In The London Court Of International Arbitration

THE UNITED STATES OF AMERICA,

Claimant,

v.

CANADA

Respondent.

CANADA'S RESPONSE TO REQUEST FOR ARBITRATION

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September 12, 2007

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RESPONSE OF
THE RESPONDENT CANADA

In accordance with Article 2 of the London Court of International Arbitration ("LCIA") Rules, the Government of Canada ("Canada") respectfully submits the following Response to the Request for Arbitration (the "Request") filed on August 13, 2007 by the United States ("Claimant") under the 2006 Softwood Lumber Agreement (the "Agreement"). The Government of Canada reserves the right under Article 15.3 of the LCIA Rules to submit a full Statement of Defence in response to the U.S. Statement of Case.

INTRODUCTION

1. The Agreement between Canada and the United States concerns trade in softwood lumber. It came into force on October 12, 2006 and allows for dispute settlement under the LCIA Rules as modified by the Agreement. Under the Agreement, Canada agreed to apply export measures to exports of softwood lumber from softwood lumber producing regions of Canada to the United States. In exchange, the United States agreed not to initiate trade remedies proceedings or other actions with respect to softwood lumber products from Canada, agreed to revoke the countervailing and antidumping duty orders that had been in place for five years and agreed to return a portion of the estimated duties it collected previously on Canadian softwood lumber imports.

2. The Agreement is structured in a bifurcated manner in that it establishes two alternative forms of "export measure," referred to as Option A and Option B, and allows each Canadian Region (province or part of a province) to choose the export

measure that will apply to its exports. Option A is an export charge that varies according to the prevailing monthly price of softwood lumber ("Option A"). Option B is a volume restraint (alternatively referred to in the Agreement as a quota) coupled with a lesser export charge, which also varies according to the prevailing monthly price of lumber ("Option B"). The structure and operation of the alternative options differ in numerous respects under the terms of the Agreement.

3. The U.S. Request makes two claims that Canada has breached the Agreement. Each claim is based on a misinterpretation of a single provision of the Agreement: paragraph 14 of Annex 7D ("paragraph 14"). Paragraph 14 provides for an adjustment for Option B Regions, in certain circumstances, to the calculation of "Expected United States Consumption" ("EUSC"), a variable used in the calculation of regional quota volumes under Option B and regional trigger volumes (volumes above which an additional export charge will be imposed) under Option A.

4. The first U.S. claim is that paragraph 14 requires an adjustment to EUSC, not only for Option B Regions (which Canada acknowledges) but also for Option A Regions (which Canada denies). The U.S. claim ignores the plain language of paragraph 14. In describing the circumstances when adjustment is required, paragraph 14 uses the limiting words "for which quotas are being determined." Because no quotas are determined for Option A Regions, the adjustments provided in paragraph 14 apply only to the Regions for which quotas are determined, *i.e.*, Option B Regions. The United States provides no valid explanation for why these limiting words were chosen when the term "Export Measures" – which embraces both Option A and Option B – would have been used, if the adjustment to EUSC in paragraph 14 applied in all cases.

5. Canada acknowledges that the possible application of paragraph 14 to Option A Regions was considered during Canada's planning for the administration of the Agreement, as is reflected in the documents cited by the United States. However, Canada did not adopt and implement that position, because paragraph 14 does not apply to Option A.

6. The second U.S. claim is that paragraph 14 requires adjustments to be made to the EUSC beginning on January 1, 2007. That claim also ignores the plain language of the Agreement. The earliest date on which an adjustment under paragraph 14 could be made is July 1, 2007, given that the actual U.S. consumption data for the first quarter of 2007, with which the EUSC must be compared, was not available until the middle of the second quarter of 2007.

7. Thus, Canada has not breached the Agreement. Canada has, at all times, properly applied the export measures required under the Agreement, collecting all export charges from softwood lumber producers in Option A and B Regions, and limiting the volume of exports of softwood lumber from Option B Regions as required under the Agreement.

8. Because Canada has not breached the Agreement, the issue of ordering a cure of a breach, or an adjustment of export measures in the absence of a cure under Article XIV(22) of the Agreement, does not arise. Moreover, the U.S. Request, with respect to both claims, asks for relief of a nature and degree beyond that permitted under the dispute settlement provisions of Article XIV of the Agreement.

I. BACKGROUND

9. The North American market for softwood lumber is highly integrated. The United States cannot produce enough softwood lumber to supply U.S. domestic demand, and consequently it relies to a significant degree on imports of softwood lumber. Canada is the primary source of U.S. imports, supplying approximately one-third of the softwood lumber consumed in the United States.

10. Over the last 25 years the U.S. lumber industry has frequently sought the imposition of unilateral U.S. restrictions on Canadian lumber imports through application of U.S. countervailing and antidumping duty laws. Canada has successfully challenged such restrictions as inconsistent with both U.S. law and multilateral trade agreements. However, the harm caused by U.S. measures that remained in effect during the pendency of legal challenges, and the time and cost of those legal challenges, induced Canada to enter into agreements restricting exports in return for a U.S. commitment not to take unilateral measures of any kind against Canadian softwood lumber. Canada has entered into three such agreements over the last 25 years.

11. The most recent countervailing and antidumping duty investigations were initiated in 2001 by the United States against imports from Canada, at the request of the U.S. industry. Canada challenged the imposition of duties by the United States on lumber imports from Canada pursuant to these investigations as inconsistent with both U.S. law and the rules of the World Trade Organization. These Canadian challenges were repeatedly upheld by U.S. courts, NAFTA panels and the WTO. Throughout the pendency of the legal challenges to its actions, the United States collected, and held, deposits of estimated duties on Canadian shipments of softwood lumber to the United

States. U.S. courts and international tribunals found that the duties had been unlawfully imposed, and ultimately required the return of the illegally collected duty deposits. In the interim, however, the imposition of duties was highly detrimental to Canadian producers.

12. It was against this backdrop that the Governments of Canada and the United States negotiated and entered into the Agreement at issue here.

13. Under the Agreement, the United States revoked the countervailing and antidumping duty orders and resulted in the return of just over 80 percent of the approximately U.S.$5.5 billion of illegally collected duty deposits to Canadian lumber producers and agreed not to initiate domestic trade actions with respect to softwood lumber for the life of the Agreement. In exchange, Canada agreed to impose export measures in the form of export charges and quotas on softwood lumber exports from Canada to the United States.

14. The imposition of export measures under the Agreement is tied to the U.S. price of lumber. When the monthly U.S. price is above U.S.$355 per MBF, no export measures are applied to any Canadian exports of softwood lumber to the United States. If the monthly price of lumber is below U.S.$355 per MBF, the Agreement requires Canada to impose export measures on Canadian exporters operating in provinces covered by the Agreement (British Columbia, Alberta, Saskatchewan, Manitoba, Ontario and Québec).

15. Under Article VII of the Agreement, each Canadian province (referred to as "Regions" in the Agreement because the province of British Columbia comprises two Regions – Interior and Coastal) chose the form of export measure to which it would be subject. The first export measure, Option A, consists of an export charge. Alberta, the B.C. Coast and the B.C. Interior chose this Option. The second export measure,

Option B, combines a lower export charge with a quota on exports to the United States. Manitoba, Saskatchewan, Ontario, and Québec chose this Option.

16. Under Option A, a Region may ship an unlimited volume of lumber to the United States, subject to the requirement that exporters pay an export charge when the price of lumber is below U.S.$355. The export charge varies based on the monthly price of lumber – charges increase as prices decrease. An additional export charge is imposed if the volume of exports from a Region exceeds the Region's "Trigger Volume" (as calculated under Annex 8 to the Agreement) by more than one percent.

17. Under Option B, a Region is subject to a quota on exports and to a lower export charge when the price of lumber is below U.S.$355.

II. DENIAL OF CLAIMS

18. Canada denies all allegations of fact and law in the Request, except to the extent expressly admitted herein.

A. Parties to the Arbitration

19. With regard to paragraphs 2 and 3 of the Request, Canada states that it is the respondent named in this proceeding and admits that it is represented by the counsel listed at paragraph 3 of the Request and by Guillermo Aguilar-Alvarez and Charles Roh.

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B. The Arbitration Agreement

20. With respect to paragraph 4 of the Request, Canada admits that the United States has complied with the formal consultation requirements of Article XIV of the Agreement with respect to the claims set out in its Request.

C. Matters Regarding the Arbitration

21. With respect to paragraphs 5 through 10 of the Request, Canada states that the language of the Agreement speaks for itself, and controls over the Claimant's characterizations thereof.

D. Canada's Response to Statement of the Claims

22. With respect to paragraphs 12 through 14 of the Request, Canada denies all facts and legal interpretations alleged. Without limiting the generality of this denial, Canada specifically notes as follows:

(a) Paragraph 14 of Annex 7D, by its own terms, relates only to Regions "for which quotas are being determined." Paragraph 14, therefore, can apply only to Option B Regions, as Option A Regions are not subject to quotas.

(b) No adjustment under paragraph 14 of Annex 7D was required for Option B Regions until July 1, 2007.

(c) The Claimant is not entitled to any relief because Canada has not breached the Agreement. Moreover, even if there were a breach of the Agreement, the United States asks for remedies that are not authorized under the Agreement. Article XIV, paragraph 22 of the Agreement provides that if the Tribunal finds that a Party has breached an obligation under the Agreement, the Tribunal shall "identify a reasonable period of time for that Party to cure the breach" and "... *if* that Party fails to cure the breach within the reasonable period of time" determine " ... adjustments to the Export Measures to compensate for the breach" (emphasis added). The Agreement does not allow compensation to a successful claimant, and provides for compensatory adjustments in the form of increased (or decreased) volume restrictions or export charges imposed or collected by Canada only if Canada does not cure the breach within the time period identified by the Tribunal. Even if there were a breach of the Agreement, which Canada denies, the Tribunal does not have power to award relief outside the specific terms of Article XIV, including most of the relief requested by the United States.

23. With regard to paragraphs 15 through 26 of the Request, Canada denies all facts and legal interpretations alleged other than as admitted in the following:

(a) Canada disagrees with the Claimant's characterization of the Agreement and its obligations and denies all factual and legal allegations in paragraphs 15 and 16 of the Request, except for the first sentence of paragraph 15 which is admitted.

(b) Paragraph 17 is admitted.

(c) Paragraph 18 is admitted, except that the characterization of the "'trigger'" volume as a "soft volume cap" is denied.

(d) Paragraph 19 is denied as a mischaracterization of the Agreement.

(e) Paragraph 20 is denied. Canada was not required under paragraph 14 of Annex 7D to make the downward adjustment to EUSC for Option A Regions and was not required to make any adjustments for Option B Regions until July 1, 2007. Thus, Canada has not exceeded its regional trigger volumes or regional quota volumes and has not breached the Agreement.

(f) The legal allegations in paragraph 21 are denied.

(g) Paragraph 22 is admitted, except for the last sentence, which is denied.

(h) Paragraph 23 is denied. As noted above at paragraph 5 of this Response, the documents to which the United States refers in its Request in arguing that "Canada originally interpreted the Agreement correctly" reflect a position that was considered during the planning for the administration of the Agreement, but was never the position adopted or implemented. Canada did not apply paragraph 14 to Option A Regions because paragraph 14 does not apply to Option A.

(i) Paragraphs 24 through 26 are denied.

E. Canada's Response to Claimant's Allegations Regarding Breach of the 2006 Softwood Lumber Agreement

24. Paragraph 27 is admitted, except for the last sentence, which is denied. Paragraphs 28 through 32 are admitted, subject to the Background section of this Response at paragraphs 9 through 17.

F. Expected United States Consumption

25. With respect to paragraph 33 of the Request, the language of the Agreement speaks for itself and controls over the Claimant's characterizations thereof.

26. Paragraph 34 is denied.

G. Application of Adjusted Expected United States Consumption to Option A Trigger Volumes

27. With respect to paragraphs 35 through 47 of the Request, Canada generally denies the Claimant's allegations, and states that contrary to the Claimant's allegations, paragraph 14 of the Agreement does not apply to the Option A regional trigger volumes. Paragraph 14 clearly states that the adjustment is applied to the calculation of EUSC for the following quarter "for which quotas are being determined." There is no language in the Agreement that makes the adjustment applicable to Option A Regions. Canada further states more specifically as follows:

(a) With respect to paragraph 35 of the Request, Canada denies that its interpretation that paragraph 14 applies only to Option B Regions violates the text of the Agreement, denies that this interpretation contravenes the purpose of the Agreement, and denies that its interpretation is belied by actions Canada took after the Agreement came into force.

(b) Canada denies that paragraph 14 applies to the calculation of EUSC for Option A Regions, as paragraph 14 contains the limiting words "for which quotas are being determined." The paragraph can only apply to Option B because quotas are not determined under Option A.

(c) With respect to paragraph 37 of the Request, Canada agrees that the Claimant has properly quoted the language of paragraph 14.

(d) With respect to paragraph 38 of the Request, Canada denies the Claimant's allegation that "nothing in the Agreement suggests that Canada may calculate expected United States consumption differently for purposes of applying export measures under Option A or Option B." The U.S. misses the point – paragraph 14 on its face applies only to Option B Regions – those "for which quotas are determined."

(e) Paragraphs 39 and 40 are denied. Paragraph 14 by its terms applies only to Option B Regions.

(f) With respect to paragraphs 41 and 42 of the Request, Canada denies the statement that nothing in paragraph 14 limits the application of paragraph 14 to either Option A or Option B Regions. Canada further disagrees with the arguments as to the meaning of the language of paragraph 14. The United States is unable to explain the decision of the Agreement's drafters to include the words "for which quotas are being determined" which could easily have been replaced with other terms of no greater length had the drafters wished paragraph 14 to apply to both Option A and Option B Regions.

(g) With respect to paragraph 43 of the Request, Canada denies that any language in the Agreement requires that all calculations of EUSC must include application of paragraphs 12 through 14. Paragraphs 13 and 14 have limitations that make them apply by their own terms only in particular circumstances, including, but not limited to, the limitation that paragraph 14 applies only to Option B Regions.

(h) Paragraph 44 of the Request is denied. Canada denies that the primary purpose of the export measures is to control exports from the B.C. Interior. At the time the Agreement was drafted, no Region had selected Option A or Option B. Further, Canada denies the U.S. contention that paragraph 14 was intended to "enhance export measures." Canada also disagrees with the argument that the Agreement "cannot possibly be interpreted to provide for less stringent restrictions" for Regions electing Option B than those electing Option A. The Agreement does not contemplate a unitary scheme applicable to all exports of softwood lumber from Canada. The export measures in the Agreement are structured in a bifurcated manner. There is no requirement that Option A and Option B have the same effect at any time or in any circumstances, and the structure and operation of the export measures under Option A and Option B accordingly differ in numerous respects. Each of the seven Regions was able to choose the Option under which it would operate. It is consistent with the purpose of a bifurcated system (as well as the plain language of the Agreement) for the EUSC adjustment to apply only to the Option B quota calculation.

(i) The quotations in paragraph 45 are admitted. The characterizations of the United States are all denied, as explained in paragraph 4 of this response.

(j) Paragraphs 46 and 47 are denied.

H. Timing of the First Application of the Adjustment to Expected United States Consumption

28. With respect to paragraphs 48 through 60 of the Request, Canada denies all facts and legal positions advanced therein. Without limiting the generality of this denial, Canada specifically notes as follows:

(a) In response to Claimant's allegations at paragraphs 52 through 53 of the Request, Canada denies that the Agreement required an adjustment to EUSC for Option B Regions prior to July 2007. Canada's calculation of quota volumes for Option B Regions was and continues to be consistent with its obligations under the Agreement. The actual U.S. consumption data for the first quarter of 2007 with which EUSC for the first quarter of 2007 must be compared was not available until part way through the second quarter of 2007, so the earliest any adjustment could be applied to Option B Regions was July 1, 2007 (*i.e.*, the beginning of the third quarter of 2007). Under Article 7 and Annexes 7B and 7D, there is no basis for making an adjustment to the quota volumes for the first quarter in which the quota system was operational.

(b) Contrary to the U.S. allegations at paragraph 53 of the Request, January through March of 2007 was the first quarter in which the EUSC calculation could be, and was, used in the formula to determine the quota

allocated to Option B Regions under Annex 7D, since quotas were not in effect before this time. The first quarter of 2007 was also the first "Quarter" under the Agreement. As such, the first quarter of 2007 (January through March) was the first quarter under the Agreement for which a difference between actual and expected U.S. consumption could be calculated to make the adjustment required under paragraph 14. Canada correctly used this difference to apply the adjustment in the third quarter of 2007, beginning on July 1, 2007.

(c) Contrary to paragraph 54 of the Request, the actual U.S. consumption data for the first quarter of 2007, with which EUSC for the first quarter of 2007 must be compared, was not available until part way through the second quarter of 2007, so the earliest any adjustment could be applied to Option B Regions was July 1, 2007 (*i.e.*, the beginning of the third quarter of 2007).

(d) Contrary to paragraph 55 of the Request, Exhibit E does not demonstrate Canada's position, but rather constitutes the opinion of a private party in litigation as to what position Canada might take.

(e) Paragraphs 58 and 59 are denied.

(f) Paragraph 60 is denied. Canada has not breached its obligations, and therefore no remedy is appropriate. Further, even if Canada had breached its obligations for the period January 1 – June 30, which is denied, this breach has been cured by the timely application of the adjustment for Option B Regions effective July 1, 2007. Therefore, no adjustments may be required or authorized under Article XIV of the Agreement.

III. CLAIMANT'S REQUEST FOR RELIEF SHOULD BE DENIED

29. With regard to the Claimant's request that the Tribunal determine a reasonable period of time for Canada to cure alleged breaches, appropriate adjustments to the export measures, and any additional steps, retrospective and prospective, necessary to "fully" cure the alleged breaches, Canada denies that it has committed any breaches and that any adjustments or additional steps are necessary. Canada reserves its right to raise jurisdictional objections to any relief outside that permitted by the Agreement. Canada specifically notes that paragraph 22 of Article XIV of the Agreement provides that "[i]f the [T]ribunal finds that a Party has breached an obligation under the SLA 2006, [it] shall identify a reasonable period of time for that Party to cure the breach ... and 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." Therefore, even if a breach is found, (1) no adjustment is authorized if the breach is cured within the period of time set by the Tribunal; (2) even in the event of a failure to cure the breach, no remedy or relief is authorized except in the form of adjustment to the export measures; and (3) there is no authorization for any monetary or other compensation to a successful claimant, nor is there any provision to compensate in relation to alleged effects of the breach prior to the time set by the Tribunal by which the Party is to cure the breach.

IV. RELIEF REQUESTED

30. Canada respectfully requests that the Tribunal render an award in favour of Canada and against the United States:

(a) Declaring that Canada has collected the proper amount of export charges from softwood lumber producers in Option A Regions, and therefore has not breached paragraph 1(b) of Article VIII of the Agreement,

(b) Declaring that Canada has set the proper limits on exports of softwood lumber from Option B Regions, and therefore has not breached paragraph 4(b) of Article VII of the Agreement, and, therefore,

(c) Denying and dismissing the claims of Claimant in their entirety, with prejudice.

V. MATTERS REGARDING THE ARBITRATION

31. Canada admits the United States' representation that the parties agreed in writing to matters regarding the Arbitration, including the selection of the Arbitral Tribunal, remuneration of the arbitrators, hearings of the Tribunal, the taking of evidence, and the award of the Tribunal.

VI. RESPONDENT'S NOMINATION OF ARBITRATOR (NAME, ADDRESS, TELEPHONE, FACSIMILE AND EMAIL)

32. Pursuant to Article XIV(9) of the Agreement, Canada nominates as arbitrator:

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Mr. Hanotiau meets the requirements of independence and impartiality of Article 5.2 of the LCIA Rules. Mr. Hanotiau's resumé is attached as Appendix A.

33. Pursuant to Section XIV(10) of the Agreement:

> The 2 nominated arbitrators shall jointly nominate the Chair of the tribunal within 10 days after the date on which the second arbitrator is nominated. The nominated arbitrators may consult with the Parties in selecting the Chair. If the nominated arbitrators fail to nominate a Chair within 10 days, the LCIA Court shall endeavour to nominate the Chair within 20 days thereafter.

34. In the event that the co - arbitrators fail to nominate the chair of the Tribunal, Canada respectfully requests that the LCIA designate a person who is not a national of those countries of which the co-arbitrators are nationals.

VII. STATEMENT OF COUNTERCLAIMS

35. Canada reserves its right to raise counterclaims against the United States.

VIII. CONFIRMATION OF SERVICE

36. As required by Article 2.1(e) of the LCIA Rules, this Response, together with attachments, is being simultaneously transmitted by email to the legal representatives of the Claimant. A courtesy copy is also being hand delivered to Patricia McCarthy on September 12, 2007.

Respectfully submitted,

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September 12, 2007

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