



Canadian and U.S. flags positioned together on a meeting table. Source: U.S. Department of Agriculture, Flickr/Creative Commons.

Canada-U.S. Trade Disputes in Perspective: Challenges, not Crises

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Introduction

Americans and Canadians may look at the vast amount of trade which crosses their borders and conclude that the U.S.-Mexico-Canada Agreement (USMCA), the successor to NAFTA, is functioning smoothly. While this is true overall, a number of recent issues are now putting USMCA to the test. On the positive side, one potential crisis was avoided when U.S. legislation subsidizing domestically manufactured electric vehicles was also applied to vehicles manufactured in Canada and Mexico, and the U.S. and Canada are making common cause as they challenge Mexican energy policy.

But both Canada and Mexico are resorting to USMCA's formal dispute settlement process regarding the U.S. interpretation of the agreement's North American content requirements for automotive parts. Bilaterally, Canada is once again challenging U.S. duties which restrict the entry of softwood lumber, while the U.S. is doing the same regarding Canada's administration of its supply management regime for dairy products. While the trade lawyers fight these issues out, political leaders will need to take care to keep them from damaging the generally strong relationship between our two countries.

Dodging a Bullet on Electric Vehicles

One trade issue which could have been of consequence for the relationship was successfully defused with the passage of the "Inflation Reduction Act" by the U.S. Congress in August. The original legislation proposed by the Biden administration under the rubric of the "Build Back Better Act"¹ had included subsidies for purchases of electric vehicles which required that they be assembled in the United States. This was seen in Canada as freezing it out of this fast-emerging sector despite the close integration of the Canadian and U.S. auto industries.

Luckily, while the original bill languished in the U.S. Senate, Canadian officials and industry representatives had time to urge the Biden administration to alter the proposed legislation.² Mexico, too, pressed for changes, and when it re-surfaced as the Inflation Reduction Act, the electric vehicle credit had been reworked to the surprise of many.

Now, electric vehicles manufactured in North America will qualify for two credits of US \$3,750 each.³ The first credit applies where the critical minerals in the batteries, notably lithium, are extracted or processed in countries with which the U.S. has a free trade agreement. This would include Canada, which has exten-

1 Picone, Brian and Bond, David E. "House 'Build Back Better Act' Sets Stage for Trade Disputes over Green Energy." White & Case. November 19, 2021. <https://www.whitecase.com/insight-alert/house-build-back-better-act-sets-stage-trade-disputes-over-green-energy>

2 Siekierska, Alicja. "Canada-made electric vehicles will qualify for tax credits under revised U.S. bill." Yahoo Finance Canada w/Canadian Press. July 28, 2022. <https://www.yahoo.com/video/canada-made-electric-vehicles-will-qualify-for-tax-credits-under-revised-us-bill-185014201.html>

3 Philips, Steven R. et al. "Inflation Reduction Act seeks to jumpstart electric vehicle market." DLA Piper. August 19, 2022. <https://www.dlapiper.com/en/us/insights/publications/2022/08/inflation-reduction-act-seeks-to-jumpstart-electric-vehicle-market/>

sive lithium deposits, though they are difficult and expensive to access with current technology. Lithium from Australia, the world's largest producer, would also qualify, as would that from Chile and Peru, both of which are potentially big lithium producers if regulatory and political hurdles can be overcome. Argentina, an important current producer, and Bolivia, another potential producer, would not benefit from the credit. The second credit will be available if battery components are manufactured or assembled in North America.

As the auto manufacturers decide where to put their plants for electric vehicle production and where to purchase automotive parts, Canada will not be unduly disadvantaged from the outset. General Motors, Ford, Honda, and Stellantis have announced electric vehicle investments totaling US \$10 billion⁴ while Tesla is reportedly considering a major investment.⁵

Automotive Parts: Canada and Mexico Take on the U.S.

Treatment of automotive parts was a key element of the revision of NAFTA into the new USMCA. A major goal of U.S. negotiators had been to tighten the rules of origin under which vehicles could be considered as made in North America and thus eligible to enter the United States duty free. USMCA increased the “regional vehicle content” for passenger vehicles and light trucks from 62.5 pct to 75 percent and imposed requirements that 40–45 percent of vehicles be produced by labor earning at least US\$ 16.00 per hour and that 70 percent of the steel and aluminum used originate within North America. The new requirements are to take effect in July 2023.⁶

USMCA speaks of the “core parts” of a vehicle — auto train, transmission etc. — and of the vehicle as a whole which must meet the regional content requirement. Mexico and Canada argue that if the core parts meet the minimum requirement, then USMCA allows them to then be counted completely towards meeting the threshold for the vehicle as a whole: “rolled up” into this calculation in the technical jargon. The U.S. disagrees with what it sees as an effort to allow non-North American content to improperly be counted as such.⁷ The interpretation of the agreement by U.S. Customs and Border Protection was challenged by Mexico in August of 2021, with Canada joining in January of 2022; the matter is now before a dispute settlement panel, which is expected to make a final decision shortly.⁸

Why do the USMCA partners take such differing stances? The Trump administration, which negotiated USMCA, prioritized minimizing the amount of work done outside North America. The Biden administration, with strong ties to labor unions, seemingly has a similar view. But Canada and Mexico may worry that they may be vulnerable to competition from vehicles produced from outside of North America despite their tariff advantage if vehicles produced in North America become more costly. Passenger vehi-

4 Molnar, Coleman. “How automakers are investing in Canadian EV production.” *Driving*. May 17, 2022. <https://driving.ca/auto-news/industry/how-automakers-are-investing-in-canadian-ev-production>

5 Sriram, Akash. “Tesla discloses lobbying effort to set up factory in Canada.” *Reuters*. August 9, 2022. <https://www.reuters.com/business/autos-transportation/tesla-discloses-lobbying-effort-set-up-factory-canada-2022-08-09/>

6 “USMCA Fact Sheet: Automobiles and Automotive Parts.” Office of the U.S. Trade Representative. https://ustr.gov/sites/default/files/files/Press/fs/USMCA/USMCA-Autos_and_Auto_Parts.pdf

7 Wilson, Christopher, de Rosenzweig, Francisco, and Rubio, Luis. “The Expert Take: USMCA Rules of Origin Disputes.” *Woodrow Wilson International Center for Scholars*. September 23, 2021. <https://www.wilsoncenter.org/article/expert-take-usmca-rules-origin-disputes>

8 Ljunggren, David. “Canada joins Mexico in challenging U.S. on auto trade rules, latest sign of strains.” *Reuters*. January 13, 2022. <https://www.reuters.com/world/americas/canada-join-mexican-complaint-about-us-auto-industry-move-2022-01-13/>

cles face a WTO bound tariff of 2.5 percent while trucks face one of 25 percent.⁹ Canada's auto industry, which has been in decline for decades, may see the inclusion of as much non-North American content possible as vital to its continued survival in the face of global competition.

Energy: Canada and the U.S. Challenge Mexico

While Canada and Mexico have joined forces against the U.S. on auto parts, Canada and the U.S. are working together on energy to challenge Mexico's policies. In July, Canada followed the U.S. in requesting consultations, a preliminary step to seeking a formal dispute settlement panel.¹⁰ Canada has reason to be concerned: it has energy investments in Mexico totaling US\$ 10.1 billion, of which US\$ 3.9 billion is in renewable energy.¹¹

One particularly prominent Canadian investment is the 252 megawatt El Mezquite wind farm near Monterrey owned by Cubico Sustainable Investments, an entity created by the Ontario Teachers' Pension Plan. Cubico also has an interest in the 350-megawatt Solem solar energy plant in Aguascalientes.¹²

Both the United States and Canada are concerned about the energy policies of Mexican President Andres Manuel López Obrador, whose vision of Mexico's development is based on a return to the statist model which his recent predecessors had jettisoned. They accuse Mexico of policies which would allow the state-owned the Federal Electricity Commission, which both produces electricity from coal and oil-fired plants and distributes it through the nationwide grid, to purchase power from its own plants even if it costs more than that produced by private, including foreign, firms which had been allowed to enter the market.¹³ Mexico is accused of "delays, denials and revocations of private companies' abilities to operate in Mexico's energy sector."¹⁴

Also, U.S. and Canadian oil and gas producers and pipeline firms were attracted by the liberalization which Mexico is now seeking to reverse. Among concerns are regulations requiring that that users of Mexico's gas transportation network demonstrate that they source gas from the Federal Electricity Commission or state oil and gas producer Pemex.

It should, however, be noted that the relationship with Mexico is not entirely conflictual. Calgary-based TC Energy has recently signed an agreement with the Federal Electricity Commission to enter into a

9 "Is USMCA a tipping point for Canada's auto sector?" PwC Canada. 2020. <https://www.pwc.com/ca/en/industries/automotive/is-usmca-a-tipping-point-for-canadas-auto-sector.html>

10 "Statement by Minister Ng on Canada launching Canada-United States-Mexico consultations on Mexico's new energy policies." Global Affairs Canada. July 21, 2022. <https://www.canada.ca/en/global-affairs/news/2022/07/statement-by-minister-ng-on-canada-launching-canada-united-states-mexico-agreement-consultations-on-mexicos-new-energy-policies.html>

11 "Canada in Mexico: Energy." Canadian Embassy Mexico. <https://canadainmexico.com/canada-mexico-relationship/mutual-prosperity/>

12 Lillian, Betsy. "Mezquite Wind Farm Begins Operating in Mexico." North American Windpower. October 17, 2019. <https://nawindpower.com/mezquite-wind-farm-begins-operating-in-mexico>

13 Ibarra Chaoul, Alejandra and Siegfried, Kevin. "Mexico's electricity reform draws opposition from investors, U.S." Washington Post. April 16, 2022. <https://www.washingtonpost.com/world/2022/04/16/mexico-electricity-reform-amlo/>

14 "United States Requests Consultations under the USMCA Over Mexico's Energy Policies." Office of the U.S. Trade Representative. July 20, 2022. <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2022/july/united-states-requests-consultations-under-usmca-over-mexicos-energy-policies>

strategic alliance to accelerate gas pipeline development in southeastern Mexico.¹⁵

Mexico will undoubtedly seek to defend itself before a dispute settlement panel by invoking the provisions regarding energy sovereignty in its constitution, which USMCA is pledged to respect. Canada and the United States will look to the accord's market access, investment protection, and state-owned enterprises chapters. Given López Obrador's commitment to his energy program, we can expect that should the U.S. and Canada gain a favorable ruling, this will result in an especially rancorous political dispute among the three countries.

Softwood Lumber: Canada Presses the U.S.

The United States and Canada have their own longstanding bilateral trade headaches over softwood lumber and dairy products. The softwood lumber issue has existed in one form or another since 1982 and has been the subject of trade complaints and temporary negotiated arrangements through the forty year time period. The most recent development was the August 4th decision by Canadian Trade Minister Ng to invoke the dispute settlement procedures under USMCA.¹⁶

Both the U.S. and Canada are major producers of softwood, principally pine, which is used in the construction sector. However, the two countries' industries compete against each other in the huge U.S. market. American lumber producers insist that they are unfairly disadvantaged because Canada improperly subsidizes its producers, while Canada asserts that that the U.S. position is pure protectionism. It also argues that since wood is used in a range of industries, any subsidy would not be subject to anti-subsidy ("countervailing") duties as it is not confined to a specific industry.¹⁷

The dispute arises from the different structures of the two countries' industries. American lumber companies generally either own the land in which the trees they harvest are grown or rent it from private landowners. In Canada, the land belongs to the government, largely at the provincial level, and lumber firms are charged for the wood which they harvest—so-called stumpage fees. The amount charged is a subject of negotiation and thus can vary depending on the economic environment.

Does the Canadian practice constitute a subsidy? American producers have consistently asserted that Canadian provinces maintain stumpage fees below the market value of the wood to promote their industries' competitiveness. But, as a U.S. Congressional Research Service Report notes "this can only be determined by examining provincial fees and U.S. prices for comparable timber, but such comparisons are difficult...."¹⁸

Whether the stumpage fees constitute a subsidy and how a countervailing duty should be imposed to protect the American lumber industry from it is determined by the producer-friendly U.S. Department of Commerce and International Trade Commission. From 2006 to 2015, the United States and Canada had

15 Smith, Christopher E. "TC Energy, Mexico to build 1.3 bcf Southeast Gateway pipeline." Oil and Gas Journal. August 8, 2022. <https://www.ogj.com/pipelines-transportation/pipelines/article/14280921/tc-energy-mexico-to-build-13-bcf-southeast-gateway-pipeline>

16 "Statement by Minister Ng on U.S. duties on softwood lumber products from Canada." Global Affairs Canada. August 4, 2022. <https://www.canada.ca/en/global-affairs/news/2022/08/statement-by-minister-ng-on-us-duties-on-softwood-lumber-products-from-canada.html>

17 "Top facts to understand about the softwood lumber dispute." A & A Customs Brokers. 2021. <https://www.aacb.com/facts-to-understand-about-softwood-lumber-dispute/>

18 "Softwood Lumber Imports from Canada: Current Issues." Congressional Research Service. April 12, 2018. <https://crsreports.congress.gov/product/pdf/R/R42789>

managed trade through a Softwood Lumber Agreement, providing negotiated duties and quotas. Since its expiration, the United States has set duties annually while Canada has pursued the matter at the World Trade Organization, where a panel ruled in 2020 that the United States had erred in not accepting Canada's use of benchmark prices for softwood lumber in various provinces.¹⁹ Washington has appealed this to the WTO appellate body; however, this entity currently does not function because the United States has not agreed to nominations for vacant seats on it. In the meantime, U.S. duties remain in force.

In August, the U.S. Department of Commerce issued its latest list of duties on Canadian lumber. The overall tariff rate (which varies from company to company) was dropped from 2021's 17.91 pct to a much lower 8.59 pct, likely because of changing market conditions as lumber demand rose during the pandemic. Nonetheless, Canada is now seeking a USMCA panel ruling. In a public statement, Ottawa stresses that real harm is being done to U.S. builders and consumers by the duties. Nonetheless, with the U.S. housing market beginning to cool, one can expect the American lumber sector to aggressively press the U.S. government to defend it.

Dairy: The U.S. Wants More from Canada

If the United States is seeking to fend off Canadian demands for market access on softwood lumber, the shoe is on the other foot in the dairy sector. Canada's restrictive policies, which keep imports of dairy products to a minimum, have long been contentious, and figured in the negotiations of USMCA. Indeed, they were publicly cited by then-President Trump as an example of the supposed bad deal that NAFTA had been for the United States.²⁰ USMCA was seen by Americans as having provided some additional access for a range of U.S. dairy products in the form of larger quotas. However, the way in which Canada has administered its commitments under USMCA has led to one dispute settlement panel ruling requiring further changes, with another one possibly coming.

At the root of the dispute is way in which Canada closely manages its dairy sector for the benefit of producers. Domestically, production quantity is tightly regulated with the aim of keeping prices up. Internationally, Canada imposes tariffs to limit foreign competition. Of course, Canadians are well aware that the United States aids its own dairy industry through subsidies; however, such subsidies are permitted under USMCA, as long as they are not specifically targeted for exports.

In theory, USMCA created additional access for U.S. dairy producers. However, Canada's implementation largely allowed their products, which ranged from milk and cream to cheese and skim milk powder, to largely be imported by pools of "processors" and, to a much lesser degree, by "distributors." This meant that while blocks of mozzarella might be allowed for Canadian frozen pizza manufacturers to use, higher value products with greater profitability such as fine cheeses were largely kept out.

The United States challenged this system, and in December 2021 a dispute settlement panel, the first to rule since USMCA entered into force, ruled against Canada. The panel ruled that while overall Canada's dairy supply management system was USMCA-consistent in principle, it could not restrict importation largely to processors. The report delved deep into such issues of interpretation as how an "allocation" is defined and under what circumstances the word "an" means "any". The U.S. Department of Agriculture

19 "DS533: United States—Countervailing Measures on Softwood Lumber from Canada." World Trade Organization. August 24, 2020. https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds533_e.htm#bkmk533r

20 Diamond, Jeremy. "Trump: Canada's dairy measures a 'disgrace.'" CNN. April 20, 2017. <https://www.cnn.com/2017/04/20/politics/donald-trump-canada-dairy-farmers/index.html>

and U.S. Trade Representative saw the ruling as a significant victory.²¹ However, they and the U.S. dairy industry found to their dismay that Canada's subsequent revisions of its regime seemed designed to maintain the status quo.

Instead of allowing for the importation of dairy products by whoever wants them (up to the quota limits), the revised regime provides additional access to distributors who can bring in U.S. dairy products while still not allowing end-users such as grocers and restaurants to directly import. It also requires that potential importers show that they have been active for the previous twelve months, which seems aimed at discouraging new entrants. Canadian authorities have also been administering the quotas for the different categories of dairy products which are covered in three-month tranches rather than designating them for the whole year, something which they explicitly linked to their concerns about how the now resolved electric vehicle issue would be treated by the U.S. Congress.²² Presumably, this would have been an area for potential retaliation had legislation passed supporting only American-made vehicles.

In announcing the decision to seek consultations, a preliminary step to resorting to a dispute settlement panel, U.S. Trade Representative Katherine Tai said she was "deeply troubled" by Canada's restrictive policies while Agriculture Secretary Tom Vilsack said Canada has "failed to honor and implement its USMCA commitments."²³ Canadian Trade Minister Mary Ng responded that the panel had recognized that Canada had "full discretion" to administer its tariff-rate quotas to support its supply management system and that it would always "stand up for its dairy industry, farmers and workers."²⁴

The reality is that there are strong dairy lobbies on both sides of the border and real political interests at play. In Canada, the industry has a particularly large presence in the province of Quebec, which is of great importance to the Liberal Party of Prime Minister Trudeau. While the U.S. industry is scattered fairly widely, there are some states where it is especially important such as Wisconsin, a key swing state in Presidential elections. The incentives are for both countries' governments to fight hard on this issue.

Look at the Big Picture, Please

Energy, automobiles, lumber, and dairy products are important industries, and it is not surprising that disagreements arise even in the context of a broad free trade agreement. However, U.S.-Canada trade (plus that with Mexico) is enormous, and these disputes should not overshadow the amount of commerce that crosses borders without any controversy. The dispute settlement procedure under USMCA provides a means to wall off specific problems and prevent them from damaging the broader economic and political relationship.

21 "Canada Dairy TRQ Allocation Measures Final Panel Report." Canada-US-Mexico Agreement. December 20, 2021. <https://ustr.gov/sites/default/files/enforcement/USMCA/Canada%20Dairy%20TRQ%20Final%20Panel%20Report.pdf>

22 "Message to Industry—Opening of the Application Period for the 2022-2023 Dairy Year TRQs and CUSMA and CUSMA Calendar Year 2022 Dairy TRQs (August to December 2022)." Global Affairs Canada. May 16, 2022. <https://www.international.gc.ca/trade-commerce/controls-controles/messages/2022-05-16-message-industry-industrie.aspx?lang=eng>

23 "United States Initiates Second USMCA Dispute on Canadian Dairy Tariff-Rate Quota Policies." Office of the U.S. Trade Representative. May 25, 2022. <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2022/may/united-states-initiates-second-usmca-dispute-canadian-dairy-tariff-rate-quota-policies>

24 "Statement by Minister Ng on dairy tariff rate quota policies under CUSMA." Global Affairs Canada. May 16, 2022. <https://www.canada.ca/en/global-affairs/news/2022/05/statement-by-minister-ng-on-dairy-tariff-rate-quota-policies-under-cusma.html>

Both the U.S. and Canada should realize that it is not in their long-term interest to fight every issue to the bitter end, as this will only lead to greater tension and decrease public confidence in a free trade agreement which functions remarkably well. Thus, it was a very positive development that the final version of the law providing subsidies for electrical vehicles covered North American and not merely U.S. content.

Defending legally and economically dubious policies that support specific sectors in the face of adverse initial dispute settlement decisions, whether they be American lumber producers, Canadian dairy farmers, or, quite probably, Mexican energy parastatals, is ultimately just an exercise in kicking problems down the road. Our countries would be better served if governments would realistically calculate their chances of winning and tell their affected businesses “no” if their case is not strong enough to ultimately prevail.

Dragging these cases out will result in lost consumer welfare and ultimately lead to governments facing the unpleasant choice of having either painfully backing down after last ditch defenses finally are breached or having to accept retaliatory tariffs on other unrelated sectors which will only spread the pain to more businesses, workers, and consumers. Both outcomes would undermine the rules-based trade regime which serves our countries so well.







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