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## Canada Institute Commentary

# From Log Export Restrictions to a Market-Based Future: Towards an Enduring Canada-U.S. Softwood Agreement

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with a response by Colin Robertson

*“As the fifth round of the lumber dispute dawns, a key question for Canada is how to create enduring trade peace and end the ‘Nightmare on Log Street’ once and for all. To get there, it is time for Canada to undertake a careful reassessment of its lumber policies with a view to making them more market-oriented.”*

It is the “Freddy Krueger” of trade irritants.<sup>2</sup> The United States and Canada have been fighting over softwood lumber since George Washington was president. Indeed, the lumber industry has been integral to shaping the evolution of the two countries. The very border between Maine and New Brunswick was set in 1842 by the treaty that resolved the Aroostook lumber dispute.<sup>3</sup> Since 1982, the United States and Canada have been through four major rounds of lumber disputes with more legal twists, turns, recriminations and negotiations than one can shake a plank at.

And now this ancient feud is back. The 2006 Canada-U.S. Softwood Lumber Agreement (SLA)<sup>4</sup>, which established a governance framework for the industry for a decade, expired on October 12, 2015. The terms of the SLA mandated that no new trade remedy case could be filed for at least one year after the expiration of the agreement. With the end of this abeyance period and little fundamental change in the positions of the players, it seems likely that the U.S. industry will file a petition with the U.S. government seeking the imposition of countervailing duties on Canadian softwood lumber imports before the spring of 2017.

While the landscape of lumber production in both countries has shifted over the past decade, the fundamentals of Canada's lumber policies have not changed. British Columbia's log export restrictions (LERs) have generated particular controversy. The unique structure of the regime guarantees B.C. wood processors access to cut-rate inputs at the expense of domestic timber harvesters. These subsidized inputs create an array of distortionary effects up and down the supply chain, putting them at odds with the market-based approach taken in almost every other sector of the Canadian economy. Similar to "supply management" in the Canadian dairy sector, many respected economists see LERs as a highly dubious policy that benefits a narrow array of interests.<sup>5</sup>

Just as countries such as the United States and New Zealand sought an end to supply management in the Trans-Pacific Partnership (TPP) negotiations, Canada's major trading partners are increasingly seeking reform of the B.C. LER regime. In the TPP negotiations, for example, Japan demanded an exchange of letters with Canada on LERs. While this occurred, early indications suggest that the two countries have starkly different views about what was agreed. Japan views Canada's commitment to "issue permits upon request for the export of logs destined to Japan" as a statement of intent to relax existing export restrictions on unprocessed logs. Canada understands its commitment to Japan as upholding the status quo.<sup>6</sup> In an environment of renewed softwood lumber litigation and WTO concerns about export restraints in countries, LERs also will carry increased legal risks for Canada. The U.S. Lumber Coalition has previously asserted the illegality of LERs and it is not unreasonable to consider that they may form part of future softwood lumber litigation.<sup>7</sup>

The B.C. LER regime was not addressed in the 2006 Softwood Lumber Agreement. The SLA created an interregnum of managed trade during which the parties agreed to a "ceasefire" and to not discuss fundamental reform of Canadian lumber policies. Yet, simply agreeing not to discuss a problem will not make it go away. With SLA 2006 now in the history books, those in the United States who are negatively affected by Canadian lumber policies are now motivated to push a long-deferred reform agenda.

The Canadian softwood lumber narrative typically holds that Canada is on the side of the angels and that U.S. concerns about its practices are protectionist or the work of a bully. Yet, the evidence suggests that in some cases Canadian lumber really is subsidized and

really does displace U.S. production. As will be set forth below, in the case of LERs this is almost indisputable. Faced with damage to its domestic industry and given the law and practice of the U.S. trade remedy system, it is difficult to imagine the U.S. government not imposing countervailing duties in a lumber case. There are certainly many examples across the economy of the Canadian trade remedy system providing relief to Canadian firms injured by subsidized imports. Fair enough. These processes are entirely consistent with every trade agreement that the United States and Canada have signed.

Acknowledging imperfections and re-examining one's own policies and practices is an unsettling experience, but it is fundamental to countries preparing themselves for trade peace. Over the previous four rounds of lumber litigation, Canada has understandably hunkered down for the fight. It has looked to find transitory peace through market share arrangements, but has not been proactive in identifying a reform path to address the subsidies at the heart of U.S. concern. To achieve a durable agreement with the U.S., Canada must address areas in its lumber regime where government policies create market distortions. For its part, the United States will also have to consider how it can encourage a permanent resolution of this vexing North American trade challenge.

This paper will set forth a pathway for how this reform process could be executed. After describing the key dynamics in the softwood lumber dispute, it will focus on LERs as a case study of a problematic measure deployed by Canada that is ripe for reform. It will then explain how reform of log export restrictions and similar distortionary policies could be synchronized in a more comprehensive package that delivers long-term lumber peace.

## **Part One: The Basis of the Dispute**

North America's timber industry is massive. In Canada, the forest products sector is worth C\$58 billion annually.<sup>8</sup> In the United States, it is worth US\$200 billion annually.<sup>9</sup> Given the industry's substantial employment impacts (especially in rural areas), high dollar value outputs and cross-country geographic distribution, lumber has always been political as well.

The "lumber wars" are, at base, a series of trade remedy cases brought by the United States against what it alleges to be subsidized Canadian timber. The subsidy stems partly from different ownership structures of forests in Canada as compared to the United States, how production rights are granted and priced, and directly restrictive Canadian policies.

### **Stumpage Subsidies**

The most visible aspect of the U.S.-Canada lumber dispute has long been "stumpage fees." The vast majority of Canadian forests are publicly owned. Private companies can be authorized to harvest timber on this land through a licensing process. Governments charge them fees ("stumpage") in exchange for this right to harvest and impose a variety

of conditions. The United States has long contended that these government-set fees are significantly lower than they would be in an open market environment. The under-pricing of harvest rights flows through to cheaper raw inputs for processors and low-cost outputs. The net effect of the subsidized harvest rights is that U.S. lumber and, indirectly, U.S. lumber products, are displaced by cheaper Canadian outputs in the United States, Canada and third country markets. The various U.S. trade remedy cases against Canada over the past four decades have focused on trying to force the Canadian government to raise stumpage fees to reflect equivalent market conditions. In absence of a willingness to act, the U.S. has imposed import duties equivalent to the level of the perceived Canadian subsidy.

By contrast, more than 70% of U.S. lumber production originates from timber harvested from private land, including almost all of the production in the east and south of the United States. Harvest rights, to the extent that they are granted to third parties, are sold on a market basis, usually by way of auction.

#### **Ownership Of Forests: Canada Vs. The United States**

	<b>Canada</b>	<b>United States</b>
<b>Public</b>	94%	37%
<b>Private</b>	6%	63%

*Source: UN Food and Agricultural Organization. (2016) Retrieved from: <http://www.fao.org/forestry/country/en/>.*

While most Canadian timber harvesting is on public land, Canada has some significant harvesters on private land. Most production in Atlantic Canada occurs on private land, is not subject to LERs, and uses a market-based pricing formula very similar to that in the United States. As a consequence, harvesters in this region have been excluded from U.S. trade actions, including an explicit exemption from the 2006 SLA. By contrast, in British Columbia, companies that harvest timber on private land are subject to the same U.S. trade restrictions as those harvesting on public land. This stems from the fact that harvesters on private land are subject to the same distortionary LERs as their public land-producing counterparts.

In addition to Atlantic Canada, the SLA exempted 29 Quebec and 3 Ontario companies that had previously been found not to benefit from any type of subsidies. This suggests that the United States may be willing to work with Canadian companies and regions when they harvest and sell timber on a market basis. Policymakers should embrace this example and seek to expand on it going forward.

### **2006 Softwood Lumber Agreement**

As noted, the 2006 SLA did not seek to address the market-distorting elements of Canada’s lumber regime. Rather, it: (1) allocated market share through the control of Canadian lumber imports; and (2) distributed approximately \$5 billion in import duties paid by Canadians to the United States over the previous five years.

To control Canada’s share of the U.S. softwood lumber market, the agreement allowed Canada’s major lumber producing regions to choose from one of two mechanisms:

- Option A was a graduated export charge with a surge penalty. If any region’s exports to the U.S. exceeded 111 % of its allocated share in any period, then those exports faced an export charge equal to 150% of the prevailing export charge during the period.
- Option B was a straightforward export quota with a lower-than-Option-A in-quota charge.

In short, one option provided for an indirect export limitation regime while the other was direct.

The necessity of optionality arose from Canada’s de-centralized political system. British Columbia, Canada’s lumber powerhouse, was subdivided further into its coastal and interior regions. When decision time came, coastal and interior British Columbia both chose Option A, as did Alberta. Quebec, Ontario, Manitoba and Saskatchewan chose Option B.

**Canada Softwood Lumber Exports to the United States – 2015<sup>10</sup>**

	Quantity (Cubic Meters)	Value (000,000 CAD)	Percentage (by value)
<b>British Columbia</b>	15,521,764	3,311	56
<b>Quebec</b>	6,419,896	1,057	18
<b>Alberta</b>	3,643,530	600	10
<b>New Brunswick</b>	2,205,848	403	7
<b>Ontario</b>	2,310,645	398	7
<b>Other</b>	986,780	165	2
<b>Canada (Total)</b>	31,088,463	5,934	100

Source: B.C. Stats with data from Statistics Canada. (2016). Retrieved from: <http://www.bcstats.gov.bc.ca/StatisticsBySubject/ExportsImports/Data.aspx>.

An essential driver of the 2006 Canada-U.S. agreement was a desire by Washington to clear the decks of key irritants between the Bush Administration and the incoming Harper government. The White House was keen to avoid the oldest of bilateral irritants souring its relationship with a new Canadian government.<sup>11</sup> For its part, the Canadian government was happy for a break from expensive and extensive litigation. Given this context, deferring discussion of fundamental reforms of the market-distorting elements of the Canadian lumber regime was understandable.

The original agreement was designed to last seven years, well beyond the tenure of Bush administration and after the next Canadian election. As the deadline approached in October 2013, the Harper Government and the Obama administration, already in the midst of a heated debate over the Keystone XL Pipeline, agreed to extend the SLA for an additional two years through October 2015.

Despite the close personal relationship between President Obama and Prime Minister Trudeau, the pragmatism and political necessity that accompanied the original agreement is absent in 2016. Also, ten years is a long time to agree to simply not address fundamental problems. Many U.S. stakeholders want a new lumber agreement to finally address Canada's market distorting policies. Simply deferring yet again is a less feasible option.

Even though the governments are negotiating, at the time of writing, the likelihood of a return to litigation appears to be very high. Numerous media reports suggest that the United States and Canada remain far apart on key issues.

## Part Two: Log Export Restrictions

A good place for Canada to start a fundamental reassessment of its lumber regime is with British Columbia's log export restrictions. LERs prioritize the narrow interests of a small group of B.C. wood processors over consumers, the public purse, timber harvesters and Canada's broader trade interests.

**Canada – Exports of Logs to the United States - 2015<sup>12</sup>**

	Value (000,000 CAD)	Percentage
<b>British Columbia</b>	65	66
<b>Ontario</b>	26	26
<b>Other</b>	8	8
<b>Canada (Total)</b>	99	100

Source: B.C. Stats. (2016). Retrieved from: <http://www.bcstats.gov.bc.ca/StatisticsBySubject/ExportsImports/Data.aspx>.

The LER regime governs the exportation of unprocessed logs to foreign markets. Many jurisdictions impose such measures. Indeed, all logs exported from Canada require a federal export permit. In the United States, all logs harvested from federal and state lands west of 1000 longitude are also subject to export licencing. The British Columbia regime is unique in two ways. First, it mandates that logs be deemed "surplus" in order to be exported, which creates tremendous distortionary effects. Second, it applies to timber harvested on private land, not just public land.

**British Columbia – Exports Of Logs By Market - 2015<sup>13</sup>**

	Value (000,000 CAD)	Percentage
<b>China</b>	334	50
<b>Japan</b>	140	21
<b>South Korea</b>	120	18
<b>United States</b>	65	10
<b>Other</b>	7	1
<b>Total</b>	666	100

Source: B.C. Stats. (2016). Retrieved from: <http://www.bcstats.gov.bc.ca/StatisticsBySubject/ExportsImports/Data.aspx>.

The B.C. regime has three major pillars. These elements are known as 1) the surplus test; 2) “blocking”; and 3) fee in-lieu of manufacture, each of which is further described below.

### *i) The Surplus Test*

A cornerstone of the British Columbia LER regime is the “Surplus Test,” which the federal and provincial governments applied jointly. The Surplus Test requires that logs harvested on both private and public land in British Columbia be deemed surplus to the needs of the log processing sector in the province before they are eligible to be exported.

While to the layperson this may seem reasonable, it is not. By limiting the sales of most logs to B.C. processors, the regime substantially reduces competition and depresses prices for those that grow and harvest timber in the province. In a world of intensive international trade, British Columbia is putting one of its most attractive assets on deep discount to a small group of processors. Moreover, these cut-rate timber inputs become a bilateral trade problem when they are processed into cut-rate lumber products that are then exported to the United States.

The B.C. lumber processors that benefit from the regime decry attempts to change it by claiming that an end to the Surplus Test would lead to a shortage of supply for domestic sawmills. Yet there is little evidence that this is the case as seen by British Columbia’s consistent failure to reach its full sustainable annual harvest.<sup>14</sup> Rather, eliminating the Surplus Test would simply allow the timberland owners to get a competitive price for their logs.

So how specifically does the regime work?

There are four major categories of land in ownership in British Columbia:

- a. Provincial Crown land;
- b. Private land granted after March 12, 1906;
- c. Federal Crown land (including aboriginal lands); and
- d. Private land granted before March 12, 1906.

The provincial government controls the first two categories of land, on which the vast majority of production occurs, while the federal government controls the latter two categories. In practice, the two levels of government and their Timber Export Advisory Committees (TEAC<sup>15</sup> and FTEAC<sup>16</sup> respectively) cooperate to administer the log export restrictions in British Columbia in tandem. Their cooperation is so institutionalized that the two committees have virtually identical membership.

Under the B.C. Forest Act, logs may be authorized for export under one of three conditions: (1) they are deemed surplus to the needs of B.C. log processors; (2) they cannot be processed economically in British Columbia; or (3) exportation would prevent the waste or improve the use of timber on Crown lands. There are strict limits on how much timber

can be considered for export with each application, thereby preventing a loophole through which large volumes of exported logs could pass.<sup>17</sup>

Under both the federal and provincial systems, the prospective exporter must begin by advertising the logs in the provincial “Weekly List.”<sup>18</sup> Once listed, B.C. processors are free to make offers to purchase the logs. If no offer is made or the offer(s) are at a price less than what TEAC determines to be a “fair representation of the domestic value of the log,” an export permit may then be issued. If a “fair” price is offered, TEAC will recommend that the federal government not issue the permit. The federal system largely operates on the same basis.

By virtue of these restrictions, harvesters are effectively precluded from selling their logs to foreign processors if a domestic processor makes an offer on logs which TEAC/FTEAC, (not the harvester), determines to be the log’s fair value in B.C.. Because the “benchmark domestic log value” is established with recent historic price data and largely ignores factors such as supply/demand, exchange rates, and transportation costs, it tends to be less responsive to market realities. The fact that determinations of “fairness” are made behind closed doors and with a lack of transparency does not help matters.

## *ii) Blocking*

Any regime that imposes substantial restrictions on where a firm can sell its products creates a power imbalance and opportunities for abuse. British Columbia’s timber processors have the ability to stop exports by objecting to the granting of export licenses for B.C. logs. Under the regime, a processor merely has to make an offer on an export application in order to bring the process to a halt; hence the application is blocked.

So what do the timber harvesters do? They negotiate informal supply arrangements at discounted prices with key B.C. log processors in exchange for their agreement not to block exports.

Many of the largest timber harvesters make a substantial share of their profits from exports for which they can receive world market price. According to a number of industry players that spoke on the condition of anonymity, some harvest operations are forced to sell logs at or below their cost of production to the domestic processors. In other words, the net effect of B.C. policy is to force timber harvesters to make next to nothing (or worse) on the domestic side of their business in order to safeguard their profitable export operations.

Because the side agreements are informal, they cannot be litigated or taken to arbitration if they are not respected. Processors can change the terms at any time, demanding more product or a different price as it suits their needs. The only leverage the harvesters have is to refuse to cut their trees, which suits nobody’s interests. The trick for the processors is to exert just enough pressure to keep the harvesters producing timber.



When government policy results in such extreme distortions it needs to be overhauled. Beyond the profitability question, one of the key impacts of the blocking threat is that B.C. timber harvesters cannot enter into long-term supply agreements with international customers. Nor can they take long positions on ocean freight transport. Because they do not have certainty due to the constant threat of blocking, they are forced to sell on the spot market. This moves B.C. timber further away from receiving the true world price and diminishes B.C.'s competitiveness overall.

In 2002, Canada told the World Trade Organization that it granted 97% of applications to export from Crown land in British Columbia.<sup>19</sup> This is hardly surprising. Almost every timber harvester has negotiated side agreements to keep its exports from being blocked. If not, this number would have been substantially lower.

The real question is not what percentage of exports is formally approved. Rather, one should ask what percentage of B.C. timber production can be said to be legitimately available for export. Because blocking agreements between harvesters and processors are informal, one may never know precisely, but it is certainly much less than 97%.

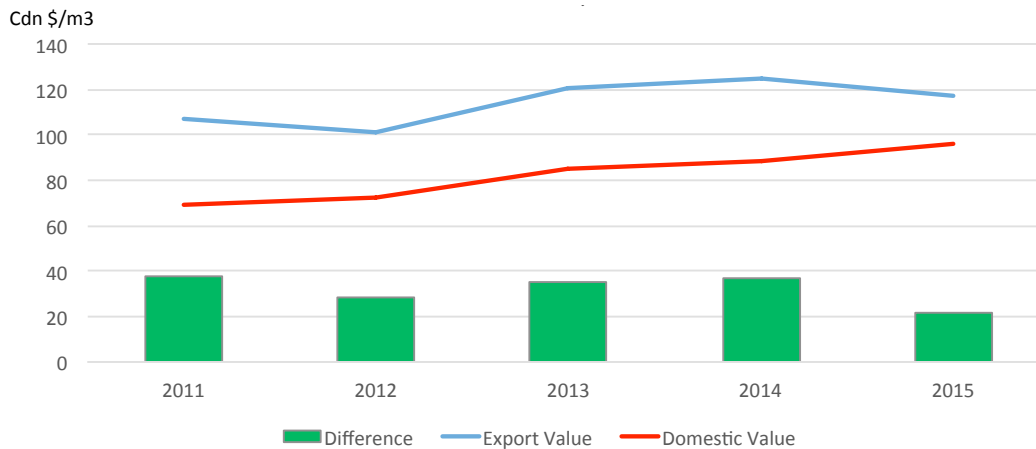
### *iii) Fee-in-Lieu of Manufacture*

Once a log originating on provincial Crown land (and private lands granted after March 12, 1906) is deemed surplus and is not blocked, harvesters seeking to export it must pay a "fee in-lieu of manufacture." The rates vary depending on whether the log originates from the coast or the interior.

The theory is that the fee captures the "benefits" that are lost to the province when a log is exported for processing abroad. In practice, these types of export taxes are virtually unknown in North America today.

The fee is based on the average price gap between domestic and export prices during the preceding three-month period. What makes this significant in the context of Canada-U.S. softwood lumber is that the "fee-in-lieu" is essentially the official percentage by which the B.C. Government deems its production be subsidized. Over the past five years, the B.C. Government's own data has identified a domestic discount of over 28% relative to export prices.<sup>20</sup>

### Coastal Fee-In-Lieu Multiplication Factor: The Domestic Discount<sup>21</sup>



Source: Government of British Columbia.

As UBC's David Haley explains, the fee-in-lieu and the rest of the B.C. LER regime is akin to:

*a transfer of wealth from the timber owners, both the Crown and the private sector, to forest products manufacturing companies. In other words, manufacturers receive a subsidy at the expense of timber growers.<sup>22</sup>*

By lowering domestic log prices, reducing the monies flowing to the public purse from stumpage, and reducing the returns to harvesters which sell their logs on the domestic market, it is clear the B.C.'s LER regime serves but one purpose: to substantially lower the input costs paid by domestic lumber processors.

If British Columbia were an isolated autarkic society, its log export restrictions would have little impact. But British Columbia – like the rest of Canada – depends on international trade for its prosperity. Increasingly, its trading partners, whether in the United States or elsewhere, are legitimately demanding that B.C. end the LER subsidy for its log processors and embrace a lumber regime that places the market and reciprocity at its core.

### ***Impacts and Considerations Related to British Columbia's LER Regime***

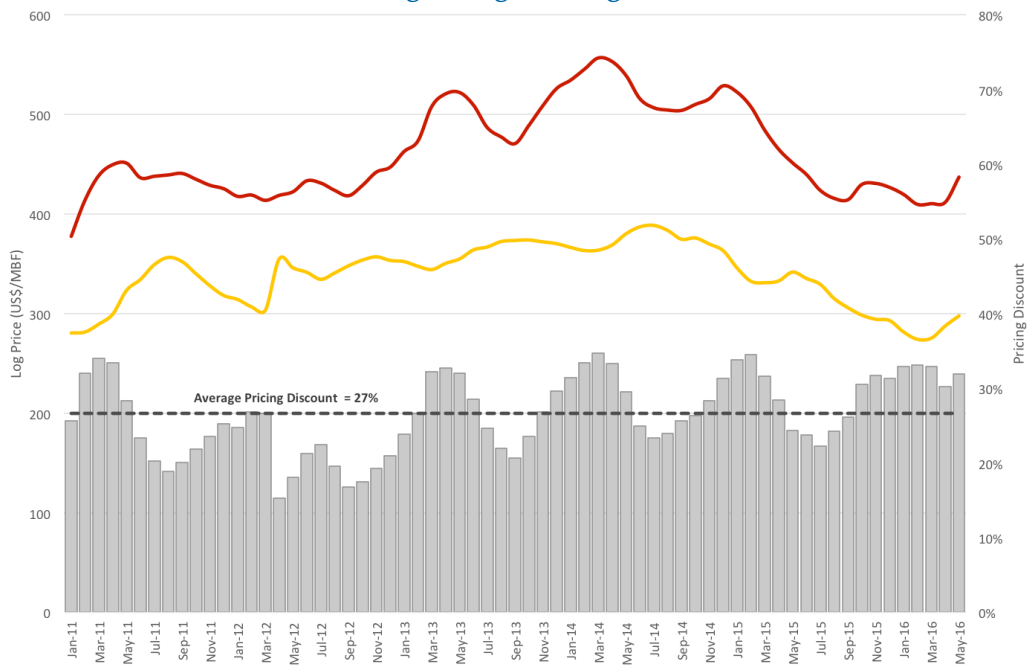
In order to fully grasp the consequences of British Columbia's LER policy and the need for reform, it is useful to assess both the regime's distortionary effects and the risks that it creates for the North American economy.

#### ***Downward Pressure on Prices***

The impact of LERs on log prices is clear: British Columbia domestic prices are consistently below U.S. and world market prices. While the specific gap may vary, it is widely seen across different types of logs. Take, for example, the gap between B.C. Hembal J Grade Logs and U.S. Hemlock #3 Sawlog – two comparable products in the market. Using a three-month

trailing average, over the past five years the average pricing differential between the U.S. and the B.C. product was 27%. In other words, B.C. logs sold at an average discount of 27% relative to their U.S. counterpart over the past five years. There is no way to rationalize away such a large gap by claiming other mitigating factors. The net effect of LERs is to push down B.C. domestic prices.

### The Long-Term Domestic Discount: 3-Month Trailing Average 2-G Log Prices-Nominal



Source: Author's calculations using data from B.C. Ministry of Forests, Lands and Natural Resource, Operations and Washington State Department of Natural Resources.

The export regime deprives harvesters' full value for their product and a maximum return on their investment. Government policy therefore, in effect, mandates timber harvesters to subsidize the domestic processing industry. These low cost inputs then cascade into discounted exports from B.C. to the United States and other countries.

### Conformity with Trade Law

In recent decades, international trade law has evolved in the direction of disciplining subsidies and export restrictions. LERs seem to be inconsistent with Canada's obligations under the WTO and NAFTA on both counts.<sup>23</sup>

The price gap data strongly suggests that the B.C. LERs are countervailable subsidies. With respect to export restrictions, the Surplus Test would seem to constitute a government direction to process logs in Canada. This raises the possibility that Canada will face a WTO challenge to British Columbia's LER regime.

### ***Effect on Canadian (and North American) Foreign Policy***

While B.C.'s LER regime is poor policy and probably illegal under international trade law, it also damages Canada's foreign economic policy and efforts by countries across the G-7 to discipline similarly bad practices by China.

The rise of China has been a substantial source of disruption in the international trading system over the past two decades. As China becomes more powerful, many countries are debating how to respond. In December 2001, China joined the World Trade Organization, and in so doing made extensive commitments to rules-based and transparent conduct in global trade. Consistent with the behaviour of a rising power, however, China has been keen to test the limits of what the system will tolerate.

One of the ways that China has challenged the system is through the use of export restrictions. For example, over the past 20 years, China has become the global center of production for 17 types of rare earth elements. These minerals are essential to the manufacture of everything from cars to missiles to technology products. In 2010, China substantially decreased the amount of these products that it would make available for export. In 2012, the United States responded by launching a WTO case that claimed that China's restrictions on the export of rare earths, tungsten and molybdenum were illegal. Canada joined this process as a third party observer. China eventually lost the case and, in 2015, began to dismantle its restrictions.

Canada's decision to stand with the United States, the European Union and others against China's rare earth protectionism was a principled position in favour of free trade and the need to ensure respect for the WTO rules. Sadly, Canada's defence and direct support of British Columbia's export restrictions on logs puts it in a weaker position to stand against similar Chinese practices in the future, placing Canada in a "do as I say, not as I do" position. While export restrictions may be justified in certain cases, it is hard to reasonably argue that lumber is one of them. There is no timber shortage in Canada, nor could one argue that B.C.'s LER system is essential to Canadian national security. As a leading supporter of a rules-based system, Canada would burnish its reputation and reinforce the global regime of open trade if it reformed B.C.'s LERs.

## **Part Three: LERs and the Path to a Durable Lumber Framework**

As demonstrated above, British Columbia's log export restrictions have created a variety of problematic effects. If nothing else, the price suppression impacts and blocking suggest that LERs make Canada's long-held assertion that the U.S. is merely being a bully on softwood lumber seem tenuous.

Formally, the B.C. and Canadian governments could agree tomorrow to eliminate LERs. Yet, such measures are seldom done away with all at once. After all, LERs have long been an integral part of British Columbia's and, by extension, Canada's existing lumber regime. Consequently, the path to trade peace and normalization in the Canada-U.S. lumber realm will require careful political management and a clear staging for reform measures.

### **Key Principle: Market Basis**

If there is one principle that can lead to a durable lumber framework, it is that Canada must ensure that its lumber industry operates on a fully market based approach going forward. Of course, defining what this looks like will be challenging, especially when navigating the tricky issue of equivalency of stumpage fees. A durable lumber agreement will therefore have to include a methodology for understanding how the United States and Canada set benchmarks and interpret auction prices. The majority of Canada's timber will not suddenly migrate to private land, so the two countries will have to reach an agreement on how to determine equivalency.

Fortunately, the 2006 Softwood Lumber Agreement offers several important examples of what the two countries deem to be market-based or unsubsidized production. As noted above, it excluded production from Atlantic Canada and from 32 companies in Quebec and Ontario.

The 2006 SLA did contemplate creating an assessment mechanism that would allow regions undertaking market-oriented reforms to see their new status reflected in the form of exemptions from the agreement. Specifically, Article XII committed to the creation of a "Working Group on Regional Exemptions," which would define:

*substantive criteria and procedures for establishing if and when a Region uses market-determined timber pricing and forest management systems and therefore that its exports of Softwood Lumber Products to the United States qualify for exemption from the Export Measures.<sup>24</sup>*

Despite a commitment to establish this body within three months of the entry into force of the Agreement, the Working Group was never created.

Consequently, in 2013, when Quebec established a timber marketing board system to sell lumber from Crown land by auction<sup>25</sup>, there was no mechanism through which it could petition for these reforms to be reflected in the SLA. The province believed that the new system put its industry on a full market basis. Yet, there was no way for the U.S. and Canada to jointly assess whether its production would be deemed as unsubsidized. Despite its bold reforms, Quebec had no "exit ramp" from the punitive U.S. export measures imposed by the SLA.<sup>26</sup>

This is not good for either the United States or Canada. Presumably, the United States is sincere in its desire to see market-oriented reforms in the Canadian lumber system. These will not happen, however, if policymakers cannot identify a tangible reward for action. Even if it is the right thing to do, policy reforms such as the ones Quebec undertook are disruptive and politically costly. If future political leaders are to be empowered to follow Quebec's lead, they will require access to a functional bilateral mechanism that can determine on an objective basis whether the reformed regime makes lumber production subsidy-free. This same mechanism would also have the power to grant Atlantic-like exemptions from any U.S. softwood lumber measures in place at that time. Under any future agreement, the two countries should not defer the structuring and launch of a Working Group on Regional Exemptions for three months. It must be defined in the text of the deal and launched on Day One.

### ***Step One: Eliminate LERs on Private Land in B.C.***

The best path forward for reforming Canada's lumber regime would be to proceed in two stages. The first would be a pilot case that is designed to build confidence: the elimination of B.C. LERs on private land. The second stage, described in more detail below, would be the negotiation via envoys of a comprehensive and long-term accord on open and free lumber trade in North America.

British Columbia is the only jurisdiction in North America to impose LERs on private land. Arguably, it already recognizes the distinction between private and public land by only charging the "fee-in-lieu of manufacture" only on the exportation of logs originating on Provincial Crown land (and private lands granted after March 12, 1906). Now B.C. should go the rest of the way and eliminate LERs on all private land.

Part of the theory of LERs is that timber that is harvested on public lands is a public resource that should be managed in accordance with the public good. While private lands like private industries are subject to regulation, their primary focus is to serve the interest of their owners who have substantial investments in timberland assets. British Columbia's log export restrictions undermine this focus.

Starting with LER elimination on private land is not only good policy, it is also practical. Private forest land accounts for less than 2% of B.C.'s land base, or about 823,000 hectares. When planning a new approach, it is good to start small.

By eliminating LERs, production on British Columbia's private lands would become as market-oriented as Atlantic Canadian production. It should therefore be exempted from present and future U.S. trade actions. Given the substantial size of B.C.'s lumber output and the long-standing controversy about this issue, eliminating LERs would send a strong signal about Canada's willingness to reform.

The regulatory mechanics of exempting timber harvested on private land from LERs would be relatively simple. Canada would nonetheless want to be certain that timber harvested and sold under this open market regime would be deemed to be unsubsidized by the United States and therefore be free of all export measures.

The Canadian and U.S. governments would need to coordinate policy actions on this front. In a reform environment, both governments would presumably want a mechanism that could certify production under the new regime as being unsubsidized. The two countries may wish to form the “Working Group” contemplated by the SLA and develop criteria for how “market-oriented assessments” of policy reforms could be carried out. There is little doubt that LER-free production on B.C. private land would qualify for an exemption from U.S. trade action. This would therefore provide a good first case for assessment.

If Canada takes the first step and agrees to the elimination of LERs on private land and the two countries ensure that this production is recognized as subsidy-free in the United States, this would provide a major boost to confidence that a broader, permanent softwood lumber arrangement is possible.

### ***Step Two: Enter the Envoys***

The path to a durable lumber agreement is complicated from a political and operational perspective. Given all of the history involved in this issue, one wonders how much confidence the U.S. and Canadian sides have that their counterparts are truly negotiating in good faith. Yet, negotiate they must.

The Office of the U.S. Trade Representative and Global Affairs Canada will continue to work toward a short to medium-term agreement on managing the bilateral softwood lumber agreement. If successful, the deal would likely be time-limited and focus on allocating market access and monitoring compliance. A key reason for eschewing a major reform agenda in these talks is that were the Canadian trade minister to put, say, B.C. LERs on the table, she would be making a tacit admission that the province was currently offside. One of the consequences of shorter-term arrangements is that countries resume their acrimony each time the agreement winds down.

While both ministries say they want a deal, the odds of avoiding litigation seem long. Consequently, Canada and the United States need to complement the work of their trade ministries with a “second track” of diplomacy. This would be done through the appointment of softwood lumber envoys that report directly to the White House and the Prime Minister’s Office. Their mandate would be focused on the longer term. They would be asked to answer the question: what steps would be required by both Canada and the United States if they were to develop a permanent framework for softwood lumber



trade that would negate the perceived necessity of trade remedy actions and provide predictability to market players into the future?

The selection of these envoys would be crucial, as would the framing of their mandates. Canada and the United States need experienced individuals who are able to work through the design of an integrated package that gets everybody “in the zone” for a deal. The package would obviously be theoretical until the leaders and their ministers bless it. Because they would be tasked with working through difficult longer-term issues, the leaders should contemplate the possibility of failure. Ensuring that the envoys are isolated from the day-to-day cut-and-thrust of the trade ministers’ management of softwood litigation, but nonetheless empowered to think through a long-term framework would be essential.

The basis for a long-term agreement is simple in principle: (1) Canada reforms its lumber systems on a market basis; and (2) these reforms are recognized by the United States with a guarantee of secure future market access. However, achieving such an agreement will be very complicated. Canada does not want a situation where it reforms and the United States still subjects lumber exports to countervailing duties.

A long-term lumber agreement would need to address, inter alia, the following questions:

- What would constitute a recognized “market-oriented framework” in each of the major lumber producing jurisdictions in Canada?
- How would the staging of the reforms work, and what would be the basis of access to the U.S. market while it is in progress?
- What would be the institutional mechanism for certifying “market-orientedness,” carrying out ongoing monitoring, providing guidance and resolving disputes?
- What would be the “end goal” of access to the U.S. market after each Canadian jurisdiction reforms – full, unfettered access, a quota, or something else?
- What guarantees would Canada have that a future U.S. administration would not re-impose trade remedy measures for strictly protectionist purposes?
- During a transition period, would Canadian producers be subject to a quota? How could incentives be built into such a system to provide increasing levels of reward as producers move toward the unsubsidized side of the ledger?

While pursuing a comprehensive long-term agreement is more challenging than tinkering with the 2006 SLA, it would be much more rewarding and, ultimately, conducive to long-term investment in both the U.S. and Canadian timber industries. The two countries must end the cycle of litigation that has dominated the softwood lumber trade for four decades. The unique political circumstances of 2006 are unlikely to re-emerge any time soon. The two countries must secure a durable outcome.



## **Solving the Hard Policy Issues**

### ***LERs on Public Land***

Given the market distortions, trade risks and complications to Canadian policy, British Columbia should commit to eliminating its system of LERs. In order to ensure that this shift does not radically disrupt the market for logs in B.C. and remains politically viable, it is necessary to phase in a liberalized regime over time. A key question is what would a post-LER regime look like? Perhaps the ideal path could be for the B.C. and federal governments to appoint a commission that includes both harvester and processor interests. They could instruct this group to develop a reform plan that would be fully operational in, say, five years. One idea that they could consider is a staging process that would free B.C. production from the “sell domestic” requirement by 20% or so per year. Another would be to ensure a pricing review process for the surplus that ensures that timber harvesters actually receive a fair price based on true international market fundamentals. The commission would also be charged with developing a simplified export process.

### ***Stumpage***

Given that measuring equivalence is always challenging, reforming stumpage could be a hard nut to crack. Fortunately, the new Quebec system offers a useful model that should be examined in detail. In a Canadian context, stumpage reform would necessarily require the buy-in of the provinces. If the federal government and the provinces were to designate representatives to develop a coherent approach for an auction based methodology, Canada would be in a position to approach the envoy negotiations with the United States from a position of greater strength and clarity. For its part, the United States should make clear its priorities on stumpage reform as well as its view of the Quebec model.

## **Part Four – A Time for Boldness**

As the old saying goes, the definition of insanity is doing the same thing over and over and expecting a different result. As Lumber V looms, the necessity of pursuing a substantially different approach seems clear.

Finding a permanent solution to an issue over which there has been so much acrimony is supremely difficult. Each side can legitimately point to instances where the other side has acted in less than good faith and history has a way of compounding these grievances. Nevertheless, history does not absolve us of the responsibility for finding a long-term solution to the Canada-United States softwood lumber dispute.

Both countries, within their own economies and internationally, have accepted the principle that markets should allocate scarce resources. By contrast, British Columbia’s system of log export restrictions distorts its timber market. With no legitimate national security or

other reason for maintaining the current system, it is time for British Columbia to move to a model that is more similar to that of other North American jurisdictions.

The appropriate place to start is to remove log export restrictions on private land in British Columbia. This policy shift should be complemented with the development and application of a mechanism that could be used to recognize its newly unsubsidized status and to provide for its exemption from U.S. import duties or export restraints.

Taking this first small step would lay the foundation for a much deeper reform. With creativity and willingness to apply the best evidence available, Canada and the United States can achieve a durable lumber peace.



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# Response:

## Learning from the Lessons of History

by Colin Robertson

The dispute over the sale of Canadian softwood lumber, or timber as it is known in the U.S., is set to return to Canadian headlines and to create discord between Canada and the United States. Canadian policymakers should read, and integrate into their planning, the useful paper, *From Log Export Restrictions to a Market-Based Future: Towards an Enduring Canada-U.S. Softwood Agreement*, by former trade policy negotiator Eric Miller.

The 365-day moratorium, wisely inserted into the termination provisions of 2006 Canada-U.S. Softwood Lumber Agreement to give additional time for a new agreement, concluded in mid-October 2016. Unfortunately, there is no new agreement in the offing.

The U.S. timber industry coalition is poised for action and the inter-agency U.S. trade remedy machine will rumble into action. As a consequence, sometime before the end of 2016, the U.S. Commerce Department will announce countervail duties on Canadian lumber exports into the United States. This Freddy Krueger of trade disputes appears doomed to make another appearance.

Reconciliation will happen, but not likely until the United States has collected substantial fees from Canadian producers, anxious to sustain their U.S. markets, and apparently willing to pay for the privilege.

The latest iteration of the dispute will cast a pall on their reset of the Canada-U.S. relationship emerging out of the Trudeau-Obama March 'bromance' summit in Washington and the subsequent Three Amigos meeting in June.

The inability to reach a new accord reflects badly on both leaders and their governments. It's not as though they did not know it was coming. The Stephen Harper government also bears some responsibility. It should also have done more to either renew the Agreement, as was done in 2013, or re-negotiate it. So what next?

The instinct on the Canadian side will be, writes Eric Miller, to "hunker down" and find a "transitory peace through a market share agreement." Instead, argues Mr. Miller, Canada should reform the protectionist practices that consistently result in conflict and cost to consumers. Instead of yet another temporary agreement Mr. Miller lays out a market-based plan.

As Mr. Miller writes, Canada and the United States have historically taken different policy approaches to the ownership and harvesting of forest lands. This historical difference lies at the heart of the softwood lumber dispute.

Most of the harvested lands in Canada are on crown or government-owned lands subject to a stumpage fee payable to either the provincial or federal government. In the United States (and in Canada's Maritime provinces), most harvested land is owned by private interests.

There are variations in the administration of the crown lands in Canada reflecting the different policy approach of the provincial governments. In the case of British Columbia there are also particular policies, related to lumber exports that apply to its coastal territory.

The U.S. industry believes that Canadian governments give Canadian harvesters a special advantage in its pricing, thereby putting U.S. producers at a pricing disadvantage. Thus the repeated appeal from U.S. industry to its government for trade remedy action to level the playing field.

A look at a topographical map of North America reveals that most of Canada is still covered in trees. Canada's northern climate endows its trees with particularly resilient qualities in the framing for construction of new homes and, once-upon-a-time, for ships. This natural advantage has led to its export, especially into the United States but increasingly overseas. Natural resources are Canada's crown jewels and, as Mr. Miller points out, the forest products sector is a \$58 billion industry representing 1.25% of the country's GDP.

If history is any guide a resolution will require the following ingredients:

**First, a federal-provincial agreement on a pan-Canadian negotiating position.**

Canada's political geography on softwood lumber breaks down into four divisions: the Maritimes where most of the land is privately owned and that seeks an exemption, usually successfully, from U.S. trade remedy legislation; Ontario and Quebec that usually come to an agreed position on managed trade; Alberta with its own policies; and British Columbia, where there is a further divide between the interior and coastal properties, the latter benefiting from export controls on logs.

As Mr. Miller persuasively argues, the Canadian side needs to look at its protectionist policies, especially log policy in British Columbia that subsidizes local producers. This policy also threatens a Canada-Japan Economic Partnership Agreement. The manufacturing jobs that the policy supports along the Fraser River are at stake and the governments of British Columbia and Canada should be thinking now about adjustment assistance and how investments in technology and innovation can make this industry competitive.



Getting the provinces into alignment is necessary before the Canadian government can present a coordinated position to the USTR. Keeping these fractious geographic interests together is essential and requires both diplomatic tact and political finesse.

Success will require the personal intervention of Minister of International Trade Chrystia Freeland with her provincial trade counterparts. She has demonstrated this capability through the personal relationships that she developed with U.S. Senate Agriculture committee chair Pat Roberts and with European counterparts. Consequently, she was able to close deals in the United States on the country-of-origin labeling dispute and finalize the Canada-European Union Free Trade Agreement (CETA).

**Second, a personal commitment to resolution by the Prime Minister and President.**

Mr. Miller suggests the appointment of special envoys, an approach that has served Canada-U.S. interests on other resources issues including fisheries and the Great Lakes.

The involvement of the U.S. President is key. The personal intervention of Ronald Reagan was central to resolution of the shakes and shingles dispute that threatened to upset the Canada-U.S. Free Trade negotiations (1985-8) and, during the nineties, the successive lumber agreements required the involvement of Presidents George H.W. Bush and Bill Clinton.

Personal intervention by the President George W. Bush was vital to the 2006 accord. Tired of having this 'condominium issue' intrude on the top table discussions with first, Canadian Prime Minister Paul Martin, and then, Prime Minister Stephen Harper, President Bush instructed the United States Trade Representative (USTR) to fix it. Deputy USTR Susan Schwab, the point person on the file, conducted the negotiations with Bush's Deputy Chief of Staff, Karl Rove, managing the congressional politics.

Ms. Schwab worked out a tentative deal during the autumn of 2005 with Canadian Ambassador Frank McKenna but dithering by Paul Martin meant that the deal was not concluded before the January 2006 election. Ambassador Michael Wilson picked up the file immediately after presenting his credentials to President Bush in March 2006 and, after intensive negotiations, the agreement was announced in October. The sweetener for that deal was the billions that had already been collected in levies that were distributed to various U.S. interests.

Canadians can help themselves (and the White House) in the current dispute by understanding the political geography of the United States. The competition to Canadian timber comes from U.S. producers in the north-west and south-east of the United States who rely on powerful congressional support. Former Senate Finance Chair and Montana Senator Max Baucus was a perennial critic of Canadian forest practices.



Where once ownership was represented by national companies, the rationalization and integration of the industry now means owners have forest properties on both sides of the border. This should help in finding a solution and Canadians will have to find allies – consumers and homebuilders, for example – to counter the producers. But, if it becomes a Canada versus United States dispute then we are in trouble.

Do not underestimate the tenacity of the opposition. During a visit to Mississippi in 2006, then Governor Haley Barbour explained to me that for many working class southerners, the ancestral piece of land where they hunt, fish, and harvest timber is both their annuity and legacy. Barbour, whose considerable political knowledge of how Washington works made him a top lobbyist, observed that harvesting timber has historical significance in southern culture. It's as important as pulled pork and boiled peanuts. A visit to the Mississippi Agriculture and Forestry Museum in Jackson, Mississippi confirms Barbour's observation. Canadians need to be sensitive to this fact.

For now we appear headed into a renewed dispute and there will be both rancor and costly fees before resolution is reached. If resolution is to come sooner than later, and if we are to put this dispute to bed for good, Canadian and American negotiators would do well to read Mr. Miller's prescription.



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*All opinions are solely those of the authors.*



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