UNITED STATES – MEASURES AFFECTING THE PRODUCTION AND SALE OF CLOVE CIGARETTES: RECOURSE TO ARTICLE 22.6 OF THE DSU

(DS406)

First Written Submission of
the United States of America

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I. INTRODUCTION

1. Indonesia lacks any reasonable basis for its request for authorization under Article 22 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* ("DSU") to suspend concessions or other obligations to the United States at a level of $42.9 million. Rather, the level of nullification or impairment of benefits to Indonesia is zero, given U.S. implementation actions that ground the different treatment of menthol and clove cigarettes in a legitimate regulatory distinction, given that any plausible alternative implementation action would not result in renewed clove cigarette sales and imports, and given that the Indonesian clove cigarette industry has successfully implemented a deliberate business plan to continue selling "cloves" despite the U.S. measures, resulting in no loss of exports to Indonesia.

2. The United States has fully implemented the recommendations and rulings of the Dispute Settlement Body (DSB) in this dispute and, therefore, there is no nullification or impairment of the benefits accruing to Indonesia under the *Agreement on Technical Barriers to Trade* ("TBT Agreement"). The Appellate Body found that the U.S. ban on cigarettes with characterizing flavors other than tobacco or menthol, Section 907(a)(1)(A),[1] was inconsistent with TBT Article 2.1 because the detriment to competitive opportunities of imported clove cigarettes compared to domestic menthol cigarettes did not appear to stem exclusively from a legitimate regulatory distinction.[2] The United States has complied by undertaking a new, comprehensive evaluation of the public health effects of menthol cigarettes, resulting in new findings (unavailable during the original proceeding) that demonstrate a distinction between the products that that the Appellate Body erroneously assumed did not exist. Specifically, based upon new analysis and information, the presence of menthol in cigarettes is likely associated with increased addiction and difficulty with cessation. In the context of this evidence, the United States has taken new measures affecting the competitive opportunities of menthol cigarettes. The new analysis, findings, and measures demonstrate that any remaining detriment to the competitive

[1] Section 907(a)(1)(A) of the Federal Food, Drug and Cosmetic Act ("FFDCA") (as amended by the Family Smoking Prevention and Tobacco Control Act (Tobacco Control Act). The Tobacco Control Act was adopted June 2009 and went into effect September 2009 as an amendment to the Federal Food, Drug and Cosmetic Act, 21 U.S.C. §387g(a)(1)(A) (Exhibit US-1).

[2] Appellate Body Report, para. 225.

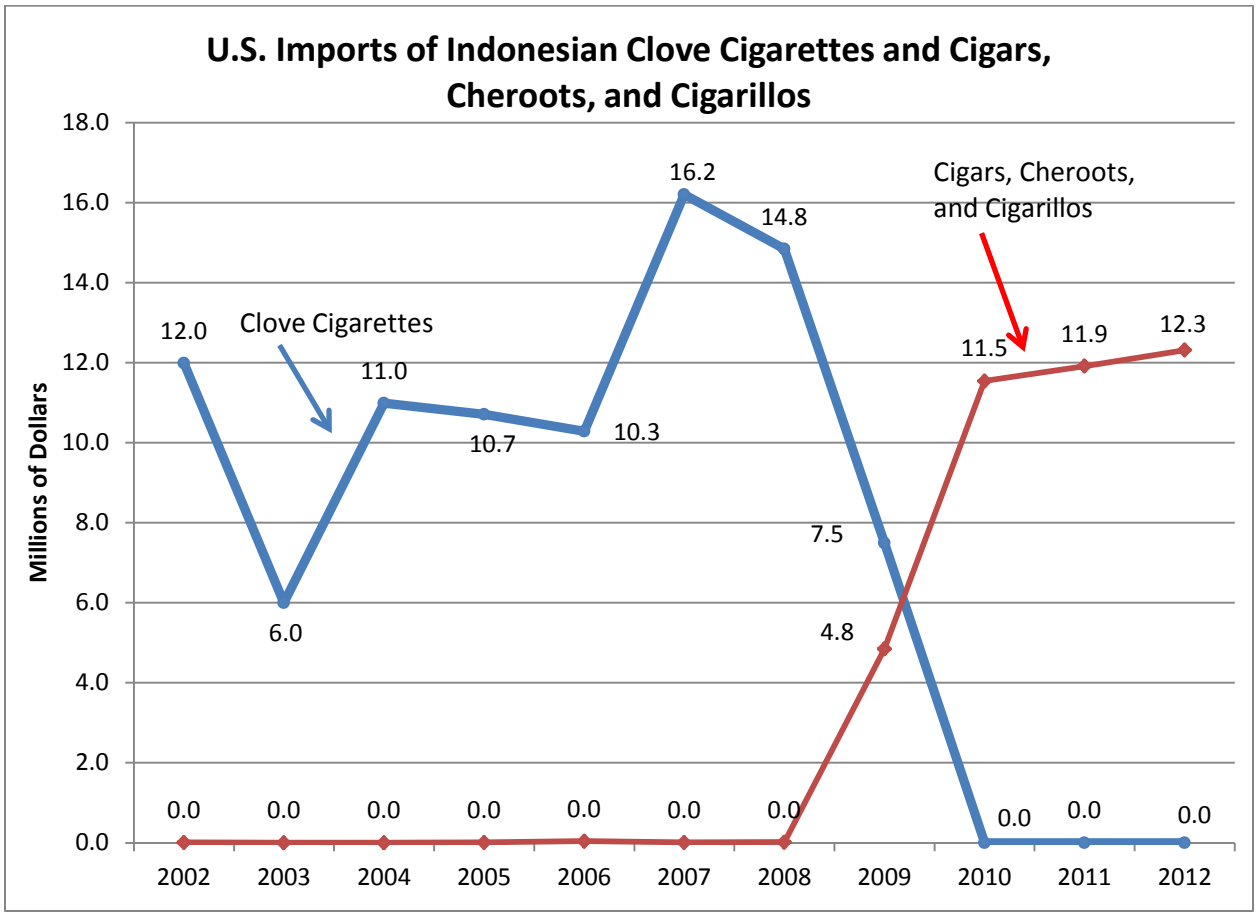
opportunities for imported clove cigarettes stems exclusively from a legitimate regulatory distinction – bringing the U.S. measure into full compliance with the DSB recommendations and rulings.

3. Even setting aside the fact that the United States has complied fully, the level of nullification or impairment of Indonesia's benefits under the TBT Agreement is zero, for two, independent, further reasons.

4. First, there is no plausible or reasonable alternative scenario under which the United States would come into compliance by taking a measure that would be contrary to the public health. That is, the United States would not take a compliance measure that would make cigarettes *more* available in the U.S. market, such as allowing clove cigarettes into the U.S. market by eliminating or amending Section 907(a)(1)(A). Any alternative compliance measure, therefore, would concern the treatment of menthol cigarettes. Even a ban or other restrictive measure with respect to menthol cigarettes would not result in any increased level of trade for Indonesian clove cigarettes. Therefore, the current U.S. measures do not nullify or impair any benefits to Indonesia.

5. Second, and notwithstanding U.S. efforts to prevent clove cigarettes from entering the U.S. market, an analysis of import data demonstrate that Indonesia effectively has not lost any exports as a result of Section 907(a)(1)(A). In fact, internal company communications reveal that Indonesian producers have developed and implemented a business plan to replace their exports of clove cigarettes dollar-for-dollar by slightly tweaking the product and marketing and selling it as a clove "cigar" or clove "cigarillo," instead of a clove "cigarette," so that it is not subject to the ban. The results of this strategy could not be more apparent – since Section 907(a)(1)(A) went into effect in 2009, imports of clove cigars and clove cigarillos from Indonesia have surged from effectively zero to over $11 million, replacing imports of clove cigarettes from Indonesia at approximately the same level.[3]

[3] U.S. import statistics (Exhibit US-5). The level of imports of "cigarettes containing tobacco and cloves" (HS2402201000) dropped to zero after 2009. Meanwhile, the level of imports of "cigars, cheroots, and cigarillos, containing tobacco, each valued less than 15 cents" (HS2402103070) suddenly increase from close to zero before 2009 to $11.5 million in 2010.



6. Given this import data showing one product replaced the other, and that this was the deliberate business strategy of clove manufacturers, it would be unreasonable (and contrary to the data) to assume that, were clove cigarettes permitted to be sold in the United States, Indonesian clove cigarettes exports would be any greater than its exports today of "cigars" or "cigarillos." Therefore, for a third reason, the level of nullification or impairment of benefits accruing to Indonesia from the current U.S. measures is zero.

7. Finally, even though Indonesia's proposed level of suspension must be rejected for all the reasons above, for the sake of completeness, the United States demonstrates that Indonesia's methodology paper is riddled with errors and flawed assumptions.

II. PROCEDURAL BACKGROUND

8. The DSB adopted its recommendations and rulings on April 24, 2012, which included several findings concerning the consistency of Section 907(a)(1)(A) of the Federal Food, Drug

and Cosmetic Act with the TBT Agreement.[4] The DSB found that Indonesia failed to demonstrate that Section 907 (a)(1)(A) is inconsistent with TBT Article 2.2, because Indonesia failed to demonstrate that the measure is more trade restrictive than necessary to achieve a legitimate objective – reducing youth smoking. The DSB also found that Indonesia failed to demonstrate inconsistencies with Articles 2.5, 2.8, 2.9.3, and Article 12.3. On the other hand, the DSB found that Section 907(a)(1)(A) is inconsistent with Article 2.1, on the basis that the measure accords imported clove cigarettes less favorable treatment than domestic menthol cigarettes. The DSB also found that the United States acted inconsistently with Article 2.9.2 by not notifying Members of the proposed measure when amendments and comments were still possible, and that the United States acted inconsistently with Article 2.12 by not allowing an interval of no less than six months between publication and entry into force.

9. The United States notified the DSB on May 24, 2012, of its intention to implement the recommendations and rulings of the DSB.[5] The United States and Indonesia agreed that the reasonable period of time for the United States to implement the DSB's recommendations and rulings would end on July 24, 2013, and jointly notified the DSB of this agreement on June 14, 2012.[6]

10. At the DSB meeting on July 23, 2013, the United States explained that it had fully implemented the DSB's recommendations and rulings of the DSB, but Indonesia stated that it did not agree.[7] Subsequently, on August 12, 2013, Indonesia filed a request for authorization to suspend concessions or other obligations under Article 22.2 of the DSU.[8] In its request, Indonesia sought authorization to suspend concessions or obligations consisting of one or more of the following: (1) suspension of tariff concessions and other related obligations under the *General Agreement on Tariffs and Trade 1994* ("GATT 1994") on a list of U.S. products to be established in due course; (2) suspension of concessions and other obligations under the TBT

[4] Appellate Body Report, para. 298.

[5] WT/DSB/M/316.

[6] WT/DS/406/10.

[7] WT/DSB/M/334.

[8] WT/DS406/12 (12 August 2013).

Agreement; and (3) suspension of concessions and other obligations under the Agreement on Import Licensing. Indonesia's request did not quantify the level of suspension of the concessions or obligations it requested to suspend.

11. In a communication dated August 22, 2013, the United States objected to Indonesia's request and referred the matter to arbitration.[9]

III. STATEMENT OF FACTS

A. Measure at Issue

12. Section 907(a)(1)(A), the measure at issue in this dispute, is a product standard which establishes that, within the United States, a cigarette or any of its component parts (including the tobacco, filter, or paper) shall not contain, as a constituent (including a smoke constituent) or additive, an artificial or natural flavor (other than tobacco or menthol) or an herb or spice, including strawberry, grape, orange, clove, cinnamon, pineapple, vanilla, coconut, licorice, cocoa, chocolate, cherry, or coffee, that is a characterizing flavor of the tobacco product or tobacco smoke.[10]

B. The Measure Protects Public Health

13. Section 907(a)(1)(A) is part of the Tobacco Control Act, which is designed to protect the public health (and, in particular, to reduce youth smoking and other tobacco use) by regulating the manufacturing, composition, advertising, promotion, labeling, sale and distribution of tobacco products.[11] Since its implementation in 2009, cigarette use has declined by 27.5 percent among young people under age 18 and by 10.9 percent among young people between the ages of 18 and 25.[12] Consumption of cigarettes in the United States overall has declined by at least 19.7

[9] WT/DS406/13.

[10] Panel Report, para. 2.4; Section 907(a)(1)(A) of the FFDCA. Exhibit US-1. *See also* U.S. First Written Submission (AB), para. 19; U.S. First Written Submission (Orig. Panel), para. 125.

[11] U.S. First Written Submission (Orig. Panel), paras. 111-118.

[12] National Survey on Drug Use and Health, 2008 – 2012 (Exhibit US-2) (statistics represent change from 2008 (the year before the Tobacco Control Act went into effect) until 2012 (the last year for which data is available).

percent since the annual average from 2006-2008.[13] Approximately 97 percent of cigarettes sold in the United States are made by U.S. producers, which means that domestic producers have lost approximately $567 million in U.S. sales since the 2006-2008 annual average before Section 907(a)(1)(A) went into effect.[14] Also since the period of 2006-2008, consumption of menthol cigarettes in the United States has declined by 6.3 percent, translating to a loss of approximately $52 million in sales since the 2006-2008 annual average before Section 907(a)(1)(A) went into effect.[15]

C. Section 907(a)(1)(A) Has Not Had a Negative Impact on Exports by Indonesian Clove Cigarette Manufacturers

14. Although Section 907(a)(1)(A) technically prevented U.S. imports of clove cigarettes in September 2009, clove cigarette manufacturers were able to maintain their market share for their products by modestly altering the product specifications of clove cigarettes and marketing the product as a clove "cigar" instead, so that it would fall outside the scope of the ban. This was a deliberate strategy (as explained below), the result of which is clear in U.S. import data. Based on U.S. import statistics, the average annual value of U.S. imports of clove cigarettes from Indonesian in the three years before Section 907(a)(1)(A) took effect (*i.e.*, 2006-2008) was $13.8 million.[16] The average annual value of U.S. imports of cigars and cigarillos from Indonesia during the same period was $0.02 million.[17] After Section 907(a)(1)(A) went into effect, the value of U.S. imports of Indonesian cigarettes fell to zero, while the value of U.S. imports of Indonesian cigars and cigarillos rose in the three full years after the ban went into effect to an average annual value of $11.9 million, nearly the same level of trade as Indonesian clove cigarettes before the ban.[18]

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[13] Cigarette Consumption in the United States (Exhibit US-3).

[14] Cigarette Consumption in the United States (Exhibit US-3).

[15] Menthol Cigarette Consumption in the United States (Exhibit US-4).

[16] U.S. import statistics (Exhibit US-5). As explained below, to project this figure forward, one would need to take account of the steadily decreasing cigarette consumption in the United States, which brings the level down to $11.05 million.

[17] U.S. import statistics (Exhibit US-5).

[18] U.S. import statistics (Exhibit US-5) (comparing HS 2402201000 and HS 2402103070). U.S. import statistics do not include tariff lines differentiating between cigars and cigarillos *that do not contain clove* and cigars

15. Internal company documents reveal that Kretek International (Kretek), which dominated the U.S. import market for clove cigarettes with a 97 percent market share, began planning as early as 2007 – that is, while Section 907(a)(1)(A) was being considered – to replace its market share of clove cigarettes in the United States with products marketed as clove cigars, in the event of a ban covering clove cigarettes.[19] Kretek planned to tweak the structure and labeling of its clove cigarettes, based on the differences in technical specifications between a clove "cigarette" and a clove "cigar."[20] Internal communications among senior executives at Kretek reveal that the company developed a plan in 2007 to "be prepared for a seamless transition from Djarum Clove cigarettes to Djarum Clove cigars in the event of [an] FDA ban on clove" and to "develop a brand […] to replace clove cigarettes."[21] In a 2008 communication, a Kretek executive described the plan in the following manner:

> Your management team and my management team have discussed for many months the production of Clove cigars using similar packaging as our present clove cigarettes. […] I have no idea why it is taking so long with getting into production so we can start introducing them into the market just in case clove

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or cigarillos *that do contain clove*. However, data from the Nielsen company, which collects sales information by scanning retail sales (not including online sales), confirms that nearly all Indonesian imports of cigars contain clove. Exhibit US-6. In particular, Nielsen data shows that since October 2009, nearly all cigar imports from Indonesia were *clove* cigars; nearly all of the Indonesian clove cigars are P.T. Djarum brand. This trend is consistent with the strategy employed by Kretek International (Kretek), discussed below, to replace its dominant market share of Djarum clove cigarettes with Djarum clove cigars when Section 907(a)(1)(A) went into effect (*see* Exhibit US-7, Exhibit US-8 and Exhibit US-9).

[19] The technical differences between a cigarette and a cigar can be slight. Under U.S. federal definitions (Exhibit US-10), a cigar is a roll of tobacco wrapped in leaf tobacco or any substance containing tobacco. *See* Section 900(11) of the FFDCA (defining little cigars), Section 3(7) of the Federal Cigarette Labeling and Advertising Act (defining little cigars), and 26 U.S.C. 5702(a) (defining cigars). However, cigars do not include any roll of tobacco that meets the definition of a cigarette. The definitions of cigarette have two main parts. A cigarette includes any roll of tobacco wrapped in paper or in any substance not containing tobacco, as well as any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette. *See* section 900(3) of the FFDCA, Section 3(1) of the Federal Cigarette Labeling and Advertising Act, and 26 U.S.C. 5702(b). Thus, it is possible that a product marketed as a "cigar" could be a "cigarette" for the purposes of section 907(a)(1)(A) of the FFDCA.

[20] *See* Letter from Congressman Henry Waxman, Ranking Member of the U.S. House of Representatives Committee on Energy and Commerce, to Margaret Hamburg, Commissioner of the FDA, March 28, 2011 (Exhibit US-7). *See also* Exhibit US-8 and Exhibit US-9 (Kretek communications and sales presentation).

[21] Email from John Geoghegan to Bunjoto Astono, October 15, 2007 (Exhibit US-8).

> cigarettes are outlawed in the USA. *The cigars will look and taste just about (sic) the except for the wrapper and therefore will not qualify as a cigarette.*[22]

16. A May 2009 communication confirms Kretek's objectives for the new clove cigar roll-out. A Kretek executive wrote the following to Kretek's sales and marketing departments:

> First, because clove cigarettes may be banned before the end of this year, and we are launching a cigar replacement product *that will continue our business*.
>
> Second, because the SCHIP bill[23] has raised the price of all cigarettes and tobacco products, and we want consumers *who enjoy cloves* to continue to have an affordable product.
>
> Third, because we are *number one in cloves* and we want to stay that way – continuing to provide our distributor customers with a solid source of business.
>
> We have worked for 2 years to get the taste right. We are positioning this as "the taste *your clove customers* expect."[24]

17. As is evident from this communication and others, Kretek does not distinguish between clove cigarettes and clove cigars; from a production and marketing standpoint, the product that Kretek offers to its consumers is "cloves." Kretek's response to Section 907(a)(1)(A) was to "replace" clove cigarettes in order to "continue our business" through the same distributors, and to the same customers at the same level of trade.[25] Their goal was not to attract U.S. clove cigarette smokers to a *new or different* product, but to deliver "the taste" that "clove smokers *expect*" because it is the same experience delivered through clove cigarettes.

18. A Kretek presentation prepared for a national sales meeting in July 2009, the month the U.S. Congress adopted Section 907(a)(1)(A), describes the company's plan to satisfy its U.S.

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[22] Email from Hugh Cassar to Robert Budi Hartono and Victor Rachmat Hartono, August 2, 2008 (italics added) (Exhibit US-8).

[23] The "SCHIP bill" presumably refers to a State Children Health Insurance Program Reauthorization Act of 1009 which raised excise taxes on tobacco products to help fund the program.

[24] Email from John Geoghehan to "Kretek Sales" and "Kretek Manager," May 14, 2009 (italics added). (Exhibit US-8).

[25] Exhibit US-9, p.1332.

market for clove cigarettes with a product marketed as a clove cigar. An introductory slide graphically depicts the strategy: [26]

The presentation, based on results from pilot testing and research, announced that "new cigar product research indicates it's the clove rather than the product format. *Cigar/cigarette choice is secondary*;"[27] the "strong majority of clove smokers state *they will transition* to new cigar product;[28] and "clove smokers are looking for the 'clove moment' and recognize that *taste and aroma of clove are nearly the same*."[29] The presentation also projected that clove cigars would be "*a replacement product* for Djarum clove cigarettes"[30] and would provide "the rich smooth taste clove smokers expect."[31]

19. Similar to its industry, the Indonesian government apparently also does not recognize a product distinction between clove cigarettes, clove cigars, and clove cigarillos. In 2005, the Indonesian government appears to have begun assigning *all* exports to the United States of clove cigarettes, clove cigars and clove cigarillos under the tariff classification for clove cigars.[32]

[26] Exhibit US-9, p. 1328.

[27] Exhibit US-9, p. 1328 (italics added).

[28] Exhibit US-9, p. 1339 (italics added).

[29] Exhibit US-9, p. 1339 (italics added).

[30] Exhibit US-9, p. 1347 (italics added).

[31] Exhibit US-9, p. 1347 (italics added).

[32] Indonesia export statistics (Exhibit US-11). According to Indonesian export statistics, Indonesian clove manufacturers exported *no* "clove cigarettes" (HS2402202000) or "machine-made clove cigarettes" (HS240220200)

Thus, from Indonesia's perspective, it appears that "cloves" are "cloves," whether presented as cigarettes, cigars or cigarillos.

20. The United States currently does not impose the same restrictions on "other tobacco products," including cigars and cigarillos, that it imposes on cigarettes. As the United States explained in its submissions in the original proceedings in this dispute,[33] U.S. public health authorities have taken a careful, incremental approach to regulating tobacco products because of the difficulty and complexity involved in restricting access to harmful, highly addictive, and popular products. The prohibition on cigarettes with characterizing flavors is narrow by design; it targets "niche" products specifically appealing to youth. Accordingly, at this time, the United States has not extended the ban on characterizing flavors to other tobacco products. Indonesian exporters are taking advantage of fine distinctions between "cigarettes" and "cigars" or "cigarillos," and the different rules and regulations that currently apply to each, and have replaced their U.S. market share of clove cigarettes with comparable products being sold as clove cigars or cigarillos nearly dollar-for-dollar since the Tobacco Control Act went into effect.

D. DSB Recommendations and Rulings

21. As discussed below, the issue in this arbitration under DSU Article 22.6 is whether the suspension proposed is equivalent to the level of any nullification of impairment of benefits to Indonesia. That issue is comprised of two intermediate steps: *first* – whether there is any ongoing breach of a covered agreement through the current U.S. measures; *second* – if so, at what level, if any, are Indonesia's benefits being nullified or impaired.

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from 2005 through 2012 (except for an anomalous $0.001 million in 2012). However, during those same years, Indonesia export statistics do register consistent values of exports for "cigars, cheroots, and cigarillos, containing tobacco" (HS240210000 and HS2402100000). Of course, these statistics do not reflect U.S. import statistics, which show that the clove products Indonesian manufacturers were exporting to the United States were cigarettes, not cigars and cigarillos. Both the United States and Indonesia have recognized that U.S. import statistics are the more accurate measure of Indonesian trade values (Indonesia and U.S. Responses to Panel Question 80) (Exhibit US-12). However, Indonesian export statistics are relevant in this context to demonstrate that Indonesia apparently has been classifying clove cigarettes and clove cigars or cigarillos *as the same product* and that, from Indonesia's perspective, *there is no difference* between clove cigarettes and clove cigars or cigarillos.

[33] U.S. Appellant Submission (AB), paras. 12-15; U.S. First Written Submission (Orig. Panel), paras. 22-26, 79-81, 101, 108, 134; U.S. Second Written Submission (Orig. Panel), paras. 17-32.

22. Article 22.4 of the DSU requires that "[t]he level of the suspension of concessions or other obligations authorized by the DSB shall be equivalent to the level of the nullification or impairment." Article 22.7 of the DSU applies this requirement in the context of an arbitration under Article 22.6.[34] As further explained below, past arbitrators have recognized that the task under Article 22.6 involves two sides of an equation – the level of nullification or impairment and the level of suspension of concessions. It is not possible for an arbitrator to complete its task without examining both sides of the equation. And if there is no nullification or impairment, the arbitrator's task is simplified – the level of suspension of concessions would be zero.

23. Therefore, it is first necessary to examine whether the United States has implemented the recommendations and rulings of the DSB in order to determine whether Indonesia's benefits are being nullified or impaired, and if so, at what level. In the context of this dispute, this means determining whether the measures taken by the United States demonstrate that there is a legitimate regulatory reason to reduce youth smoking by banning clove-flavored cigarettes while taking other steps to address menthol-flavored cigarettes.

24. Key findings of the original panel and Appellate Body reports set out the analytical framework from which to assess U.S. compliance. The original panel report found that the U.S. measure banning clove and other flavored cigarettes is supported by scientific consensus and makes a "material contribution" to reducing youth smoking:

> 7.389 …However, even if we accept Indonesia's numbers, these numbers do not show that an insignificant number of youth smoke clove cigarettes.
>
> 7.390 To the contrary, Indonesia's own estimate, approximately 6,800 minors *regularly* smoked clove cigarettes. In our view, that is hardly an insignificant number.
>
> …
>
> 7.401 Here we consider that the evidence before the Panel provides a solid basis for reaching a definite conclusion. The evidence before the Panel from health experts squarely contradicts Indonesia's assertion that there is no scientific evidence to support the United States ban on clove cigarettes. The United States

[34] Article 22.7 states that "[t]he arbitrator acting pursuant to paragraph 6 … shall determine whether the level of such suspension is equivalent to the level of nullification or impairment."

> has submitted a number of studies from qualified and respected sources, and all appear to advance the same view. Indeed, there appears to be a growing consensus, among those who have conducted research on the issue, in support of the United States' position on this particular question. This is not a case in which a Member is seeking to base a public health measure on a minority view within the scientific community; this is a case in which the measure actually reflects at least the majority view, and potentially the unanimous view.
>
> …
>
> 7.415 In our view, the evidence reviewed above basically speaks for itself: it is not correct, as Indonesia asserts, that the scientific basis for banning clove and/or other flavoured cigarettes consists of a 'single line from a single study'. Rather, there is extensive scientific evidence supporting the conclusion that banning clove and other flavoured cigarettes could contribute to reducing youth smoking.
>
> 7.416 We note that the conclusion arising from the scientific evidence reviewed above is only further reinforced by Indonesia's counter evidence. We find it striking that Indonesia has apparently only been able to find one scientific expert who expresses a contradictory view, and then only in the form of a post to his own web blog (as opposed to peer-reviewed medical or scientific journal).
>
> Conclusion
>
> 7.417 For these reasons, we conclude that Indonesia has failed to demonstrate that the ban on clove cigarettes makes no 'material contribution' to the objective of reducing youth smoking. In our view, there is 'a genuine relationship of ends and means' between the objective pursued and the measure at issue. (Citations omitted.)

25. The DSB recommendations and rulings also recognize that Section 907(a)(1)(A) does not exceed the level of protection sought by banning many, but not all, of the tobacco products that are appealing to young people, or even the tobacco products most often used by young people.[35] The original panel found no "contradiction in the idea that a Member may seek to *reduce* (rather than eliminate) certain risks by banning *certain* (but not all) products."[36] The original panel finally considered – and rejected – Indonesia's argument that the United States could achieve its policy objective with a less trade restrictive alternative measure.[37]

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[35] Panel Report, para. 7.377.

[36] Panel Report, para. 7.377.

[37] Panel Report, paras. 7.418-28, 7.431.

26. Building upon the original panel findings, the Appellate Body found that the WTO-inconsistency of Section 907(a)(1)(A) does *not* stem from the fact that it bans most cigarettes with characterizing flavors, but rather from an insufficiency of evidence that there is a legitimate regulatory reason for exempting one of the two types of cigarettes not banned under the measure – menthol cigarettes. In other words, the Appellate Body found that the WTO-inconsistency of the U.S. ban on cigarettes with characterizing flavors is not that it went too far in restricting trade, but that there did not appear to be a legitimate regulatory reason not to go further. The Appellate Body report sets out this reasoning as follows:

> 174. Finally, as noted earlier, the object and purpose of the *TBT Agreement* is to strike a balance between, on the one hand, the objective of trade liberalization and, on the other hand, Members' right to regulate. This object and purpose therefore suggests that Article 2.1 should not be interpreted as prohibiting any detrimental impact on competitive opportunities for imports in cases where such detrimental impact on imports stems exclusively from legitimate regulatory distinctions.
>
> 175. Accordingly, the context and object and purpose of the *TBT Agreement* weigh in favour of reading the "treatment no less favourable" requirement of Article 2.1 as prohibiting both *de jure* and *de facto* discrimination against imported products, while at the same time permitting detrimental impact on competitive opportunities for imports that stems exclusively from legitimate regulatory distinctions.
>
> …
>
> 215. However, as noted earlier, the existence of a detrimental impact on competitive opportunities in the relevant market for the group of imported products vis à vis the group of domestic like products is not sufficient to establish a violation of the national treatment obligation contained in Article 2.1 of the *TBT Agreement*. Where the technical regulation at issue does not *de jure* discriminate against imports, a panel must carefully scrutinize the particular circumstances of the case, that is, the design, architecture, revealing structure, operation, and application of the technical regulation at issue, and, in particular, whether that technical regulation is even handed, in order to determine whether the detrimental impact on imports stems exclusively from a legitimate regulatory distinction rather than reflects discrimination against the group of imported products.
>
> …
>
> 225. Moreover, we are not persuaded that the detrimental impact of Section 907(a)(1)(A) on competitive opportunities for imported clove cigarettes does stem from a legitimate regulatory distinction. We recall that the stated objective of

Section 907(a)(1)(A) is to reduce youth smoking. One of the particular characteristics of flavoured cigarettes that makes them appealing to young people is the flavouring that masks the harshness of the tobacco, thus making them more pleasant to start smoking than regular cigarettes. To the extent that this particular characteristic is present in both clove and menthol cigarettes, menthol cigarettes have the same product characteristic that, from the perspective of the stated objective of Section 907(a)(1)(A), justified the prohibition of clove cigarettes. Furthermore, the reasons presented by the United States for the exemption of menthol cigarettes from the ban on flavoured cigarettes do not, in our view, demonstrate that the detrimental impact on competitive opportunities for imported clove cigarettes does stem from a legitimate regulatory distinction. The United States argues that the exemption of menthol cigarettes from the ban on flavoured cigarettes aims at minimizing: (i) the impact on the US health care system associated with treating 'millions' of menthol cigarette smokers affected by withdrawal symptoms; and (ii) the risk of development of a black market and smuggling of menthol cigarettes to supply the needs of menthol cigarette smokers. Thus, according to the United States, the exemption of menthol cigarettes from the ban on flavoured cigarettes is justified in order to avoid risks arising from withdrawal symptoms that would afflict menthol cigarette smokers in case those cigarettes were banned. We note, however, that the addictive ingredient in menthol cigarettes is nicotine, not peppermint or any other ingredient that is exclusively present in menthol cigarettes, and that this ingredient is also present in a group of products that is likewise permitted under Section 907(a)(1)(A), namely, regular cigarettes. Therefore, it is not clear that the risks that the United States claims to minimize by allowing menthol cigarettes to remain in the market would materialize if menthol cigarettes were to be banned, insofar as regular cigarettes would remain in the market.

226. Therefore, even though Section 907(a)(1)(A) does not expressly distinguish between treatment accorded to the imported and domestic like products, it operates in a manner that reflects discrimination against the group of like products imported from Indonesia. Accordingly, despite our reservations on the brevity of the Panel's analysis, we agree with the Panel that, by exempting menthol cigarettes from the ban on flavoured cigarettes, Section 907(a)(1)(A) accords to clove cigarettes imported from Indonesia less favourable treatment than that accorded to domestic like products, within the meaning of Article 2.1 of the TBT Agreement. (Citations omitted.)

…

236. While we have upheld the Panel's finding that the specific measure at issue in this dispute is inconsistent with Article 2.1 of the TBT Agreement, we are not saying that a Member cannot adopt measures to pursue legitimate health objectives such as curbing and preventing youth smoking. In particular, we are not saying that the United States cannot ban clove cigarettes: however, if it chooses to do so, this has to be done consistently with the TBT Agreement.

> Although Section 907(a)(1)(A) pursues the legitimate objective of reducing youth smoking by banning cigarettes containing flavours and ingredients that increase the attractiveness of tobacco to youth, it does so in a manner that is inconsistent with the national treatment obligation in Article 2.1 of the TBT Agreement as a result of the exemption of menthol cigarettes, which similarly contain flavours and ingredients that increase the attractiveness of tobacco to youth, from the ban on flavoured cigarettes. (Citations omitted.)

27. Finally, the original panel found that the United States "has acted inconsistently with Article 2.9.2 of the *TBT Agreement*" by "failing to notify to WTO Members through the Secretariat the products to be covered by the proposed Section 907(a)(1)(A)"[38] and "has acted inconsistently with Article 2.12 of the *TBT Agreement*" by "not allowing an interval of no less than six months between the publication and the entry into force of Section 907(a)(1)(A)."[39] The Appellate Body affirmed the finding on Article 2.12.[40]

E. U.S. Measures to Regulate and Reduce Use of Menthol Cigarettes

28. The United States has undertaken additional evaluation of the public health effects of menthol cigarettes and taken new measures in relation to menthol cigarettes that reduce use of the product, particularly among youth.

29. In July 2013, the U.S. Food and Drug Administration (FDA) released a "Preliminary Scientific Evaluation of the Possible Public Health Effects of Menthol Versus Nonmenthol Cigarettes" ("FDA Menthol Report"). The FDA Menthol Report evaluated existing data and research regarding the possible public health effects of menthol cigarettes ***and found that the presence of menthol in cigarettes is likely associated with increased addiction and difficulty with cessation***.[41]

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[38] Panel Report, para. 8.1(f).

[39] Panel Report, para. 8.1(h).

[40] Appellate Body Report, para. 298(b). The original panel finding on Article 2.9.2 was not appealed.

[41] FDA Menthol Report, pps. 6, 113, 130 (Exhibit US-13).

30. At the same time that FDA issued the report, it issued an Advanced Notice of Proposed Rulemaking (ANPRM) concerning menthol cigarettes, seeking public input on possible regulatory measures, including a possible ban.

31. As the regulatory process advances, the Center for Tobacco Products (CTP), the agency within FDA responsible for tobacco regulation, has developed a comprehensive public education campaign, the General Market Youth Tobacco Prevention Campaign (Youth Tobacco Prevention Campaign), to combat youth smoking, including a particular focus on menthol cigarettes. In terms of investment and scope, the Youth Tobacco Prevention Campaign is the largest U.S. federal government initiative to use paid media efforts to target youth tobacco use. The campaign focuses on youth aged 12-17 who are either open to smoking or are already experimenting with cigarettes. The campaign will provide information about the risks associated with tobacco use, including the use of menthol cigarettes. Media campaigns targeting at-risk populations such as teens have proven to be among the most effective means of reducing demand for pervasive tobacco products like regular and menthol cigarettes.[42] The United States has invested an initial $115 million over two years to develop and implement the campaign.

[42] The Center for Disease Control and Prevention (CDC) and the Surgeon General emphasize that educational campaigns are a highly effective measure in reducing tobacco use. *See* Centers for Disease Control and Prevention (CDC). (2007). Best Practices for Comprehensive Tobacco Control Programs—2007. Atlanta: U.S. Department of Health and Human Services, Centers for Disease Control and Prevention, National Center for Chronic Disease Prevention and Health Promotion, Office on Smoking and Health ("CDC Best Practices") (Exhibit US-16). *See also* U.S. Department of Health and Human Services. (2012). Preventing tobacco use among youth and young adults: A report of the Surgeon General. Atlanta, GA: U.S. Department of Health and Human Services, Centers for Disease Control and Prevention, National Center for Chronic Disease Prevention and Health Promotion, Office on Smoking and Health. Chapter 6, "Efforts to Prevent and Reduce Tobacco Use Among Young People," pp. 629-691 ("U.S. Surgeon General Report 2012") (Exhibit US-17). The Surgeon General's Report examines various initiatives in recent years to help counter the influences that encourage young people to begin tobacco use. The Report finds that evidence is sufficient to infer a causal relationship between adequately funded antismoking media campaigns and a reduced prevalence of smoking among youth. Mass media campaigns have increasingly become a key strategy to reduce smoking among youth and young adults. Mass media messages have the potential to influence not only individual behaviors but also social norms and institutional policies, which in turn can shape patterns of population-wide tobacco use.

1. U.S. Public Health Authorities Conducted a Comprehensive Evaluation of the Effects of Menthol Cigarettes and Made Preliminary Findings That the Presence of Menthol in Cigarettes Is Likely Associated With Increased Dependence and Increased Difficulty in Quitting Smoking

32. The U.S. Congress empowered the FDA through the Tobacco Control Act to regulate tobacco products, and directed the FDA's Tobacco Products Scientific Advisory Committee (TPSAC) to develop a report on the public health impact of menthol cigarettes.[43] The report of the TPSAC was issued in 2011 and found that the availability of menthol cigarettes represents an adverse impact on the public health,[44] and suggested that FDA conduct "further assessment in respect of the contraband of menthol cigarettes and recommended research to address gaps in understanding of menthol cigarettes and public health."[45]

33. FDA advanced this work by conducting a comprehensive, scientific evaluation of existing data and research on menthol cigarettes, including information and materials provided to the TPSAC as well additional information, and by performing and commissioning additional analyses. The FDA Menthol Report addressed the association between menthol cigarettes and various outcomes, including initiation, addiction, and cessation.

34. The FDA Menthol Report makes two findings relevant to the Appellate Body's finding concerning the regulatory distinction between menthol and clove cigarettes. As discussed below, the Appellate Body found (although without citing to any uncontested evidence or factual findings by the original panel) that the only reason a menthol smoker might experience withdrawal if menthol cigarettes were unavailable and, therefore seek medical attention or illicit products, is because of the presence of *nicotine* in menthol cigarettes. However, the FDA Menthol Report finds that, with respect to the association between menthol cigarettes and

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[43] Panel Report, para. 2.23. The U.S. Congress required in Section 907(e) of the FFDCA that FDA refer to its Tobacco Products Advisory Committee (TPSAC) for its report and recommendation "the issue of the impact of the use of menthol in cigarettes on the public health, including such use among children, African-Americans, Hispanics, and other racial and ethnic minorities." The TPSAC Report (Exhibit US-14) is also available at http://www.fda.gov/downloads/AdvisoryCommittees/CommitteesMeetingMaterials/TobaccoProductsScientificAdvisoryCommittee/UCM247689.pdf.

[44] Panel Report, para. 7.227.

[45] Panel Report, para. 2.23.

dependence, "the weight of evidence supports the conclusion *that **menthol** in cigarettes* is likely associated with increased dependence."[46]

35. Similarly, the FDA Menthol Report finds that, with respect to the association between menthol cigarettes and cessation, "the weight of evidence supports the conclusion *that **menthol** in cigarettes* is likely associated with reduced success in smoking cessation, especially among African American menthol smokers."[47] These findings were not available to the original panel, and therefore constitute new findings and evidence that the presence of menthol in cigarettes likely worsens menthol smokers' addiction level and ability to quit smoking.

36. To reach these preliminary conclusions,[48] FDA evaluated new research, data, and analyses generated in 2011 or later. Additionally, FDA completed three new secondary analyses:

- FDA conducted its own analysis of raw data from a study conducted by the tobacco company, Altria. The FDA study examined differences between approximately 4000 menthol and non-menthol smokers across a wide variety of smoke exposure measures, measures of smoking behavior and nicotine dependence. The FDA's analysis was included in the evaluation of dependence in menthol and non-menthol smokers.

- FDA conducted an analysis of data collected and used in a 1999-2008. National Health and Nutrition Examination Survey (NHANES). NHANES is a nationally representative household health survey that is designed to be a "snapshot" of the U.S. population as a whole. Approximately 10,000 people participated during each two-year cycle. FDA's analysis compared the characteristics, smoking behavior and smoke exposure of menthol and non-menthol smokers. The FDA's

[46] FDA Menthol Report, pps. 6, 113 (italics and bolding added) (Exhibit US-13).

[47] FDA Preliminary Menthol Report, pps. 6, 130 (italics and bolding added) (Exhibit US-13).

[48] The period for public comment on the FDA Menthol Report closed on November 22, 2013. FDA will review and addresses the public comments.

analysis was included in the evaluation of exposure to smoke chemicals in menthol and non-menthol smokers.

- FDA analyzed data from 2006/2007 Tobacco Use Supplement to the Current Population Survey (CPS-TUS), which is a large nationally representative survey of over 200,000 adults. Data includes information on subject characteristics and tobacco use. The FDA's analysis was included in the evaluation of initiation of smoking among menthol and non-menthol smokers.

2. U.S. Public Health Authorities Are Evaluating Whether Banning Menthol Cigarettes Would Be Appropriate for the Public Health

37. The FDA issued its preliminary menthol report in conjunction with an ANPRM seeking public input on possible measures, including restricting or prohibiting menthol in cigarettes.[49] The ANPRM seeks comments and other information to inform regulatory decisions on possible measures such as:

- Should FDA consider establishing a tobacco product standard for menthol in menthol cigarettes? If so, what allowable level of menthol (*e.g.*, maximum or minimum) would be appropriate for the protection of the public health?

- If a product standard prohibiting or limiting menthol were to be established, what length of time should manufacturers be provided to achieve compliance with the standard? If a product standard prohibiting or limiting menthol were to be established, would a stepped approach in which the level of menthol was gradually reduced be appropriate for the protection of the public health?

- If menthol cigarettes could no longer be legally sold, is there evidence that illicit trade in menthol cigarettes would become a significant problem? If so, what would be the impact of any such illicit trade on public health? How would any such illicit trade compare to the existing illicit trade in cigarettes?

[49] The ANPRM is contained in Exhibit US-15 and available at the following web site: http://www.regulations.gov/#!documentDetail;D=FDA_FRDOC_0001-4088

To date, 112,787 comments have been filed, representing views from state and city public officials, tobacco product retailers, tobacco manufacturers, public policy campaigns and other interested observers and stakeholders. The public comment period close on November 22, 2013. FDA will review and analyze the comments and information submitted.

38. FDA's issuance of the ANPRM was a serious effort toward determining appropriate regulation of menthol in cigarettes. Section 907 of the FFDCA sets out the public health guidelines, goals and considerations by which all tobacco product standards must be established or revised. Under Section 907, FDA may establish tobacco product standards with a view to risks and benefits of the population as a whole, and FDA must consider possible negative consequences such as a significant increase in demand for contraband (*i.e.*, Section 907(a)(2)-(4) and Section 907(b)). Section 907(a)(3) provides that tobacco product standards must be appropriate for the public health, based on the following considerations:

- the risks and benefits to the population as a whole, including users and nonusers of tobacco products of the proposed standard;
- the increased or decreased likelihood that existing users of tobacco products will stop using such products; and
- the increased or decreased likelihood that those who do not use tobacco products will start using such products.

Sections 907(b)(1) and 907(b)(2) set out further considerations:

- The Secretary shall consider information submitted in connection with a proposed standard regarding the technical achievability of compliance with such a standard; and
- The Secretary shall consider all other information submitted in connection with a proposed standard, including information concerning countervailing effects of the tobacco product standard on the health of adolescent tobacco users, adult tobacco users, or nontobacco users, such as the creation of a significant demand for

> contraband or other tobacco products that do not meet the requirements of this chapter and the significance of such demand.

39. The FDA has also taken action to obtain information on the potential threat of an increase in illicit trade in menthol cigarettes, should menthol cigarettes become unavailable. At the request of the FDA, two non-profit institutions (the Committee on Law and Justice in the Division of Behavioral and Social Sciences and Education of the National Research Council, in collaboration with the Board on Population Health of the Institute of Medicine), have convened a committee to assess and report on the scope of the global and U.S. illicit tobacco markets, including demand, structure, volume, variations by country and the impact of changes in policy. This illicit trade report should provide FDA with a better understanding of the possible illicit trade impacts from different regulatory options.

3. U.S. Public Health Authorities Initiated a Multi-Million-Dollar Campaign That Is Expected to Reduce the Use of Menthol Cigarettes Among Youth

40. On a parallel track with the regulatory process, FDA also has taken measures that do not require new rulemaking that are expected to reduce the use of menthol cigarettes among youth.

41. First, FDA is initiating a broad-scale public education campaign to educate youth about the dangers of smoking, including menthol cigarettes. The Youth Tobacco Prevention Campaign targets "at-risk youth," which refers to young people aged 12-17 who either have not yet tried smoking but are open to it, or have already begun experimenting.[50] The campaign uses a comprehensive multimedia approach to reach its target audience. FDA will evaluate the outcomes of the campaign over several years (including collecting and assessing data on youth awareness and receptivity) to continue improving the effectiveness of FDA's public education campaigns over time.

42. In addition, U.S. public health authorities have taken steps to educate the public about the health consequences of menthol cigarettes by developing and providing content through U.S.

[50] Approximately 90 percent of smokers in the United States began before age 18, and nearly every other smoker began before the age of 26.

Government websites and social media. The U.S. Department of Health and Human Services developed in November 2012 an online hub for tobacco information and cessation tools, BeTobaccoFree.gov.[51] This site contains information specifically geared toward discouraging use of menthol cigarettes and will contain information related to the Youth Tobacco Prevention Campaign.

43. The National Cancer Institute has also developed a website designed to help persons quit smoking (SmokeFree.gov). This website, which includes a significant amount of content that has been added since the DSB adopted the recommendations and rulings in this dispute, educates the public on the health risks posed by menthol cigarettes. The website contains a specific page geared toward youth (teen.smokefree.gov), which emphasizes "menthol cigarettes" among the four highlighted topics related to the health effects of smoking (the others are secondhand smoke, weight and fitness, and E-cigarettes).[52] Warnings on the teensmokefree.gov menthol page include that menthol cigarettes may be more addictive than non-menthol cigarettes and that the tobacco industry historically has targeted its marketing to women, youth, and minority groups.[53] The U.S. Government also regularly updates two Twitter feeds with updates about menthol cigarettes and links to the menthol webpage.[54]

44. The United States substantial and sustained investment in efforts to target the pervasive use of menthol and regular cigarettes among at-risk youth through social and other media are based on comprehensive research and guidance on the effectiveness of such measures. The Center for Disease Prevention and Control (CDC) and the U.S. Surgeon General advise regulators that producing and maintaining effective campaigns, designed specifically to target populations, is a critical factor in reducing youth tobacco use, and use of menthol cigarettes, in particular.[55]

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[51] U.S. Government web content on menthol cigarettes (Exhibit US-20). (providing screenshots of U.S. Government web content on menthol cigarettes).

[52] U.S. Government web content on menthol cigarettes (Exhibit US-20).

[53] U.S. Government web content on menthol cigarettes, (Exhibit US-20).

[54] U.S. Government web content on menthol cigarettes, (Exhibit US-20).

[55] CDC Best Practices (Exhibit US-16); U.S. Surgeon General's Report 2012 (Exhibit US-17).

45. There is a dose-response relationship between exposure to smoking prevention media messages and reduced youth smoking, *i.e.*, the greater exposure the less likely youth are to smoke.[56] The CDC reports that new tobacco health communication campaigns that successfully reach the target audience can expect to produce changes in tobacco-related knowledge, attitudes, and behaviors within 2 years.[57] For example, a recent evaluation of CDC's 2012 "Tips From Former Smokers" campaign (which cost $54 million to develop and implement and aired for 12 weeks) found that 1.6 million smokers tried to quit smoking and more than 100,000 likely quit smoking permanently as a result of the campaign.[58] A 2000-2004 campaign targeting youth smokers, The Legacy Foundation's national "truth" campaign, was similarly effective. The truth campaign aired TV commercials targeting youth from 2000 through 2002 in 210 media markets throughout the United States.[59] Findings suggest that approximately 450,000 fewer youth and young adults initiated smoking between 2000 and 2004 as a result of the campaign.[60]

46. The current, broad-reaching U.S. initiatives, which include a focus on menthol cigarettes, are draw from these past successful efforts. Accordingly, the United States has undertaken unprecedented initiatives to prevent menthol smoking among youth after the DSB adopted the recommendations and rulings in this dispute. These education initiatives are based on a proven track record of effectiveness for similar initiatives.

IV. REQUIRED APPROACH UNDER ARTICLE 22 OF THE DSU

47. As noted above, Article 22.4 of the DSU requires that the level of any suspension of concessions or other obligations authorized by the DSB must be equivalent to the level of nullification or impairment. Article 22.7 provides that the arbitrator "shall determine whether the level of such suspension is equivalent to the level of nullification or impairment."

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[56] CDC Best Practices (Exhibit US-16); U.S. Surgeon General's Report 2012 (Exhibit US-17).

[57] CDC Best Practices (Exhibit US-16), p.34.

[58] McAfee, T, et al., "Effect of the first federally funded US antismoking national media campaign," The Lancet, September 9, 2013 ("Effects of First Federal Campaign") (Exhibit US-18).

[59] Farrelly, M. C., Nonnemaker, J., Davis, K. C., & Hussin, A. (2009). The Influence of the National truth campaign on smoking initiation. Am J Prev Med, 36(5), 379-384. doi: 10.1016/j.amepre.2009.01.019, p. 380 ("Influence of Truth Campaign") (Exhibit US-19).

[60] Influence of Truth Campaign (Exhibit US-19), p. 383.

48. Therefore, to fulfill its mandate, the Arbitrator will need to first determine whether the United States has brought its measure into compliance. This assessment of the nature and extent of compliance or non-compliance is necessary to identify whether there is any nullification and impairment to which the level of suspension can be compared at all. And in this instance, the level of nullification or impairment is zero, because there is no current breach of WTO obligations; the United States has fully implemented the recommendations and rulings of the DSB.

49. This approach is consistent with the way arbitrators have handled this issue in the past. In *EC – Bananas III* – where, as here, the Member concerned maintained that it had taken measures to comply – the arbitrator found that the mandate of Articles 22.4 and 22.7 required that the arbitrator make a determination of the nature and extent of compliance or non-compliance.[61] The arbitrator reasoned that:

> the concept of *equivalence* between the two levels (i.e. of the proposed suspension and the nullification or impairment) remain a concept devoid of meaning if either of the two variables in our comparison between the proposed suspension and the nullification or impairment would remain unknown.[62]

The arbitrator further concluded that:

> consequently, we cannot fulfill our task to assess the equivalence between the two levels before we have reached a view on whether the revised EC regime is, in light of our and the Appellate Body's findings in the original dispute, fully WTO-consistent.[63]

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[61] *EC – Bananas III (US) (Article 22.6 – EC)*, para. 4.7.

[62] *EC – Bananas III (US) (Article 22.6 – EC)*, para. 4.7.

[63] *EC – Bananas III (US) (Article 22.6 – EC)*, para. 4.8. The arbitrator further reasoned (in footnote 10) that "we note that Article 23.2(a) of the DSU provides that Members shall make any determination to the effect that a violation has occurred or that benefits have been nullified or impaired 'consistent with the findings contained in the panel or Appellate Body report adopted by the DSB *or an arbitration award* rendered under this Understanding.'" (emphasis in original.) And that this "by implication suggests that issues of violation and nullification or impairment can be determined by arbitration."

50. As set out below, in this proceeding, the United States has fully implemented the recommendations and rulings of the DSB. Accordingly, the level of nullification or impairment is zero, and the Arbitrator would have determined the level pursuant to its mandate under Article 22.7.

V. INDONESIA'S BENEFITS HAVE NOT BEEN NULLIFIED OR IMPAIRED, AND THEREFORE THE LEVEL OF NULLIFICATION OR IMPAIRMENT IS ZERO, BECAUSE THE UNITED STATES HAS FULLY IMPLEMENTED THE RECOMMENDATIONS AND RULINGS OF THE DSB

51. Indonesia's request for authorization based on its claim that its benefits under the TBT Agreement have been nullified or impaired at a level of $42.9 million should be rejected because the United States has fully implemented the recommendations and rulings of the DSB.

52. The Appellate Body and original panel reports recognize that Section 907(a)(1)(A) benefits the public health. These reports found further that Section 907(a)(1)(A) is WTO-consistent except to the extent that it was not clear that the detrimental impact on the competitive opportunities for imported clove cigarettes compared to domestic menthol cigarettes stemmed exclusively from a legitimate regulatory distinction. Thus, the United States has come into compliance in this dispute by (1) conducting a comprehensive evaluation of the public health effects of menthol cigarettes, resulting in new findings that the presence of menthol in cigarettes likely is associated with increased addiction and difficult with cessation; and (2) taking measures concerning the treatment of menthol cigarettes, consistent with the current science on the public health effects of menthol cigarettes, that have the effect of reducing competitive opportunities for menthol cigarettes. As a result, despite the fact that Section 907(a)(1)(A) treats clove and menthol cigarettes differently, viewed in the light of the new findings on menthol cigarettes and U.S. measures affecting menthol cigarettes, the detriment to imported clove cigarettes *does* stem exclusively from a legitimate regulatory distinction. Therefore, the treatment afforded under Section 907(a)(1)(A) is not "less favorable treatment" within the meaning Article 2.1 of the TBT Agreement.

53. While Indonesia may have preferred that the United States comply by repealing its measure altogether, the United States is not required to do so. Indeed, panels, the Appellate Body, and arbitrators have all recognized that a Member has discretion as to how to implement

DSB recommendations and rulings.[64] Further, in this case, where the panel and Appellate Body reports both recognized that Section 907(a)(1)(A) benefits the public health, it would not be reasonable for the United States to comply by repealing its measure, and thus, adversely affecting the public health.

54. With regard to other DSB findings, the United States considers that there is no ongoing breach with respect to Article 2.9.2, which relates to notification of a proposed technical regulation, or Article 2.12, which provides for a reasonable interval of time for producers to adapt their products or production methods to the requirements of a final technical regulation. Given the absence of an ongoing breach, there is neither nullification nor impairment of benefits, and there is no need to address this matter further.

A. The Legal Standard for Assessing Whether a Member Has Implemented DSB Recommendations and Rulings by Bringing a Measure into Conformity with Its WTO Obligations

55. Article 19.1 of the DSU provides that where a panel or the Appellate Body concludes that a measure is inconsistent with a covered agreement, it shall recommend that the Member concerned bring the measure into conformity with that agreement. Article 22 provides for the suspension of concessions or other obligations only where the Member concerned fails to bring a WTO-inconsistent measure into conformity with the recommendations and rulings of the DSB.

56. In previous proceedings that involved an examination of compliance, panels and the Appellate Body have emphasized that compliance must be evaluated in the context of the particular recommendations and rulings in each dispute.[65]

57. The compliance panel in *US – Gambling* also emphasized this point in its report under Article 21.5 of the DSU. In that dispute, Antigua asserted that the United States had taken no

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[64] *US – Gambling (Article 22.6 – US)*, para. 3.24, note 58 ("This issue has been addressed in arbitrations under Article 21.3(c) for the determination of the RPT. *See, e.g., Australia – Salmon (Article 21.3(c))*, para. 30. *See also Korea – Alcoholic Beverages (Article* 21.3(c)), para. 45 ('Choosing the means of implementation is, and should be, the prerogative of the implementing Member, as long as the means chosen are consistent with the recommendations and rulings of the DSB and the provisions of the covered agreements'").

[65] *US – Gambling (Article 21.5 – Antigua and Barbuda)*, para. 6.21; *Chile – Price Band System (Article 21.5 – Argentina) (AB)*, para. 136.

"measures to comply," arguing that the United States had not supplemented, amended, or otherwise changed the measures at issue in the original proceeding. The United States countered that Article 21.5 requires compliance with the recommendations and rulings of the DSB, which are particular to each dispute, and that, in that particular dispute, the recommendations and rulings could be implemented by providing new evidence that the measure at issue was WTO-consistent. Affirming aspects of the U.S. view, the compliance panel stated that "[t]he possible form of measures taken to comply with a recommendation under Article 19.1 of the DSU will depend on the rulings of the DSB in the particular dispute."[66] The panel further reasoned that compliance "could conceivably be achieved through changes to the factual or legal background to a measure at issue, without a change to the text of the measure itself."[67] The panel declined to determine exactly what would constitute "measures taken to comply" under Article 21.5 in that particular dispute, but emphasized that while some change is required, it "does not exclude any potential 'measures taken to comply' due to their form."[68]

58. In *EC – Continued Suspension*, the Appellate Body applied similar reasoning in interpreting Article 22.8 of the DSU to determine when the legal authority to suspend concessions under Article 22 lapses because a Member has come into compliance. The Appellate Body found that a Member may maintain its suspension of concessions only until one of three resolutive conditions set out in Article 22.8 obtains, the first being that the "measure found to be inconsistent with a covered agreement has been removed."[69] In that dispute, the EU claimed that it had satisfied the first requirement under Article 22.8 because it had removed the measure at issue in the original proceeding and replaced it with a different measure. The United States and Canada disagreed that the actions brought the EU into compliance. The Appellate Body found that the point of compliance is to reach a "substantive resolution of the inconsistency found by the DSB."[70] The Appellate Body expressly recognized that it is the inconsistency of

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[66] *US – Gambling (Article 21.5 – Antigua and Barbuda)*, para. 6.21.

[67] *US – Gambling (Article 21.5 – Antigua and Barbuda)*, para. 6.22.

[68] *US – Gambling (Article 21.5 – Antigua and Barbuda)*, para. 6.23.

[69] *US – Continued Suspension (AB)*, para. 303.

[70] *US – Continued Suspension (AB)*, para. 304.

the measure, and not the existence of the measure itself, that must be remedied.[71] The Appellate Body further noted that such an interpretation is "congruent with the scope of compliance proceedings under Article 21.5 of the DSU."[72]

59. Bringing a measure into conformity, therefore, requires remedying the WTO-inconsistency of the measure, as set out in the DSB recommendations and rulings. The Appellate Body has recognized that compliance proceedings do not occur in isolation from the original proceedings but form part of a "continuum of events."[73] The Appellate Body continued:

> The text of Article 21.5 expressly links the "measures taken to comply" with the recommendations and rulings of the DSB concerning the original measure. A panel's examination of a measure taken to comply cannot, therefore, be undertaken in abstraction from the findings by the original panel and the Appellate Body adopted by the DSB. Such findings identify the WTO-inconsistency with respect to the original measure, and a panel's examination of a measure taken to comply must be conducted with due cognizance of this background.[74]

B. The DSB Found That The U.S. Ban on Cigarettes With Characterizing Flavors is WTO-Consistent Except to the Extent That The Detriment to Imported Clove Cigarettes Does Not Appear to Stem Exclusively From A Legitimate Regulatory Distinction

60. The DSB recommendations and rulings in this dispute make clear that, to come into conformity with the TBT Agreement, the United States (1) is *not* obligated to allow clove cigarettes back into the U.S. market and (2) may maintain its public health measure, if the

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[71] *US – Continued Suspension (AB)*, para. 304 ("It is the inconsistency resulting from the measure, rather than the mere existence of the measure, that must be remedied before the obligation to cease the suspension of concessions arises.").

[72] *US – Continued Suspension (AB)*, para. 305.

[73] *Chile – Price Band System (Article 21.5 – Argentina) (AB)*, para. 136.

[74] *Chile – Price Band System (Article 21.5 – Argentina) (AB)*, para. 136.

detriment to the competitive opportunities for imported clove cigarettes compared to domestic menthol cigarettes stems exclusively from a legitimate regulatory distinction.

1. The DSB Recommendations and Rulings Recognize That Banning Clove Cigarettes Is Not, in and of Itself, Inconsistent With Article 2.1 of the TBT Agreement

61. First, the DSB found unambiguously that banning clove cigarettes reduces youth smoking and is consistent with protecting public health.[75] The Appellate Body and the original panel clarified that the inconsistency of Section 907(a)(1)(A) with Article 2.1 of the TBT Agreement *was not* based on the fact that the measure bans clove and other cigarettes;[76] rather, the inconsistency was based on the fact that the measure, in essence, does not appear to go far enough. That is, the Appellate Body did not find an apparent public health reason to exclude menthol cigarettes from a measure designed to reduce youth smoking.

62. Accordingly, the DSB recommendations and rulings do not suggest that the United States must roll back and, thereby, weaken, its public health measure by allowing clove cigarettes back into the U.S. market. A measure to comply that weakens the public health would be counter to U.S. public policy objectives and is not required by the recommendations and rulings of the DSB, which expressly affirm that the U.S. measure in this case is consistent with protecting the public health; that there is *not* a less trade restrictive alternative measure that would achieve U.S. policy objectives; and that the TBT Agreement permits Members to use technical regulations to

[75] Panel Report, paras. 7.415-16 ("In our view, the evidence reviewed above basically speaks for itself: it is not correct, as Indonesia asserts, that the scientific basis for banning clove and/or other flavoured cigarettes consists of a 'single line from a single study'. Rather, there is extensive scientific evidence supporting the conclusion that banning clove and other flavoured cigarettes could contribute to reducing youth smoking. We note that the conclusion arising from the scientific evidence reviewed above is only further reinforced by Indonesia's counter evidence. We find it striking that Indonesia has apparently only been able to find one scientific expert who expresses a contradictory view, and then only in the form of a post to his own web blog (as opposed to peer-reviewed medical or scientific journal)").

[76] Appellate Body Report, paras. 235-236 ("In particular, we are not saying that the United States cannot ban clove cigarettes[…]"); Panel Report, para. 7.290 ("We are not saying that the United States is not allowed to adopt measures such as Section 907(a)(1)(A) to regulate products for public health reasons[.]").

achieve legitimate objectives, even in some circumstances where there is an adverse effect on trade.[77]

2. The Appellate Body Found That Section 907(a)(1)(A) Was Inconsistent With Article 2.1 of the TBT Agreement Based on An Apparent Assumption That the Possible Negative Consequences Identified by the United States Would Not Materialize if Menthol Cigarettes Were Banned

63. It also is clear that the recommendations and rulings of the DSB do not require the United States to ban menthol cigarettes. According to the DSB recommendations and rulings, Section 907(a)(1)(A) was determined to be inconsistent with Article 2.1 of the TBT Agreement because the Appellate Body was not persuaded that the detriment to imported clove cigarettes stems "exclusively from a legitimate regulatory distinction."[78] Therefore, the United States may maintain Section 907(a)(1)(A) if the measure *is* even-handed because the detriment to imported clove cigarettes *does* stem exclusively from a legitimate regulatory distinction.

64. The Appellate Body and the original panel emphasized that the TBT Agreement does not prevent Members from making legitimate regulatory distinctions among "like products."[79] The Appellate Body noted, in particular:

> We thus understand the sixth recital [of the Preamble to the TBT Agreement] to suggest that Members have a right to use technical regulations in pursuit of their legitimate objectives, provided that they do so in an even handed manner and in a manner that is otherwise in accordance with the provisions of the *TBT Agreement.*[80]

65. To determine whether Section 907(a)(1)(A) accords less favorable treatment to imported clove cigarettes than to domestic menthol cigarettes under Article 2.1, both the Appellate Body and the original panel first determined that imported clove cigarettes and domestic menthol

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[77] Appellate Body Report, paras. 94-95 ("The objective of avoiding the creation of unnecessary obstacles to international trade through technical regulations, standards, and conformity assessment procedures is, however, qualified in the sixth recital by the explicit recognition of Members' right to regulate in order to pursue certain legitimate objectives.")

[78] Appellate Body Report, para. 225; See section II.A para. 9.

[79] Appellate Body Report, paras. 88-95, 174-75, 225; See section II.A para. 9.

[80] Appellate Body Report, para. 5.

cigarettes are "like" products,[81] and then determined that Section 907(a)(1)(A) has a detrimental effect on the competitive opportunities of the group of imported like products compared to the group of domestic like products.[82]

66. The Appellate Body and the original panel then conducted an additional analysis of the public health basis provided by the United States for why the imported and domestic products are accorded different treatment.[83] The Appellate Body and original panel considered that the national treatment obligation under the TBT Agreement does not prohibit technical regulations that draw distinctions among products deemed to be "like," even where the result is an adverse impact on the competitive opportunities of the group of imported like products. The Appellate Body explained that

> The "treatment no less favourable" requirement of Article 2.1 of the *TBT Agreement* applies "in respect of technical regulations". A technical regulation is defined in Annex 1.1 thereto as a "[d]ocument which lays down product characteristics or their related processes and production methods … with which compliance is mandatory". As such, technical regulations are measures that, by their very nature, establish distinctions between products according to their characteristics or their related processes and production methods. This suggests, in our view, that Article 2.1 should not be read to mean that *any* distinction, in particular those that are based *exclusively* on particular product characteristics or their related processes and production methods, would *per se* accord less favourable treatment within the meaning of Article 2.1.[84]

67. The United States argued that it bans clove and other flavored cigarettes, and not menthol and regular cigarettes, because of differences in how the products are used by consumers in the U.S. market. When the U.S. Congress adopted Section 907(a)(1)(A), it found that, in contrast to most flavored cigarettes which are used almost exclusively as "starter" cigarettes by young people, menthol and regular cigarettes are used habitually by a large population of adults;[85] therefore, legislative record demonstrates that while banning clove and other flavored cigarettes

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[81] Appellate Body Report, para. 160.

[82] Appellate Body Report, paras. 161-175.

[83] Appellate Body Report, paras. 161-175; 215, 224-25; Panel Report, para. 7.289-7.291;

[84] Appellate Body Report, para. 169.

[85] Panel Report, para. 2.25; U.S. First Written Submission (Orig. Panel) paras. 132-134; U.S. House Report, p. 38 (Exhibit US-21) (Orig. Panel US-Exhibit 67).

would reduce smoking initiation without a risk of significant possible negative public health consequences, the potential ban of menthol or regular cigarettes *could* result in negative public health consequences – *e.g.*, a strain on public health resources to accommodate addicted smokers seeking cessation services, or increased illicit trade in cigarettes.[86]

68. To be clear, the United States did not argue that such consequences are *certain* to occur if menthol cigarettes are banned, but that there is a real possibility that they would occur, which requires further evaluation. On the other hand, no comparable concern existed with respect to clove and other flavored cigarettes smoked in small numbers primarily by young, experimental smokers.[87]

69. The Appellate Body and original panel found, on different grounds, that the United States was unable to demonstrate that the differences between clove cigarettes and menthol cigarettes constitute a legitimate basis to ban the former but not that latter. The original panel concluded that the U.S. objective – *i.e.*, banning only the "niche" cigarettes used primarily by young people and at the same time avoiding the possible negative consequences which might result from banning widely-used menthol cigarettes – actually appeared to be related to avoiding costs on U.S. entities, while imposing costs on foreign exporters.[88] The Appellate Body modified this analysis, noting that, even were actual or potential costs relevant to an Article 2.1 analysis, the panel "did not elaborate on why, in its view, Section 907(a)(1)(A) does not impose costs on 'any U.S. entity.'"[89]

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[86] U.S. First Written Submission (Orig. Panel) paras. 132-134; U.S. House Report, p. 38 (Exhibit US-21) (Orig. Panel Exhibit US-67).

[87] *See, e.g.*, Panel Report, para. 7.389; U.S. First Written Submission (Orig. Panel) para. 134; U.S. Submission (AB), para. 62.

[88] Panel Report, para. 7.289-90 ("These reasons which the United States has presented as constituting legitimate objectives by themselves, appear to us as relating on one way or another to the costs that might be incurred by the United States were it to ban menthol. […] It seems to us that the effect of banning cigarettes with characterizing flavours other than menthol is to impose costs on producers in other Members, notably producers in Indonesia, while at the same time imposing no costs on any U.S. entity.").

[89] Appellate Body Report, para. 221.

70. The Appellate Body's analysis focused on the legitimacy of the regulatory distinction between menthol cigarettes and clove cigarettes, rather than on the legitimacy of the objective of the measure.[90] The Appellate Body Report summarized the appropriate analysis as follows:

> Where the technical regulation at issue does not *de jure* discriminate against imports, a panel must carefully scrutinize the particular circumstances of the case, that is, the design, architecture, revealing structure, operation, and application of the technical regulation at issue, and, in particular, whether that technical regulation is even handed, in order to determine whether the detrimental impact on imports stems exclusively from a legitimate regulatory distinction rather than reflects discrimination against the group of imported products.[91]

71. In applying this analysis, the Appellate Body noted that the "design, architecture, revealing structure, operation, and application of Section 907(a)(1)(A) strongly suggest" discrimination, because the products prohibited consist primarily of clove cigarettes imported from Indonesia, while the like products that are actually permitted under the measure consist primarily of domestically produced menthol cigarettes.[92] The Appellate Body was not convinced that the possible negative consequences associated with banning menthol cigarettes identified by the United States actually would materialize and, therefore, found that the possibility of those consequences materializing does not mean that the different treatment stemmed solely from a legitimate regulatory distinction. The Appellate Body characterized U.S. concerns regarding the healthcare system and illicit market as arising from "withdrawal symptoms that would afflict menthol cigarette smokers in case those cigarettes were banned."[93] The Appellate Body then reasoned that withdrawal symptoms were tied to the addictive nature of menthol cigarettes,[94] and that "the addictive ingredient in menthol cigarettes *is nicotine, not peppermint or any other ingredient that is exclusively present in menthol cigarettes*."[95] That is,

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[90] Appellate Body Report, para. 225.

[91] Appellate Body Report, para. 192.

[92] Appellate Body Report, para. 224.

[93] Appellate Body Report, para. 225 ("Thus, according to the United States, the exemption of menthol cigarettes from the ban on flavored cigarettes is justified in order to avoid risks arising from withdrawal symptoms that would afflict menthol cigarette smokers in case those cigarettes were banned.").

[94] Appellate Body Report, para. 225.

[95] Appellate Body Report, para. 225 (emphasis added).

the Appellate Body found (without citing to any panel findings) that the level of addiction among menthol cigarette smokers is solely attributable to nicotine. The Appellate Body then stated that it "is not clear" that such possible negative consequences would materialize, insofar as regular cigarettes, which also contain nicotine, would remain on the market.[96]

72. In sum, the Appellate Body was not convinced that the risks associated with banning menthol cigarettes are linked to any characteristic other than the presence of nicotine. Because other sources of nicotine would remain available, the Appellate Body reasoned that negative consequences from banning menthol would not materialize. The Appellate Body's conclusion to this apparent reasoning is that the regulatory distinction was not legitimate. The Appellate Body finally concluded that "even though Section 907(a)(1)(A) does not expressly distinguish between treatment accorded to the imported and domestic like products, it operates in a manner that reflects discrimination against the group of like products imported from Indonesia."[97]

C. The United States Has Fully Implemented the Recommendations and Rulings of the DSB by Taking Measures That Demonstrate That the Detrimental Effect on Imported Clove Cigarettes Stems Exclusively From a Legitimate Regulatory Distinction

73. After the DSB adopted the recommendations and rulings set out above, the United States undertook a comprehensive evaluation of the public health effects of menthol cigarettes and took new measures affecting the treatment of menthol cigarettes. On the basis of the resulting treatment of imported clove cigarettes compared to domestic menthol cigarettes, any remaining detrimental impact on imported clove cigarettes stems exclusively from a legitimate regulatory distinction. As described above, the United States has fully implemented the recommendations and rulings of the DSB by undertaking additional evaluation and taking measures related to menthol cigarettes.

74. First, U.S. public health authorities have conducted a comprehensive analysis of available data and information on the public health effects of the presence of menthol in cigarettes. The results of this rigorous analysis by U.S. public health authorities demonstrate that there are

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[96] Appellate Body Report, para. 225.

[97] Appellate Body Report, para. 226.

factors related to menthol cigarettes *in addition to the presence of nicotine* which likely effect addiction and cessation and, by the Appellate Body's reasoning, therefore validate U.S. concern that possible negative consequences could result from a precipitous ban on menthol cigarettes.

75. Second, the United States has ensured that regulation of clove cigarettes and menthol cigarettes is even-handed by taking measures in relation to menthol cigarettes that have the effect of reducing competitive opportunities – that is, which result in reduced demand for menthol cigarettes and a loss of sales for domestic menthol cigarette producers. The United States is also advancing the regulatory process with respect to menthol cigarettes.

1. New Findings Confirm That the Presence of Menthol in Menthol Cigarettes Is Likely Associated With Increased Addiction and Difficulty With Cessation

76. The FDA has conducted a comprehensive evaluation of the public health effects of the presence of menthol in cigarettes, and the results demonstrate that the presence of menthol in cigarettes is likely associated with increased addiction. In addition, the results demonstrate that menthol in cigarettes is likely associated with an increased difficulty with cessation.[98]

77. The essence of the DSB recommendations and rulings is not that the United States must ban menthol cigarettes if it maintains its ban on clove cigarettes, but that, if it does not, the regulatory distinction between the products must be legitimate. The Appellate Body further clarified that the reason it was not persuaded that the regulatory distinction is legitimate was that it appeared that the source of U.S. concern over the possible negative consequences of banning menthol cigarettes was the presence of nicotine in cigarettes. Therefore, so long as regular cigarettes remain on the market, those possible negative consequences would not materialize.[99] The Appellate Body was not convinced that a strain on the health system or the worsening of the black market would materialize if menthol cigarettes are banned, because consumers would still have access to nicotine through other products.

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[98] FDA Menthol Report, pps. 6, 113, 130 (Exhibit US-13).

[99] Appellate Body Report, para. 225.

78. The findings in the FDA Menthol Report demonstrate that there likely are factors related to menthol cigarettes other than the presence of nicotine which affect addiction and cessation. This finding directly addresses what the Appellate Body apparently considered to be a logical flaw in the U.S. public health rationale concerning the risks of banning menthol cigarettes. Contrary to the Appellate Body's assumption, menthol smokers appear to be more addicted than non-menthol smokers and have a harder time quitting, which might make them more likely than regular smokers to seek medical treatment for cessation assistance or illicit cigarettes if their preferred type of cigarette were no longer available.[100]

79. The United States completed its analysis on the relationship between addiction and menthol subsequent to the DSB recommendations and rulings. While there has never been a question that menthol cigarettes may have an adverse impact on public health, FDA had not completed its evaluation of their specific public health implications by the time the DSB made its recommendations and rulings. The FDA's July 2013 Menthol Report, produced subsequently pursuant to authority provided in the Tobacco Control Act,[101] provides critical findings about the association between the presence of menthol in cigarettes and users' level of addiction and likely success at cessation.

80. While Congress was aware when it enacted Section 907(a)(1)(A)) that banning widely-used, harmful products may involve risks to the public health that banning lesser-used harmful products does not involve,[102] the significance of the FDA Menthol Report and its timing is that it provides specific evidence addressing what the Appellate Body understood as a logical flaw in the U.S. regulatory distinction. It provides critical findings about the association between the

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[100] This does not mean that such concerns *necessarily* would materialize. Rather, the Appellate Body's finding was that they *would not* materialize. The U.S. burden is to demonstrate that the concern, and therefore the regulatory distinction, is legitimate. The United States does not maintain that such concerns mean that menthol cigarettes should not or could not be banned; rather, the United States maintains that the concerns must be evaluated and managed through a regulatory process, which necessarily will take more time than if there were no such complicating factors, as was the case with clove and other, lesser-used cigarettes with characterizing flavors.

[101] Congress empowered FDA to regulate tobacco products, which enabled the FDA to evaluate the public health effects of menthol cigarettes and the risks associated with potential efforts to regulate them.

[102] First Written Submission (Orig. Panel) paras. 132-134; U.S. House Report, p. 38 (Exhibit US-21) (Orig. Panel Exhibit US-67).

presence of menthol in cigarettes and users' level of addiction and likely success at cessation, and thus, has changed the situation since the DSB recommendations and rulings were adopted.

2. The United States Has Taken Measures That Ensure That Its Regulation of Clove Cigarettes and Menthol Cigarettes is Even-Handed

81. The United States also has taken measures that ensure that it is regulating clove cigarettes and menthol cigarettes in an even-handed manner within the meaning of the Appellate Body's findings, and is moving without delay in determining possible further regulation of menthol cigarettes. In conjunction with completing and releasing the FDA Menthol Report, FDA released an Advanced Notice of Proposed Rulemaking (ANPRM) soliciting information and input on possible measures with respect to menthol cigarettes, including a possible restriction or ban.[103] FDA also has taken the initiative to obtain additional information and assessments relating to the actual or potential illicit markets in tobacco products.

82. In parallel with the regulatory process, U.S. public health authorities have taken actions that reduce demand for menthol cigarettes that do not require rulemaking. As described above, the United States is initiating a Youth Tobacco Prevention Campaign to educate youth about the risks of smoking cigarettes, including menthol cigarettes. The U.S. Government invested $115 million for the first two years of the campaign. Health authorities also have created a new website, BeTobaccoFree.gov, and are regularly providing new content on the existing website, Smokefree.gov/Teensmokefree.gov, and its related Twitter accounts, to provide information to consumers on the risks of smoking menthol.[104]

83. These investments in projects to educate youth and the larger public about the risks of menthol cigarettes have had a direct impact on the sale of menthol cigarettes in the United States thus far, and this impact is expected to increase. Direct results of these education efforts cannot be specifically quantified at this time. However, as set out in more detail above, evidence shows that education campaigns are effective at reducing cigarette consumption.[105] For that reason, the

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[103] ANPRM (Exhibit US-15).

[104] U.S. Government web content on menthol cigarettes (Exhibit US-20).

[105] Effects of First Federal Campaign, Exhibit US-18, Influence of Truth Campaign (Exhibit US-19).

United States has made a serious investment – already $115 million for the first two years – to establish and maintain significant education efforts. These U.S. measures with respect to menthol cigarettes are reducing (and should continue to reduce) demand for the product, and therefore constitute treatment that is even-handed in comparison to the treatment accorded to imported clove cigarettes. Domestic menthol producers have lost approximately $52 million in U.S. sales since the 2006-2008 annual average before Section 907(a)(1)(A) went into effect.[106]

84. U.S. public health measures affecting imported clove cigarettes and domestic menthol cigarettes make a material contribution to the reduction of cigarette smoking in the United States. Measured in terms of effect on smoking initiation, the contributions of both measures are balanced. The ban on cigarettes with a characterizing flavor of cloves could contribute by eliminating smoking among up to 6,800 youths in the United States that Indonesia identified as clove smokers.[107] Education efforts that that eliminate smoking among just 0.007 percent of the 1 million youth who smoke menthol cigarettes achieves the same result.[108] Other tobacco campaigns have far surpassed these results.[109] Accordingly, U.S. public education efforts to reduce youth menthol smoking demonstrate that the United States is *not* regulating clove and menthol cigarettes in such a way that discriminates against imported products and is, instead, according even-handed treatment to menthol cigarettes compared to clove cigarettes, in light of the particular public health risks associated with each product.

85. In conclusion, the United States has fully implemented the recommendations and rulings of the DSB in this dispute by undertaking a new, comprehensive evaluation of the public health effects of menthol cigarettes, resulting in new findings (which were not available during the original proceeding) that demonstrate a distinction between the products that that the Appellate Body assumed not to exist. Thus, in the context of the evidence at this time, the United States has taken new measures that affect the competitive opportunities of menthol cigarettes. The new

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[106] Menthol Cigarette Consumption in the United States (Exhibit US-4).

[107] Panel Report, para. 7.390 (Indonesia maintained that 6,800 youth in the United States smoked clove cigarettes).

[108] U.S. Government web content on menthol cigarettes (Exhibit US-20).

[109] Effects of First Federal Campaign (Exhibit US-18), Influence of Truth Campaign (Exhibit US-19).

analysis, findings and measures demonstrate that any remaining detriment to the competitive opportunities for imported clove cigarettes stems exclusively from a legitimate regulatory distinction and, therefore, have brought the U.S. measure into compliance.[110]

VI. EVEN ASIDE FROM THE FACT THAT THE UNITED STATES HAS COMPLIED, THE LEVEL OF NULLIFICATION AND IMPAIRMENT OF INDONESIA'S BENEFITS UNDER THE TBT AGREEMENT UNDER ANY REASONABLE COUNTERFACTUAL IS ZERO

86. Should the arbitrator conclude that the United States has fully implemented the recommendations and rulings of the DSB, it should determine that the level of nullification or impairment is zero, and therefore, the level of suspension of concessions or other obligations would also be zero. The arbitrator would have fulfilled its mandate under Article 22.7 of the DSU and would not need to conduct any further analysis.

87. Even aside from the fact that the United States has complied, however, the level of nullification and impairment from current U.S. measures is still zero under any other plausible compliance scenario.

88. The guiding principle in determining the level of nullification or impairment should be to determine what would have been the value of Indonesia's clove cigarette exports to the United States in the situation of compliance.[111] In previous proceedings, arbitrators have compared the actual amount of exports that are affected by the WTO-inconsistent measure to the amount of exports in a "counterfactual" (in which the responding party brought the WTO-inconsistent measure into conformity).[112] The difference in the amount of exports to the responding party under these two situations typically represents the "level" of nullification or impairment.

89. Any counterfactual that assumes that the U.S. would comply by permitting clove cigarettes into the U.S. market is *not* reasonable. In fact, it would run directly counter to U.S. public health objectives to take measures to promote *more* cigarette availability, such as lifting

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[110] *US – Gambling (Antigua) (Article 21.5 – Antigua and Barbuda)*, para. 6.22 (The arbitrator recognized that compliance could be achieved through a change to the factual circumstances and without a change to the text of the measure itself.).

[111] *See, e.g., EC – Hormones (Canada) (Article 22.6 – EC)*, paras. 37, 40.

[112] *See, e.g., EC – Hormones (Canada) (Article 22.6 – EC)*, paras. 37, 40.

the ban on sales of clove cigarettes. Rather, another plausible compliance scenario could be a ban on menthol cigarettes, which would not result in any clove cigarette exports for Indonesia. This scenario again demonstrates that the nullification or impairment to Indonesia from the current measures is zero.

90. A threshold question in any examination of the level of nullification and impairment involves determining the appropriate counterfactual to use to compare the level of trade that would occur in a scenario where there is compliance with the actual scenario being examined. Past arbitrators have also been confronted with a choice among possible counterfactuals, and decided to choose on the basis of what is "reasonable."[113]

91. Indonesia proposes a counterfactual in which the United States removes Section 907(a)(1)(A). Indonesia goes so far as to assert that this is "at least a plausible or 'reasonable' compliance scenario."[114] To be clear, when Indonesia refers to "resumption of this trade" as its proposed counterfactual, it means permitting clove and other flavored cigarettes to be sold in the U.S. market. That is, Indonesia assumes that the United States would therefore take action with demonstrated adverse effects on public health.

92. Contrary to Indonesia's assertion, it is <u>not</u> a "plausible" or "realistic" compliance scenario that the United States would come into compliance with the recommendations and

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[113] *See EC – Bananas III (US) (Article 22.6 – EC)*, para. 7.7 (There, the arbitrator was choosing among at least 4 possible counterfactuals and said: "There are various counterfactual regimes that would be WTO consistent. We have evaluated the various counterfactuals and we have decided to choose, as a reasonable counterfactual, a global tariff quota equal to 2.553 million tonnes (subject to a 75 Euro per tonne tariff) and unlimited access for ACP bananas at a zero tariff (with the ACP tariff preference being covered as now by a waiver). .") *See also US – Gambling (Article 22.6 – US)*, para. 3.30 (Presented a counterfactual by Antigua that assumed unrestricted access to the U.S. remote gambling market, and a counterfactual proposed by the United States that assumed much more limited access, the Arbitrator found in favor of the United States. The Arbitrator explained that "[the determinations in *US – Section 110(5) Copyright Act* and *EC – Bananas III*] confirm us in our view that, to the extent that the estimation of the level of nullification or impairment requires certain assumptions to be made as to what benefits would have accrued, in a situation where compliance would have taken place, such assumptions should be reasonable, taking into account the circumstances of the dispute […]."

[114] Indonesia Methodology Paper, p. 2. Indonesia also states that: "It is beyond cavil that one of the benefits that could accrue to the Republic of Indonesia ('Indonesia') from compliance with the rulings and recommendations of the DSB in the instant dispute would be the removal of the Measure and the resumption of this trade. Indeed, this is likely one of the few ways the United States could comply with its obligations under Articles 2.9.2 and 2.12 of the TBT Agreement." However, Indonesia fails to explain why this is the case or why the DSB recommendations rulings with respect to Articles 2.9.2 and 2.12 of the TBT Agreement should be interpreted to call for adversely affecting public health.

rulings of the DSB by removing any part of Section 907(a)(1)(A). Those DSB recommendations and rulings are clear that Section 907(a)(1)(A) makes a material contribution to the public health.

93. It is important to all Members, and indeed all of their citizens, that the WTO is clear on this very important point. There is nothing in the TBT Agreement that requires a Member to sacrifice public health in order to meet its trade obligations. To the contrary, the WTO Agreement fully accommodates Members' legitimate objective of protecting the public health.

94. The reality then is that in order to be reasonable, any counterfactual must take into account that U.S. compliance will continue to protect the public health at the level at least the same as under Section 907(a)(1)(A). A counterfactual that involves permitting the sale of clove cigarettes would not be one that safeguards the public health, and therefore would not be reasonable. In light of the nature of the DSB recommendations and rulings at issue then, which involved the difference in treatment of clove and menthol cigarettes, any compliance would of necessity be focused on measures concerning menthol cigarettes. [115]

95. This means that under any reasonable counterfactual, sales of clove cigarettes, with their adverse effect on public health, would not be permitted. Because a reasonable or likely compliance scenario in this dispute would not involve any level of trade in clove cigarettes, the level of nullification or impairment of Indonesia's benefits under the current U.S. measures is zero.

VII. EVEN UNDER INDONESIA'S INCORRECT COUNTERFACTUAL, THE LEVEL MUST REFLECT THAT INDONESIAN PRODUCERS HAVE NOT LOST EXPORT OPPORTUNITIES

96. The United States has explained how Indonesia's counterfactual – the resumption of exports of clove cigarettes – is unreasonable and must be rejected. In the next section, we will explain that, not only is Indonesia's counterfactual incorrect, its methodology is riddled with methodological errors. In this section, the United States notes that even a counterfactual based

[115] Previous arbitrators have clarified that withdrawing a WTO-inconsistent measure is not the only way to come into compliance. *US – Gambling (Article 22.6 – US)*, para. 3.46 ("We also note that while Article 3.7 of the DSU does provide that the objective of dispute settlement proceedings is *usually* the withdrawal of the inconsistent measures, we do not read this provision to mean that this is in all cases the only possible outcome[…].").

on Indonesia's faulty notion that the U.S. should have lifted Section 907(a)(1)(A) results in a level of nullification or impairment of zero.

97. An analysis of what level of benefits would accrue to Indonesia in the scenario where Section 907(a)(1)(A) were revoked must take account of the fact that Indonesian clove manufacturers have not been economically impacted by the U.S. measure. Those manufacturers retained their exports by deliberately making minimal alterations to their products and marketing them as clove cigars and cigarillos instead of as clove cigarettes. As set out above, Indonesia's clove cigarette manufacturers anticipated Section 907(a)(1)(A) by adjusting the specifications of clove cigarettes in order to market them as clove cigars and cigarillos, and thereby maintain their market share. Under this business strategy, Kretek has been marketing its products as a "replacement" of clove cigarettes through the same distribution channels[116] to the same consumers[117] at nearly the same annual trade value.[118]

98. The U.S. market for clove cigars and cigarillos has been created by Indonesian manufacturers as a means to continue their pre-existing business. Kretek is explicit that it is "continuing its business" by tapping the existing market for "cloves" in the United States. The presence of Indonesian clove cigars in the U.S. market has satisfied demand for "cloves." Indonesia has maintained the position throughout this dispute that demand for clove cigarettes has "remained flat" at approximately 0.1 percent of the U.S. cigarette market for at least the 10

[116] *See, e.g.*, May 14, 2009 email ("because we are number one in cloves and want to stay that way – continuing to provide our distributor customers with a solid source of business.") (Exhibit US-8); July 2009 National Sales Meeting Presentation ("Maintain the continuity of our relationship with each distributor." (p. 1332) "Djarum filtered clove cigars: Maintaining Djarum volume will create up to 5% market share for Djarum in [other tobacco products]." (p. 1335)". According to Kretek's July 2009 National Sales Meeting Presentation, Kretek managed a roll-out with existing distributor clients of seven new styles of clove cigars, modeled after Kretk's most popular clove cigarette brand, Djarum Black (Exhibit US-9), pps. 1332, 1335-37.

[117] *See, e.g.*, May 14, 2009 email ("[…]we want consumers who enjoy cloves to continue to have an affordable product" … "We are positioning this as 'The taste your clove customers expect. For POS seen by consumers it will say "The taste you expect.") (Exhibit US-8); July 2009 National Sales Meeting Presentation ("Goal is seamless conversion to clove cigars as cigarettes are depleted." (p. 1332) "Clove cigar development action plan: A replacement product for Djarum clove cigarettes; […] the rich smooth taste clove smokers expect." (p. 1334). According to Kretek's July 2009 National Sales Meeting Presentation, Kretek understood clove cigars would be accepted by existing clove cigarette smokers in the United States as an acceptable replacement, delivering the "taste" they "expect." Exhibit US-9, pps. 1332, 1334, 1339-40.

[118] U.S. import statistics (Exhibit US-5).

years before Section 907(a)(1)(A) took effect.[119] The average annual value of clove cigarette imports during the 10 years before Section 907(a)(1)(A) went into effect was $10.3 million.[120]

99. In the three years before the measure took effect, annual average value of clove cigarette imports was $13.8 million.[121] The average annual value of clove cigars and cigarillos in the three years before Section 907(a)(1)(A) was $0.02 million.[122] Strikingly, but consistent with the business plans of Indonesian manufacturers, in the three years *after* the measure took effect, the average annual value of clove cigar and cigarillo imports increased to $11.9 million.[123] While the level of clove cigars and clove cigarillos is slightly lower (reflecting steadily decreasing consumption of cigarettes in the United States, as discussed in the next section), the trend is undeniable. Kretek has "seamlessly" maintained its export level:

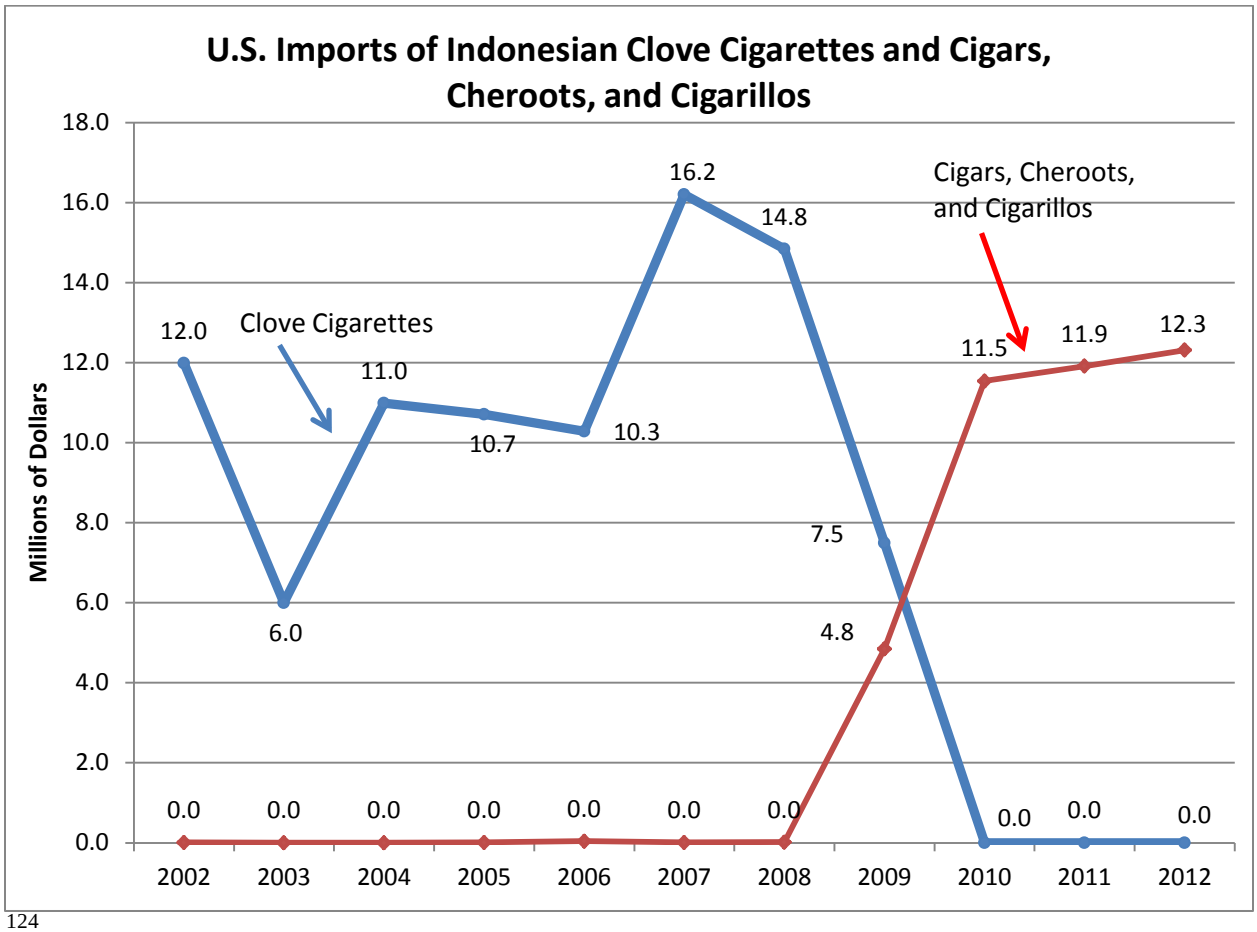
[119] Indonesia's response to Panel Question 16 ("**Q 16 Both Parties:** According to Indonesia' clove cigarettes 'currently account' for 0.09 per cent of all cigarettes consumed in the United States. Have clove cigarettes had a greater or lesser share of the US cigarette market over time, or did the market share remain generally flat at around 0.1 per cent? Please provide figures for the past 10 years. **Indonesia**: Clove cigarette market share has remained generally flat at around 0.1 per cent. See exhibit IND-48.") (Exhibit US-22).

[120] U.S. import statistics (Exhibit US-5).

[121] U.S. import statistics (Exhibit US-5).

[122] U.S. import statistics (Exhibit US-5).

[123] U.S. import statistics (Exhibit US-5).



[124]

100. Therefore, there is *no* reasonable basis to assume that there is unmet demand for Indonesian clove cigarettes and that Indonesia's trade opportunities are being nullified or impaired. Even under Indonesia's incorrect counterfactual, which assumes that the United States removes Section 907(a)(1)(A), Indonesia would not see an increase in U.S. demand for, and its exports of, "cloves." Further, there is no reasonable basis to assume as Indonesia does that the annual level of imports of Indonesian clove cigarettes would suddenly increase dramatically or even double, such that current clove "cigar" or "cigarillo" sales would be maintained at current levels if the United States were to again permit clove cigarettes in the market.

101. Accordingly, even under Indonesia's incorrect counterfactual of the elimination of Section 907(a)(1)(A), the level of nullification or impairment would need to reflect the extent to

[124] U.S. import statistics (Exhibit US-5).

which Indonesian exporters have continued to enjoy the benefits of clove exports. As explained above, Indonesian clove exports have continued under another name, and the resulting level of nullification or impairment from the U.S. measures therefore is zero.[125]

VIII. EVEN UNDER INDONESIA'S INCORRECT COUNTERFACTUAL, ITS METHODOLOGY IS RIDDLED WITH ERRORS AND FLAWED ON ITS OWN TERMS

102. As explained, Indonesia proceeds from the wrong counterfactual, and under any different, plausible implementation scenario, the level of nullification or impairment is zero. This alone is sufficient to demonstrate that the methodology proposed by Indonesia in its methodology paper is incorrect. And under that incorrect counterfactual, its analysis fails to take into account that its manufacturers have continued to export a product to satisfy demand for "cloves." This too demonstrates that the level of nullification or impairment of benefits to Indonesia from current U.S. measures is zero.

103. For purposes of completeness, it may also be useful to note that even under Indonesia's counterfactual, Indonesia's methodology is riddled with errors and flawed. The discussion that follows examines Indonesia's application of its incorrect counterfactual and demonstrates that, even under that unrealistic counterfactual, the proposed level of nullification or impairment is greatly exaggerated by faulty assumptions and methodological errors.

104. Indonesia's incorrect methodology also makes unreasonable assumptions, such as speculating about trade values where actual numbers exist; includes unreasonable factors, such as a "multiplier effect"; and ignores relevant and indeed crucial factors, such as declining demand for cigarettes in the United States.

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[125] As set out in the next section, the average annual value of clove cigarette imports in the three years before Section 907(a)(1)(A) took effect (*i.e.*, 2006-2008) was $13.8 million, before taking account of the steady decrease in cigarette consumption in the United States. Cigarette consumption decreased by 19.7 percent from the 2006-2008 average to 2012 (the last year for which data is available). Exhibit US-3. Therefore, to accurately project hypothetical prospective export values of clove cigarettes, one would need to reduce by 19.7 percent the average from the three-year period before the ban, resulting in a level of **$11.06**. Accordingly, when one compares the level of estimate prospective imports of clove cigarettes from Indonesia **–$11.06** – to the level of imports of clove cigars and clove cigarillos from Indonesia after the ban – **$11.9** – the resulting level of nullification or impairment is zero.

105. As a primary example, although the value of Indonesia's clove cigarette exports to the United States each year averaged $13.8 million in the three years before the ban took effect, Indonesia unreasonably proposes that the level of nullification or impairment of its benefits under the TBT Agreement is $42.9 million per year. This figure vastly overstates the level of nullification or impairment because it is based on (improperly) constructed rather than actual trade values, and inappropriately incorporates a vague and speculative "multiplier effect." As explained below, even under Indonesia's incorrect counterfactual, the level of nullification or impairment should be no more than the average annual trade value before the ban took effect ($13.8 million), adjusted downward to account for the decline in demand for cigarettes in the United States ($11.06 million).

106. Among the major flawed steps that Indonesia includes in its calculation are the following:

- Indonesia asserts that a "plausible" or "reasonable" counterfactual would be the removal of Section 907(a)(1)(A);[126]
- Indonesia asserts that the benchmark for determining the level of nullification or impairment should be the average annual value of clove cigarettes imports for "the three year period before the measure took effect"[127] – but then departs from its own proposed benchmark and instead constructs a value based on the *two-and-a-half years* preceding the ban (January 2007 through June 2009) and "estimates" a value for July through December of 2009,[128] resulting in an average value of US$15.4 million built on speculation;[129]

[126] Indonesia's Methodology Paper, p.2.

[127] Indonesia's Methodology Paper, p.2.

[128] Indonesia's Consultant Report, p.1.

[129] Indonesia's Consultant Report, p.1.

- Indonesia then incorrectly theorizes that the level of nullification or impairment should reflect some supposed broader effects on the Indonesian economy – a so-called "multiplier effect;"[130]

- Indonesia calculates an alleged "negative demand shock" in 2010 by adjusting the 2007-2009 import values according to the U.S. CPI inflation rates for each year, resulting in a value of $15.9 million;[131]

- Indonesia purports that the "multiplier effect" of the "negative shock demand" is 2.5, and will be felt by 2014, meaning that the constructed value of $15.9 million should be multiplied by 2.5, the product of which is $39.75 million; and

  Finally, Indonesia asserts that this figure must again be upwardly adjusted for U.S. inflation from 2011 through 2013, resulting in a proposed nullification or impairment value of $42.9 million.[132]

In following this flawed methodology, Indonesia ultimately arrives at proposed level of nullification and impairment that is over three times the average level of imports during the prior three year period prior to adoption of the measure, a completely inflated estimate.

107. In addition to the flaws highlighted above, another problem with Indonesia's approach is that it fails to take into account both the decline in demand in the United States for cigarettes. The result is a methodology that, examined on its own terms, is riddled with erroneous assumptions and flaws.

A. The Annual Average of U.S. Imports of Indonesian Clove Cigarettes Would Need to Be Based on Actual Trade Values in the Years Before Section 907(a)(1)(A) Went Into Effect

108. Indonesia's methodology paper suggests that an appropriate basis for the level of nullification or impairment would be the trade values in the three year period before the ban took

[130] Indonesia's Consultant Report, p.1.

[131] Indonesia's Consultant Report, p.2.

[132] Indonesia's Consultant Report, p.2.

effect.[133] Inexplicably, Indonesia's consultant report then calculates its average including "estimated values" *after* the ban went into effect.[134]

109. Under Indonesia's counterfactual, one starting point in determining the level of nullification or impairment could be the average annual value of Indonesian clove cigarette exports to the United States for the three years immediately before the measure went into effect. Including an even longer period, however, would show that the average over three years may be higher than what is appropriate.

110. Regardless of which period is chosen, a fundamental flaw in Indonesia's approach is to include in its annual average an *estimated value* for clove imports during four months *after* Section 907(a)(1)(A) went into effect (*i.e.*, September, October, November and December 2009). Indeed, Indonesia provides no rationale as to why it would be more accurate to guess at monthly totals rather than to use the actual totals for the three full years (or more) preceding the ban. The United States is unaware of a circumstance in which an arbitrator based a finding of an average export level on a time period including months after the WTO-inconsistent measure went into effect and based on estimations rather than actual trade values.

111. Additionally, Indonesia apparently upwardly adjusted the values for the months of July and August 2009 based on the uncorroborated suggestion that imports "dropped drastically" starting in July.[135] Indonesia provides no evidence or explanation to support its estimation.

112. Even adopting Indonesia's three year approach, a more accurate period to establish the average annual export level would be the three full years before Section 907(a)(1)(A) went into effect, *i.e.* January 2006 through December 2008. The yearly values were:[136]

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[133] Indonesia's Methodology Paper, p.1.

[134] Indonesia's Consultant Report, p.1. The Consultant Report relies on data from the World Trade Atlas on the total value of U.S. imports of clove cigarettes, and assuming that all clove cigarette imports are from Indonesia, observes that the totals were US$16.2 million, US$14.8 million and US$7.7 million in 2007, 2008 and 2009, respectively. The Consultant Report then asserts that imports dropped drastically in July 2009 and estimates that, in the absence of the ban (which went into effect in September 2009), the total value of imports for 2009 would have been US$ 15.4 million, resulting in a three-year average of US$15.5 million.

[135] Indonesia's Consultant Report, p.1.

- January 2006 – December 2006: $10.3 million
- January 2007 – December 2007: $16.2 million
- January 2008 – December 2008: $14.8 million

The average of the three years, which accurately reflects Indonesia's annual export values immediately prior to the ban, is $ 13.8 million. If one were to include the trade values during the months in 2009 before Indonesia claims that imports began to drop (*i.e.*, until July 2009), the average annual value still would be $13.8 million. One could just as reasonably use the average of the five years preceding the ban (2004 through 2008), which would result in an average of $12.6 million (or $12.8 million including January – June 2009).

113. In short, there is simply no reason to speculate about trade values where actual data exist. Estimating likely trade values in a situation where no data exists may require speculation. However, identifying average annual trade values where data does exist must not be based on speculation but must be based on the actual values.[137] The accurate value then, based on Indonesia's proposal to use the three years before the measure took effect, is $13.8 million.

B. There Is No Basis in the DSU to Include a "Multiplier" In Determining the Level of Nullification or Impairment

114. In its methodology paper, Indonesia argues that any nullification or impairment of its benefits under the TBT Agreement must be multiplied to reflect the effect on Indonesia's overall economy from this relatively minor loss of exports in one industry. Indonesia's consultant asserts that "a reasonable and appropriate estimate for the multiplier effect on Indonesia's economy of the negative shock to cigarette demand in 2009 is 2.5."[138]

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[136] U.S. import statistics (Exhibit US-5).

[137] *See, e.g., US – FSC (Article 22.6 – US)*, paras. A1-A2 (suggesting that it is only permissible to speculate when there is no actual data available); *US – 1916 Act (EC) (Article 22.6 – US)*, para. 5.54 (stating that the arbitrator "needs to rely, as much as possible, on credible, factual, and verifiable information" and "cannot base any such estimates on speculation."); *US – Offset Act (Byrd Amendment) (Article 22.6 – US)*, para. 3.150 (uses existing data from the previous three years to make its future projection);; *US – Offset Act (Byrd Amendment) (Article 22.6 – US)*, para. 3.148 (citing to *EC – Hormones (Canada) (Article 22.6 – EC)* when using existing data from the previous three years to make its future projection).

[138] Indonesia's Consultant Report, p. 3.

115. Indonesia's misguided theory of a "multiplier effect" increases Indonesia's proposed level from the already-inflated $15.5 million to $42.9 million. It does so by first estimating a "negative shock demand" for 2010 by adjusting its 2007-2009 annual trade values for the U.S. CPI rate of inflation, resulting in a new figure of $15.9 million. Indonesia then multiplies the "negative shock demand" ($15.9 million) by the multiplier (2.5), which comes to $39.75 million. Indonesia then posits that this effect will be felt by 2014, and adjusts for the U.S. CPI inflation rates for 2011-2013,[139] resulting in a final figure of $42.9 million.

116. There is no basis under the DSU for applying such a multiplier. First, the DSU establishes that nullification or impairment relates to the benefits arising under specific obligations of the covered agreements. For example, DSU Article 3.3 states that prompt settlement of situations in which "any benefits accruing to [a Member] … under the covered agreements are being impaired" is essential. Similarly, Article 26.1(b) speaks of a measure found "to nullify or impair benefits under … the relevant covered agreement." And DSU Article 22.3(b)(ii) distinguishes nullification or impairment from "the broader economic elements related to the nullification or impairment."[140]

117. Consistent with these and other provisions, Article 22.6 arbitrations have concluded that the figure calculated must represent the nullification and impairment of benefits under the covered agreement, not some broader, subjective measure of the overall economic impacts supposedly related to non-compliance.

118. The concept of a "multiplier" is speculative and attempts to capture economic effects that are not directly tied to lost exports. For example, in *US – Gambling*, the arbitrator rejected Antigua's argument that the level should reflect a multiplier effect, suggesting that including a multiplier effect would be inconsistent with the approach taken in prior arbitrations, which

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[139] There is no reason that U.S. CPI inflation rates would be relevant to a so-called multiplier effect on the Indonesian economy.

[140] Indeed, in the negotiations concerning the DSU, some Members have proposed amending the DSU to provide for a "request that the arbitrator, in addition to determining the level of nullification or impairment on the basis of the trade affected by the challenged measures, make an estimate of the impact of those measures on its economy." (Proposal by Ecuador in TN/DS/W/33 (an amendment to what would become Art. 21.3bis)). There would have been no need for this proposal if the DSU already accommodated Indonesia's approach.

focused on the trade effects of a given measure, and not on alleged "shock" effects on the broader economy.[141]

119. In this dispute, Indonesia's multiplier theory is similarly misguided and inappropriately focused on alleged effects that go beyond possible effects on Indonesia's benefits under the TBT Agreement. Indonesia's consultant report makes clear that Indonesia's proposed multiplier is included to theoretically reflect effects on internal transactions *within* the Indonesian economy – such as effects on the purchase of Indonesian goods or services by Indonesian producers and workers.[142] As such, the transactions which would serve as the basis for Indonesia's suggested multiplier are not lost Indonesian exports, and thus are not properly included in a measurement of Indonesia's nullification or impairment of trade benefits under the covered agreements.

120. This is incorrect. An analysis of the level of nullification or impairment must focus on the "benefit" allegedly nullified or impaired "as a result of" the failure of the Member to fulfill its obligation – *i.e.*, as a result of the inconsistency found by the DSB.[143] Arbitrators in past proceedings have uniformly based their determinations on ascertainable facts and have refused to "accept claims that are 'too remote', 'too speculative', or 'not meaningfully quantified.'"[144] As

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[141] *See, e.g., US – Gambling (Article 22.6 – US),*, para. 3.123; *EC – Hormones (US) (Article 22.6 – EC),* para. 41; *see also EC – Hormones (US) (Article 22.6 – EC),* para. 77 (Refusing to consider, as "too speculative," lost exports that would have resulted from foregone marketing campaigns); *US – 1916 Act (EC) (Article 22.6 – US),* para. 6.10; *see also US – 1916 Act (EC) (Article 22.6 – US),* paras. 5.54 and 5.69 ("In determining the level of nullification or impairment ... we need to rely, as much as possible, on credible, factual, and verifiable information. We cannot base any such estimates on speculation.").

[142] Indonesia's Consultant Report, p. 2.

[143] The concept of nullification or impairment derives from Article XXIII of the *General Agreement on Tariffs and Trade 1994* ("GATT 1994"). Article XXIII provides: "If any contracting party should consider that *any benefit* accruing to it directly or indirectly under this Agreement *is being nullified or impaired ... as a result of ... the failure of another contracting party to carry out its obligations* under this Agreement ... the matter may be referred to the CONTRACTING PARTIES." For example in *US – Section 110(5),* the arbitrators agreed with the U.S. position that the "nullification-or-impairment analysis must focus on what benefits the EC would receive if the measure at issue – Section 110(5)(B) – were modified in accordance with the DSB recommendation." *See US – Section 110(5),* U.S. Oral Statement to the Arbitrators (September 5, 2001), para. 22; *US – Section 110(5) Copyright Act (Article 25),* para. III.34.

[144] *US – 1916 Act (EC) (Article 22.6 – US),* para. 6.10; *see also US – 1916 Act (EC) (Article 22.6 – US),* paras. 5.54 and 5.69 ("In determining the level of nullification or impairment ... we need to rely, as much as possible, on credible, factual, and verifiable information. We cannot base any such estimates on speculation. ... We are of the view that any claim for a deterrent or 'chilling effect' by the European Communities in the present case would be too speculative, and too remote.").

the arbitrator found in *EC – Hormones*, "we need to guard against claims of lost opportunities where the causal link with the inconsistent [measure] is less than apparent, i.e. where exports are allegedly foregone not because of the [inconsistent measure] but due to other circumstances."[145]

121. Second, the specific DSU requirement is that the "level of suspension of concessions . . . shall be equivalent to the level of nullification and impairment." If, as Indonesia asserts, the level of nullification must be increased by a multiplier, then to maintain equivalence, the proposed level of suspended benefits would need to be adjusted to account for a multiplier effect. In other words, to the extent that the level of nullification or impairment is increased by a multiplier to reflect broader economic effects on Indonesia of the U.S. measure, the corresponding level of suspension would need to be *decreased* by an appropriate divisor to account for the broader economic effects on the U.S. economy of the suspended trade (that is, through the "multiplier effect" of the suspension of concessions). Otherwise, the arbitration would not be an apples-to-apples determination of equivalency, as required under the DSU.[146]

122. Finally, Indonesia has failed to make a *prima facie* case that the loss of clove cigarette exports to the United States has had any multiplier effect on the broader Indonesian economy in any case. Indonesia offers no evidentiary basis whatsoever to support the notion that the relatively small loss of its clove cigarette exports to the United States could have a multiplier effect of 2.5 on the Indonesian economy. Indonesia's consultant explains that this figure is derived from a World Bank report on the multiplier effect of government spending in Malaysia.[147] Indonesia fails to provide any explanation as to how a World Bank Report discussing economic factors in another country has any relevance to questions at issue in this proceeding.

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[145] *EC – Hormones (US) (Article 22.6 – EC)*, para. 41; *see also* para. 77 (Refusing to consider, as "too speculative," lost exports that would have resulted from foregone marketing campaigns.).

[146] *See, e.g., EC – Bananas III (US) (Article 22.6 – EC)*, para. 7.1 (In deciding to take account of the impact of the WTO-inconsistent measure on the value of U.S. imports, rather than on the U.S. firms' costs and profits, the Arbitrator explained that to "estimate the level of nullification or impairment, the same basis needs to be used for measuring the level of suspension of concessions.")

[147] Indonesia's Consultant's Report, p. 3.

C. The Level Must Reflect Declining Demand for Cigarettes

123. Even under Indonesia's incorrect counterfactual, the level of nullification or impairment would need to reflect what annual prospective imports of Indonesian clove cigarettes would be if the United States lifts the ban.[148] Aside from the fact that Indonesian exporters are already exporting cigars and cigarillos at levels equivalent to previous cigarette exports, viewed in isolation, the counterfactual level of cigarette exports would need to reflect any increase or decrease in demand for the product in the United States after the measure went into effect (*i.e.*, September 2009).[149]

124. Consumption of both domestic and imported cigarettes in the United States has been declining steadily for the last few decades, when the United States began strengthening its regulation of cigarettes.[150] In particular, consumption data demonstrate that, since 1992, demand for cigarettes in the United States has decreased by 42 percent and at an average annual rate of 2.7 percent.[151]

125. In addition, even an analysis based on Indonesia's incorrect counterfactual must reasonably assume that clove cigarettes would be accorded treatment no less, but no more favorable than the treatment accorded to all other cigarettes. In particular, the analysis must take account that clove cigarettes would not be exempted from measures (that were not subject to this dispute) that apply to all cigarettes in the United States. Accordingly, the counterfactual must assume that clove cigarettes would be subject to U.S. public education efforts and the other measures imposed on cigarettes under the Tobacco Control Act, including restrictions on manufacturing, advertising and distribution.[152] The effect of such measures would also be a

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[148] *See, e.g. EC – Hormones (US) (Article 22.6 – EC)*, paras. 37, 40.

[149] *See, e.g., EC – Hormones (US) (Article 22.6 – EC)*, para.68 ("We consider it reasonable to make a downward adjustment to the pre-ban exports to take account of the demonstrated decline in 'apparent consumption' of EBO in the EC market since the imposition of the ban."); Decision of the Arbitrator, *US – Gambling (Antigua) (Article 22.6 – US)*, paras. 3135-3.139, 3.170-3.187 (acknowledging the calculation of prospective imports of the relevant product should reflect factors other than the measure at issue which affect demand).

[150] Cigarette Consumption in the United States (Exhibit US-3).

[151] Cigarette Consumption in the United States (Exhibit US-3).

[152] *See* First U.S. First Written Submission (Orig. Panel), paras. 113-117.

decline in demand for clove cigarettes. Accordingly, the value of Indonesian imports in the years preceding the ban ($13.8 million) must be reduced by the rate of decline in demand for cigarettes in the United States.[153]

126. The average annual consumption during the corresponding years (2006 through 2008) was 360 billion individual cigarettes, while consumption in 2012 (the last year for which data is available) was 289 billion individual cigarettes, representing a 19.7 percent decline.[154]

127. Accordingly, the value of Indonesian imports in the years preceding the ban ($13.8 million) would need to be reduced by at least 19.7 percent to $11.06 million to accurately reflect prospective imports of Indonesian clove cigarettes. The chart below indicates what would happen if one were to use different periods as the benchmark.[155]

	Imports (millions)	Consumption Decline	Level of Nullification/Impairment
3 years 2006-08	13.774	-19.71%	11.059
3.5 years 2006-Jan-June 2009	13.849	-17.15%	11.474
5 years 2004-08	12.605	-21.60%	9.882
5.5 years 2004-Jan-June 2009	12.759	-19.66%	10.250

128. In addition, under a methodology looking prospectively to a current level of nullification or impairment, any level would need to be adjusted annually to reflect further decreases or increases in demand. Accordingly, a current level (adjusting historic imports solely for

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[153] *In EC – Hormones*, the arbitrator noted that part of the decline in demand was due to the hormone ban, and carved out the decline stemming from the ban. *EC – Hormones (United States) (Article 22.6)*, para. 68. The situation in this dispute is different because of the narrow scope of the ban. For example, the DSB found that "the products that are prohibited under the ban consist primarily of clove cigarettes from Indonesia," (Appellate Body Report, para. 224) which comprised approximately 0.1 percent of the U.S. market cigarette market before Section 907(a)(1)(A) went into effect (Panel Report, para. 2.25). Accordingly, it is consistent with the DSB recommendations and rulings to assume that the measure at issue has a *de minimis* effect on overall demand in the United States, given the finding with respect to Article 2.1 that the measure does not impact products other than imported clove cigarettes, which accounted for 0.1 percent of the market.

[154] Cigarette Consumption in the United States (Exhibit US-3).

[155] *See* annual import statistics and 2009 monthly import statistics in Exhibit US-5 and Exhibit US-23.

decreasing demand) would be $11.06 million, and in subsequent years, the level would be adjusted by the percentage of change in cigarette consumption for the prior year. This again demonstrates that Indonesia's methodology, on its own terms, is flawed and must be rejected.

IX. CONCLUSION

129. For the foregoing reasons, the United States requests that the Arbitrator find that Indonesia is incorrect that its benefits under the TBT Agreement have been nullified or impaired at a level of $42.9 million per year. Rather, the level of nullification or impairment is zero. There is no nullification or impairment because the United States has fully implemented the recommendations and rulings of the DSB. Even setting aside U.S. compliance in this dispute, under any reasonable counterfactual, clove cigarettes would not be permitted to be sold in the U.S. market and, therefore, no benefits accruing to Indonesia are being nullified or impaired by the current measures. Even under the incorrect counterfactual proposed by Indonesia, the level of nullification or impairment is zero because Indonesian exporters have not lost benefits but, rather, are currently exporting replacement products marketed as clove "cigars" or "cigarillos" at levels equivalent to the levels of exports of clove cigarettes prior to the U.S. measure. Finally, in addition to being based on an incorrect assumption of non-compliance, and in addition to using an incorrect counterfactual, the Indonesian methodology paper is replete with assumptions and errors that undermine its conclusion, and it must be rejected.