In the London Court of International Arbitration
No. 111790

THE UNITED STATES OF AMERICA,

Claimant,

v.

CANADA

Respondent.

CANADA'S RESPONSE TO REQUEST FOR ARBITRATION

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February 17, 2011

CANADA'S RESPONSE TO REQUEST FOR ARBITRATION

In accordance with Article 2 of the LCIA Rules, the Government of Canada ("Canada") respectfully submits the following Response to the Request for Arbitration (the "Request") filed on January 18, 2011 by the United States of America ("Claimant") under the 2006 Softwood Lumber Agreement ("SLA" or "Agreement") between the Government of Canada and the Government of the United States of America. Canada reserves the right under Article 15.3 of the LCIA Rules to raise counterclaims against the Claimant in its Statement of Defence.

PRELIMINARY STATEMENT

1. In its Request, the Claimant attempts to create a violation of the SLA out of the devastation inflicted on the forests of British Columbia by the Mountain Pine Beetle ("MPB"). The MPB epidemic is the most destructive recorded pest infestation ever to infect a forest ecosystem. This infestation has already affected over tens of millions of hectares of lodgepole pine in British Columbia's Interior region. Lodgepole pine is the predominant species of standing timber in the Interior region.

2. While the MPB epidemic began prior to 2006, both its scope and its severity increased dramatically following the SLA's entry into force in October 2006. The increase in the quantity of MPB-killed timber, combined with the need to salvage the diminishing value of that timber by harvesting dead stands as quickly as possible, has resulted in a significant increase in the amount harvested since 2006. From 2006 to 2010, for example, the volume of MPB-killed timber harvested in the B.C. Interior nearly doubled from an estimated 11 million cubic meters in 2006 to an estimated 19 million cubic meters in 2010, even while overall timber harvesting

declined following the U.S. housing market collapse. By 2010, MPB-killed timber represented nearly 70 percent of the total harvest of lodgepole pine in the B.C. Interior, compared to less than 35 percent in 2006, and about 44 percent of the total Interior softwood harvest, compared to less than 20 percent in 2006. At the same time, as explained below, British Columbia's overall harvest and its share of the U.S. market have declined.

3. In light of the explosive growth of the MPB epidemic, it is hardly surprising that there has been a corresponding decline in the quality of timber harvested in British Columbia, with a growing proportion of timber available for the manufacturing of softwood lumber consisting of poorer quality "Grade 4" MPB-killed timber. Grade 4 timber has, since before the SLA came into force, been sold for a fixed price of 25 cents per cubic meter rather than the variable price charged for higher quality timber. The Claimant surmises, and only surmises, that the mere increase in the percentage of Grade 4 timber must constitute a form of "grant or other benefit" provided to producers or exporters of Canadian softwood lumber. According to the Claimant, this results in an offset or reduction to the Export Measures in violation of the SLA. But a mere increase in Grade 4 timber, without more, cannot constitute a violation of the SLA's anti-circumvention provisions.

4. The SLA's anti-circumvention provisions are found in Article XVII. Circumvention under Article XVII must be demonstrated and not assumed. The Claimant must identify a specific government "action" taken by the Respondent that has "the effect of reducing or offsetting the Export Measures." In the context of this case, the Claimant must demonstrate that the provincial government of British Columbia has provided "grants or other benefits…on a *de jure* or *de facto* basis to producers or exporters of Canadian softwood lumber products." The United States cannot satisfy these criteria in this case.

5. Even if the United States were to satisfy these criteria, the SLA – in Article XVII(2) – provides an illustrative list of "safe harbours," which the Parties agreed do not constitute circumvention. As a result, any challenged measure or action that falls within one or more of these safe harbours is protected from a finding of circumvention. Article XVII(2)(a) provides a safe harbour for all of the timber pricing and forest management systems in place in British Columbia as of July 1, 2006, as well as certain modifications or updates to those systems, by categorically deeming them *not* to constitute circumvention. The Claimant concedes this, and purports to base its claim on "post-July 1, 2006 changes to B.C.'s provincial timber pricing system." U.S. Request for Arbitration, para. 21. When it comes to identifying these "changes," however, or explaining how they caused the alleged "underpricing" of timber that lies at the heart of the U.S. claim, the Request offers nothing but vague and conclusory assertions.

6. The Claimant's innuendo notwithstanding, Canada has not violated the SLA. The increase in the percentage of Grade 4 timber that has coincided with the MPB infestation does not constitute a government action that offsets or circumvents Canada's commitments under the SLA, does not provide a benefit to producers of Canadian softwood lumber products, and falls squarely within the SLA's safe harbour provisions. It therefore does not breach the anti-circumvention provisions of Article XVII.

II. MATTERS REGARDING THE ARBITRATION

7. Article XIV of the SLA sets forth the Parties' agreement regarding Arbitration. The language of the SLA speaks for itself and controls over the Claimant's characterizations.

8. Canada admits that the United States and Canada have held consultations pursuant to Article XIV regarding the Claimants' allegations of circumvention.

9. Canada and British Columbia have engaged in extensive informal consultations and discussions with the United States since early 2008 over the issues raised in the U.S. Request.

A. Parties to the Arbitration

10. Canada is the Respondent named in this proceeding. Canada's legal representatives in this proceeding are:

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B. Respondent's Nomination of Arbitrator

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

Professor Albert Jan van den Berg
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12. Professor Van den Berg meets the requirements of independence and impartiality of Article 5.2 of the LCIA Rules. Professor Van den Berg's curriculum vitae is attached as Appendix A.

13. Pursuant to Article XIV(10) of the SLA:

> 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.

III. DENIAL OF CLAIMS

14. Canada has complied with its obligations under the SLA. The United States' allegations that British Columbia has taken action to reduce or offset the Export Measures under the SLA are based on conjecture and are without merit.

15. Canada therefore denies all allegations of fact and law in the Request, except to the extent expressly admitted herein. As a general observation to the allegations in the Request, Canada states that the SLA speaks for itself and controls over the Claimant's characterizations thereof.

A. The Softwood Lumber Agreement

16. The North American market for softwood lumber, used for housing construction and other purposes, is highly integrated. For many decades the United States has been unable to meet a substantial portion of the demand for softwood lumber from its own production, and therefore has been a significant net importer of softwood lumber. Canada has long been the primary source of U.S. imports, historically supplying approximately one-third of the softwood lumber consumed in the United States. Since the SLA entered into force, however, Canada's share of the U.S. market has declined significantly, from over 33 percent in 2006 to less than 28 percent in 2010. Over this period, softwood lumber production in the B.C. Interior region declined by 33 percent, and its share of the U.S. market suffered a corresponding decline, from roughly 17 percent in 2006 to 15 percent in 2010. All of Canada's lost market share has been captured by the U.S. industry.

17. For the past quarter-century, the U.S. lumber industry has frequently asked the U.S. Government to restrict Canadian lumber imports, chiefly through requests for application of U.S. countervailing and antidumping duty laws. The most recent countervailing and antidumping duty investigations against imports of softwood lumber products from Canada were initiated by the United States in 2001, at the request of the U.S. industry. Canada challenged the imposition of duties by the United States on softwood lumber imports from Canada resulting from these investigations as inconsistent with both U.S. law and the rules of the World Trade

Organization. Throughout the pendency of these legal challenges, the United States collected, and held, deposits of estimated duties on Canadian shipments of softwood lumber to the United States.

18. The U.S. courts and NAFTA and WTO tribunals found that the United States had unlawfully imposed estimated duties in violation of U.S. law and the United States' WTO obligations. After the invalidation of the underlying antidumping and countervailing duty orders, the United States was ordered to return, with interest, approximately C$5 billion in estimated duties. It was against this backdrop that the Governments of Canada and the United States negotiated and entered into the SLA in 2006.

19. Under the SLA, Canada agreed to apply "Export Measures" to exports of softwood lumber to the United States from certain softwood lumber producing regions of Canada when the price of lumber is below U.S. $355 per thousand board feet. Export Measures may take the form of export charges (taxes), or a combination of export charges and volume restraints. In return, the United States agreed to refrain from initiating trade actions regarding softwood lumber, to revoke the invalidated countervailing and anti-dumping duty orders, and to refund the C$5 billion in unlawfully collected duties.

20. Article XVII of the SLA provides that neither Canada nor the United States shall take action to circumvent their respective commitments under the SLA, including action having the effect of reducing or offsetting the Export Measures. When Canada negotiated the SLA with the United States, it was of paramount importance to Canada to ensure that this anti-circumvention provision could not be used by the United States to challenge existing forest management and timber pricing systems, nor to interfere with Canada's flexibility to modify existing programs or implement new programs consistent with the SLA. Accordingly, Article

XVII also includes the "safe harbour" provisions, a non-exclusive list of actions, measures and programs that the Parties agreed would not constitute circumvention. By the express terms of the SLA, measures that fall within these safe harbour provisions do not circumvent commitments under the SLA.

21. The safe harbour provisions of the SLA protect the right of Canada and its provinces to continue to operate and manage the timber pricing and forest management systems that were in existence, and which the Parties necessarily took into account in determining their level of commitments, when the SLA was negotiated. These systems are not static, but employ many variables and procedures that respond to changing conditions. The safe harbours also preserve the right of Canada and its provinces to implement new environmental or forest management, protection or conservation programs.

22. Article XVII(2)(a) and (c) provide explicitly that measures that shall not be considered to reduce or offset the Export Measures in the SLA 2006 include, without limitation:

> (a) provincial 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. Fluctuations in stumpage charges that result from such modifications or updates, including fluctuations resulting from changes in market conditions or other factors affecting the value of the province's timber, such as transportation costs, exchange rates, and timber quality and natural harvesting conditions, do not constitute circumvention. A provincial timber pricing or forest management system includes, without limitation, the data, variables, and procedures it employs;
>
> (c) actions or programs undertaken by a Party, including any public authority of a Party, for the purpose of forest or environmental management, protection, or conservation, including, without limitation, actions or programs to reduce wildfire risk; protect watersheds; protect, restore, or enhance forest ecosystems; or to facilitate public access to and use of non-timber forest resources, 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.

23. Further, Article XVII(4) specifically identifies and protects from challenge British Columbia's existing and safe-harboured timber pricing system (described below), and recognizes that the stumpage charges will fluctuate in response to factors that include market conditions, timber quality, and natural harvesting conditions.

24. The SLA provides for the resolution by consultations of disputes, and if consultations are unsuccessful, allegations of circumvention of the SLA may be taken to arbitration under the LCIA Rules as modified by Article XIV of the SLA. The present arbitration marks the fourth proceeding under that article.

B. British Columbia's Timber Pricing and Forest Management Systems

25. In British Columbia, the vast majority, or roughly 95 percent, of the timberland suitable for harvesting and softwood lumber production is owned by the Province. Timber on land owned by the Province is known as "Crown" timber. Forest companies, including those that produce softwood lumber, hold timber harvesting rights primarily in the form of long-term licenses known as tenures. These licensees pay "stumpage" fees when they harvest standing Crown timber. As a condition of the licenses, the Province's forest management system requires licensees to provide numerous in-kind services that promote the sustainability of the forest, such as forest planning, tree replanting, road construction and maintenance, and other silviculture (forest renewal) services.

26. British Columbia uses a market-based system to price Crown timber. Roughly 20 percent of the Crown timber, representing timber stands throughout the Province, is auctioned by BC Timber Sales ("BCTS") to private bidders that submit the highest bid for each stand. MPS, a

transaction evidence pricing system which was developed over several years with the assistance of auction economists, is then used to translate the winning bids for BCTS auctions into stumpage rates for the remaining Crown timber stands held under long-term licenses. The MPS takes into account a large number of timber stand characteristics – including species mix, timber quality, terrain, and distance from processing facilities – to ensure that stumpage rates for long-term licenses reflect market-based rates for comparable stands sold at auction.

27. Under British Columbia's forest management and timber pricing systems, Crown timber is "scaled" and "graded" by licensed "scalers" overseen by the Province's Ministry of Forests. Scaling determines the volume of harvested timber using objective criteria to determine log volume on a cubic meter basis. The B.C. cubic meter scale is a world-class scaling system, appropriate for use as a benchmark in assessing the reliability and accuracy of other scaling systems. B.C. scalers also determine the grade of logs based on a regime which was in force on July 1, 2006, and which remains in force today.

28. Under B.C.'s schedule of Interior log grades, logs harvested from Crown licenses and designated as Grade 1 or Grade 2 are subject to prices per cubic meter determined by the MPS system, while Grade 4 logs are subject to a minimum statutory rate for Crown logs of 25 cents per cubic meter. Most Crown timber stands contain some combination of logs of each grade. Under the criteria for determining which logs are subject to the 25 cent rate, a significant portion of such logs may be useable to produce lumber. These criteria, as well as the 25 cent rate for certain Crown logs, were in place long before the Agreement entered into force, and form an integral part of the Province's timber pricing system.

C. The Mountain Pine Beetle Infestation and its Impact on British Columbia

29. In recent years, the Interior region of British Columbia has been subjected to a devastating and unprecedented epidemic attack of the MPB, which has killed millions of hectares of lodgepole pine timber throughout the B.C. Interior. The Mountain Pine Beetle, or *Dendroctonus ponderosae*, is an aggressive and fast-moving killer of lodgepole pine. The MPB kills standing timber by boring through the bark to lay its eggs, infecting the tree as it does so with a blue-staining fungus that, over the course of only several weeks, cuts off the flow of water and nutrients and effectively starves the tree. The MPB has an annual life cycle in which eggs deposited under the bark turn first into larva, then pupa, and finally adults that leave the tree and migrate in large numbers in search of new green lodgepole pine stands to attack.

30. MPB-killed trees dry out, and typically develop cracks, known as "checks," as the trees lose moisture and deteriorate. In the first phase of timber mortality, known as the green attack phase, the lodgepole pine needles remain green for roughly one year as the killed trees begin to dry. In the second, or red attack, phase, which typically lasts one or two years, the needles turn red as the dead trees continue to lose moisture. In the gray attack phase, the exterior of the dead and dry timber turns gray and the needles fall off while checking and other deterioration continues. Aerial surveys show that vast swaths of the B.C. Interior forest are now red, red turning to gray, or gray. The death of such a substantial portion of the B.C. Interior forest has posed an enormous challenge for the Province's forest management systems and the softwood lumber processing industry.

31. The severity and scope of the ongoing MPB attack in British Columbia is unprecedented in North America in several respects. First, its geographic breadth dwarfs the extent of every previous known outbreak. In a previous outbreak in the mid-1980s, the timber

area attacked by the MPB annually peaked at roughly 500,000 hectares. In contrast, the current outbreak reached a peak of over 10 million hectares killed in 2007, by far the largest and most devastating bark beetle attack ever recorded, anywhere in the world. Further, in previous attacks, the MPB has preferred larger diameter, older trees, while in the current attack the MPB is also attacking younger trees, and trees as small as 15 cm in diameter. Forest scientists attribute the unprecedented scale of the current infestation to warmer average winter temperatures. A sustained temperature of minus 35 degrees Celsius is needed to kill the MPB, but such low temperatures have been rare over the last decade in British Columbia.

32. The MPB infestation has increased dramatically in scope since the Agreement entered into effect in 2006, and has now killed about 25 percent of British Columbia's 60 million hectares of forested land in the Interior region. By 2010, the cumulative impact was reaching 700 million cubic meters of timber, or more than 10 times the average annual harvest level. The epidemic is expected to kill over 60 percent of interior lodgepole pine by 2017, representing over a quarter of the entire standing timber inventory in the B.C. Interior. The MPB infestation has substantially reduced the value of the Province's forest asset, and much investment in the health of the Interior forest has been lost. This explosion of lodgepole pine killed by the MPB epidemic has resulted in a significant increase in the volume of dry and cracked logs, which has increased along with the portion of the Interior forest in the red and gray attack phases of the MPB infestation.

D. U.S. Allegations of Breach

33. The principal allegations of breach of the SLA in the Request consist merely of inferences of improper conduct drawn from partial statistics and misleading characterizations of B.C.'s timber management system. The Claimant has failed altogether to specify *how* the

increase in the volume of timber classified as Grade 4 constitutes a breach of the SLA. Increases in the percentages of timber accurately classified as Grade 4 do not suggest underpricing, they simply indicate that there is more Grade 4 timber, an outcome wholly consistent with the devastation caused by the MPB epidemic. Nor does the Claimant explain how the "other actions" it alleges may have contributed to the alleged "underpricing." U.S. Request for Arbitration, para. 31. Re-drying logs in kilns at temperatures equivalent to a warm summer's day, for example, merely serves to improve the accuracy of timber grading.

34. British Columbia has not underpriced provincial timber. British Columbia's timber scaling regime is an integral and fundamental part of its timber pricing and forest management systems. The B.C. Ministry of Forests systematically monitors the scaling and grading of timber throughout the province.

35. The Claimant has equally failed to explain how B.C.'s pricing or scaling practices have been inconsistent with B.C.'s systems as they existed on July 1, 2006, and how any changes alleged to have been made in those systems result in any circumvention of the SLA. Nor has the Claimant explained how any change to these systems arguably provided a benefit to B.C. lumber producers or injured U.S. producers. The Interior Region of British Columbia's lumber production, exports to the United States, and share of the U.S. lumber market all have declined substantially since the SLA entered into force. For example, its share of the U.S. lumber market has declined from over 19 percent in 2006 to 16 percent in 2010. Over this same period, the U.S. industry's market share has risen from 62 to 71 percent. The U.S. claim that British Columbia has provided a benefit to its softwood lumber producers through under-pricing of timber is without any factual basis.

VI. CLAIMANT'S REQUEST FOR RELIEF SHOULD BE DENIED

36. With respect to Claimant's request for relief in paragraph 36, Canada denies that British Columbia or any other part of Canada has committed any breach of the SLA and denies that any relief or remedy for the Claimant is justified.

37. With regard to the United States' request that the Tribunal order "any further relief as may be appropriate," Canada notes that no such relief is available under the SLA. U.S. Request for Arbitration, para. 36(d). The only relief that is authorized under the SLA is adjustments to the Exports Measures during the life of the SLA to compensate for a breach if the breaching Party fails to cure the breach within a reasonable period of time. Accordingly, this portion of the U.S. request for relief is outside the jurisdiction of the Tribunal.

VII. RELIEF REQUESTED BY CANADA

38. Canada respectfully requests that the Tribunal render an award in favour of Canada and against the Claimant:

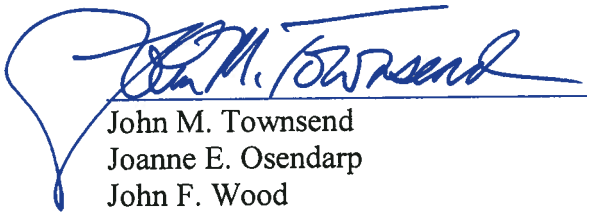
a. Declaring that neither Canada, nor the provincial government of British Columbia, has circumvented or otherwise breached the SLA.

b. Denying and dismissing Claimant's claims in their entirety.

VIII. CONFIRMATION OF SERVICE

39. As required by Article 2.1(e) of the LCIA Rules, this Response, together with its attachments, is being simultaneously transmitted by email to the legal representatives of the Claimant. A courtesy copy is also being Federal Expressed to Patricia McCarthy at the United States Department of Justice.

Respectfully submitted,



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