumber.¹¹¹ Overall, the tests showed that grey-stage logs could be manufactured into just as much lumber as green logs, and that the lumber from the grey-stage logs was only marginally

¹⁰⁵ *Id.* at CAN-007015.

¹⁰⁶ *Id.* at CAN-007021.

¹⁰⁷ *Id.* at CAN-007022.

¹⁰⁸ *Id.* at CAN-007021.

¹⁰⁹ *Id.*

¹¹⁰ *Id.* at CAN-007024.

¹¹¹ *Id.* at CAN-007023. As discussed above, this difference in quality is accounted for in the BC pricing system by adjustments to the variable prices for Grade 1 and 2 logs.

less merchantable than the lumber from the green logs. The test results confirmed that, to the extent that there was any decline in *value*, the logs fell squarely within Grade 2 and not within Grade 4.

84. Critically, the Princeton mill study compared the most affected timber (grey-stage) to green stage timber and still found there to be an insignificant difference in lumber recovery. The differences would have been even less significant if the study had compared more recently damaged timber (for example, red stage, the middle stage of attack, versus green stage that is just recently affected). The Princeton study is particularly compelling because it is the only one of the four studies to use exclusively lodgepole pine in the grey-stage and green log samples. The study considers the very same timber at issue in the arbitration.¹¹²

2. The Vanderhoof, Quesnel, and Prince George Mill Studies

85. FII commissioned three other mill studies of lumber recovery and value comparing grey-stage (more than five years dead) and green timber in late 2006 and 2007. In these studies, the lumber recovery and value of the grey-stage logs compared to green logs were similarly high.

86. The first study was at a “stud” mill in Vanderhoof, British Columbia, in late 2006. In this study, grey-stage timber produced 87.5 percent of the lumber recovery of the green logs and 94.3 percent of the average value recovery.¹¹³ The high percentages of lumber recovery and value were attained despite the presence of root rot at many of the sites where the researchers harvested the grey-stage lumber, and despite the fact that

¹¹² *Id.* at CAN-007007, CAN-007009.

¹¹³ C-39, CAN-029325-61 at CAN-029360.

many of the grey-stage trees showed signs of fire scarring.¹¹⁴ The green logs did not have these deficiencies,¹¹⁵ and were larger than the grey logs by a statistically-significant margin.¹¹⁶ In this way, the grey-stage and green test samples in the Vanderhoof study were less than comparable, explaining at least part of the decline in lumber recovery and value. Had they been more comparable, the lumber recovery would have been even higher. As it was, the lumber recovery was generally consistent with what BC expected it to be before it abandoned the 2006 reforms.

87. The second study was carried out at a mill in Quesnel, British Columbia, in September 2007.¹¹⁷ The lumber recovery factor of the grey-stage logs was 92.9 percent that of the green logs, and the lumber value was 76.5 percent of that of the green logs.¹¹⁸ Of all the studies, the Quesnel study produced the lowest value lumber from grey-stage logs.¹¹⁹ However, the test used a “green” sample that was nearly 85 percent spruce rather than lodgepole pine.¹²⁰ Notwithstanding this difference, the decline in lumber recovery from the grey-stage logs was only 7.1 percent.¹²¹ Again, the results were consistent with expectations.

¹¹⁴ *Id.* at CAN-029334.

¹¹⁵ *Id.* at CAN-029340.

¹¹⁶ *Id.* at CAN-029359.

¹¹⁷ C-40, CAN-029247-66.

¹¹⁸ *Id.* at CAN-029266.

¹¹⁹ *Id.* at CAN-029265-66.

¹²⁰ *Id.* at CAN-029260.

¹²¹ *Id.* at CAN-029266.

88. The third FII-commissioned study was in late 2007 at a mill in Prince George, British Columbia.¹²² The Prince George study compared grey-stage timber that had been attacked in 1998 and 1999 to fresh green logs.¹²³ The results of the study were that the lumber recovery of the grey-stage timber was 91.8 percent of that of the green timber.¹²⁴ Moreover, the value of the lumber from the grey-stage timber was 88.1 percent of the value of that from the green logs.¹²⁵ The test used a “green” sample that was 54 percent spruce; thus, like the Quesnel mill study, the tests did not compare lodgepole pine to lodgepole pine.¹²⁶

89. It is important to reiterate that these four studies compared MPB timber at times when Canada claims the infestation “exploded.” All of the studies confirm that BC timber between 2007 and 2009 was actually suitable for lumber and only a very small percentage was useable to make merchantable lumber.

90. Finally, a 2010 study by a private company analyzed and built upon the mill studies’ findings and reached essentially the same conclusion.¹²⁷ Using data from the company’s own benchmarking studies in 2008 and early 2009, the study found that lumber recovery factor for beetle-affected timber of one to five years was virtually the

¹²² C-41, CAN-029267-291.

¹²³ *Id.* at CAN-029276.

¹²⁴ *Id.* at CAN-029285.

¹²⁵ *Id.* at CAN-029288.

¹²⁶ *Id.* at CAN-029275.

¹²⁷ C-102.

same as for green logs, and that beetle-affected timber older than five years had only small drops in its lumber recovery factor.¹²⁸ The study also found that lumber value remained high for a long time in MPB timber. After conducting some additional research, the study examined the mill studies' results and determined that logs with no beetle-attack, or one year after attack, produced merchantable lumber at a rate of 87 percent (87 percent of the lumber produced from the logs was merchantable). That number dropped slowly over time: 83 percent for logs two to three years after attack; 80 percent for logs four years after attack; 73 percent for logs eight years after attack; and 67 percent for logs 12 years after attack.¹²⁹ As with the mill studies, this study shows that the rates of Grade 4 timber reported by BC after March 2007 lack any connection to the actual lumber recovery and value of the MPB timber.

3. The Mill Study Results Corroborate Misgrading

91. The BC mill studies showed only a small reduction in lumber recovery, implying that, as a general matter, the portion of the grey-stage, long-dead logs usable for lumber is not significantly smaller than the useable portion of green logs. Further, the reduction in lumber recovery would logically be much less for green-stage and red-stage timber – timber that has been dead for less time than the grey-stage logs used in the tests. The small reduction in lumber recovery constitutes concrete evidence that the share of dead logs that fail to meet the 50/50 test did not increase significantly in comparison to logs in the green sample. Nonetheless, the BC scalers who scaled the logs in the mill

¹²⁸ *Id.* at p. 32.

¹²⁹ *Id.* at p. 34.

studies classified a much larger percentage of the grey-stage logs as Grade 4. In this way, the studies confirm an incorrect application of the 50/50 rule to MPB timber.

Misgrading of Logs in BC Mill Studies
(shares of grades in each test sample)¹³⁰

Mill Test	Grade 1	Grade 2	Grade 4
Princeton – Green	32 %	67 %	1 %
Vanderhoof – Green	34 %	61 %	5 %
Quesnel – Green	13 %	71 %	17 %
Prince George – Green	39 %	57 %	5 %
Princeton – Grey-Stage	0 %	67 %	33 %
Vanderhoof – Grey-Stage	1 %	63 %	36 %
Quesnel – Grey-Stage	0 %	64 %	36 %
Prince George – Grey-Stage	0 %	53 %	47 %

92. If the difference in grading of these logs by the BC scalers had been due to a decrease in the amount of log volume useable for lumber, the studies would have concluded that there was a large difference in the lumber recovery between green and grey stage timber. Instead, they concluded the opposite. For example, in the Princeton test, the share of logs classified as Grade 1 or Grade 2 (at least 50 percent useable for lumber) fell by 32 percentage points, and the share of logs classified as Grade 4 (less than 50 percent useable for lumber) likewise increased by 32 percentage points – yet the volume of lumber actually produced from the lower-graded logs was only 1.5 percent less.¹³¹ The only reasonable conclusion is that the grey-stage logs in the Princeton study

¹³⁰ C-5, CAN-007000-31 at CAN-007026.

¹³¹ C-5, CAN-00700-31, at CAN-007015, CAN-007021.

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were not graded according to the regulatory definitions. Even taking the somewhat larger declines in lumber recovery in the other mill tests at face value – that is, setting aside the other known factors that could have skewed those analyses – there is no reasonable explanation for the difference in grading with the actual differences in lumber recovery.

93. These results are consistent with BC studies on the “shelf life” of MPB-affected timber. As early as 2003, [

] ¹³² Although shelf-life estimates have varied over the years, the Ministry reported in a 2009 presentation that the shelf life of MPB timber is 8 to 12 years. ¹³³

94. The BC mill studies show that, during the breach period, lumber recovery from MPB timber is routinely over 90 percent of lumber recovery from green logs; further, the value of the lumber manufactured from the grey-stage logs is still over 75 percent of that of the green logs. The volume of lumber produced, and the share of that lumber which is of merchantable quality, are not affected as much as the value of the merchantable lumber produced. The reduction in value might explain or justify a reduction in the price for Grade 1 and 2 sawlogs, but would not justify a downgrade to Grade 4 under BC’s April 2006 grading rules. Thus, the mill studies demonstrate that the vast majority of grey-stage logs actually satisfy the 50/50 sawlog standard and, in line with April 2006 expectations, should have been graded and priced as Grade 1 or 2 sawlogs.

¹³² See, e.g., C-43, CAN-030198-99, at CAN-030199; C-3, CAN-037151-77 at CAN-037161.

¹³³ See C-44, CAN-015327-44 at CAN-015329-30.

III. BC Acted To Ensure That MPB Timber Is Misgraded As Grade 4

95. Canada, through BC, circumvented the SLA by underpricing and selling lumber-quality timber for the minimum stumpage fee, a price well below the variable price required by the BC Interior system grandfathered by the SLA, and certainly not a price that moved in the direction of better reflecting market conditions. BC then changed the provincial timber grading and scaling system in ways that ensured that large amounts of timber were misclassified as Grade 4 “lumber reject” and sold at the minimum stumpage rate. These modifications breached the SLA.¹³⁴

96. The Interior timber pricing system grandfathered by the SLA requires that timber be graded and priced according to its suitability for lumber. BC changed its system by applying substitute practices and rules that do not assess lumber suitability. In other words, as a result of BC’s actions, timber that actually meets the 50/50 rule has been graded as if it fails to meet that rule. For example, BC invited lumber producers to use “local knowledge” and be creative in ways to detect defects in logs, thus increasing the likelihood of the logs’ being misgraded as Grade 4, regardless of whether they meet the 50/50 rule. After soliciting these new ideas, BC further: (i) amended its scaling manual without testing or validating the new ideas; (ii) allowed for industry-generated practices called “bucking” and “kiln warming” that illegitimately inflated the share of Grade 4 timber; and (iii) permitted the BC lumber industry to defy and modify in practice BC’s own scaling procedures to increase the share of Grade 4 timber. These modifications all succeeded in making logs more likely to be misgraded as Grade 4. This

¹³⁴ SLA, art. XVII, ¶ 2.

increased likelihood of logs being misgraded as Grade 4 was a benefit to BC softwood lumber producers and exporters.

97. These actions by BC alone would not necessarily be deemed a circumvention of the SLA, had Canada shown that the changes and practices were part of a move toward market pricing or reflected market conditions.¹³⁵ But Canada has failed to make any showing of this kind, and, indeed, BC implemented these changes without any of the rigorous testing to which it had subjected its April 2006 reforms. In fact, the available evidence – most notably BC’s own mill studies discussed above – shows that BC’s changes and practices, already known to divert more timber into Grade 4, are inconsistent with the grandfathered 50/50 rule, and the standard that timber be graded according to its suitability for lumber. None of the changes could be defended as a move toward market pricing or an effort to reflect market conditions.

98. BC’s actions do not fall within any Article XVII exception to the Anti-circumvention rule because they do not, in fact, maintain or increase the extent to which the stumpage price reflects market conditions, and they undermine or counteract movement toward the market pricing of timber.¹³⁶ Canada has therefore breached the SLA as a result of these actions.

A. BC Promoted And Facilitated Deviations From The Grandfathered Interior Timber Pricing System To Divert More Timber To Grade 4

99. By early 2007, BC’s commitment to the Interior timber pricing system grandfathered by the SLA most certainly had wavered, if not crumbled entirely. During

¹³⁵ See *id.*, ¶ 2(a).

¹³⁶ See *id.*

this time, the share of the BC Interior harvest assigned to Grade 4 and sold at the minimum stumpage rate of C\$0.25 per cubic meter was dramatically increasing. This was no surprise to the Ministry because the Ministry had asked the mills' log graders, or "scalers," to develop and use untested grading practices based on their "local knowledge." To be sure, the grandfathered system incorporated "local knowledge," which BC defines as "a variety of accepted indicators at the local level" that are used to assess defects during the scaling process.¹³⁷ The changes to the Interior timber pricing system developed from "local knowledge," however, worked only direct more logs to Grade 4 for sale at the minimum stumpage fee. The United States is unaware of any "local knowledge" practices that decreased the prospects of a log being graded as Grade 4.

100. BC beseeched lumber scalers to use "local knowledge" even though applying "local knowledge" was already permitted, and presumably scalers knew to use it where appropriate. In February 2007, for example, a Ministry official sent lumber producers, including the scalers, a memorandum "to encourage the development of local scaling knowledge with regard to checks."¹³⁸ "Checks" are cracks in logs that are often found in trees affected by the mountain pine beetle.¹³⁹ The Ministry official was reacting to industry complaints raised at the January 2007 ISAC grading subcommittee meeting that existing grading conventions were not generating enough Grade 4 logs because

¹³⁷ C-50, CAN-008253-742 at CAN-008462 (2007 Scaling Manual § 8.5.1).

¹³⁸ C-45, CAN-010975.

¹³⁹ C-48, CAN-007998-8174 at CAN-008074 (2008 Scaling Manual § 8.3.1.1).

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checks were hard to detect in the winter.¹⁴⁰ The ISAC had been well aware of a potential issue regarding the visibility of checks in changing weather since at least 2005, when it had said that the “Solution” was that “scalers will have to pay closer attention and spend more time to properly assess checks.”¹⁴¹ By issuing the February 2007 memorandum encouraging the use of “local knowledge,” however, the Ministry seemingly reversed its 2005 position and instead publicly indicated to lumber producers and scalers that the assessment of checks could, or even should, be modified based on the scalers’ “local knowledge.”¹⁴²

101. Soon after the Ministry issued its directive for scalers to use “local knowledge” in assessing checks, the share of timber assigned Grade 4 increased dramatically. Tellingly, the Ministry did *not* respond by testing the “local knowledge” to determine whether scalers were properly applying the 50/50 rule. Instead, the focus was on ensuring that checks were treated *consistently* throughout BC Interior.¹⁴³ That is, the Ministry promoted consistent use of untested and unverified “local knowledge” was applied consistently throughout the region.¹⁴⁴ According to [

¹⁴⁰ C-79, CAN-007177-82 at CAN-007178-80.

¹⁴¹ C-12, CAN-000001-13 at CAN-000006.

¹⁴² See C-45, CAN-010975.

¹⁴³ See C-97, CAN-051293-94 at CAN-051293 [

].

¹⁴⁴ See C-84, CAN-010278-325 at CAN-010279 (Ministry addressing difficulties experienced in measuring checks and development of “Local grading applications contrary to policy.”); at CAN-010280 (“Bring consistency to grading checked logs.”).

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] ¹⁴⁵ These []

do not show that the Ministry was concerned with ensuring that the 50/50 rule was being properly applied to logs with checks. Rather, they show that the Ministry was attempting to standardize new untested practices that increased the likelihood that logs would be classified as Grade 4, regardless of the logs' suitability for producing lumber, notwithstanding the Ministry's awareness of the unexpected and dramatic rise in Grade 4 timber.

102. Indeed, there was concern among lumber producers that there was so much inconsistency in local practices that it was leading to inconsistent scaling and log pricing. [

] ¹⁴⁶ It also viewed [

]. ¹⁴⁷

¹⁴⁵ See C-80, CAN-051098-292 at CAN-051103; see also C-54, CAN-007292-295 at CAN-007293 [

].

¹⁴⁶ See C-97, CAN-051293-94 at CAN-051293.

¹⁴⁷ *Id.*

103. To be clear, because “local knowledge” is recognized in the Scaling Manual, BC’s promotion of the use of “local knowledge” is not itself a breach of the SLA. But because the resultant grading practices increased the share of Grade 4 timber, BC is in breach unless Canada can show that the grading practices derived from “local knowledge” resulted in stumpage fees that maintain or improve the extent to which stumpage prices reflect market conditions.¹⁴⁸ Canada has produced no evidence of this type to date, and the practices that BC promoted and allowed during this time appeared only to work by reducing grades. The Ministry understood this, and when it encouraged scalers in 2007 to use “local knowledge” to assess checks, it facilitated the unjustified diversion of more and more logs to Grade 4, to the benefit of BC lumber producers and exporters. In fact, the timber assigned Grade 4 *nearly doubled* in the year following the Ministry’s February 2007 memorandum encouraging the use of local knowledge in scaling, rising from 17.1 to 33 percent of the total timber harvest.¹⁴⁹ This concurrent rise in timber classified as Grade 4 demonstrates that the Ministry’s increased use of local knowledge in scaling diverted more timber into Grade 4. This was a breach of the SLA.

B. BC Codified New Scaling Conventions That Increase Grade 4

104. As discussed above, BC specifically designed the April 2006 grading and pricing reforms to ensure that logs would be graded and priced based on the logs’ ability to produce lumber, and that is the system that the United States accepted as grandfathered into the SLA. The new reforms were thoroughly vetted. BC took approximately two

¹⁴⁸ See C-1, art. XVII, ¶ 2.

¹⁴⁹ C-2 at Ex. 3.

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years to develop and test the 2006 reforms to the grading system, and it incorporated the reforms as amendments to the 2005 version of the Scaling Manual. They were reissued in the May 2007 version of the Scaling Manual.¹⁵⁰ Since it developed the Scaling Manual, BC has approved and codified modifications to the scaling policies and procedures and amended the Scaling Manual in July 2008, November 2009, and January 2010.

105. Then, determined to make practices derived from “local knowledge” uniform throughout the Interior region, the Ministry issued conventions derived from “local knowledge” that applied Interior-wide, effective December 1, 2007.¹⁵¹ The Ministry’s stated purpose in rapidly standardizing these new rules Interior-wide was “to bring consistency and to recognize the difficulties in measuring checks between scale sites in the Interior.”¹⁵² That is, without ever testing the December 2007 conventions to ensure that they allowed the accurate application of the 50/50 rule, the Ministry hastily decreed them as the new scaling requirements throughout the region.

106. In July 2008, the Ministry formally adopted the December 2007 conventions in a periodic amendment to the Scaling Manual.¹⁵³ The conventions

¹⁵⁰ See C-12, CAN-000001-13 at CAN-000004.

¹⁵¹ C-82, CAN-011400-02.

¹⁵² *Id.*; see also C-84, CAN-010278-325 at CAN-010323 (“In the event that these requirements appear to contradict sections of the Scaling Manual, these requirements will supersede those sections.”).

¹⁵³ C-83, CAN-011867-68, at CAN-011867; C-47 CAN-026604-07 at CAN-026604 ([

]). The July 2008 amendments concerning lodgepole pine are nearly identical to the December 2007 conventions.

incorporated by the 2008 amendment to the Scaling Manual apply to the grading of lodgepole pine even though they were never subjected to rigorous testing and review.¹⁵⁴ Unlike BC's extensive process in developing and testing the 2006 grading and pricing reforms grandfathered by the SLA, BC undertook no comprehensive testing and review process before codifying the 2008 amendments to the Scaling Manual. Rather, BC hastily codified these untested modifications, including at least three material changes to the grading manual that have contributed to the dramatic rise in Grade 4 timber.

107. In fact, as late as 2009, the ISAC acknowledged that December 2007 conventions "were implemented over a tight time frame and were based on a data set that was never tested with 'real' logs."¹⁵⁵ The ISAC further recognized that the use of the "local knowledge"-based scaling conventions, along with kiln warming, "was also not tested."¹⁵⁶

1. The New Checks Convention Diverts MPB Timber To Grade 4

108. First, and obviously targeted toward MPB timber, BC made changes to the assessment of "checks," which are separations or splits in the wood fiber.¹⁵⁷ These modifications, which apply only to MPB timber, divert more MPB timber into Grade 4, resulting in timber that is not priced in accordance with the pricing system grandfathered by the SLA.

¹⁵⁴ C-81, CAN-007343-56 at CAN-007354.

¹⁵⁵ C-81, CAN-007343-56 at CAN-007354.

¹⁵⁶ *Id.*

¹⁵⁷ C-48, CAN-007998-8174 at CAN-008074.

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109. BC had extensively researched the effects of checks on lumber recovery while developing and testing the 2006 reforms grandfathered by the SLA. Under the 2006 grading and pricing reforms, checks were assessed in the same manner for all logs, and surface checks two centimeters or less in depth were not part of the grade calculation.¹⁵⁸

110. Despite industry's concern about the importance of checks in determining grade, and BC's own detailed studies preceding the 2006 reforms, Interior scalers failed to assess checks in a consistent and reliable manner.¹⁵⁹ By September 2007, ISAC had recognized that "something was drastically wrong" with the measurement and assessment of checks and observed that the call for second check scales had "gone up dramatically," indicating that industry scalers and Ministry check scalers were unable to agree on the assessment of checks.¹⁶⁰ By October 2007, [

] ¹⁶¹ Nevertheless, ISAC continued to rely on the development of "local knowledge" as its solution to the difficulties inherent in identifying checks.¹⁶²

111. Against this backdrop, in December 2007, the Ministry approved and promulgated new grading conventions that applied only to logs "displaying blue stain or

¹⁵⁸ C-50, CAN-008253-8742 at CAN-008509, CAN-008515-16.

¹⁵⁹ See C-18, CAN-007146-64 at CAN-007148; C-84, CAN-010278-325 at CAN-010280.

¹⁶⁰ C-49, CAN-011306-29 at CAN-011309.

¹⁶¹ C-54, CAN-007292-95 at CAN-007293.

¹⁶² C-49, CAN-011306-29 at CAN-011328.

beetle galleries.”¹⁶³ These characteristics are found primarily, if not exclusively, in MPB timber. Logs that did not display the blue stain or galleries associated with the mountain pine beetle were assessed and graded under the usual grading standard that focused solely on the 50/50 rule grandfathered by the SLA.¹⁶⁴ By contrast, the new conventions applying only to MPB timber focused not on the 50/50 rule, but rather relied on a simple method of tallying checks and assessing bark coverage in order to grade logs. That is, MPB timber’s suitability for lumber has become irrelevant under BC’s new conventions.

112. Under the new conventions that apply only to MPB timber, the scaler counts the number of checks present within a 2.5 meter section of a log, determines whether the log is at least 50 percent covered by bark, and then applies a formula to assign a grade.¹⁶⁵ The new conventions allow any check to be considered when assessing the applicable grade reduction.¹⁶⁶ At no point does the scaler calculate, or attempt to calculate, whether the log actually meets the 50/50 rule. That is, under the new conventions, the scaler does not determine whether the MPB log is suitable for lumber under the 50/50 rule. Thus, BC promoted and codified the practice of using checks as a proxy for quality without regard to whether the timber is capable of meeting the 50/50 rule.

¹⁶³ C-82, CAN-011400-02 at CAN-011402.

¹⁶⁴ See C-48, CAN-007998-8174 at CAN-008131; C-50, CAN-008253-742 at CAN-008515.

¹⁶⁵ C-48, CAN-007988-8147 at CAN-008123; C-84, CAN-010278-325 at CAN-010289.

¹⁶⁶ C-82, CAN-011400-02 at CAN-011402; C-84, CAN-010278-325 at CAN-010282.

113. The change in how checks in MPB timber are assessed circumvents the SLA because the modification was not part of the grandfathered timber system and does not maintain or improve the extent to which stumpage rates reflect the market.¹⁶⁷ As an initial matter, BC failed to provide any evidence that the modification could potentially come within any Anti-circumvention exception.¹⁶⁸ Indeed, the new method of assessing checks against MPB timber is a marked deviation from the grandfathered system that focused on the log's suitability for lumber. The United States agreed to have the SLA grandfather a system in which BC sold most MPB timber at sawlog prices, and BC agreed to abide by that standard or to change it so that the changes maintained or improved how market conditions are reflected. This change to the Scaling Manual, however, abandons the 50/50 rule and simply counts checks in blue-stained logs without regard to whether the beetle-affected log can produce merchantable lumber. This practice simply does not more accurately reflect the market conditions for MPB timber. Further, that the practice applies only to MPB timber indicates that the modification does not move the timber pricing system toward the market, but instead increases the probability that MPB timber will be classified as Grade 4, even if it produces merchantable lumber. Accordingly, the changed assessment of checks is a modification to the grandfathered system and does not maintain or improve the extent to which price reflects market conditions. BC's modification thus circumvents the SLA.¹⁶⁹

¹⁶⁷ SLA, art. XVII, 2(a).

¹⁶⁸ *See id.*, art. XV.

¹⁶⁹ *Id.*, art. XVII ¶ 2(a).

2. The Two-Centimeter Rule Diverts MPB Timber To Grade 4

114. In a second grading change targeted at MPB timber, BC enacted the “two-centimeter rule,” which also has diverted more MPB timber into Grade 4. The two-centimeter rule applies only to logs “with less than 50% bark covering (visual estimate +/- 10%) and also displaying blue stain or beetle galleries.”¹⁷⁰ This new rule can lead to an automatic reduction in the volume of the log considered when considering defects and, depending on the number of defects, can lead to a reduction in grade.¹⁷¹ Again, missing bark, blue stain, and beetle galleries are conditions found primarily, if not exclusively, in MPB timber. Thus BC implemented a change that was directly aimed at increasing the likelihood that beetle-affected timber would be classified as Grade 4.

115. The two-centimeter rule provides that, for logs with a radius equal to or greater than 10 centimeters, scalers “subtract 2 cm of radius from the diameter as a grade reduction.”¹⁷² This means that a significant portion of the log’s volume is treated as not suitable for lumber production, *even if* the log has no visible defects that would indicate in any way that this portion of volume is, in fact, not suitable for lumber production.¹⁷³

¹⁷⁰ C-48, CAN-007998-8174 at CAN-008131.

¹⁷¹ *Cf. id.*, *see also id.* at CAN-008084.

¹⁷² *Id.*

¹⁷³ For example, for a five meter log with a radius of 10 centimeters, the gross volume of the log using the formula for a cylinder, $\pi * r^2 * h$ would be:

$$\pi * (0.1\text{m})^2 * 5\text{m} = \pi * (0.05)\text{m}^3$$

With the automatic deduction of 2 centimeters from the radius, the initial volume would be:

$$\pi * (0.08\text{m})^2 * 5\text{m} = \pi * (0.032)\text{m}^3.$$

116. The initial reduction of the log's total volume by more than one-third for a 10-centimeter log effectively creates an automatic grade reduction for MPB timber. The rule applies without regard to the log's suitability for lumber, and no such automatic deduction occurs for logs with more than 50 percent bark covering or those without blue stain or beetle galleries.

117. The two-centimeter rule is another example of how BC has modified its timber system in a manner that does not more accurately reflect market conditions, and thus provides a benefit to its lumber producers. Like the new check rules discussed above, BC failed to prove to the United States that the two-centimeter rule has maintained or improved the extent to which stumpage charges reflect market conditions. Because the two-centimeter rule applies without regard to the actual quantity and quality of lumber that a log will produce, this new change to the scaling policy simply cannot be shown to maintain or improve the relationship between the stumpage fee and market conditions. Rather, it increases the probability that MPB timber will be classified as Grade 4 and sold at the minimum stumpage fee, even if it produces sufficient merchantable lumber to satisfy the 50/50 rule later on. BC circumvented the SLA by codifying this rule.¹⁷⁴

3. Kiln Warming Diverts Timber To Grade 4

118. BC's decision to sanction, expand, and standardize industry's practice of drying MPB logs in conventional lumber kilns before grading is yet another example of

¹⁷⁴ SLA, art. XVII.

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how BC modified the Interior grading and pricing system to allow producers to derive a benefit on a *de jure* basis.

119. Kiln warming, which is sometimes referred to as “kiln drying,” is the process of artificially heating logs before scaling in large kilns intended for finished lumber. [

] ¹⁷⁵ [

] ¹⁷⁶ Heating logs dries the logs, causing checks in the logs to expand and become easier to detect. Kiln warming resulted in logs being downgraded to Grade 4, when they otherwise would have been classified as Grade 1 or 2. ¹⁷⁷

120. As an initial matter, Canada has never established whether kiln warming makes checks more visible, whether it worsens them, or whether it actually creates new checks. But that is beside the point. Kiln warming, like the 2007 scaling conventions described above, has never been tested for its accuracy in applying the 50/50 rule. When BC developed the scaling rules in place as of July 1, 2006, BC determined that certain identifiable checks warrant a scoring deduction, and that, taken together, a certain number and combination of deductions would push a log below the 50/50 threshold. If these scaling rules are “accurate,” then the collective deductions on a given log will correlate with the volume of lumber that can be produced from that log, and the volume of lumber that is of merchantable quality. BC tested the 2006 scaling rules for accuracy

¹⁷⁵ C-51, CAN-028705-708 at CAN-29706.

¹⁷⁶ *See id.*

¹⁷⁷ *See, e.g.,* C-51, CAN-028705-08 at CAN-028706; (kiln warming []).

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before it adopted the reforms. Without evidence or justification under the SLA, BC has altered the grading rules tested in 2006 and since adopted a novel practice, kiln warming, that it is known to identify and potentially create defects in logs that correspond with a grade deduction. Kiln warming does not correlate with the correct application of the grade definitions. That is, even if kiln warming makes checks easier to detect, Canada has failed to provide any evidence that kiln warming increases the accuracy of the log grades.

121. As explained below, BC's decision to allow its industry to warm beetle-affected logs in conventional lumber kilns before grading is an example of how BC changed the grandfathered grading and pricing system in effect as of July 1, 2006, to benefit producers.

122. Warming logs in lumber kilns before grading is hardly a time-honored industry practice; it appears that industry first proposed it in the fall of 2007, and especially for MPB logs. In September 2007, [

] ¹⁷⁸ [

] ¹⁷⁹ [

¹⁷⁸ C-52, CAN-010637-44 at CAN-010641.

¹⁷⁹ *Id.*

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]»¹⁸⁰ [

] ¹⁸¹

123. Despite its concerns, the Ministry authorized the practice of kiln warming prior to grading at [

] ¹⁸² On January 15, 2008, the pilot program was expanded to all authorized scale sites with available kilns, with the pilot program ending on June 30, 2008.

124. The pilot program did not put an end to the controversy surrounding kiln warming. The ISAC Subcommittee stated that there were [

] ¹⁸³ Despite [

] ¹⁸⁴ The director of the Revenue Branch

also [

] ¹⁸⁵ He added that the “[

¹⁸⁰ *Id.*

¹⁸¹ *Id.*

¹⁸² C-53, CAN-011389-90 at CAN-011389; C-51, CAN-028705-08 at CAN-28706.

¹⁸³ C-54, CAN-007292-95 at CAN-007294.

¹⁸⁴ *Id.*

¹⁸⁵ C-53, CAN-011389-90 at CAN-011389.

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].¹⁸⁶ ISAC raised [

].¹⁸⁷ ISAC also [

].¹⁸⁸

125. That kiln warming substantially increased the share of timber classified as Grade 4 and, as a result, substantially reduced the amount that producers pay for Crown-owned timber, was clear from the earliest days of the pilot program. For example, [

], a lumber manufacturer, [

].¹⁸⁹ Ministry analysis

revealed that approximately [

].¹⁹⁰ Thus, if [] stumpage

fees in two districts were recalculated for only December 2007 and January 2008, []

would have paid about [] in stumpage.¹⁹¹ If the same []

in Grade 4 and stumpage adjustment were extrapolated to all interior timber licensees for

¹⁸⁶ *Id.*

¹⁸⁷ C-55, CAN-007296-306 at CAN-007301.

¹⁸⁸ *Id.* at CAN-007300-01

¹⁸⁹ C-56, CAN-042482 [

].

¹⁹⁰ C-57, CAN-021032-34 at CAN-021033.

¹⁹¹ *Id.* The Ministry [

] *Id.* at CAN-

021034.

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the same two to three-month period, the monetary effect would have been []¹⁹²

126. Moreover, the Ministry's estimate [] is likely understated by a significant amount. *Id.* Early studies into kiln drying conducted by [] found that kiln drying could []¹⁹³ A simple example contained in []

] ¹⁹⁴

127. Although seemingly high, those study results were consistent with the results of other industry studies before BC officially sanctioned kiln warming in 2008. For instance, [] conducted study on October 17, 2007, in which it kiln dried a sample of []¹⁹⁵ After kiln warming, []

¹⁹² *Id.* at CAN-021034; *see also* C-98, CAN-052418 []

¹⁹³ C-29, CAN-051733.

¹⁹⁴ *See id.* at CAN-051735; C-33 CAN-51765.

¹⁹⁵ C-101, CAN-052521.

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].¹⁹⁶ Kiln warming thus resulted in a [] percent of grade 2 logs converting into grade 4 logs, depending on how the “borderline” logs are counted.¹⁹⁷ Yet other studies found that kiln warming converted [] percent of grade 2 logs into grade 4 logs.¹⁹⁸ It is therefore not surprising that once BC adopted kiln drying, there was a disparity between the amounts of grade 4 reported by mills that kiln dried and the amounts of grade 4 reported by mills that did not kiln dry.

128. [] also complained [

] ¹⁹⁹ Nine Southern Interior lumber producers [

] ²⁰⁰ They [

] ²⁰¹ [

] ²⁰² [

¹⁹⁶ *Id.*

¹⁹⁷ *See id.*

¹⁹⁸ C-100 CAN-052516; C-99 CAN-052391.

¹⁹⁹ C-98, CAN-052418.

²⁰⁰ C-95, CAN-054393-98 at CAN-054393.

²⁰¹ *Id.* at CAN-054394.

²⁰² *Id.*

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] ²⁰³ [

] ²⁰⁴

[

] ²⁰⁵

129. [

²⁰⁶

Based on information collected from [

] in Grade 4 timber.²⁰⁷ Therefore, kiln

drying can be attributed with [

] in Grade 4

timber.²⁰⁸

130. Even though the new practice of kiln warming had demonstrably increased the amount of logs classified as Grade 4, and [

] ²⁰⁹ the practice continued and expanded throughout

²⁰³ *Id.*

²⁰⁴ *Id.*

²⁰⁵ *Id.*

²⁰⁶ *See* C-58, CAN-11853-54 at CAN-011853; C-55, CAN-007296-306

[

].

²⁰⁷ *Id.*

²⁰⁸ *Id.*

²⁰⁹ For example, in February 2009, ISAC [

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2008 and 2009.²¹⁰ While kiln warming certainly does not explain all of the increase in Grade 4 timber since April 2007, it is irrefutable that a second major increase in the share of Grade 4 timber started in late 2007, at exactly the time when the practice was introduced.²¹¹

131. BC implemented and continued the practice of kiln warming without undertaking any research to verify that it leads to more accurate log scaling.²¹² This was problematic given the dramatic changes in grading that accompanied the practice. The most that can be said of kiln warming is that makes beetle-affected logs more likely to be classified as Grade 4. Yet, as demonstrated by the BC mill studies carried out in 2007-2009, BC is aware that there is every reason to believe that beetle-affected logs will meet the 50/50 rule.

132. The few studies related to kiln warming only evaluate the effects of kiln warming on checks; they do not evaluate the effects of the practice on grading accuracy, that is, whether kiln warming combined with the other new scaling rules is consistent with correctly applying the grade definitions. In any event, the studies lack the rigorous analysis associated with the 2006 reforms and later mill studies. For example, the 2008

] C-59, CAN-007320-25 at CAN-007321. [

] C-60 CAN-018853-54; *see* C-46,
CAN-008928-36; *see also* C-62, CAN-011568-71 ([

]).

²¹⁰ *See, e.g.*, C-63, CAN-019668-82 at CAN-019670 ([
]); C-64, CAN-019684 (through Oct. 09).

²¹¹ C-2, Neuberger Report at Ex. 3.

²¹² *See* C-46, CAN-008928-36 at CAN-008935.

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report by Forintek entitled “Follow-up on the Implementation of the Guidelines for Heating up {Mountain Pine Beetle} Logs in Conventional Lumber Dry Kilns” simply gathered information by discussing kiln drying with kiln operators and scalers.²¹³ The report states that “it was clear {kiln warming} did not produce or worsen existing checks,” but cites no scientific basis for this statement. Instead, the conclusion is based solely upon discussions with the very people possessing the financial incentive to continue kiln drying.²¹⁴

133. The report admits that scientific research has not been done and recommends, among other things, a “scientific study to prove that present guidelines for re-drying logs in kilns do not create any risk of downgrading logs due to checking,” and “research to examine relationships between grading rules, actual log grades and the sawmill results (lumber and grade recovery).”²¹⁵ Although the report recommends continuing the kiln drying program, it acknowledges the absence of any scientific basis for the statement that checks were not created or made worse and no scientific research showing that the grading rules were correlated with actual grades and results.²¹⁶ Thus, there is no scientific, credible information as to whether the practice of kiln warming merely makes checks more visible, or creates and exacerbates checks.

²¹³ C-65, CAN-002774-808 at CAN-002776.

²¹⁴ *Id.*

²¹⁵ *Id.*

²¹⁶ *Id.*; *see also* C-88 CAN-052385-90 at CAN-052390 ([

]).

134. Kiln warming is a new practice that the mills introduced, with the known effect of diverting more logs to Grade 4. The practice was not grandfathered by the SLA as part of the grading system in effect as of July 1, 2006. BC has presented no evidence that the practice maintains or increases the extent to which Interior stumpage reflects market conditions.²¹⁷ In fact, BC has presented no such evidence and cannot show that the practice increases the accuracy of grading in relation to the 50/50 rule. Instead, the practice is one of the methods authorized by BC to increase the share of Grade 4 timber, thereby decreasing the cost of timber to lumber producers. Kiln warming, therefore, is yet another circumvention of the SLA.²¹⁸

4. The Practice Of Bucking Logs Diverts Timber To Grade 4

135. Yet another way that BC has changed the grading and scaling system to divert more timber into Grade 4 is by encouraging the practice of “bucking,” or cutting logs at the scaling site before scaling. Although bucking is not restricted during the harvest of logs, bucking at the scale site prior to scaling requires Ministry approval.²¹⁹ In 2008, the Ministry began to actively encourage bucking at scale sites.²²⁰ At the time, bucking was viewed as a way to “improve the accuracy of defining Grade 4 beetle killed timber at non kiln warming sites.”²²¹ But, as the Ministry was well aware, bucking

²¹⁷ See SLA, art. XV 14.

²¹⁸ *Id.*, art. XVII.

²¹⁹ See C-19 CAN-007431-47 at CAN-007446-47; C-85, CAN-010535.

²²⁰ See C-83, CAN-011867-68.

²²¹ *Id.*

before scaling also allows rules regarding the minimum length of logs to factor into grade decisions in a manner that diverts more timber into Grade 4.²²²

136. For example, before scaling, a scaler may buck a log to a length of just under five meters. If the resultant log is 4.99 meters long, under the check conventions codified in the scaling manual, any check is assumed to run 2.5 meters along the length of the log.²²³ Thus, if the first 2.5 meter segment of the log is downgraded due to checking, the second segment of the log is then below the minimum sawlog length of 2.5 meters. Accordingly, the scaler may then downgrade the entire 4.99 meter log.²²⁴ This allows more logs under five meters to be classified as Grade 4, even though those logs may be capable of meeting the 50/50 rule. Sixteen foot lumber (4.87 meters) is very common and a preferred length for many end uses. Because this length of lumber can be produced from logs slightly less than five meters in length, the Ministry's decision to encourage bucking has allowed the industry to use the practice to divert more timber toward Grade 4 while also retaining the ability to sell manufactured lumber in the most commercially preferable way.

137. The Ministry's encouragement of bucking prior to scaling is yet another deviation from the system grandfathered by the SLA; bucking undermines the grandfathered system by ensuring that increasing amounts of timber are assigned to Grade 4 without regard to the timber's lumber-suitability. Once again, BC did not

²²² C-85, CAN-010535; C-86 CAN-026568-70 at CAN-026568.

²²³ C-87, CAN-007362-71 at CAN-007368.

²²⁴ *Id.*

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provide the United States with evidence that the changes to the bucking practices maintain or improve the extent to which the stumpage charges reflected market conditions. In fact, BC could not make such a showing; bucking, especially when used in conjunction with changes to the scaling manual, generates prices for logs in a manner that is inconsistent with the 50/50 rule. Bucking allows the industry to manipulate the grading system such that the grade assigned to a log does not reflect the lumber-suitability of that log. Thus, this practice does not maintain or improve the extent to which stumpage charges reflect market conditions. Accordingly, BC provided a benefit to lumber producers by promoting the widespread use of bucking.

138. Indeed, Interior scalers have diverted even more timber into Grade 4 by combining the practice of bucking with changes to the scaling manual for the treatment and evaluation of log “sweep,” or the curvature along the length of the log. In September 2007, [

] ²²⁵ [

] ²²⁶ For logs over five meters long, [

] ²²⁷

139. The new sweep rule, however, provides dramatically different results for a 4.99 meter log than for a five-meter log. For example, when the new sweep rule is

²²⁵ C-80, CAN-051098-292 at CAN-051101.

²²⁶ *See id.* at CAN-051107-15.

²²⁷ *See id.* at 051110-15.

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applied to a comparable size log with a comparable amount of sweep, a five-meter log would have a [], while a 4.99 meter log would have a [

] ²²⁸ Like the check conventions discussed above, the sweep conventions result in more logs under five-meters long being classified as Grade 4, even though those logs are likely capable of meeting the 50/50 rule.

140. Also, many merchantable lumber products can be made from logs under five meters in the length, so the new sweep provision created an incentive for companies to “buck,” or cut, logs in order to classify more logs as Grade 4, even though the logs would meet the 50/50 sawlog standard. [

] ²²⁹

Despite its knowledge that industry was using the practice in order to divert more timber into Grade 4, the Ministry promoted the practice of bucking logs prior to scaling. ²³⁰

C. BC Sold Timber At The Minimum Fee *Knowing* That Industry, In Practice, Was Modifying The 50/50 Rule And Other Timber Pricing Policies And Procedures

141. As explained above, under the BC provincial timber pricing system, as it existed in July 2006, scalers employed by the BC lumber companies examine sample loads of logs to determine the volume of the timber and to assign each log a grade to denote quality. The grades are then extrapolated to all of the timber harvested. As discussed earlier, whether a particular log is classified as Grade 1, 2, or 4 significantly affects the price paid.

²²⁸ C-55, CAN-007296-306 at CAN-007305.

²²⁹ *Id.* at CAN-007300, at CAN-007305.

²³⁰ C-85, CAN-010535; C-83, CAN-011867.

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142. Because scalers are employed by the companies that purchases timber from BC, they are vulnerable to pressures from employers who may “ask scalers not to scale too high because it’s going to cost them money”²³¹ The Ministry, which is responsible for licensing and auditing scalers, has long been aware that the scaling process is subject to “deliberate manipulation.”²³²

143. Scalers must follow the Scaling Manual.²³³ ISAC generally reviews changes to the Scaling Manual, and, although the Ministry must approve all Scaling Manual amendments, ISAC’s involvement in the development of the Scaling Manual means that industry often plays a crucial, even leading, role in modifications to the grading process.²³⁴ For example, as discussed above, the industry helps derive “conventions,” that is, assumptions based on perceived relationships between external log characteristics and the effect of those characteristics upon lumber content and recovery that are used to increase the pace and consistency of scaling determinations.²³⁵

144. From the time BC enacted the scaling and grading reforms in April 2006, the Ministry knew that scalers did not always adhere to the province’s scaling guidelines

²³¹ C-66, SLAIII-US0089-93 at SLAIII-US0091.

²³² *Id.*; see also C-67, CAN-018817-18 at CAN-018818 [

].

²³³ See C-50, CAN-008253-742 at CAN-008256 (Scaling Manual, intro).

²³⁴ See C-83, CAN-011867-68 at CAN-011867 (providing guidance “to enable {ISAC} to develop enhanced scaling procedures”).

²³⁵ C-48, CAN-007998-8174, at CAN-008053. Scalers may only rely upon the conventions if actual information or indicators are not available, because “strict adherence to some conventions will not always yield the most accurate scale.” *Id.*

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and misgraded logs. Yet, BC did not stop those practices. BC's continued failure to apply and enforce the Interior pricing and grading system grandfathered by the SLA has allowed increasing amounts of timber to be assigned to Grade 4 without regard to the timber's lumber-suitability. BC's failure has provided a benefit to producers, thereby circumventing the SLA.²³⁶

145. For example, the Ministry was aware that the amount of timber classified as Grade 4 was rising and raised concerns about the increase on multiple occasions.²³⁷ The Ministry also knew that industry would manipulate the scaling process. For example, in March 2007, the regional scaling supervisors in the northern interior discussed [

]²³⁸ In response, the [

]²³⁹

146. The Ministry was also cognizant that scalers were manipulating the sample loads. Specifically, scalers would [

²³⁶ C-1, SLA, art. XVII.

²³⁷ See C-68, CAN-011645-47 at CAN-011645 (Revenue Branch Manager of Scaling refers to “{mountain pine beetle} Grade 4 challenge”); C-62, CAN-011568-571 ([

]); C-69, CAN-010409-10 ([
]); C-70, CAN-007044-49 at CAN-007048 (discussion of “game playing (where Grade 1 lowered, to have more Grade 4)”).

²³⁸ C-67, CAN-018817-18 at CAN-018818 (“Scaler integrity is being compromised by site owners telling them to ensure their scales are 2% lower than check scales. Several districts know examples of where it is happening.”).

²³⁹ *Id.* [

)].

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was []²⁴⁰ ISAC's apparent response
[]²⁴¹

147. At times, industry was openly defiant and disregarded Ministry staff and directives. For example, in August 2007, Ministry staff [

] ²⁴² [

] ²⁴³ [

] ²⁴⁴

148. In another example, [

] ²⁴⁵ A representative of

[

²⁴⁰ C-71, CAN-026468-69 at CAN-026468.

²⁴¹ *Id.*; see C-72, CAN-018850-51 at CAN-018850 (NIRS, confidential) (noting that, in March 2008, [

]).

²⁴² C-73, CAN-010539-44 at CAN-010542. "2-by-4" or "2 x 4" refers to 2 inches by 4 inches—the dimensions of a common lumber product in North America.

²⁴³ See *id.* at CAN-010539.

²⁴⁴ *Id.*

²⁴⁵ C-74, CAN-042437-39 at CAN-042439.

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] ²⁴⁶ [

] ²⁴⁷ [

] ²⁴⁸ Nothing indicates the Ministry disciplined or otherwise responded to the lumber producer's refusal to adhere to the Ministry's interpretation, even when the producer countermanded the Ministry and instructed its scalers to follow the producer's view on the correct grade.

149. [

] ²⁴⁹ [

Yet industry appeared to pay no price for its defiance.]

²⁴⁶ C-75, CAN-042440-41 at CAN-042440.

²⁴⁷ *Id.*

²⁴⁸ *Id.*

²⁴⁹ *See, e.g.*, C-76, CAN-018841-42 at CAN-018842; C-77, CAN-011249-54 at CAN-011249 ([
007201 ([
]); C-78, CAN-007196-213 at CAN-
]).

150. All of these incidents show that the BC lumber industry has in practice changed the grandfathered MPS's rules and requirements. BC is simply acquiescing to industry's practices and accepting the misgrading of MPB timber. As a result, BC is selling BC lumber producers sawlogs for prices that are far below what BC is required to command in the grandfathered MPS, and the changes do not more accurately reflect market conditions. Thus, BC is providing lumber producers with a benefit in breach of the Article XVII of the SLA.

IV. No Article XVII Exceptions Sanction BC's Underpricing Of MPB Timber

151. Article XVII of the SLA provides that Canada circumvents its SLA commitments if it or one of its provinces provides a benefit to softwood lumber producers or exporters on a *de jure* or *de facto* basis. As just demonstrated, BC circumvented the SLA by selling underpriced timber to softwood lumber producers, providing an obvious benefit to those producers.

152. Since 2007, this benefit has resulted in lumber producers paying nearly C\$500 million less than they should have paid for timber that they ultimately sold as merchantable lumber, after having purchased it at the minimum stumpage rate. Under the terms of the SLA, this benefit directly contravenes the BC Interior grading and pricing system in place when the parties entered into the SLA, and is deemed to circumvent the Agreement.

153. "Grants or other benefits" are deemed to circumvent the Agreement, unless they fall into an enumerated exception.²⁵⁰ Canada has raised two of these

²⁵⁰ C-1, SLA, art. XVII, ¶ 2.

exceptions in its response to the Request for Arbitration.²⁵¹ Contrary to Canada's contention, however, neither exception applies.

154. First, provincial timber pricing systems, including modifications or updates, are excepted, but only if they "maintain or improve the extent to which the stumpage charges reflect market conditions, *including prices and costs.*"²⁵²

155. Timber prices in BC have been consistently below market prices, and the reforms grandfathered by the SLA were intended to bring BC closer to market prices.²⁵³ Yet BC's underpricing of lumber-quality timber has *lowered* timber prices, making them *less* sensitive to market forces (the flat minimum stumpage rate never fluctuates), driving Interior timber prices further from market prices. Accordingly, to the extent BC's departure from the April 2006 grading rules is viewed as one or more modifications to the Interior timber pricing system, it could not have maintained or improved the extent to which the stumpage charges reflect market conditions. Therefore, the first exception is not satisfied.

156. Second, programs or actions undertaken "for the purpose of forest or environmental management, protection, or conservation" are excepted provided that they do not "involve grants or other benefits that have the effect of undermining or counteracting movement toward the market pricing of timber."²⁵⁴ Despite Canada's suggestion that this exception may apply, there is no evidence that BC's underpricing of

²⁵¹ See Can. Response to U.S. Request for Arbitration at ¶ 21.

²⁵² C-1, SLA, art. XVII, ¶ 2(a) (emphasis added).

²⁵³ SLA, Art. XVII, ¶ 4(b) (Canada warranty that the grandfathered BC system is "more sensitive to market forces than pre-existing systems.").

²⁵⁴ *Id.*, ¶ 2(c).

MPB timber was undertaken for the purpose stated in the exception. Moreover, the modifications to the BC Interior provincial timber pricing system – even assuming a legitimate forest or environmental management purpose – had the effect of counteracting and undermining movement toward market pricing. Therefore, the second exception likewise does not apply.

V. Remedy

A. Introduction

157. Upon finding that Canada has breached the SLA, the SLA requires the Tribunal to make two determinations. First, the Tribunal decides a reasonable period of time of up to 30 days for Canada to cure its breach. Second, the Tribunal sets the compensatory adjustments to the Export Measures to be imposed should Canada fail to cure its breach within the reasonable period of time prescribed by the Tribunal.²⁵⁵

158. In considering appropriate compensatory adjustments to the Export Measures, it is important to consider the consequences of Canada's breach since the adjustments should wipe out the consequences of the breach. In this case, the consequences of Canada's underpricing of MPB timber are hundreds of millions of dollars in benefits to the Canadian softwood lumber industry. An appropriate remedy must account for both (1) the benefits that Canada has provided to its softwood lumber industry in violation of the SLA; and (2) any ongoing breaching conduct. This comprehensive approach to remedy is consistent with the parties' agreement as expressed in the SLA and honors the general principle in international law requiring "full reparation" for wrongful acts, ensuring that Canada does not benefit from its breach.

²⁵⁵ SLA, art. XIV, ¶ 22.

159. To aid the Tribunal in its task of determining a remedy, the United States proposes specific adjustments to the Export Measures. We respectfully request that the Tribunal determine in its Award that these adjustments be imposed should Canada not cure its breach within a reasonable period of time.

B. The Remedy Provisions Of Article XIV

160. The SLA's dispute resolution article, Article XIV, provides for the United States' remedy in this case. Under paragraph 22 of Article XIV, the Tribunal makes two determinations once a breach is found. The Tribunal is to:

(a) identify a reasonable period of time for that Party to cure the breach, which shall be the shortest reasonable period of time feasible and, in any event, not longer than 30 days from the date the tribunal issues the award; and

(b) determine appropriate adjustments to the Export Measures to compensate for the breach if that Party fails to cure the breach within the reasonable period of time.²⁵⁶

161. Pursuant to the ordinary meaning of paragraph 22, the Tribunal *simultaneously* (1) identifies a reasonable period of time for Canada to cure its breach, and (2) determines the appropriate adjustments to the Export Measures to compensate for the breach should Canada fail to cure the breach within a reasonable period of time.²⁵⁷ The Tribunal is to include both findings in its Award.²⁵⁸ The Tribunal performs both tasks simultaneously so that the breaching party is aware both of the time it has to cure the breach and of the consequences of its failure to do so.

²⁵⁶ SLA, art. XIV, ¶ 22.

²⁵⁷ *Id.*

²⁵⁸ *Id.*

162. Where Canada is the breaching party, compensatory adjustments consist of increases to export charges, reductions in export volumes, or both, and must be in an amount that remedies the breach.²⁵⁹ The SLA requires that if the breach by Canada is “attributable to a particular Region,” the Tribunal shall determine compensatory adjustments applicable to that Region.²⁶⁰

163. In the event a party considers that the breaching party has failed to comply with the Tribunal’s determinations made under paragraph 22, Article XIV authorizes that party to make compensatory adjustments or impose compensatory measures.²⁶¹

164. Article XIV also provides that the breaching party may commence a new arbitration to determine whether the compensatory adjustments or measures permitted under paragraphs 26 or 27 exceed what the Tribunal determined or otherwise authorized in its award made under paragraph 22.²⁶² If either party commences an arbitration under paragraph 29, the LCIA “shall appoint to the tribunal the arbitrators comprising the original tribunal, to the extent they are available.”²⁶³ If the Tribunal finds in this follow-on arbitration that the compensatory adjustments or measures are inconsistent with the award in the original arbitration, the Tribunal “shall determine the extent to which the

²⁵⁹ SLA, art. XIV, ¶ 23.

²⁶⁰ SLA, art. XIV, ¶¶ 22-27.

²⁶¹ SLA, art. XIV, ¶¶ 26-27.

²⁶² SLA, art. XIV, ¶ 29(a), (b).

²⁶³ SLA, art. XIV, ¶ 30.

compensatory adjustments or measures should be modified or whether they should be terminated.”²⁶⁴

165. The ordinary meaning of this series of paragraphs is that, once the reasonable cure period determined under paragraph 22 has passed, the United States is entitled to impose compensatory measures consistent with the adjustments determined by the Tribunal under paragraph 22 if the United States considers that Canada has failed to cure the breach and has failed to make the compensatory adjustments itself.

166. For the Tribunal’s Award in this arbitration, the United States would accept that Canada be granted the maximum 30-day period allowed under the Agreement to cure its breach.²⁶⁵ In carrying out its determination under paragraph 22, the Tribunal’s adjustments to the Export Measures must compensate for Canada’s breach both retrospectively and prospectively. That is, a remedy must compensate for the past effects of the breach as well as the effects that continue in the future. As discussed in the Introduction, Section III, the two previous LCIA Tribunals rejected Canada’s position in those arbitrations, concluding that the SLA provides for both prospective and retrospective remedies for breach.²⁶⁶

²⁶⁴ SLA, art. XIV, ¶ 31.

²⁶⁵ C-1, SLA, art. XIV, ¶ 22(a).

²⁶⁶ CA-7, *United States v. Canada*, LCIA No. 81010, ¶ 357, (Jan. 20, 2011); CA-5, *United States v. Canada, Award on Remedies*, LCIA No. 7941, ¶ 306, (Feb. 26, 2009).

C. Any Remedy Must Re-Establish The Playing Field By Capturing The Full Amount Of The Benefits That Canada Conferred On BC Lumber Producers By Its Breach

167: Any proposed remedy for Canada’s breach must be appropriate.²⁶⁷ The 7941 Tribunal stated: “It is obvious that, once a breach and the applicability of subsection [22](b) is established, . . . there must be *at least one appropriate adjustment* satisfying the requirements of that subsection and the further qualification in § 23.”²⁶⁸

168. We respectfully request that the Tribunal determine compensatory adjustments to the Export Measures that collect the full amount of the benefits provided by means of BC’s breaching conduct. A remedy that captures the wrongful benefits is consistent with the plain language of the Anti-circumvention commitments of Article XVII and the dispute resolution provisions of Article XIV, and is well-tailored to the nature of the breach in this case.

169. Article XVII bars Canada and the United States from taking any action to circumvent or offset the commitments each made, including any action that has the effect of offsetting the Export Measures.²⁶⁹ Whereas the United States undertook to refrain from certain domestic trade remedies, Canada is obligated under the SLA to impose the system of Export Measures intended to restrict lumber exports to the United States when prices in the United States are low.²⁷⁰

²⁶⁷ CA-5, *United States v. Canada, Award on Remedies*, LCIA No. 7941, at ¶ 319.

²⁶⁸ *Id.*, at ¶323 (emphasis added).

²⁶⁹ SLA, art. XVII, ¶ 1.

²⁷⁰ SLA, art. V, art. VII.

170. Because Canada collects the export charges under the SLA, the entire system of export charges could be nullified and circumvented if Canada or its provinces could simply funnel the collected charges back to the softwood lumber industry or otherwise offset those charges. This is one reason the parties included language in Article XVII to prohibit Canada from providing grants or other benefits to its softwood lumber industry.²⁷¹ Paragraph 2 of Article XVII presumes that “grants or other benefits” breach the SLA with no further proof unless the grant or benefit meets one of the enumerated exceptions that follow.²⁷² The provision explains that actions by Canada that reduce or offset the Export Measures were the Parties’ primary concern, and that Canadian grants or other benefits to its softwood lumber industry, if no exception applies, constitute circumvention.²⁷³

171. The centerpiece of Article XVII is the general prohibition on government benefits to the Canadian softwood lumber industry; it is, therefore, fitting that the focus of a remedy for a breach of Article XVII should be as well. Because the ordinary meaning of the Agreement requires that all benefits be considered to reduce or offset the Export Measures unless they meet one of the enumerated exceptions, the benefits impermissibly provided to softwood lumber producers must be included in the remedy determination.

172. The terms of Article XIV also contemplate a remedy that captures the benefits impermissibly conferred by Canada on its industry. Paragraph 22(b) states that

²⁷¹ SLA, art. XVII, ¶ 2.

²⁷² *Id.*

²⁷³ *Id.*, ¶ 1.

the adjustments are to be “appropriate” and are to “compensate” for the breach.²⁷⁴ It is logical and appropriate to capture the benefits back from the industry that received the benefits in the first place. In so doing, this “compensates” for, or offsets, the breach.

173. To borrow the language of the 7941 Tribunal, only a remedy that targets and recaptures the impermissible government benefits “wipes out” all the consequences of the breach.²⁷⁵ Indeed, a remedy that recaptures the breaching government benefits is consistent with the Award in LCIA 7941, in which the Tribunal accepted a straightforward remedy directing Canada to assess an additional export charge of 10 percent until the total benefit amount, including interest, was collected.²⁷⁶

174. In contrast, the 81010 Tribunal declined to adopt a remedy based on the benefits conferred by Canada’s breach of the SLA.²⁷⁷ The 81010 Tribunal concluded that the reduction or offset to the Export Measures did not have to be measured in the amount of the benefits provided.²⁷⁸ At the same time, the 81010 Tribunal found that the SLA grants “a certain level of discretion to determine the measure of the adjustments that will remedy the breach.”²⁷⁹ How the Tribunal exercises that discretion, the 81010 Tribunal

²⁷⁴ SLA, art. XIV, ¶ 22(b).

²⁷⁵ CA-5, at ¶¶ 273-306.

²⁷⁶ *See id.* at ¶¶ 330-331.

²⁷⁷ CA-7, *United States v. Canada*, LCIA No. 81010, at ¶ 348.

²⁷⁸ *Id.* at ¶ 345, 347.

²⁷⁹ *Id.* at ¶ 345.

continued, “is a matter that needs to be assessed in the light of the circumstances of each case.”²⁸⁰

175. Although we disagree with the 81010 Tribunal’s ultimate remedy focusing only on the effects of the breach on U.S. producers, we agree that the SLA grants this Tribunal discretion to craft an appropriate remedy that is tailored to the particular circumstances of this case. Consistent with the 81010 Tribunal’s observation that the SLA established a “level playing field” that, in the case of a breach, should be re-established by means of a remedy,²⁸¹ the only appropriate remedy in the circumstances of this case is one that recaptures the benefits that BC impermissibly provided to BC softwood lumber producers.

176. Any other result would permit Canada and its producers to profit from the breach. Indeed, a remedy that does anything less than recapture the benefits would give Canada an incentive to circumvent the SLA and assist its industry, with the knowledge that only a fraction of the benefits would eventually be collected from producers. Given the very structure of the Export Measures for which the United States negotiated to control Canadian exports of softwood lumber to the United States, a remedy that permits Canada essentially to reimburse its lumber producers for the Export Measures – even in part – necessarily abrogates the system negotiated by the parties.

²⁸⁰ *Id.* at ¶ 347.

²⁸¹ *Id.* at ¶ 352.

D. The United States' Remedies Appropriately Capture The Benefits Conferred On Canadian Softwood Lumber Producers By Canada's Breach

177. The United States has calculated the extent of the breach in terms of benefits to Canada's softwood lumber industry in violation of Canada's obligations under the SLA. The United States' expert Jonathan Neuberger proposes a straightforward remedy in which the Tribunal would determine that Canada should impose an additional export charge on BC Interior exports, in an amount commensurate with the benefits conferred by the breach.

178. In this case, the benefits of misgrading to BC Interior softwood lumber producers are twofold: (1) lumber producers pay less in stumpage on the timber affected by misgrading as Grade 4 (the "share effect"); and (2) lumber producers realize an additional benefit caused by the feedback effects of the misgrading on the price of Grade 1 and Grade 2 timber in the MPS system that sets the average market price ("AMP") for the higher grades (the "AMP effect").²⁸² An appropriate remedy will consider and compensate the cumulative benefit that the misgrading of timber as Grade 4 provides to BC Interior lumber producers.

1. The Grade 4 "Share Effect" Of The Benefit To Canadian Producers

179. The first component of Dr. Neuberger's benefit calculations, the "share effect," requires a determination of the volume of misgraded logs and, using the difference between the amount charged for such logs and the amount charged for logs

²⁸² C-2 at p. 30.

properly graded as Grade 1 or 2, calculates a dollar volume.²⁸³ This required an estimate of the quantity of logs that would have been classified as Grade 4 if not for the misgrading.²⁸⁴ To present the Tribunal with alternatives, Dr. Neuberger calculated this estimate using three different “benchmarks” or Grade 4 “base periods”: (1) the average Grade 4 share during the 12-month period immediately following the April 2006 grading rules; (2) the estimate by BC of the expected Grade 4 share at the time of the April 2006 grading rules; and (3) an estimate of Grade 4 share that attempts to adjust the share for MPB attack. FN C-2 at 31-43.

180. Dr. Neuberger explains that his preferred remedy utilizes the first method for setting a base period Grade 4 share.²⁸⁵ This is because a base period of the first 12 months of the new grading system is grounded on actual experience with the new system.²⁸⁶ Dr. Neuberger also notes that the evidence suggests that, although there may have been some misgrading during this period, substantial misgrading occurred later. Moreover, the Grade 4 shares during this base period are somewhat aligned (but still higher than) BC’s expectations at the time of the April 2006 grading rules,²⁸⁷ making the first method conservative. Using the first benchmark, Dr. Neuberger calculates that the

²⁸³ C-2 at pp. 30-31.

²⁸⁴ *Id.* at p. 30.

²⁸⁵ C-2 at p. 43.

²⁸⁶ *Id.* at p. 43.

²⁸⁷ *Id.* at pp. 25-26.

average Grade 4 share during the first 12 months after the April 2006 rules was 17.8 percent.²⁸⁸

181. Dr. Neuberger then calculated the difference between actual, reported Grade 4 shares from May 2007 forward (the “violation period”) and the 17.8 percent average Grade 4 share during the base period.²⁸⁹ He then multiplied the misgraded volume times the AMP for each mark net of the C\$0.25 minimum price.²⁹⁰ These calculations lead to a “share effect” benefit of C\$208 million through September 2010 using available data from Canada, or C\$268 million through March 2012 (the date of the scheduled hearing in this case) extrapolating from the available data.²⁹¹

182. Dr. Neuberger’s “share effect” reduces the benefit to compensate for the fact that some misgraded logs are sent to pulp mills (for paper) and not sawmills (for lumber).²⁹² Therefore, his calculations are appropriately limited to benefits realized by softwood lumber producers.

2. The Grade 1 And 2, Or “AMP Effect,” Component Of The Benefit To Canadian Producers

183. The second part of Dr. Neuberger’s benefit calculations is a determination of the effect of the misgrading on Grade 1 and 2 prices during the violation period.²⁹³

²⁸⁸ *Id.* at p. 26.

²⁸⁹ *Id.* at p. 31.

²⁹⁰ *Id.* at pp. 31-32. A “mark” an area of cutting authority granted by BC. C-50, CAN-008253-008742, at CAN-008294.

²⁹¹ *Id.* at p. 33.

²⁹² *Id.* at pp. 32-33.

²⁹³ *Id.* at p. 32.

For this part of the calculation, Dr. Neuberger inputted the corrected Grade 4 volumes into the AMP calculations for each quarter for each mark, then multiplied the difference between the original rate and the corrected rate by the total volume of Grade 1 and 2 timber.²⁹⁴

184. An important input into the “AMP effect” is the calculation of the “tenure obligations adjustment” (“TOA”) component of the BC AMP.²⁹⁵ For each Interior timber stand or “mark” sold through an administered pricing system, BC first calculates a price for Grade 1 and Grade 2 timber on that mark that purports to reflect outcomes of auction prices in the BC Timber Sales program. However, holders of long-term timber tenures who pay these administered prices incur certain costs (silviculture, road building, etc.) that are not included in the BC Timber Sales auction prices. Thus, administered timber prices are adjusted to reflect these additional costs.

185. Because the price of Grade 4 timber is fixed at C\$0.25/m³ for all timber sales (auction and administered), only the price for Grade 1 and Grade 2 is adjusted. Thus, the TOA is calculated by taking the total expected lump-sum cost incurred as a result of tenure obligations, divided by the volume of Grade 1 and 2 timber in the stand.²⁹⁶ This adjustment is then incorporated into the “average market price” used to calculate the BC Interior Base Rate for administered timber. It is clear that, when too much timber is graded as Grade 4, too little timber is graded as Grade 1 and 2, and

²⁹⁴ *Id.*

²⁹⁵ *Id.* at p. 30, n.50.

²⁹⁶ *Id.*

therefore the TOA will be greater – and administered stumpage rates lower – than would otherwise be the case.²⁹⁷ This is an important reason for the AMP effect.

186. Dr. Neuberger’s calculation of the “AMP effect” is C\$165 million through September 2010, and C\$231 million through March 2012.²⁹⁸ The total benefits as calculated by Dr. Neuberger are summarized in the table below.²⁹⁹

Benefits Of Misgrading To Canadian Softwood Lumber Producers			
May 2007 – September 2010		May 2007 – March 2012 (Est.)	
Share Effect	AMP Effect	Share Effect	AMP Effect
C\$208 million	C\$165 million	C\$268 million	C\$231 million
C\$373 million		C\$499 million	

187. To fully wipe out the effects of Canada’s breach, we respectfully request that the Tribunal determine that an appropriate remedy consists of imposing additional export charges designed to collect C\$499 million on softwood lumber exports from the BC Interior.

E. The United States’ Proposed Remedies

188. In addition to the amount that must be collected via compensatory adjustments to the Export Measures, the Tribunal should also determine the rate at which the total additional export charge is to be collected on softwood lumber exports to the

²⁹⁷ *Id.*

²⁹⁸ *Id.*

²⁹⁹ *Id.*

United States. In setting the rate of collection, the Tribunal's determination should consider that the SLA is a seven-year agreement that may be extended for an additional two years if the parties agree.³⁰⁰ The current expiration date of the SLA is October 12, 2013.

189. We also note that the remedy ultimately determined by the Tribunal may need to be updated to reflect any additional information from Canada or an extension of the SLA. The United States' proposed remedies assume that Canada brings BC's timber pricing system into compliance with the SLA close in time following the Tribunal's Award. Given the expected remaining life of the SLA, we respectfully request that if the Tribunal determines the following adjustments to the Export Measures shall be applied, the Tribunal also should state in the Award that the adjustments are to remain in place until the entire amount is collected.

190. Based on monthly export charges expected to be collected on softwood lumber exports from Interior British Columbia to the United States during the 19-month period between April 2012 and the expiration of the SLA in October 2013, an additional export charge of 30.6 percent on British Columbia exports would be expected to recover the full amount of the benefits.³⁰¹ If the SLA is extended for two years as permitted by the Agreement, the remedy amount would then be collected over a period of 43 months, requiring an reduced additional export charge of 13.5 percent to collect the full amount.³⁰²

³⁰⁰ SLA, art. XVIII.

³⁰¹ C-2 at pp. 44-45.

³⁰² *Id.*

191. Because the SLA allows the Tribunal to determine compensatory adjustments to the Export Measures, which include both export charges and volume restraints, the Tribunal could determine an appropriate remedy that includes a *lower* export charge coupled with a volume restraint on lumber exports from British Columbia to the United States. Such a remedy combination would be more complex than an export charge alone. However, Dr. Neuberger can design such a remedy if the Tribunal so desires.

CONCLUSION

192. The United States respectfully requests that the Tribunal determine that Canada breached the SLA by underpricing BC Interior timber.

193. If the Tribunal finds Canada has breached the SLA, the United States respectfully requests that the Tribunal determine a reasonable period of time for Canada to cure the breach, and respectfully requests that the Tribunal also identify appropriate compensatory adjustments to the Export Measures that remedy the breach.

194. With respect to the cure period, the United States would accept that Canada be granted 30 days, the maximum amount of time permitted under the SLA, to cure its breach.

195. With respect to compensatory adjustments to the Export Measures, the United States respectfully requests the Tribunal to determine:

- (1) An additional export charge of 30.6 percent, to be collected on softwood lumber exports from Interior BC until the current end date of the SLA in October 2013; or
- (2) An additional export charge of 13.5 percent to be collected on softwood lumber exports from Interior BC, if the period of the SLA is extended for two years to October 2015; and
- (3) The additional export charge on softwood lumber exports from Interior BC is to be applied until the amount of \$499 million is collected in its entirety.

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