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

(DS406)

Responses of the United States of America
to the Questions by the Arbitrator
Following the Substantive Meeting With the Parties

April 10, 2014

TABLE OF EXHIBITS

Exhibit Number	Description
US-39	Report on Cigarette Consumption by the Tobacco Merchants Association / Tobacco USA
US-40	U.S. Youth Tobacco Prevention Campaign on Menthol Cigarettes
US-41	Monthly U.S. Import Levels of Indonesian Clove Cigarettes
US-42	U.S. Consumer Price Index (for the period January 2008 to the present)

TABLE OF REPORTS

US –Clove Cigarettes (AB)	Appellate Body Report, *United States – Measures Affecting the Production and Sale of Clove Cigarettes*, WT/DS406/AB/R, adopted 24 April 2012
EC – Hormones (US) (Article 22.6 – EC)	Decision by the Arbitrators, *European Communities – Measures Concerning Meat and Meat Products (Hormones), Original Complaint by the United States – Recourse to Arbitration by the European Communities under Article 22.6 of the DSU*, WT/DS26/ARB, 12 July 1999
US – 1916 Act (EC) (Article 22.6 – US)	Decision by the Arbitrators, *United States – Anti-Dumping Act of 1916, Original Complainant by the European Communities – Recourse to Arbitration by the United States under Article 22.6 of the DSU*, WT/DS136/ARB, 24 February 2004
US – Gambling (Article 22.6 – US)	Decision by the Arbitrator, *United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services – Recourse to Arbitration by the United States under Article 22.6 of the DSU*, WT/DS285/ARB, 21 December 2007
US – Upland Cotton (Article 22.6 – US I)	Decision by the Arbitrator, *United States – Subsidies on Upland Cotton – Recourse to Arbitration by the United States under Article 22.6 of the DSU and Article 4.11 of the* SCM Agreement, WT/DS267/ARB/1, 31 August 2009

40. <u>To the United States</u>: At paragraph 9 of its response to question 3(b)(i), the United States observes that the means for compliance by the United States in this case "is similar to the means for compliance in situations where the basis for a measure has been found to be deficient, for example due to the lack of a risk assessment in the case of a finding of a breach under Article 5.1 [of the SPS Agreement]." Is it your understanding that the Appellate Body found that Section 907(a)(1)(A) was inconsistent with Article 2.1 of the TBT Agreement because of a lack of a proper analysis of the risks posed by menthol cigarettes, analogous to a finding of a breach of Article 5.1 of the SPS Agreement?

1. In instances where the DSB has found that a Member lacks a sufficient basis for a particular measure, a Member may comply by conducting further analysis related to that basis. If the results of that analysis are that the treatment accorded by the challenged measure is justified, then the measure would no longer be inconsistent with the relevant covered agreement.

2. Article 5.1 of the *Agreement on the Application of Sanitary and Phytosanitary Measures* ("SPS Agreement") provides that Members shall ensure that SPS measures are based on a risk assessment. Therefore, if a Member conducts a risk assessment subsequent to a finding of an inconsistency with that provision and demonstrates that the measure in question is based on the results of such assessment, this would bring the Member into compliance and it need not withdraw or modify the underlying measure.[1] Similarly, under the *Agreement on Technical Barriers to Trade* ("TBT Agreement"), if a Member conducts a subsequent analysis related to a particular regulatory distinction and this analysis demonstrates the legitimacy of that distinction, this too would result in compliance and the Member would not need to withdraw or modify the measure that was previously found to be WTO-inconsistent. Indeed, withdrawing or modifying the measure could result in the Member not achieving its legitimate objective at the level it considers appropriate.[2]

3. It is consistent with the object and purpose of the TBT Agreement that a Member should be able to bring a measure into conformity, without necessarily withdrawing or modifying the measure. The Appellate Body recognized in this dispute that Article 2.1 "does not operate to prohibit *a priori* any obstacle to international trade."[3] In addition, the Appellate Body noted that technical regulations are measures that, "by their very nature, establish distinctions between products according to the characteristics or related processes and production methods" and that, therefore, Article 2.1 should not be read to mean that *any* distinction would *per se* accord less favorable treatment within the meaning of Article 2.1.[4]

---

[1] This principle would also apply in the context of the *Agreement on Implementing Article VI of the General Agreement on Tariffs and Trade 1994* ("AD Agreement") and the *Agreement on Subsidies and Countervailing Measures* ("SCM Agreement"). Under certain provisions of those agreements, where the DSB finds that the basis for a challenged measure is lacking or deficient, a Member may choose to seek to bring the measure into compliance by addressing the deficiency instead of modifying the measure itself.

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

[3] *US –Clove Cigarettes (AB)*, para. 171.

[4] *US –Clove Cigarettes (AB)*, para. 169.

4. In the instant dispute, the Appellate Body found Section 907(a)(1)(A) inconsistent with TBT Article 2.1 because the Appellate Body did not consider that the detrimental impact to the competitive conditions for clove cigarettes stemmed exclusively from a legitimate regulatory distinction between cloves and menthol cigarettes.[5] In particular, the Appellate Body concluded that it appeared logically flawed to expect that addicted menthol smokers might strain the healthcare system in seeking cessation services or might turn to the illicit market to obtain their preferred product any more than clove smokers, and it rejected the U.S. argument that this was a legitimate distinction between the products.[6] Following this conclusion, the United States has conducted subsequent analysis that demonstrates that the regulatory distinction drawn by the United States is legitimate. Accordingly, the United States has cured the breach of Article 2.1 although it has not withdrawn or modified Section 907(a)(1)(a) itself.

5. To put it another way, the U.S. regulatory distinction was based on the then-current scientific understanding of the difference between the products at the time that the U.S. Congress enacted Section 907(a)(1)(A). In particular, the distinction was based on U.S. public health authorities' understanding of the prevalence and types of use of menthol cigarettes compared to other flavored cigarettes, such as cloves. The U.S. Congress determined that because menthol cigarettes are used by such a large number of addicted adults, banning them at that time might involve negative public health consequences which should be investigated and assessed before further possible regulatory action. In other words, there were, in the U.S. view, legitimate questions as to appropriate regulatory steps.

6. Subsequent to the DSB's adoption of its recommendations and rulings, the U.S. Food and Drug Administration ("FDA") found that a characteristic specific to menthol cigarettes – *i.e.*, the presence of menthol – is likely associated with increased addiction and difficulty with cessation. This finding provides additional corroboration, based specifically on a product characteristic, that banning menthol cigarettes could involve the public health consequences identified by the United States and, thus, may require a different regulatory approach than cigarettes with clove and other flavors, which were used nearly exclusively as a specialty/niche or "starter" cigarette and not typically as consumers' regular, habitual product.

7. Accordingly, similar to situations which have arisen with respect to investigations and analyses under the SCM or AD Agreements, or with respect to risk assessments under the SPS Agreement – where a measure affecting the product of another Member is found to be inconsistent because of the basis for the measure[7] – in this case, the United States may come into compliance by curing the deficiency in the basis for the measure.

---

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

[6] *US –Clove Cigarettes (AB)*, paras. 169, 219-225.

[7] U.S. Responses to the Arbitrator's Questions, Question No. 3(b)(i), paras. 9-12. The analogy to Article 5.1 of the SPS Agreement was not intended to imply that Article 2.1 of the TBT Agreement specifically requires a "risk assessment," since this is a concept unique to the SPS Agreement and which does not appear in the TBT Agreement.

8. A finding that a Member may *not* come into conformity in such a circumstance by undertaking additional investigation and analysis to address the basis for a regulatory distinction would be inconsistent with the TBT Agreement, which specifically affirms the right of Members to adopt technical regulations to pursue public health objectives.[8] It cannot be the case that a measure is deemed inconsistent (and, by inference, must be modified or withdrawn, and thereby endanger the public health) even where existing science justifies the regulatory distinction.

9. An approach under which a Member could not bring a measure into conformity by addressing any perceived deficiency in the basis for the measure would have other important systemic consequences as well. For instance, such an approach would mean that a measure would be consistent with the TBT Agreement if the Member addressed the basis for the measure before the measure was subject to dispute settlement while the same measure would be inconsistent if the basis were addressed after the DSB adopted its recommendations and rulings. This could mean the same measure maintained by two different Members with the same basis would be treated differently based on whether there had been dispute settlement proceedings.

10. The United States recalls that Article 2.5 of the TBT Agreement provides, in relevant part, that: "Whenever a technical regulation is prepared, adopted or applied for one of the legitimate objectives explicitly mentioned in paragraph 2, and is in accordance with relevant international standards, it shall be rebuttably presumed not to create an unnecessary obstacle to international trade." Thus, where a relevant international standard is adopted subsequent to the adoption of a measure, and the measure is in accordance with that relevant international standard, the measure should enjoy the presumption in Article 2.5. However, an approach under which a Member could not bring a measure into conformity with DSB recommendations and rulings unless the Member modifies or withdraws the measure would deny the measure the presumption under Article 2.5 where, for instance, the relevant international standard were adopted after the DSB adopted its recommendations and rulings.

41. <u>To the United States</u>: The information contained in the United States' Exhibit 4 and Indonesia's Exhibit 3 (p.8) suggests that the proportion of menthol cigarettes sales increased to 32% in 2011. Please comment on this increase and its relevance to the achievement of your public health protection objectives with respect to menthol cigarettes.

11. Consumption of cigarettes in the United States has declined by 19.7 percent since the Tobacco Control Act, including Section 907(a)(1)(A), went into effect.[9] Consumption of menthol cigarettes has declined by 6.7 percent during that same time.[10] The fact that menthol cigarette consumption is not decreasing as dramatically at this time as overall cigarette consumption is decreasing is not surprising. As explained in paragraph 43, it is not unusual that

[8] *US –Clove Cigarettes (AB)*, para. 236.

[9] U.S. Written Submission, para. 13.

[10] U.S. Written Submission, para. 13.

demand for particular brands of cigarettes will fluctuate, or even temporarily increase, and still follow the overall trend of decline over time.[11]

12. In addition, it is possible that the slower decrease of menthol cigarette consumption reflects the fact that the presence of menthol in cigarettes likely increases addiction and makes cessation more difficult. One might expect that menthol consumption would not decrease as quickly as consumption of other cigarettes given these features of the product.

13. The United States understands that the use of menthol cigarettes in the United States is a significant public health problem. While U.S. public health authorities have moved forward with the regulatory process – including by completing the FDA Menthol Report and issuing an Advanced Notice of Public Rulemaking – they also have implemented initiatives outside the rulemaking process to combat menthol cigarette smoking. The Youth Tobacco Prevention Campaign includes advertising[12] and educational material specifically targeting menthol cigarettes. Warnings at teensmokefree.gov include the warning that menthol cigarettes may be more addictive than non-menthol cigarettes and that the tobacco industry historically has targeted its marketing of menthol cigarettes to women, youth, and minority groups.[13]

14. Based on available science, the United States cannot conclude at this time that the same measures that are appropriate and effective to advance the U.S. public health objective of reducing youth smoking by eliminating the use of flavored cigarettes (including clove) would similarly be appropriate and effective to advance that objective by eliminating the use of menthol cigarettes. The United States is aggressively combatting use of menthol cigarettes in a way that is consistent with the current science, including through an unprecedented initiative to raise awareness about the dangers of smoking menthol cigarettes, and consumption is, in fact, declining.

15. As the United States has demonstrated, the different approach is *not* based on the origin of the products, but based on the different public health challenges associated with the different products.[14] Article 2.1 of the TBT Agreement requires that technical regulations be based on product distinctions that are not based on the origin of the products – that are, in other words, legitimate regulatory distinctions. Thus, the analysis under Article 2.1 as to whether a product distinction is legitimate fundamentally concerns whether the distinction is a proxy for discrimination based on origin. The fact that menthol cigarette use remains a difficult problem in the United States is not evidence that Section 907(a)(1)(A) discriminates based on origin.

---

[11] Report on Cigarette Consumption by the Tobacco Merchants Association / Tobacco USA (Exhibit US-39).

[12] U.S. Youth Tobacco Prevention Campaign on Menthol Cigarettes (Exhibit US-40); s*ee also* Campaign video ad on menthol at http://www.youtube.com/watch?v=15Q5qGgfz_Q.

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

[14] U.S. Written Submission, paras. 28-36, 76-80; U.S. Responses to the Arbitrator's Questions, Question Nos. 3-5, paras. 5-39.

Indeed, the available data regarding the use of menthol cigarettes in the United States are evidence that more work is needed to understand the dynamics of the problem, and that in all likelihood a multi-front effort – building on the initiatives that are underway – is necessary to address the problem.

42. <u>To the United States</u>: In your written submission, at paragraph 73, you refer to "any *remaining* detrimental impact on imported clove cigarettes" (emphasis added). Please confirm whether you accept that the measure continues to have a "detrimental impact" on imported clove cigarettes within the meaning of Article 2.1 of the TBT Agreement, in that clove cigarettes are banned while menthol cigarettes are still allowed on the US market.

16. It is correct that Section 907(a)(1)(A) bans clove cigarettes (and other flavors) and not menthol cigarettes (or regular cigarettes). As noted, however, the United States has brought Section 907(a)(1)(A) into compliance by demonstrating that any detrimental impact on clove cigarettes stems exclusively from a legitimate regulatory distinction. In addition, the United States has implemented a number of measures that are continuing to reduce menthol cigarette use and sales by substantially more than the number and value of the clove cigarettes that are no longer imported into the United States.

17. It is important to be clear that a finding that Section 907(a)(1)(A) continues to have a detrimental impact on the competitive opportunities for Indonesian clove cigarettes under Article 2.1 of the TBT Agreement is not sufficient to establish that, in fact, the benefits accruing to Indonesia under that article are nullified or impaired. These are different tests. Article 3.8 of the DSU is clear that the presumption of nullification or impairment is *rebuttable*, and the correctness of that presumption in a particular instance is an issue under Articles 22.4 and 22.7 of the DSU. Moreover, even where an arbitrator finds that nullification of impairment does exist, it still must ensure that the determined level of suspension of concessions does not exceed the current or ongoing level of actual nullification or impairment.[15] The arbitrator in *US – 1916 Act (Article 22.6 – US)* determined that the level of suspension must reflect the actual level of nullification or impairment experienced by the EU *at that time* as a result of the Act,[16] meaning nullification or impairment resulting from specific applications of the Act.[17] At the time of the Arbitrator's award, there were no such applications, and so the effective level of nullification or impairment – and of suspension – at that time was zero.[18]

18. In this instance, Indonesia has not demonstrated any level of nullification or impairment of its benefits. Section 907(a)(1)(A) is consistent with the TBT Agreement except to the extent

---

[15] *US – 1916 Act (EC) (Article 22.6 – US)*, paras. 6.14-8.2.

[16] *US – 1916 Act (EC) (Article 22.6 – US)*, paras. 7.7-8.2.

[17] *US – 1916 Act (EC) (Article 22.6 – US)*, paras. 6.14, 8.2 (the Arbitrator did not include current settlements under the Act, because the values of any such settlements were not disclosed and thus could not be specifically quantified (paras. 6.8-6.10)).

[18] *US – 1916 Act (EC) (Article 22.6 – US)*, paras. 6.14, 8.2.

that the Arbitrator determines that it continues to result in a detrimental impact on the competitive conditions for Indonesian clove cigarettes compared to domestic menthol cigarettes that does not stem exclusively from a legitimate regulatory distinction. Where, as here, producers adapt the affected product to avoid the adverse effects of an otherwise WTO-consistent measure, there is no current or ongoing nullification or impairment of the benefits accruing to the complaining Member under Article 2.1 of the TBT Agreement. Indonesian clove cigarette exporters have adapted the product to continue their level of exports.[19] There is no disagreement among the parties that this is what has occurred. Therefore, even assuming Indonesia's unreasonable compliance counterfactual – the removal of Section 907(a)(1)(A) – there would be no difference in the level of exports of clove cigarettes to the United States. The market already is satisfied by Indonesia's adapted product.

43. <u>To the United States</u>: In light of the determination made in the original proceedings that the measure at issue has a detrimental impact on competitive opportunities for imports of clove *cigarettes*, please clarify why trade in clove *cigars* should be taken into account in determining the extent to which Indonesia's competitive opportunities have been adversely impacted by the measure.

19. There is no disagreement among the parties that clove "cigars" are merely adapted clove "cigarettes," which Indonesia continues to export to the United States to continue to satisfy the market for the product.[20] Indeed, Indonesia has maintained in this proceeding that its producers should be expected to seek a way to avoid the effects of Section 907(a)(1)(A) in order to "cover its losses." Moreover, Indonesia has long classified its exports of "cloves" to the United States as clove "cigars" even while they were packaged as "cigarettes" – demonstrating that Indonesia recognizes no difference between the products.[21] Conversely, the website of PT Djarum (the primary exporter of clove "cigars" into the United States and previously the primary exporter of clove "cigarettes") identifies the company as a cigarette manufacturer and refers to its exports of "kreteks" to various countries, making no distinction between its exports to most countries of kreteks labeled as clove "cigarettes" and to the United States labeled as clove "cigars."[22]

20. This is *not* a situation where a Member has developed a new product or tapped into a new U.S. market. Indonesian clove "cigars" are the same adapted product fulfilling the same market. Moreover, this is not a situation, such as in *US – Upland Cotton (Article 22.6 – US I)* (as discussed below), where the question is whether the level of exports of the product at issue to *other markets* might mitigate or offset the determination of the trade effect of the measure. In

---

[19] U.S. Responses to the Arbitrator's Questions, Question No. 15, paras. 63-69; U.S. Opening Statement at the Substantive Meeting With the Arbitrator, paras. 48-51.

[20] Indonesia's Responses to the Arbitrator's Questions, Question Nos. 4(c) and 11(b), paras. 31, 47, 49.

[21] U.S. Written Submission, para. 19.

[22] *See* PT Djarum website at http://www.djarum.com/index.php/en/world_of_djarum/page/3; http://www.djarum.com/index.php/en/brands/page/14; and http://www.djarum.com/index.php/en/brands/page/15, accessed April 9, 2014.

this situation, Indonesian exporters continue to ship the product to the U.S. market in a form designed to be at the same time perceived as identical by the consumer but restructured with the intent of falling outside the scope of Section 907(a)(1)(A). In this situation, Indonesia's continued export of clove "cigars" to the United States means that the level of nullification or impairment of benefits to Indonesia under Article 2.1 is zero.

21. Applying Indonesia's misguided counterfactual demonstrates the point. Assuming for the sake of argument that the United States had not complied, an analysis of nullification or impairment would compare the actual current level of exports to the level of exports in a reasonable counterfactual. Although Indonesia's counterfactual is not reasonable, if it were applied, it would mean that clove cigarette imports would be permitted into the United States. The question, then, is what would be the level of U.S. clove cigarette imports in this scenario. It is clear that, in this situation, nothing would be different; there would be no increase in the level of U.S. clove cigarette imports from Indonesia.

22. Whether one refers to the product that Indonesia currently exports to the United States as a clove "cigarette" or a clove "cigar," there is no question that it is being exported to meet the *same market* formerly met by clove cigarettes.[23] As an initial matter, it would be unreasonable to assume that the market for "cloves" suddenly would double, or increase at all, if the ban were removed.

23. Moreover, the evidence on the record shows that – in this hypothetical scenario where both products are permitted – there is no basis to assume either that Kretek International ("Kretek") would switch back to exporting clove cigarettes, or that U.S. consumers would choose clove cigarettes over clove cigars if given the choice. Evidence from Kretek itself shows that the key to its "seamless conversion" was to ensure that clove cigars would be the preferred product for both distributor customers and consumers of Indonesian "cloves." Kretek's 2009 sales meeting presentation shows that part of executing the conversion from clove "cigarettes" to clove "cigars" was to offer not just the product that clove consumers "expect," but to ensure that consumers and distributor customers would remain loyal to an enhanced product that would be taxed at a lower level. Kretek's July 2009 national sales presentation highlights that clove cigars offer a taste that is "richer and smoother"[24] or "milder and smoother"[25] than clove cigarettes at a "lower consumer price per pack than cigarettes."[26] Along similar lines, clove cigars have "very

---

[23] U.S. Submission, paras. 14-20, 96-101; U.S. Responses to the Arbitrator's Questions, Question Nos. 22-25, paras. 87-98.

[24] Exhibit US-9, p. 1336

[25] Exhibit US-9, p. 1339

[26] Exhibit US-9, p. 1334. Clove "cigars" are now classified in the United States as "other tobacco products," which means that they are subject to a lower federal excise tax and lower state tax rates. The federal tax rate on cigarettes is $1.0066 per pack of twenty. By contrast, the federal tax on federal tax on cigars that meet a certain weight requirement, including clove "cigars", is 52.75% of the price charged by the manufacturer (before taxes) to wholesalers – but no more than 40.26 cents per cigar. Therefore, a pack of 20 cigarettes that is sold to wholesalers (before taxes) at $1.50 per pack of 20 would be taxed at $1.0066 per pack, while the same pack of

high retail margins[,] higher than cigarettes"[27] for Kretek's distributor customers. Kretek expected that the "stronger value" would be an "extra incentive for migration to cigar product form."[28]

24. Indonesia has not refuted the U.S. argument, or rebutted any of the evidence, that Indonesian clove "cigars" have entirely satisfied the U.S. market for clove "cigarettes." Kretek affirmed that "new cigar product research indicates that it's the clove rather than the product format. Cigar/cigarette choice is secondary."[29] There is therefore no basis to conclude that if Section 907(a)(1)(A) were lifted, there would be a remaining market for clove cigarettes in the United States – that is, any market not already satisfied by clove "cigars."

44. <u>To both parties</u>: Please comment on the relevance of the following passage of the Decision of the Arbitrator in *US – Cotton (Article 22.6 – US I)*:

> **"It may be true that, in some other markets, there is less competition from US commercial exports because these have been reallocated to supply the GSM markets. However, <u>Brazil makes a strong rebuttal that it is not legitimate or consistent with WTO practice to offset trade-distorting impacts which are found by some possible positive effects in other markets</u>. The Arbitrator finds it useful to quote Brazil in full on this point in its response to one of the questions from the Arbitrator:**
>
> **"One benefit that Brazil measures is the additional US trade flows generated by GSM 102. Other arbitrators have also measured trade flows, in particular in assessing the value of the complainant's lost exports in quantifying nullification and impairment. In these arbitrations, arbitrators have never taken into account the fact that goods not exported to the respondent's market could have been diverted to alternative markets …. Thus, <u>in previous arbitrations, the valuation of trade flows affected by WTO-inconsistent measures was not diminished by potentially mitigating factors, such as opportunity costs</u>. Brazil considers that this approach is correct."**

(Decision of the Arbitrator, *US – Cotton (Article 22.6 – US I)*, para. 4.190, emphasis added)

25. The situation in *US – Upland Cotton (Article 22.6 – US I)* provides a helpful contrast to the situation here. The question in *US – Upland Cotton* was whether the determination of the

---

cigars would be taxed at only $0.79125 if its cigars weighed just a bit more than three pounds per thousand. The difference can be quite significant because the manufacturer's price for a pack of 20 cigarette-type cigars can be quite low before taxes and before wholesaler and retailer mark-ups.

[27] Exhibit US-9, p. 1334.

[28] Exhibit US-9, p. 1335.

[29] Exhibit US-9, p. 1339.

trade effect of an export subsidy should be reduced to the extent that the exports benefitting from the subsidy would nevertheless have been sold in another market. The arbitrator found that such "opportunity costs" should not be factored into the determination of the trade effect of the prohibited subsidy. With respect to the assessment of nullification or impairment, the finding in *US – Upland Cotton* would suggest that, for example, the level of nullification or impairment caused by an import ban should not be reduced to reflect sales of the prohibited product in another Member's market.

26. However, that is not the situation here. The United States is not arguing that the level of nullification or impairment should be reduced to reflect any level of Indonesian exports of clove cigarettes or clove cigars to markets other than the United States. Indonesian exports to other markets are not relevant to determining the trade effect of Section 907(a)(1)(A) on Indonesian clove cigarettes, and thus, are not relevant to determining the level of nullification or impairment. However, the fact that Indonesian clove cigarettes continue to be exported to the United States (by virtue of a slight product adaptations designed to avoid the scope of Section 907(a)(1)(A)), *is* relevant to the effect of the measure and, thus, to the determination of nullification or impairment. Indeed, the fact that exporters are avoiding the effect of Section 907(a)(1)(A) means that there is no nullification or impairment of the benefits accruing to Indonesia under Article 2.1 of the TBT Agreement. Put differently, U.S. imports of clove "cigars" or clove "cigarettes" is zero-sum; Indonesia cannot claim that its level of trade in clove "cigarettes" is being affected while Indonesia continues that level of trade.

27. Article 2.12 of the TBT Agreement expressly envisions that producers would respond to technical measures by adapting their products or production methods. It is consistent with the TBT Agreement that where, as here, producers have adapted to a measure and continue to satisfy the same market for the product, the benefits accruing under Article 2.1 are not being nullified or impaired.

45. <u>To Indonesia</u>: In light of the determination made in the original proceedings that the measure at issue has a detrimental impact on *competitive opportunities for imports of clove cigarettes*, please clarify why adverse impacts of the measure on the Indonesian economy, beyond the loss of competitive opportunities in the United States market, would be taken into account in quantifying the level of nullification or impairment.

46. <u>To Indonesia</u>: Please clarify how you consider that equivalence would be achieved between the level of nullification or impairment and the level of suspension, if a multiplier effect is taken into account in the calculation of the level of nullification or impairment, in light of the fact that the suspension measures themselves might also have a multiplier effect.

47. <u>To both parties</u>: How do you understand the concept of "*equivalence*" between the "level of nullification or impairment" and the "level of suspension". Does this refer to equivalence between the value of trade affected by the inconsistent measure, as compared to the value of trade affected by the suspension measures, or something else?

28. It may be helpful to consider briefly the context of Article 22.4 of the DSU. The United States would note that Article 22.4 of the DSU does not refer to suspension "measures" but to the level of the suspension of concessions. This reflects the fact that a Member may suspend a concession, but is not obligated to adopt a measure that would be WTO-inconsistent but for the suspension of the concession. Furthermore, Article 22.7 of the DSU makes clear that an arbitrator is not concerned with the nature of the concessions or other obligations to be suspended. If the arbitrator is not concerned with the nature of the concessions or other obligations to be suspended, then it necessarily follows that the arbitrator is not concerned with the particular measures that a Member might adopt in light of the suspension of concessions. The measures a Member might adopt constitute a level removed from the actual suspension of the concessions.

29. With this background in mind, equivalence between the level or value of nullification or impairment and the level of suspension means that any particular concession or other obligation to be suspended must only be with respect to a level of trade that is equivalent to the level of nullification or impairment. In other words, "equivalence" refers to the level or value of trade to which a concession applies. For example, if the level of nullification or impairment were determined to be $10 million, any concessions to be suspended must apply to a category of trade valued at $10 million, regardless of the nature of any measure adopted that is permitted by virtue of the suspension of concessions. For instance, if the concessions to be suspended are tariff bindings at a 5 percent bound rate, then a Member could only suspend the tariff concessions on tariff headings representing $10 million in trade, regardless of whether as a result the Member applied a 100 percent tariff rate, a 50 percent tariff rate, or continued to apply a 5 percent tariff rate.

30. Indonesia's suggestion that nullification or impairment should reflect indirect trade effects – a notion with no legal basis under the DSU – is fundamentally inconsistent with a correct application of the equivalence standard under Articles 22.4 and 22.7 of the DSU. Article 22 requires that there be equivalence between the value of the benefits being nullified or impaired and the value of the concessions or other obligations being suspended.

48. <u>To the United States</u>: At paragraph 43 of its oral statement, Indonesia suggested the period July 2006 – June 2009 as an alternative approach to the calculation of trade levels. Please comment on this proposal.

31. Each of the time periods that Indonesia has proposed as accurate representations of the annual level of U.S. clove cigarette imports in fact appear manipulated to capture higher points and exclude lower points and, thereby, skew the average level of U.S. imports. Originally, Indonesia selected a time period that included hypothetical trade data for 2009 that artificially raised the U.S. import level for 2007-2009 from an annual average of $12.8 million to an annual average of $15.5 million. At the hearing, Indonesia retreated from this approach, and instead proposed a three-year period (July 2006-June 2009) that would result in an annual average level of $14.9 million.

32. However, this new period includes an "outlier" month (June 2009) that was clearly influenced by the approaching implementation of Section 907(a)(1)(A) in September 2009.

Import levels in 2009 averaged $920,000 per month between January and May (similar to import levels in 2006), before nearly tripling in June to $2.5 million.[30] Indonesia insists that July 2009 and August 2009 must be excluded because of the measure's alleged negative influence on U.S. imports in those months, but seeks to include the upward bias in U.S. imports in June 2009. To apply Indonesia's misguided approach in a more even-handed manner, one would need to adopt the three-year time period immediately before the ban – that is, to capture the entire bias caused by the impending measure, and not just the increase in June 2009. This time period would be September 2006-August 2009, and the resulting average would be $14.0 million.

33. However, there is no reason to include *any* of the months influenced by the measure. Extending the base period to include even more years would ensure that the average level does not reflect the impact of the measure; however, as noted, the United States has not argued that Indonesia's proposed three-year period is unreasonable. It is unreasonable, however, to include in that three-year period either inflated estimates (Indonesia's original proposal) or an anomalous monthly total for June 2009 reflecting a surge before the measure went into force (Indonesia's second proposal).

34. The United States has proposed two ways at least to improve the accuracy of Indonesia's unreasonable approach of including the biased data for June 2009: first, base the average on a longer period of time (either a three and one-half year period (January 2006-June 2009) or a five and one-half year period (January 2004-June 2009), which results in a level of $13.8 million or $12.8 million, respectively;[31] or, second, base the average on the three-year period immediately preceding when Section 907(a)(1)(A) went into effect (September 2006-August 2009), which results in a level of $14 million.

35. However, none of these approaches most accurately reflects the average annual level of U.S. imports of clove cigarettes. The U.S. approach remains the most accurate. The three full years before Section 907(a)(1)(A) went into effect, *i.e.* January 2006 through December 2008, excludes the bias on imports immediately preceding the measure. Using the three full year period (2006-2008) results in U.S. imports of an annual average of $13.8 million. Even this average is higher than trends over the past decade would justify. Before 2007, U.S. clove cigarette imports exceeded $13 million only once – in 2002. The average annual value of clove cigarettes in the ten years before Section 907(a)(1)(A) went into effect was $10.3 million. Thus, the U.S. proposal is the most accurate, and Indonesia's proposals are not reasonable and would not accurately reflect the level of nullification or impairment.

49. <u>To the United States</u>: You submitted in your oral statement, in the sub-heading above paragraph 83, that the level of nullification or impairment "should not reflect inflation". Please explain why not. Please clarify why there should be no upward

[30] Monthly U.S. Import Levels of Indonesian Clove Cigarettes (Exhibit US-41).

[31] U.S. Written Submission, para. 127.

adjustment to reflect inflation, but that the Arbitrator should make a downward adjustment to reflect declining demand for cigarettes.

36. Inflation does not affect the value of a trade concession. By contrast, the level of demand directly affects the value of the trade concession. While arbitrators in previous Article 22.6 proceedings have taken account of changes in demand, they have not attempted to adjust the level of nullification or impairment to reflect inflation. It is not clear why circumstances here would suggest a different approach.

37. Indonesia has argued that the level of nullification and impairment should reflect only inflation (based on the U.S. consumer price index). This adjustment, as Indonesia is using it, would only affect price and would not take into account any quantity change based on the higher price. According to basic economic theory, if the price of a good rises, it will move along the demand curve and end up with a smaller quantity demanded. Indonesia is ignoring this quantity effect.

38. The United States has argued instead that, consistent with the approach in previous arbitrations,[32] there should be a downward adjustment to the level of nullification and impairment to take into account declining demand for cigarettes (including clove cigarettes). The United States has cited many factors leading to the decline in demand, including increasing consumer awareness of the dangers of smoking, increasing regulatory measures that impose restrictions and requirements on cigarettes, and an increase in cigarette taxes on the federal, state, and local level. The increase in taxes directly affects the price of cigarettes and thereby has led to reduced quantity demanded. These taxes and other restrictions and requirements would also apply to clove cigarettes. Therefore price changes (one example being taxes) have already been taken into account by using the declining demand for cigarettes.

39. The increases in taxes have been significant. Federal cigarette taxes have increased from 39 cents per pack of 20 to $1.01 per pack on April 1, 2009, an increase of 156 percent.[33] State taxes increased from an average of $1.07 per pack of 20 between 2006 and 2008 to $1.56 per pack of 20 in 2013, an increase of 45 percent.[34] Together, Federal and State taxes per pack of 20 increased by 75 percent from $1.46 per pack of 20 between 2006 and 2008 and $2.56 per pack of 20 in 2013.[35] Taxes accounted for an average of 35.1 percent of the average retail price for cigarettes in the 2006-2008 period and 44.4 percent of the average retail price for cigarettes in 2013.[36]

---

[32] *See, e.g., EC – Hormones (US) (Article 22.6 – EC)*, para.68; *US – Gambling (Article 22.6 – US)*, paras. 3135-3.139, 3.170-3.187.

[33] Exhibit US-37, Exhibit US-38.

[34] Exhibit US-37, Exhibit US-38.

[35] Exhibit US-37, Exhibit US-38.

[36] Exhibit US-37, Exhibit US-38.

40. When prices for any product increase, the quantity demanded for that product declines. This concept is captured in economic terms by a price elasticity of demand. According to a recent report by the U.S. Government Accountability Office ("GAO"), the price elasticity for smoking tobacco products (including cigarettes) ranged between -0.6 to -0.3, for the low and high revenue estimates respectively.[37] This means that a 10 percent increase in the price for smoking tobacco products would result in a 3 percent to 6 percent reduction in the demand for these products. Given this range in price elasticity, the United States calculated in Exhibit US-38 that demand would decline by between 8 percent and 16 percent based on the tax increase alone.

41. Indonesia also stated at the hearing that this price elasticity range does not apply specifically to clove cigarettes. As an initial matter, Indonesia has provided no evidence to support this claim. Moreover, economic theory provides assistance on whether the clove cigarette price elasticity would be higher or lower than this range. The price elasticity of demand for a subset of a larger estimated group will be higher than the group as a whole because of the additional product substitutes for the subset (that being the rest of the larger group). Therefore, a specific type/brand of cigarettes is going to be more elastic than all cigarettes grouped together. The price elasticity of demand for clove cigarettes would also be higher due to its substitutability with clove cigars.

42. Furthermore, long run elasticity estimates (long term impact of price/tax increases) would also be higher than shorter term elasticity estimates which are cited above. This means that past and current tobacco tax increases and other U.S. interventions, especially those that reduce initiation, such as the FDA public education campaign, will have ongoing, significant downward effect for many years to come. The higher the price elasticity of demand estimates, the larger the decline in quantity demanded. The United States has argued that the decline in U.S. demand for cigarettes is likely to continue in the future given current proposals of further tax increases on cigarettes and other tobacco products (again affecting price) and increasing regulatory measures. This fact should also be accounted for in the determination.

43. Finally, Indonesia submits that demand for clove cigarettes would be immune to all of the effects of tax and regulation and would, in fact, increase even as demand for other cigarettes decreases. Indonesia attempts to support its assertion by pointing to the brief surge in imports of clove cigarettes in the two years before Section 907(a)(1)(A) went into effect. However, it is not uncommon that demand for a particular brand of cigarettes will fluctuate somewhat, and even increase temporarily, and yet nevertheless still follow the downward trend in consumption over time. For example, table 7a, table 7b, and table 7c in Exhibit US-39 show top selling cigarette brands between 1991 and 2013, in billions of cigarette units. From 1993 to 1998, sales of Marlboro cigarettes increased by nearly 50 percent (54 billion units), but declined after 1998 through 2013 by 31 percent (51 billion units) – the majority of this decline (30 billion units) occurring after 2008 – concurrent with a tax increase. Similarly, sales of Doral cigarettes

[37] Exhibit US-33.

increased by 46 percent (10 billion units) between 1993 and 1998, before declining by 85 percent (26 billion units) through 2011.

50. <u>To both parties</u>: You both discuss potential adjustments to the annual value of Indonesian exports of clove cigarettes to the United States, to reflect the evolution of circumstances after the entry into force of the ban (US inflation, US demand for cigarettes). To the extent that such adjustments are warranted, please clarify the specific point in time to which this value should be projected. If a fixed amount were to be determined for the benefits nullified or impaired, to which point in time should this amount be projected (e.g. the end of the implementation period – July 2013)?

44. The United States has explained that in light of anticipated changes in demand, it would be more appropriate in this proceeding to follow the approach of other arbitrators and provide for a formula for the level of suspension to be adjusted each year. This would help ensure consistency with the requirement in Article 22.4 of the DSU of equivalency between the level of suspension and the level of any nullification or impairment. Otherwise there would be a clear risk that the level of suspension would quickly become no longer equivalent to the level of nullification or impairment. Even aside from the fact that as the United States has demonstrated that in this instance there are multiple reasons for finding that the level of nullification or impairment is zero, in principle any amount should reflect the most recent available data concerning demand in the United States.[38] This means that using simply the three year average for 2006-2008, adjusted by the decrease in demand as of 2012, the level for 2013 would be $11.06 million. To calculate the level for 2014 and subsequent years, this figure would be adjusted by the percentage of increased or decreased demand reflected in the most recent available annual data on consumption, which becomes available in the middle of each year (but is not yet available for 2013).

51. <u>To the United States</u>: Please provide monthly data for the period January 2006 – December 2009 for US import value of clove cigarettes from Indonesia (line HS 2402201000) from Global Trade Atlas, analogous to the annual data presented in Exhibit US-5.

45. Please see Exhibit US-41.

52. <u>To both parties</u>: If the Arbitrator were to adjust the annual level of nullification or impairment for inflation, would the US Consumer Price Index in your opinion be the appropriate inflation measure to use for this adjustment? If not, please provide monthly index data for the variable you would consider relevant for the period January 2008 to the present.

[38] U.S. Written Submission, paras. 125-128; U.S. Responses to the Arbitrator's Questions, Question No. 37, paras. 113-114.

46. Notwithstanding that the United States objects to an inflation adjustment to the annual level for the reason stated above, as a general matter we have no particular objection to Indonesia's proposal to use the U.S. Consumer Price Index.

53. To the United States: Please provide monthly index data for the US Consumer Price Index for the period January 2008 to the present.

47. Please see Exhibit US-42.