UNITED STATES – MEASURES AFFECTING THE PRODUCTION AND SALE OF CLOVE CIGARETTES:

RECOURSE TO ARTICLE 22.6 OF THE DSU

(DS406)

Executive Summary
of the Opening Statement
of the United States of America

April 3, 2014

I. THE UNITED STATES HAS BROUGHT ITS MEASURE INTO COMPLIANCE

1. The United States has brought Section 907 into conformity with Article 2.1 by (1) undertaking further scientific evaluation of the public health implications of menthol cigarettes and presenting the results of that analysis in a report that demonstrates that there is a legitimate regulatory distinction between menthol cigarettes and clove cigarettes; (2) by continuing to develop its understanding of the public health implications of menthol cigarettes by issuing an ANPRM designed to advance possible appropriate regulatory measures affecting menthol cigarettes; and (3) applying measures to reduce youth smoking – including Section 907 and a public education campaign that targets menthol cigarettes – in an even-handed manner, in light of the different regulatory challenges posed by menthol cigarettes and clove cigarettes.

2. There is no question that DSB recommendations and rulings are fixed and final. At the same time, and in particular in matters of the public health, the science may continue to change and evolve. Therefore, where the basis for a technical regulation is found to be deficient, it is entirely appropriate that a Member would seek to bring its measure into compliance by conducting further analysis and assessment of the scientific evidence in order to consider what further action would be appropriate in light of that evidence. Where the analysis provides evidence of a legitimate regulatory distinction, a Member may bring its technical regulation into compliance on the basis of that evaluation without changing the measure drawing the distinction.

3. Indonesia argues incorrectly that the findings in the FDA Report should be disregarded because the TPSAC reached similar findings in July 2011. The TPSAC Report is not a U.S. Government evaluation. U.S. administrative procedure requires that any potential regulatory action be based on findings of the FDA, and not on an independent advisory committee or other third party. In conducting its evaluation, the FDA did not rely upon the TPSAC Report, but conducted its own evaluation. The TPSAC Report was not available to the U.S. Congress when it enacted Section 907. In addition, its use in the panel proceedings was limited.

4. Finally, Indonesia argues that the FDA findings with respect to menthol cigarettes do not constitute a legitimate regulatory distinction in any event because the presence of clove flavor in cigarettes also would likely be associated with increased addiction and difficulty with cessation. This contention is unfounded. Indonesia ignores the fact that menthol use in the United States is far more pervasive, especially among adults, than clove use was. The use of clove cigarettes in the United States did not pose the same regulatory challenge.

II. INDONESIA HAS NOT REBUTTED THE U.S. ARGUMENT THAT THERE IS NO NULLIFICATION OR IMPAIRMENT WITH RESPECT TO ARTICLE 2.1

5. With respect to nullification and impairment, Indonesia's argument in support of its proposed suspension level of $42.9 million is that, in order to "induce compliance," the level of suspension should not reflect the trade effect of Section 907, but must reflect the alleged "full" or "total" impact on the broader Indonesian economy.

A. The Level of Suspension Must Be Equivalent – Not "Appropriate"

6. Indonesia erroneously asserts that the level of suspension in this dispute must be "appropriate," a phrasing that contradicts the clear language of DSU Article 22, which states that

the level of suspension must be "equivalent" to the level of nullification and impairment. It is possible that Indonesia is relying on a standard applied in a set of arbitrations that is not applicable here: what level of countermeasures should be authorized for a complaining Member under SCM Articles 4.10 and 4.11. It is only in those disputes, which involve a different provision of the covered agreements and a different legal standard, that arbitrators have considered that the level of suspension may exceed, and not be equivalent to, the level of nullification or impairment.

B. A "Reasonable" Counterfactual Reflects a Realistic Compliance Scenario

7. In addition, Indonesia's arguments are flawed because they are based on a counterfactual that is not reasonable. Indonesia suggests that a "reasonable" counterfactual is one that is plausible, and that a counterfactual that is "plausible" is one that results in a level of nullification or impairment that is "appropriate." Of course, as already noted, Indonesia errs in relying on the standard of "appropriate" rather than "equivalent."

8. Indonesia claims to find support for its approach in *US – Gambling*, but mischaracterizes the findings. The arbitrator in *US – Gambling* links the concepts of plausibility and reasonableness to equivalence, and notes that a reasonable counterfactual takes account of the circumstances of the dispute. The arbitrator identified policy objectives as relevant circumstances, and adopted a counterfactual reflecting U.S. policy objectives.

9. Indonesia tacitly concedes that its proposed counterfactual – removal of Section 907 – is not plausible or reasonable insofar as those terms should reflect what the United States might actually do in these circumstances. Indonesia submits that its counterfactual would not harm the public health – but only because it is purely hypothetical and not a compliance measure that the United States must (or, by inference, should) be expected actually to take. The implicit suggestion is that the Arbitrator should adopt a counterfactual that is not realistic at all.

C. Indonesia Attests That Section 907 Does Not Cause a Loss of Exports

10. Indonesia has failed to show that Section 907 causes a decrease in the level of exports of clove cigarettes. Kretek has "adapted" Djarum brand clove cigarettes so that they may continue to be exported to the United States at the same level as prior to the U.S. adoption of Section 907.

11. Indonesia does not dispute any of the facts that the United States has put forth with respect to clove cigars. Rather, Indonesia claims these facts are irrelevant because: (1) the activity of private entities is not relevant to the calculation of nullification or impairment; (2) Kretek is located in the United States; and (3) Djarum is only a single brand of Indonesian clove cigarettes. These responses are off point. The determination of nullification or impairment is based on an actual loss of trade flows. Indonesia itself calculates the level of nullification or impairment based on the activity of these same private entities.

12. Moreover, in the course of making this assertion, Indonesia confirms that, in fact, its exports have continued after Section 907. In particular, Indonesia states that "the level of nullification or impairment of benefits should account for the full economic impact of the loss of export opportunities. This should not be conflated with a calculation of the actual impact of a measure on trade flows. *Private parties will always seek to cover their losses in the face of*

discriminatory measures." In other words, according to Indonesia, the level of nullification or impairment should not reflect the actual impact of Section 907 on trade flows of Indonesian clove cigarettes, because exporters should be expected to cover their losses.

13. The TBT Agreement contemplates that Members will "adapt" their products and production methods to conform to technical regulations. From the perspective of the public health, it is not a desirable outcome that cigarette manufacturers seek to adapt their products to avoid restrictions. Nevertheless, under the TBT Agreement, there is no nullification or impairment where a Member maintains its level of exports by adjusting to a technical regulation.

III. INDONESIA HAS NOT REBUTTED THE U.S. ARGUMENT THAT THERE IS NO LEVEL OF NULLIFICATION OR IMPAIRMENT WITH RESPECT TO ARTICLE 2.9.2 OR 2.12

14. Indonesia's argument with respect to TBT Articles 2.9.2 and 2.12 is that it bears no burden to specify and substantiate any level of nullification or impairment. Rather, Indonesia incorrectly argues that the Arbitrator must determine that the United States remains in non-compliance with Articles 2.9.2 and 2.12, and therefore, nullification or impairment exists.

A. Indonesia's Approach Is Inconsistent with Article 22 of the DSU

15. Indonesia's approach, relying on the rebuttable presumption in DSU Article 3.8, reflects a misunderstanding of the purpose of an Article 22.6 proceeding. A finding of a breach does not automatically mean that there is currently any ongoing nullification or impairment. Indeed, that is precisely why the presumption in Article 3.8 is rebuttable.

16. Indonesia ignores the approach required under Article 22.4 of the DSU and taken in prior Article 22.6 arbitrations, which is to determine the actual level of nullification or impairment. In the Article 22.6 *EC – Bananas III* proceeding, the arbitrator recognized that a Member's "legal interest in compliance" does not "automatically imply" that the Member is "entitled to obtain authorization to suspend concessions under Article 22 of the DSU."

B. Indonesia's Reasons for Not Specifying Any Actual Nullification or Impairment of Benefits Accruing Under Articles 2.9.2 or 2.12 Are Flawed

17. Indonesia claims that it need not specify or substantiate the level of nullification or impairment with respect to each article because the nullification or impairment "comes from the impact of the measure." This is incorrect.

18. First, the DSB made separate recommendations and rulings with respect to the "measure" and the "actions" that were found to be in breach of Articles 2.9.2 and 2.12. Any nullification or impairment of the benefits under Article 2.9.2 or 2.12 would result from U.S. acts.

19. Second, Articles 2.9.2 and 2.12 – while important – are inherently limited temporally. They apply at the stages before a measure takes effect. By contrast, Article 2.1 is not inherently limited temporally. Therefore, any calculation of the current nullification or impairment must take account of the fact that breaches of Article 2.9.2 and 2.12 are –in the circumstances of this dispute – more than four years in the past. The DSU only provides for suspension of concessions with respect to current and prospective trade losses.

20. Third, the benefits accruing to Members under Articles 2.9.2 and 2.12 are different from the benefits accruing under Article 2.1. This difference is relevant in this circumstance to the calculation of any nullification or impairment resulting from any alleged continued breach. Articles 2.9.2 and 2.12 provide periods of time for input on and adaptation to impending measures, but they do not, by themselves, implicate or require any type of treatment accorded to products. By contrast, Article 2.1 requires that the like products of one Member are not unjustifiably accorded less favorable treatment than the like domestic products of another Member. Accordingly, any assessment of nullification or impairment must calculate separately – and not merely conflate – any trade losses resulting from Articles 2.9.2, 2.12 and 2.1.

21. Indonesia also submits a misplaced tautology: that the only "reasonable" compliance scenario would be the withdrawal of Section 907; that, under Indonesia's methodology, such a counterfactual results in a level of nullification or impairment of $42.9 million; and that, therefore, $42.9 million must be equivalent to the nullification or impairment stemming from alleged continuing breaches of Articles 2.9.2 or 2.12. This position is without merit.

22. Indonesia's proposed counterfactual is not "reasonable." The DSB recommendations and rulings with respect to Articles 2.9.2 and 2.12 are not with respect to the measure and so would not call for its withdrawal.

23. Moreover, Indonesia has not explained how removing Section 907 would result in an accurate determination of the level of nullification or impairment with respect to these articles. The benefits accruing to Indonesia that are allegedly being nullified or impaired are the opportunities to possibly influence the final Section 907 through input at the proposal stage, and the opportunity for its producers to adapt products and production methods before the measure goes into effect. Indonesia would need to set forth a comparison between the actual value of its trade as a result of benefits accruing under Articles 2.9.2 and 2.12 (*i.e.*, under the status quo), compared to the hypothetical value of its benefits under a counterfactual. It is difficult to see how there would be any difference. Given that Indonesia actually did provide input on Section 907, and that its producers already have adapted their products to the measure, and that these actions occurred more than four years ago, there is no basis to assume that there is currently any trade effect.

C. Indonesia's Approach Would Have Serious Systemic Implications

24. Indonesia's argument that removal of Section 907 is the *only* way that the United States could come into compliance is extreme and unreasonable – and at odds with the expectations and intentions of the WTO membership. The United States conducted a careful (though non-exhaustive) inquiry into Members' notifications of technical regulations, and the intervals of time that Members provide between the date of a technical regulation's publication and entry into force. The results of this illustrative survey suggest that, if Indonesia's view was to prevail, there would be far-reaching implications that many Members did not contemplate or intend.

25. Indonesia, in particular, has drawn concern in the TBT Committee for failing to notify proposed measures. With respect to Article 2.12, Indonesia provided on average only 28 days between publication and entry into force for 15 of the 66 regular technical regulations that it has notified under the TBT Agreement.

26. Finally, Indonesia's argument that the Arbitrator must determine compliance with respect to Articles 2.9.2 and 2.12 *even if* it finds that there is nullification or impairment with respect to Article 2.1 is fundamentally contrary to the mandate under Article 22.

IV. INDONESIA'S METHODOLOGY REMAINS FATALLY FLAWED

1. The Level of Nullification or Impairment Reflects Lost Exports

27. First, as we already have addressed, Indonesia lacks any basis to assert that the calculation should reflect broader economic impacts such as those intended to be captured by a "multiplier." Arbitrators have articulated that the calculation of the level of nullification or impairment should "correspond to the trade directly affected by the maintenance" of the measure that is in breach. The only relevant report that Indonesia cites to support its argument for using some supposed broader economic impact is *US – Gambling*; however, the arbitrator in that arbitration rejected the "multiplier" argument.

2. Indonesia's Arguments on Demand Is Not Realistic

28. Even discounting the multiplier, Indonesia's proposed level of $15.9 million reflects incorrect assumptions about demand. First, Indonesia is incorrect that two aberrant years of higher export levels are evidence of an upward trend in demand. It is not uncommon that individual brands of cigarettes would experience several years of increased sales, even as, over time, the sales of that brand follow the overall downward trend. In addition, it is reasonable to assume that the levels in the period before the ban were affected by anticipation of Section 907.

29. Second, Indonesia's contention that consumption of clove cigarettes would increase while overall consumption of cigarettes is decreasing ignores regulatory and economic realities. Federal and state regulatory measures affect demand, as we already have discussed in our submission and responses. In addition, federal, state, and local taxes affect all cigarettes regardless of the brand or type. Together, federal and state taxes per pack of 20 increased by 75 percent from $1.46 per pack of 20 from 2006-2008 and $2.56 per pack of 20 in 2013. The tax increase alone would have increased the retail price by 26.3 percent. Taxes accounted for 44.4 percent of the average retail price for cigarettes in 2013, up from an average of 35.1 percent for the period between 2006 and 2008. This trend will only continue. Price elasticity for smoking tobacco products ranges between -0.6 to -0.3. Given the elasticity range, the price increase would have reduced the consumption of clove cigarettes by between 8 percent and 16 percent, even without the effect of U.S. regulatory measures and educational campaigns. It is not credible that these factors would apply to all cigarettes in the United States except clove cigarettes.

3. The Level of Nullification or Impairment Should Not Reflect Inflation

30. Indonesia provides a new figure, $17.2 million, purporting to reflect its "base" level of $15.9 adjusted by the rate of inflation between 2010 and 2013. To our knowledge, no arbitrator has calculated inflation into the level of nullification or impairment. In addition, any calculation based on the assumption of a price increase would need to take into account the demand effect.