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

RECOURSE TO ARTICLE 22.6 OF THE DSU

(DS406)

Opening Statement
of the United States of America
at the Meeting With the Arbitrator

March 27, 2014

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I. INTRODUCTION

1. Mr. Chairman, members of the Arbitrator: at the outset, we would like to express the appreciation of the United States to you, and to the Secretariat staff assisting you, for your service in this dispute. During the meeting today, we look forward to addressing any questions you may have and the points raised in Indonesia's first submission and its response to the Arbitrator's questions.

2. The issue presented, as set out in Articles 22.4 and 22.7 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* ("DSU"), is whether Indonesia's proposed level of suspension of $42.9 million is equivalent to any purported nullification or impairment of the benefits accruing to Indonesia. As the United States demonstrated in its submission and answers,[1] Indonesia's proposed level is not equivalent, and there are three bases that establish this.

3. First, the United States has fully implemented the recommendations and rulings of the Dispute Settlement Body ("DSB") in this dispute.

4. Second, there is no reasonable compliance scenario that would involve weakening the public health measure at issue. Thus, it is entirely unrealistic to base a nullification or impairment calculation on the premise that Section 907 and for clarification we will refer to the measure, 907(a)(1)(A) as 907 for purposes of this statement, would be removed.

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[1] *See*, in particular, U.S. Response to Arbitrator Question No. 1(b), paras. 3-4.

5. And third, Indonesia has – despite U.S. regulatory efforts – continued the same level of exports of cloves to the U.S. market. Therefore, authorizing suspension at any level would not be equivalent to the level of nullification or impairment being experienced by Indonesia.

6. Indonesia has failed to show that the measures taken by the United States to implement the DSB's recommendations and rulings are insufficient. The Arbitrator may determine that there is no nullification or impairment of the benefits accruing to Indonesia under Article 2.1 of the *Agreement on Technical Barriers to Trade* ("TBT Agreement") on this basis alone. However, if the Arbitrator wishes to first examine Indonesia's proposed level and methodology, even aside from the fact of U.S. compliance, the necessary conclusion still would be that the level of any nullification or impairment is zero.

7. Before turning to our specific points, it is useful to turn briefly to the broader context of the measure at issue.

8. Fundamental to the circumstances of this dispute is the fact that Section 907 is a public health measure addressing what has been recognized by the World Health Organization ("WHO") as a global public health crisis. The WHO recognizes tobacco use as "the world's number one preventable killer."[2]

9. The WHO recommends that regulators adopt a comprehensive set of measures to reduce the use of tobacco. These recommendations are set out in the WHO's Framework Convention on Tobacco Control ("FCTC").[3] Consistent with this approach, the U.S. ban on cigarettes with

[2] "The Changed Face of the Tobacco Industry," Dr. Margaret Chan, Director-General of the World Health Organization, March 20, 2012 (Exhibit US-29).

[3] World Health Organization, Framework Convention on Tobacco Control (Orig. Exhibit US-69).

characterizing flavors is part of a serious, sustained, and multi-front effort by the United States to combat the public health crisis caused by tobacco products. The United States has implemented measures consistent with nearly all of the WHO recommendations, including mandating smoke-free public spaces; regulating the content, advertising, packaging, and labeling of tobacco products; educating the public about the dangers of tobacco; and imposing taxes on tobacco products. The United States has steadily increased these and other measures for more than two decades, and, as a result, tobacco consumption in the United States has declined by 42 percent since 1992.

10. The 2009 Tobacco Control Act, [4] which includes Section 907, is a comprehensive measure designed to address the multi-faceted and complicated problem of use and addiction in the United States. Section 907 – which plays an important role in discouraging young people from taking up the habit of smoking – is one part of the broader effort of the United States to aggressively combat smoking among young people and the general population as well as the illness and death associated with this addiction. Section 907 itself is designed to target a specific niche of cigarettes that get youth hooked on smoking.

11. The concerted effort of the United States to reduce smoking within its borders almost exclusively affects U.S. products. U.S. products overwhelmingly dominate the market for cigarettes in the United States with 97 percent market share. U.S. firms have lost approximately $567 million in U.S. sales since the Tobacco Control Act, including Section 907, went into effect. U.S. menthol producers have lost approximately $52 million. The Youth Tobacco Prevention Campaign, in which the United States has already invested $115 million for the first

[4] The Federal Food, Drug and Cosmetic Act ("FFDCA") (as amended by the Family Smoking Prevention and Tobacco Control Act (Tobacco Control Act).

two years, furthers this adverse impact on U.S. domestic producers. Indeed, the public education campaign is expected to further reduce the U.S. market for what are primarily U.S. tobacco products, and for menthol cigarettes in particular.

12. Regulating tobacco products is challenging because cigarettes are highly addictive and because the tobacco industry uses every means available to expand its market. Relevant to this dispute, the tobacco industry (including producers of clove cigarettes) has apparently sought to use the classification of "cigars" to reach consumers that Section 907 is designed to protect, because the measure does not apply to flavored tobacco products other than cigarettes.[5] For decades, it has been an unfortunate reality that as regulators take measures to restrict the availability of cigarettes and to reduce their tremendous toll, the tobacco industry actively works at cross-purposes to enlist new smokers who then become addicted.[6]

13. Although Section 907 bans clove cigarettes, in reality, Indonesia is not experiencing any interruption in its level of exports of clove cigarettes to the United States, because it has minimally reconstituted the product and packaged it as a clove "cigar." As such, Indonesia continues to export the same level of clove products to the United States. Clove cigar exports from Indonesia rose from effectively zero before Section 907 to over $11 million immediately after Section 907 took effect. There is no basis for Indonesia to claim its benefits are being nullified or impaired, let alone to propose that the level of suspension should be nearly three times the actual level of trade that was occurring before the measure entered into force (a level of trade that continues to this day).

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[5] "Not your Grandfather's Cigar: A New Generation of Cheap and Sweet Cigars Threatens a New Generation of Kids," Campaign For Tobacco Free Kids, March 2013 (Exhibit US-30).

[6] "The Changed Face of the Tobacco Industry" (Exhibit US-29). "Not your Grandfather's Cigar" (Exhibit US-33).

II. THE UNITED STATES HAS BROUGHT ITS MEASURE INTO COMPLIANCE WITH THE DSB'S RECOMMENDATIONS AND RULINGS

14. Turning to the issue of compliance, the United States has brought Section 907 into conformity with Article 2.1 in three ways: (1) by 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 Advanced Notice of Proposed Rulemaking ("ANPRM") designed to advance possible appropriate regulatory measures affecting menthol cigarettes; and (3) by 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.

15. The United States has addressed the insufficiency addressed by the Appellate Body by conducting further scientific analysis, the results of which demonstrate that the regulatory distinction between clove and menthol cigarettes is legitimate. And the United States is applying measures to clove cigarettes and menthol cigarettes consistent with the status of available science on the public health implications of each product.

16. Indonesia's core argument is that the United States cannot bring Section 907 into compliance by demonstrating that any remaining detriment to clove cigarettes stems exclusively from a legitimate regulatory distinction.

17. Tobacco regulation – in all countries, including the United States – requires drawing distinctions among tobacco products based on current scientific understanding of how those products are used, by whom, in what volume, and with what effect on the public's health, addiction level, ability to quit, and the likely effects associated with potential measures. As the Appellate Body noted, all cigarettes contain nicotine and can be used to satisfy addiction.[7] This is true of tobacco products generally. However, no Member regulates all tobacco products in exactly the same way. Distinctions are made, and lines are drawn.

18. Section 907 does not apply to menthol cigarettes – even though those cigarettes contain a characterizing flavor. The DSB recommendations and rulings found that the measure lacked a sufficient basis for this different treatment of menthol cigarettes compared to clove cigarettes – that is, for the regulatory distinction drawn by the United States. In this respect, the Appellate Body found that the United States had not provided a sufficient basis to conclude that a product characteristic specific to menthol cigarettes would indicate that, if menthol cigarettes were banned, consumer reactions would strain cessation services or worsen the illicit market.

19. Subsequently, the U.S. Food and Drug Administration ("FDA") undertook a comprehensive scientific evaluation of existing information on menthol cigarettes. The resulting FDA Menthol Report finds that the presence of menthol in cigarettes likely increases addiction and makes quitting more difficult. This characteristic of menthol cigarettes provides evidence of the regulatory distinction that the Appellate Body found to be lacking: there is a legitimate regulatory distinction between a cigarette that is used pervasively and likely associated with

[7] *US – Clove Cigarettes (AB)*, para. 225.

increased addiction, and a cigarette that is used by the smallest fraction of the young population, often as a "starter" cigarette before taking up more mainstream products.

20. 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.[8] 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. Indeed, the scientific evidence may demonstrate that it would be inappropriate to change the distinction drawn in that measure, for to do so would result in the Member not achieving its legitimate objective at the level it considers appropriate.[9]

21. Indonesia argues incorrectly that the findings in the FDA Report should be disregarded because the Tobacco Products Scientific Advisory Committee ("TPSAC") reached similar findings in its July 2011 Report. As an initial matter, the TPSAC Report is not a U.S. Government evaluation. U.S. administrative procedure requires that any potential regulatory action with respect to menthol cigarettes 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

[8] U.S. Responses to Arbitrator Question No. 6, paras. 7-15.

[9] TBT Agreement, Art. 2.2; preamble, sixth recital.

not rely upon the TPSAC Report, but conducted its own evaluation, taking account of sources also used in the TPSAC Report in addition to other existing information and additional analyses.

22. In addition, because the preliminary TPSAC Report was issued in March 2011, near the close of the original panel proceedings, its use in the panel proceedings was limited. Neither party submitted the TPSAC Report as evidence. The Panel noted that it would rely upon the report to "corroborate" its findings.[10] Of course, the TPSAC Report was not available to the U.S. Congress when it enacted Section 907. As the United States presented to the original panel, the legislative record demonstrates that Congress drew its distinction between menthol and regular cigarettes, on the hand, and other flavored cigarettes, on the other hand, based on factors such as prevalence and demographics of use. It was not clear at that time that there was information available to the Congress that a particular characteristic of menthol cigarettes contributes to the risk factors it identified. Congress determined that because use of menthol cigarettes is so pervasive, further analysis of possible risks associated with potential regulatory measures was warranted. Congress directed the FDA to undertake such evaluation.

23. Finally, Indonesia further 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.[11] Indonesia asserts that the United States was obligated to undertake the same analysis with respect to clove consumption in the United States.

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[10] *US – Clove Cigarettes (Panel)*, para. 7.228.

[11] Indonesia's Written Submission, para. 69.

24. This contention is unfounded. Indonesia ignores that the regulatory distinction is a combination of the fact that menthol cigarettes are likely associated with increased addiction and difficulty with cessation, and the fact that menthol use in the United States is far more pervasive, especially among adults, than clove use was. Accordingly, the use of clove cigarettes in the United States did not pose the same regulatory challenge. The fact is that clove cigarettes were not as widely used, and so the ban did not pose a risk of black market or strain on the healthcare system, regardless of whether the presence of clove makes the cigarettes more addictive or more difficult to quit. Indeed, there is no indication that the ban of clove and other flavored cigarettes has resulted in any countervailing effects, and Indonesia has not alleged that it has.

III. INDONESIA HAS NOT REBUTTED THE U.S. ARGUMENT THAT THERE IS NO NULLIFICATION OR IMPAIRMENT OF THE BENEFITS ACCRUING TO INDONESIA WITH RESPECT TO ARTICLE 2.1 OF THE TBT AGREEMENT

25. 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,[12] but must reflect the alleged "full" or "total" impact on the broader Indonesian economy.[13] This argument is not consistent with the Arbitrator's mandate under Articles 22.4 and 22.7 of the DSU and is unsupported by the findings in prior Article 22.6 arbitrations.

26. As a starting point, Indonesia misconstrues the purpose of this proceeding when it asserts that the "*purpose of a determination of the level of nullification or impairment* is to arrive at an

[12] Indonesia's Response to Arbitrator Question No. 16, para. 32

[13] Indonesia's Response to Arbitrator Question Nos. 16, 32, paras. 30-32, 58.

appropriate level of suspension of obligations or concessions."[14] Accurately stated, the *purpose of an Article 22.6 proceeding* is to "determine whether the *[proposed] level of suspension is equivalent* to the level of nullification or impairment."[15] Significantly, throughout its analysis, Indonesia replaces the requirement that the level of suspension be "equivalent" to the level of nullification or impairment with its own concept that the level of suspension must be "appropriate." The point of these unfounded interpretations appears to be to justify Indonesia's assertion that the level of suspension should reflect the alleged "total" or "full" impact of Section 907,[16] and that a counterfactual should be adopted on the basis of what will produce this result.[17]

27. Through its faulty analysis, Indonesia fails to demonstrate that its proposed level of suspension – $42.9 million – is equivalent (using the correct standard) to the level of nullification or impairment of benefits accruing to Indonesia under the TBT Agreement. Indonesia likewise fails to rebut the U.S. argument that the level is zero.

28. In fact, in the course of its analysis, Indonesia acknowledges two central facts (even though its dismisses their relevance), which are fatal to its arguments and support the U.S. position. In particular, Indonesia concedes that:

- Indonesia's proposed counterfactual – removal of Section 907 – would negatively impact the public health and is not a form of compliance the United States would realistically take; and

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[14] Indonesia's Response to Arbitrator Question No. 16, para. 30. (emphasis added). Indonesia's Written Submission, paras. 107, 115.

[15] DSU, Article 22.7 (emphasis added).

[16] Indonesia's Response to Arbitrator Questions Nos. 16, 32, paras. 30-32, 58.

[17] Indonesia's Response to Arbitrator Questions Nos. 17, 21, paras. 34, 36, 40.

- There has been no loss of Indonesian exports resulting from Section 907.[18]

On the basis of these concessions, the only possible conclusion is that the level of nullification or impairment of the benefits accruing to Indonesia under Article 2.1 is zero.

29. This conclusion is supported by the facts and arguments without even reaching the issue of compliance. However, Indonesia similarly fails to demonstrate that U.S. measures taken to comply are insufficient to bring Section 907 into conformity with Article 2.1.

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

30. As just explained, Indonesia erroneously asserts that the level of suspension in this dispute must be "appropriate,"[19] a phrasing that contradicts the clear language of Article 22 of the DSU, which states that the level of suspension must be "equivalent" to the level of nullification and impairment.[20] Indonesia then proceeds to offer interpretations of "appropriate" that have no basis in Article 22 and do not appear in prior arbitration awards.

31. The United States does not understand from where Indonesia is deriving this standard. However, 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 Articles 4.10 and 4.11 of the *Agreement on Subsidies and Countervailing Measures* ("SCM Agreement"). SCM Articles 4.10 and 4.11 provide that in the event of a failure to follow the DSB recommendations and rulings with respect to a prohibited subsidy, the

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[18] Indonesia's Response to Arbitrator Questions Nos. 16, 22, 26, paras. 31, 45, 47, 49.

[19] Indonesia's Response to Arbitrator Questions Nos. 16, 17, 21, 32, paras. 30, 34, 40, 58.

[20] DSU, Article 22.4; DSU, Article 22.7

DSB is to authorize the complaining Member to take "appropriate countermeasures." 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.[21]

32. By contrast, arbitrators have not applied the "appropriate" standard in arbitrations conducted pursuant to DSU Article 22.6. For example, the arbitrator in *US – Offset Act (Byrd Amendment) (Brazil) (Article 22.6 – US)* specifically declined to apply the "appropriate" standard in the context of that Article 22.6 proceeding, stating that it had no discretion to authorize suspension in excess of what is "equivalent" to the level of nullification or impairment.[22] Indeed, in every arbitration where there has not been a prohibited subsidy, arbitrators have found that the level of suspension of concessions must be "equivalent" to the level of nullification or impairment.[23] Accordingly, there is no basis in this proceeding to adopt Indonesia's approach.

B. A "Reasonable" Counterfactual Reflects a Realistic Situation in the Event of Compliance

33. In addition to arguing for the wrong legal standard, Indonesia's arguments are flawed because they are based on a counterfactual that is not reasonable. Additionally, Indonesia has failed to demonstrate that the counterfactual proposed by the United States is unreasonable.

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[21] *US – FSC (Article 22.6 – EU)*, paras. 5.51-52; *Brazil – Aircraft (Article 22.6 – Canada)*, paras. 3.41-3.60.

[22] U.S. Response to Arbitrator Question No. 18, para. 80; *US – Offset Act (Byrd Amendment) (Brazil) (Article 22.6 – US)*, paras. 3.43-3.55.

[23] *EC – Bananas III (US) (Article 22.6 – EC)*, paras. 4.1, 4.2, 6.3.

34. 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."[24] Of course, as already noted, Indonesia errs in relying on the standard of "appropriate" rather than "equivalent."

35. Indonesia claims to find support for its approach in *US – Gambling (Article 22.6 – US),*[25] but Indonesia mischaracterizes the findings in that arbitration. The arbitrator in *US – Gambling* noted that a counterfactual need not be the "most likely" but must at least be "plausible" or "reasonable."[26] Nowhere, however, does the arbitrator suggest, as Indonesia does here, that a counterfactual is "plausible" or "reasonable" "to the degree which the resulting level of nullification or impairment of benefits is appropriate."[27] Rather, the *US – Gambling* arbitrator links the concepts of plausibility and reasonableness to the standard of equivalence,[28] and notes that a reasonable counterfactual takes account of the particular circumstances of the dispute.[29] The arbitrator expressly identified a Member's policy objectives as relevant circumstances, and adopted a counterfactual reflecting U.S. policy objectives.[30]

36. Indonesia justifies its proposed counterfactual only in terms of what it considers "appropriate" or likely to induce compliance[31] – and not in terms of the circumstances of the

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[24] Indonesia's Response to Arbitrator Questions Nos. 17, 21, paras. 34, 36, 40.

[25] Indonesia's Response to Arbitrator Question Nos. 17, 21, paras. 34, 36, 40.

[26] *US – Gambling (Article 22.6 – US)*, paras. 3.25-27.

[27] Indonesia's Response to Arbitrator Question No. 17, para. 34.

[28] *US – Gambling (Article 22.6 – US)*, para. 3.27

[29] U.S. Response to Arbitrator Question No. 18, paras. 78-79.

[30] U.S. Response to Arbitrator Question No. 18, paras. 78-79.

[31] Indonesia's Written Submission, paras. 107, 115, 124, 126; Indonesia's Response to Arbitrator Question Nos. 16, 32, paras. 30-32, 58.

dispute. In fact, 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.[32] The implicit suggestion is that the Arbitrator should adopt a counterfactual that is not realistic at all.

37. However, a counterfactual that does not reflect a course of compliance that the United States might realistically take is not plausible or reasonable. Indeed, the Appellate Body has expressly disavowed Indonesia's approach, explaining in *EC – Asbestos*: "In our view, France [the responding party] could not reasonably be expected to employ *any* alternative measure if that measure would involve a continuation of the very risk that the Decree seeks to 'halt'."[33] Here, Indonesia's counterfactual "would involve a continuation of the very risk" that Section 907 seeks to halt, the serious risk to public health from cloves and other flavored cigarettes. As such, Indonesia's counterfactual is not reasonable.

38. On the other hand, the counterfactual proposed by the United States – which would maintain Section 907 – is reasonable because it represents an action that the United States would plausibly take in striving to continue to fulfill its objective of protecting the public health.

39. Because Indonesia has failed to show that its counterfactual is reasonable, or that the U.S. counterfactual is unreasonable, it has ultimately failed to show that there would be any difference in the level of exports under a reasonable counterfactual.

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[32] Indonesia's Response to Arbitrator Questions Nos. 17, 21, paras. 36, 40.

[33] *EC – Asbestos (AB)*, para. 174.

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

40. Indonesia has failed to show that Section 907 causes a decrease in the level of exports of clove cigarettes. As the United States has noted in its submissions, Kretek International ("Kretek") has "adapted" Djarum brand clove cigarettes so that they may continue to be exported to the United States at the same level as they were prior to the U.S. adoption of Section 907. Kretek's so-called "clove cigars" are, by the company's own statements, essentially identical to clove cigarettes and are advertised and sold to the same consumers through the same distribution channels.[34] Djarum accounted for 97 percent of clove cigarette exports to the United States before Section 907, and accounts for more than 99 percent of clove "cigars" exported to the United States after Section 907. It is notable that there were practically no clove "cigar" exports to the United States until Kretek adapted Djarum clove cigarettes to distribute them as "cigars" after the U.S. measure was adopted.[35]

41. Indonesia does not dispute any of these facts or others that the United States has put forth with respect to clove cigars. Rather, Indonesia claims these facts are irrelevant to the calculation of nullification or impairment because: (1) the activity of private entities is not relevant to the calculation of nullification or impairment;[36] (2) Kretek is located in the United States;[37] and (3) Djarum is only a single brand of Indonesian clove cigarettes.[38]

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[34] U.S. Written Submission, paras. 14-20, 96-101; U.S. Response to Arbitrator Question No. 22, paras. 87-92.

[35] Exhibit US-5.

[36] Indonesia's Written Submission, paras. 110, 118-120; Indonesia's Response to Arbitrator Questions Nos. 22, 26, paras. 45-49.

[37] Indonesia's Response to Arbitrator Question No. 22, para. 45.

[38] Indonesia's Response to Arbitrator Question No. 22, para. 46.

42. These responses are off point. Of course the activity of private entities is relevant to the calculation of nullification or impairment, and Indonesia itself calculates the level of nullification or impairment based on the activity of private entities. In fact, to the extent that Djarum clove cigarettes comprised 97 percent of Indonesian exports of clove cigarettes to the United States before Section 907 – again Indonesia does not contest – the level of exports contained in Indonesia's own calculation reflects the activity of these same private entities.

43. The determination of nullification or impairment is based on an actual loss of trade flows. Therefore, Indonesia is incorrect in arguing that continued trade flows are irrelevant. Moreover, in the course of making this assertion, Indonesia confirms that, in fact, its exports have continued after Section 907.[39] In particular, Indonesia states that:

> [T]he 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*.[40]

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. In this instance, "cover its losses" means that Kretek is continuing to market essentially the same harmful product that the U.S. measure prohibits for the protection of the public health.

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[39] Indonesia's Response to Arbitrator Question Nos. 16, 22, 26, paras. 31, 45, 47, 49.

[40] Indonesia's Response to Arbitrator Question No. 16, paras. 30-31 (emphasis added).

44. Indonesia also states that:

> In Indonesia's view, it should not be surprising to the United States or the Arbitrator that certain private interests adopted business strategies that included *adapting products to allow for their continued sale in the United States following the imposition of the ban on flavored cigarettes in Section 907[;]*[41] *and*
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> * * *
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> *[T]he ability of a single Indonesian manufacturer to develop a product that can be sold in the United States after the implementation of the ban* does not indicate that there has been no nullification or impairment.[42]

Again, Indonesia agrees with the United States that Indonesian clove cigarette exporters "adapted" their products to "allow for their continued sale in the United States."

45. Indeed, the TBT Agreement contemplates that Members will "adapt" their products and production methods to conform to technical regulations. Of course, from the perspective of the public health, it is not a desirable outcome that tobacco product manufacturers continually seek to adapt their products to avoid restrictions. Nevertheless, under the TBT Agreement, there is no nullification or impairment where a complaining Member maintains its level of exports by adjusting to a technical regulation. Because of the adjustments explained in Kretek's July 2009 Sales Presentation,[43] Indonesia has been exporting a consistent level to meet the U.S. clove

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[41] Indonesia's Response to Arbitrator Question No. 26, para. 47 (emphasis added).

[42] Indonesia's Response to Arbitrator Question No. 26, para. 49 (emphasis added).

[43] Exhibit US-9.

market, despite Section 907. In these circumstances, to find any level of suspension of concessions would, in effect, be "double-counting."

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

46. The essence of Indonesia's argument with respect to Articles 2.9.2 and 2.12 of the TBT Agreement is that Indonesia bears no burden to specify and substantiate any level of nullification or impairment. [44] Rather, Indonesia argues that the Arbitrator must determine that the United States remains in non-compliance with Articles 2.9.2 and 2.12, [45] and that, therefore, nullification or impairment necessarily exists.[46]

47. Indonesia's argument is fundamentally incorrect. The United States put forth a *prima facie* case that the level of nullification or impairment of the benefits accruing to Indonesia under Articles 2.9.2 and 2.12 is zero. Indonesia has specified no level of *actual* nullification or impairment. Instead, Indonesia has offered flawed excuses for why it need not demonstrate a level of nullification or impairment with respect to these articles. On this basis, the only possible conclusion is that the level of nullification or impairment with respect to these articles is zero.

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[44] Indonesia's Written Submission, para. 106; Indonesia's Response to Arbitrator Questions Nos. 12, 13, 15, paras. 17, 20-21, 27-29.

[45] Indonesia's Written Submission, paras. 106, 132, 133; Indonesia's Response to Arbitrator Question No. 12, paras. 18, 20-22.

[46] Indonesia's Written Submission, para. 106; Indonesia's Response to Arbitrator Questions Nos. 12, 13, 15, paras. 17, 20-21, 27-29.

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

48. As an initial matter, Indonesia's approach, relying on the rebuttable presumption in Article 3.8 of the DSU, 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.

49. The approach that Indonesia claims is required in this arbitration is actually based upon, and reflective of, an approach taken by panels and the Appellate Body in proceedings to determine compliance, such as under Article 21.5 of the DSU.[47] In that context, where panels and the Appellate Body have been asked to consider whether nullification or impairment exists, they have quickly dispensed with the question,[48] noting that the level of nullification or impairment is properly addressed by arbitrators in Article 22.6 proceedings.[49] Thus, when Indonesia states that even an impairment of a Member's "expectations of competitive opportunities" could constitute nullification or impairment, it relies upon an irrelevant finding in *EC – Bananas III (Article 21.5 – US)*, [50] where the Appellate Body was simply making the point that a Member need not demonstrate a level of actual nullification or impairment as a requirement to bring a claim of non-compliance.[51]

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[47] Indonesia's Written Submission, paras. 95-105; Indonesia's Response to Arbitrator Question No. 15, paras. 27-29.

[48] U.S. Response to Arbitrator Question No. 15, paras. 64-68.

[49] U.S. Response to Arbitrator Question No. 15, para. 66 (citing *EC – Bananas III (US) (Article – 22.6)*, para. 6.10).

[50] Indonesia's Response to Arbitrator Question No. 15, paras. 27-28.

[51] U.S. Response to Arbitrator Question No. 15, para. 64 (citing *EC – Bananas III (Panel)* para. 7.5; *EC – Bananas III (AB)*, para. 254).

50. The purpose of the current proceeding is different. 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 expressly recognized that assessing the level of nullification or impairment under Article 22.6 is a "separate process" that is "independent" from the finding of breach by the panel or Appellate Body in the underlying proceedings.[52] The arbitrator stated 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."[53] The arbitrator goes on to reject speculative notions of nullification or impairment, such as "expectations of competitive opportunities," and finds instead that the level of nullification or impairment should be the losses in exports of goods or services caused by the EU's WTO-inconsistent tariff quotas on bananas and licensing regime.[54]

51. In other words, the arbitrator in *EC – Bananas III* found that the level of nullification or impairment must reflect actual trade losses. Thus, Indonesia is plainly wrong to contend that "the panel and Appellate Body's findings of a breach of TBT obligations amounts to a finding that nullification or impairment of benefits to Indonesia exists."[55] To the contrary, a finding of breach has no bearing on the question at issue in this proceeding, which is whether and to what extent nullification or impairment exists.

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[52] U.S. Response to Arbitrator Question No. 15, para. 66 (citing *EC – Bananas III (US) (Article – 22.6)*, para. 6.10).

[53] U.S. Response to Arbitrator Question No. 15, para. 66 (citing *EC – Bananas III (US) (Article – 22.6)*, para. 6.10).

[54] *EC – Bananas III (US) (Article – 22.6)*, paras. 6.11-6.13.

[55] Indonesia's Response to Arbitrator Question No. 12, para. 17

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

1. Indonesia Must Specify the Level of Nullification or Impairment With Respect to Each Alleged Ongoing Breach

52. Indonesia claims that its proposed suspension level of $42.9 million should be authorized with respect to any or all of the alleged breaches because the nullification or impairment "comes from the impact of the measure" and, therefore, Indonesia need not specify or substantiate the level of nullification or impairment with respect to each article.[56]

53. However, whatever merit Indonesia's argument might have in other contexts, it does not apply in this proceeding.

54. Where different breaches stemming from different acts, measures or obligations result in different trade effects, the arbitrator must assess what losses result from the different breaches. For example, in *EC – Bananas III*, the arbitrator took account of the different nature of the breaches of the *General Agreement on Tariffs and Trade 1994* ("GATT 1994") and the *General Agreement on Trade in Services* ("GATS").[57] In determining the counterfactual situation of compliance and the resulting level of nullification or impairment, the arbitrator took account of the different nature and extent of losses stemming from the different breaches.[58]

55. Similarly, in this dispute, the breaches upon which Indonesia bases its request for suspension are different in three key aspects.

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[56] Indonesia's Response to Arbitrator Question No. 13, para. 20.

[57] *EC – Bananas III (US) (Article – 22.6)*, paras. 7.7-7.8.

[58] *EC – Bananas III (US) (Article – 22.6)*, para. 7.8.

a. The Breaches of Articles 2.9.2 and 2.12 Stemmed From Acts, Not the Measure

56. First, the DSB made separate, distinct recommendations and rulings with respect to the "measure" (Section 907) and the "actions" that were found to be in breach of Articles 2.9.2 and 2.12.[59] Based on the panel and Appellate Body reports, any alleged nullification or impairment of the benefits under Article 2.9.2 or 2.12 would result from U.S. acts. This is not a semantic difference. As we will explain further, the benefits accruing to Indonesia under Articles 2.9.2 and 2.12 (which discipline Members' acts) and Article 2.1 (which disciplines Members' measures) are different. Therefore, Indonesia is incorrect that $42.9 million should be authorized with respect to any or all of the alleged breaches because the nullification or impairment "comes from the impact of the measure." With respect to Articles 2.9.2 and 2.12, any alleged nullification or impairment would not come from the measure.

b. Articles 2.9.2 and 2.12 Are Inherently Limited Temporally

57. Second, Articles 2.9.2 and 2.12 – while important – are inherently limited temporally.[60] They apply at the stages before a measure takes effect, and are expressly designed to provide an opportunity for Members to offer comments or amendments to a proposed measure (Article 2.9.2) and for their producers to adapt their products or methods of production within a period of time from publication of a the measure (Article 2.12). By contrast, Article 2.1 concerns the relative treatment accorded by an existing measure to domestic versus imported products. Article 2.1 is *not* inherently limited temporally.

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[59] U.S. Response to Arbitrator Question No. 11, paras. 46-48

[60] U.S. Response to Arbitrator Question No. 11(e), para. 59.

58. 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. In the case of Article 2.9.2, the measure is no longer proposed; in the case of Article 2.12, any "reasonable interval" after publication before entry into force has passed. The DSU only provides for suspension of concessions with respect to current and prospective trade losses, and prior arbitrators have been careful to avoid including in nullification or impairment calculations of any trade losses that are retrospective.[61]

c. The Benefits Accruing Under Articles 2.9.2 and 2.12 Are Different From Those Accruing Under Article 2.1

59. Third, and relatedly, 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 limited 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. Because the benefits are different, any resulting nullification or impairment would be different. 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. In this instance, Indonesia has not shown that U.S. breaches of Articles 2.9.2 or 2.12 result in any trade losses.

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[61] *See, e.g., EC – Bananas III (US) (Article – 22.6),* para. 5.45.

60. Therefore, Indonesia is incorrect that the Arbitrator must assume that the level of nullification or impairment must be the same with respect to any or all of the alleged continuing breaches.

2. Indonesia Has Not Articulated How Its Proposed Counterfactual Would Result in an Accurate Calculation of the Level of Nullification or Impairment of the Benefits Accruing to Indonesia Under Articles 2.9.2 or 2.12

61. Indonesia also submits what is effectively a misplaced tautology: that the only "reasonable" compliance scenario would be the withdrawal of Section 907;[62] 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.[63] This position is without merit. Even Indonesia recognizes that it is "Indonesia's burden to show that its compliance scenario is 'reasonable' and that the trade flows that will be assessed to occur under the counterfactual provide a reliable basis for an estimation of the level of nullification or impairment of such benefits."[64] Indonesia properly articulates its burden, but has failed to meet it.

62. As an initial matter, Indonesia's proposed counterfactual is not "reasonable" with respect to Article 2.1 or with respect to Articles 2.9.2 or 2.12. Any counterfactual concerning Articles 2.9.2 or 2.12 that requires withdrawal of Section 907 would be inconsistent with the DSB

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[62] Indonesia's Written Submission, para. 112; Indonesia's Response to Arbitrator Question No. 20, para. 38.

[63] Indonesia's Written Submission, paras. 81, 106, 112, 132-133; Indonesia's Response to Arbitrator Question Nos. 13, 20, paras. 19, 20-22, 38.

[64] Indonesia's Response to Arbitrator Question No. 20, para. 38.

recommendations and rulings in this dispute. 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 changes to the measure, let alone its withdrawal.

63. Furthermore, for the reasons the United States has already explained and will address again today, it would be unreasonable to expect the United States to weaken or eliminate Section 907. Such an alternative would involve a continuation of the very risk that the measure seeks to halt, yet the DSB recommendations and rulings agree that Section 907 fulfills a legitimate objective in seeking to halt the risk to the public health from clove cigarettes.[65]

64. Moreover, even aside from the other fatal flaws in Indonesia's approach, 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. Any reasonable counterfactual that would result in an accurate calculation must allow for the measuring of any current or prospective nullification or impairment of those benefits. Indonesia's proposed suspension level of $42.9 million under this counterfactual bears no relationship to the benefits accruing to Indonesia under Articles 2.9.2 and 2.12 – benefits having to do with consultation and production adaptation before a measure enters into effect, and not with the treatment subsequently accorded by the measure itself.

[65] *EC – Asbestos (AB)*, para. 174.

65. Accordingly, to proceed under this unreasonable counterfactual, Indonesia would need to set forth a comparison between the actual value or level 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 or level of its benefits under a proposed counterfactual. However, it is difficult to see how there would be any difference in the value or level of benefits accruing to Indonesia under the actual situation today and the hypothetical scenario. Given that Indonesia actually *did* provide input on Section 907,[66] and that its producers already *have* adapted their products to the measure,[67] and that these actions occurred more than four years ago, there is no basis to assume that there is currently any trade effect. Indeed, there is no disagreement between the parties that Indonesia has adapted its product to allow for its continued sale.[68]

66. For the reasons just set out, Indonesia has not established a level of nullification or impairment of its benefits accruing under Articles 2.9.2 or 2.12. There is no disagreement between the parties that Indonesia has not specified or substantiated any level with respect to these articles. Rather, Indonesia maintains that it need not do so. By contrast, the United States has demonstrated that, in fact, the level is zero. Therefore, the only conclusion supported by the facts and arguments in this proceeding is that there is no level of nullification or impairment of the benefits accruing to Indonesia under Articles 2.9.2 or 2.12.

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[66] U.S. Written Submission, para. 53.

[67] U.S. Written Submission para. 54; Indonesia's Response to Arbitrator Questions Nos. 16, 22, 26, paras. 31, 45, 47, 49.

[68] Indonesia's Response to Arbitrator Question No. 26, para. 47.

C. Indonesia's Approach Would Have Serious Systemic Implications

67. 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 likely at odds with the expectations and intentions of the WTO membership. Requiring the removal of a technical regulation where a Member is found to have failed to notify the proposed measure in a timely manner, or failed to provide a reasonable interval between publication and entry into force, would call into doubt the legitimacy of potentially hundreds of technical regulations currently in force in at least dozens of WTO Members. Such a dramatic extent of potential inconsistency with WTO obligations further supports a commonsense understanding that coming into compliance need not mean removal of a measure.

68. 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.[69] 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.

69. With respect to the Article 2.9.2 requirement that Members generally notify technical regulations that may have a significant effect on the trade of other Members, the survey suggests that there is a high degree of disparity in the Members' level of notifications. Notifications from only 15 Members (9 percent of WTO Membership) comprise over half of all the technical

[69] Survey of TBT Notifications and Intervals Between Publication and Entry Into Force of Technical Regulations (Exhibit US-31).

regulation notifications.[70] At the other extreme, 40 Members (25 percent of WTO Membership) have never notified a technical regulation.[71] This disparity suggests that possibly dozens of Members have adopted any number of technical regulations that are vulnerable to challenge under Article 2.9.2 of the TBT Agreement.

70. Indonesia, in particular, has drawn concern in the TBT Committee for failing to notify proposed measures. At several recent TBT Committee meetings, Members raised concerns about Indonesia's failure to notify the TBT Committee of several proposed technical regulations, for example, a measure which requires that a pre-approved label in Bahasa Indonesia be affixed to every good prior to entry into Indonesia (Ministry of Trade Regulations 62/2009 and 22/2010).[72] One member noted that Indonesia's failure to notify marked the third occurrence in a short period of time that legislation containing important requirements affecting a large number of goods had not been notified to the TBT Committee.[73] In response to the concerns expressed by Members, the Indonesian delegation declared at the June 2013 TBT Committee meeting that they would encourage their government to notify timely its technical regulations.[74]

71. With respect to the Article 2.12 requirement that Members generally allow a reasonable interval between the publication and entry into force of a technical regulation, a survey of only a fraction of technical regulations enacted in a sampling of Members suggests significant potential vulnerability under this provision as well. The United States was able to verify (through a limited sampling) that at least 10 Members, including Indonesia, have adopted technical

[70] TBT Survey (Exhibit US-31).

[71] TBT Survey (Exhibit US-31).

[72] TBT committee meeting minutes, G/TBT/M/52, para. 29 (Mar. 10, 2011) (Exhibit US-32).

[73] TBT committee meeting minutes, G/TBT/M/52, paras. 26 – 28 (Mar. 10, 2011) (Exhibit US-32).

[74] TBT committee meeting minutes, G/TBT/M/60, para 3.46 (Sept. 23, 2013) (Exhibit US-34).

regulations without providing at least 180 days in between publication and entry into force.[75] Indonesia has notified a total of 66 regular technical regulations under the TBT Agreement. For 15 of these (almost one quarter), Indonesia provided, on average, only 28 days between publication and entry into force.[76] Again, Indonesia's arguments in this proceeding would suggest that, for any breaches of Article 2.12, the only means for Indonesia to come into compliance would be withdrawal of all such measures.

72. The United States, like all Members, considers transparency requirements to be significant and important. Contrary to Indonesia's suggestion, however, that importance need not be validated or demonstrated through dispute settlement findings on compliance, or on nullification or impairment, that fail to take account of the nature of the breach, or the demonstrable extent of any resulting nullification or impairment.

73. 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[77] is fundamentally contrary to the mandate under Article 22.

74. Indonesia has not proposed that there would be any additional level of nullification or impairment under Articles 2.9.2 or 2.12 – and in fact has attested that there would not be.[78] Determining compliance is only within the scope of the mandate under Articles 22.4 and 22.7 to the extent that it is relevant to the level of nullification or impairment. In this circumstance, by Indonesia's own attestation, it would not be.

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[75] TBT Survey (Exhibit US-31).

[76] TBT Survey (Exhibit US-31).

[77] Indonesia's Response to Arbitrator Question No. 13, paras. 21-22.

[78] Indonesia's Response to Arbitrator Question No. 13, para. 20.

V. INDONESIA'S METHODOLOGY REMAINS FATALLY FLAWED

75. Finally, because the United States has demonstrated that there is no level of nullification or impairment of the benefits accruing to Indonesia under Articles 2.1, 2.9.2, or 2.12 of the TBT Agreement, it should not be necessary to consider Indonesia's proposed methodology. However, for the sake of completeness, the United States will address three errors that continue to inflate Indonesia's proposed level, in particular, the misuse of a multiplier, incorrect assumptions about demand, and the misuse of inflation.

1. The Level of Nullification or Impairment Reflects Lost Exports – Not Broader Economic Effects

76. 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." Since there is no basis to adopt Indonesia's approach in this proceeding, there is also no basis for Indonesia's proposed level of suspension. Arbitrators applying the standard of equivalence routinely have rejected the notion that broader impacts on an economy should be included.[79] Indeed, 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.[80]

77. The only relevant report that Indonesia cites to support its argument for using some supposed broader economic impact is *US – Gambling*; however, the findings Indonesia relies

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[79] U.S. First Written Submission, para. 118, fn. 141; U.S. Response to Arbitrator Questions Nos. 15, 18 , paras. 67, 80. *See, e.g., US – Gambling (Article 22.6 – US)*, para. 3.123; *EC – Hormones (US) (Article 22.6 – EC)*, paras. 41, 77; *EC – Bananas III (US) (Article 22.6 – EC)*, paras. 6.11-12; *US – 1916 Act (EC) (Article 22.6 – US)*, paras. 5.54 and 5.69.

[80] *See, e.g., US – Offset Act (Byrd Amendment) (Brazil) (Article 22.6 – US)*, paras. 3.43-3.55.

upon are not actually consistent with Indonesia's position. Indonesia cites to this report as evidence of the proposition that "arbitrators have previously noted that a multiplier may be used to calculate the full economic impact of an inconsistent measure and arrive at a reasonable level of nullification or impairment."[81] However, the arbitrator in *US – Gambling* expressly rejected the argument that nullification or impairment should reflect broader economic effects.[82] Accordingly, Indonesia has failed to rebut the U.S. argument that the proposed suspension level of $42.9 million is not equivalent to the level of nullification or impairment.

2. Indonesia's Arguments on Demand Do Not Match Regulatory or Economic Realities

78. Even discounting the multiplier, Indonesia's proposed level of $15.9 million reflects incorrect assumptions about demand. Indonesia points to increased export levels in 2007 and 2008 to justify its argument that (1) a benchmark period of 2007-2009, including hypothetical trade data for 2009, is more "accurate" because it can be assumed that demand for clove cigarettes was increasing[83] and (2) the consistent decline in U.S. consumption of cigarettes would not apply to clove cigarettes.[84]

79. 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, on the same basis that Indonesia claims that exports

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[81] Indonesia's Response to Arbitrator Question No. 32, para. 58; *see also* Indonesia's Written Submission, para.116.

[82] *US – Gambling (Article 22.6 – US)*, para. 3.123

[83] Indonesia's Response to Arbitrator Question No. 30, para. 54.

[84] Indonesia's Response to Arbitrator Question No. 39, para. 66.

dropped dramatically in the month Section 907 went into effect, it is reasonable to assume that the levels in the period before the ban were affected by anticipation of Section 907. There is simply no basis to treat a short spike as indicative of a trend. For that matter, to the extent Indonesia considers that the three year period before Section 907 went into effect is not representative of export levels, the period should be expanded to include additional years.[85]

80. Second, Indonesia's contention that consumption of clove cigarettes actually would increase while overall consumption of cigarettes is decreasing ignores regulatory and economic realities in the United States. In addition to the federal regulatory measures we already have discussed in our submission and responses, state spending on tobacco control programs averaged $559 million per year between fiscal year 2007 and fiscal year 2014. These investments in public education and other tobacco control programs affect all cigarette sales.

81. In addition, federal, state, and local taxes affect all cigarettes regardless of the brand or type. These taxes increased substantially between 2008 and 2013, especially at the federal level. Price elasticity for smoking tobacco products ranges between -0.6 to -0.3, for the low and high revenue estimates, respectively.[86] The increase in the price of cigarettes due to the tax increase would necessarily result in a quantity decrease. And this increased tax would have been applied to clove cigarettes (as well as other cigarettes), resulting in a decline in demand for clove cigarettes.

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[85] U.S. Response to Arbitrator Question No. 29, paras. 105-106

[86] GAO-12-475, Tobacco Taxes – Large Disparities in Rates for Smoking Products Trigger Significant Market Shifts to Avoid Higher Taxes, April 2012, pp. 22-23, available at: http://www.gao.gov/assets/600/590192.pdf (Exhibit US-33). *See also* U.S. Surgeon General Report, 2000, Chapter 6 (Exhibit US-35).

82. 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.[87] The tax increase alone would have increased the retail price by 26.3 percent. 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.[88] 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.[89] This trend will only continue. U.S. President Obama has proposed increasing the Federal tax on cigarettes from its current $1.01 per pack to about $1.95 per pack and increase all other excise taxes on tobacco products and cigarette papers and tubes by roughly the same proportion beginning in 2015. Excise tax rates would be increased for inflation annually. Accordingly, 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

83. Finally, 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 ever 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.

VI. CONCLUSION

[87] Alcohol and Tobacco Tax and Trade Bureau Summary (Exhibit US-36); The Tax Burden on Tobacco, Historical Compilation, Volume 48, 2013, pp. 172, 174, 176, 178, 180, 182, 184, 186, 188, 190, 192 (Exhibit US-37).

[88] Demand Effect on Cigarettes Due to Taxes (Exhibit US-38).

[89] The Tax Burden on Tobacco (Exhibit US-37).

84. Mr. Chairman, members of the Arbitrator, this concludes the statement of the United States. We would be pleased to respond to any questions that the Arbitrator may have.