UNITED STATES – MEASURES RELATING TO ZEROING AND SUNSET REVIEWS

RECOURSE TO ARTICLE 22.6 OF THE DSU BY THE UNITED STATES

(DS322)

Response of the United States to Additional Questions from the Arbitrator

October 26, 2010

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23. (United States) The United States has argued (paragraph 80 of the United States' written submission; paragraph 4 of the United States' response to question 1 from the arbitrator) that "there is no punitive element to the suspension of concessions". Assuming, *ad arguendo*, that the suspension of concessions requested by Japan for an amount of US$121.1 million corresponds to the level of nullification or impairment suffered by Japan for pre-RPT entries that were liquidated by the United States after the expiry of the RPT, would this suspension of concessions still be "punitive in nature"? If so, please explain why.

1. As previously discussed in the U.S. Written Submission and Response to Question 1, the suspension of concessions under Article 22 permits the complaining Member to suspend concessions in order to balance the trade benefits that are being denied as a result of a WTO-inconsistent measure. Any award in this dispute which exceeds the level of nullification or impairment of benefits currently suffered by Japan would not create a balance of rights and obligations under the covered agreements. Put differently, any level of suspension that exceeds the level of nullification or impairment would not be equivalent under Article 22. Any such award would be punitive in effect, without regard to intent.

2. What Japan is now seeking would clearly exceed the current level of nullification or impairment, and Japan does not deny this. The amount Japan is seeking for pre-RPT entries is an amount over and above the level of nullification and impairment for the current year.

3. As discussed in the Arbitrator's decision in *United States – Anti-Dumping Act of 1916*, an award which exceeds the level of nullification or impairment would be punitive in nature:

> We also agree with the critically important point that the concept of "equivalence", as embodied in Article 22.4, means that obligations cannot be suspended in a punitive manner. This means that in suspending certain obligations owed to the United States under the GATT and the Anti-Dumping Agreement, the European Communities cannot exceed the level of nullification or impairment sustained by the European Communities as a result of the 1916 Act.[1]

4. With respect to Japan's request for suspension for $121.1 million for entries that were not liquidated as of the end of the reasonable period of time (RPT), such a request is not equivalent

[1] *U.S. – 1916 Act (Article 22.6)*, para. 5.8.

to the level of nullification or impairment because it seeks suspension for past nullification or impairment based upon a retroactive analysis. Even assuming, for the sake of argument, that Japan's estimate of $121.1 million accurately corresponds to the level of nullification or impairment suffered by Japan for those goods at the time of entry – in some cases over a decade ago – suspension is not appropriate for those entries because they do not reflect the level of nullification or impairment currently suffered by Japan, and Japan admits that they do not.

5. Japan has conceded that the lost exports, *i.e.*, trade effects, associated with these pre-RPT entries accrued, by definition, at the time of entry.[2] Japan has also conceded that it is not aware of any reliable method to quantify any downward effects on future trade that may take place after the end of the RPT from those pre-RPT entries.[3] These concessions confirm that Japan's request for suspension of concessions on pre-RPT entries is not related to current nullification or impairment of benefits which Japan is suffering but instead corresponds to nullification or impairment of benefits which may have occurred over a decade ago. Accordingly, Japan's calculation of excess duties based on pre-RPT entries is not an appropriate measurement of the level of nullification or impairment.

24. (United States and Japan) Mexico has argued (paragraph 7 of Mexico's third-party submission) that:

> **"[T]he question of whether the authorization of countermeasures by the DSU provides a 'prospective' or 'retrospective' remedy does not provide an answer to the issues raised in this Article 22.6 arbitration.... The critical question before [this arbitrator] is whether a Member seeking the authorization of countermeasures is entitled to a remedy for *all* actions taken inconsistent with the DSB's recommendations and rulings after the expiry of the RPT. This inquiry does not require an answer to abstract questions of whether the WTO is providing 'prospective' or 'retrospective' relief."**

Can the United States and Japan comment on this statement.

6. The United States disagrees with the proposition that the question before the Arbitrator is whether a Member seeking the authorization of countermeasures is entitled to a "remedy" for all actions taken inconsistent with the DSB's recommendations and rulings after the expiry of the RPT. Despite Mexico's efforts to reframe the question, such an award would not be equivalent to the level of nullification or impairment currently suffered by Japan. Instead, as discussed above, such an award for pre-RPT entries would be improperly based on nullification or

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[2] *See*, *e.g.*, Japan Oral Statement, para. 44.

[3] *See*, *e.g.*, Japan's Response to Question 11 from the Arbitrator, para. 5; Japan's Response to Question 12 from the Arbitrator, para. 9.

impairment which Japan has conceded occurred in the past. The United States also disagrees that the concept of a "remedy" is an appropriate framework for this analysis. The term "remedy" does not appear in Article 22 of the DSU. Instead, Article 22 permits a member to seek suspension of concessions or other obligations equivalent to the level of nullification or impairment. Such a suspension does not provide a "remedy" because Article 22 does not function to make monetary awards for past actions. To the extent Mexico suggests by use of the term "remedy" that Article 22 should be read as providing for damages for past acts, this is the wrong concept.

7. Furthermore, the approach suggested by Mexico would be inconsistent with the approach of previous Article 22.6 Arbitrators. A previous Article 22.6 arbitrator has rejected a request for authorization based on nullification or impairment occurring in the past. In *US – Upland Cotton*, the arbitrator considered a request from the requesting Member for the level of countermeasures to include "one-time countermeasures" in the amount of the user marketing (Step 2) payments made by the United States to domestic users of upland cotton in addition to the level for other countermeasures sought by the complaining Member.[4] The compliance panel had found these Step 2 payments to be inconsistent with the SCM Agreement.[5] The expiration of the RPT was July 1, 2005; Brazil was seeking authorization for this one-time amount for the 13 months after the RPT, to July 30, 2006, when the United States repealed the Step 2 program.[6] Although the United States continued to make Step 2 payments for a period after the expiration of the RPT, the arbitrator nonetheless denied Brazil's request for a one-time amount.[7] This decision confirms that the suspension of concessions should be based upon the current level of nullification or impairment, not a retroactive analysis of nullification or impairment occurring in the past.

8. Additionally, past arbitrations awarding variable levels of suspension recognize that the calculation of a level of nullification or impairment is a forward looking exercise. In *US – CDSOA (Article 22.6)*, the arbitrator stated that "*the requirement that the level of such suspensions remain equivalent to the level of nullification or impairment suffered by the complaining party* seems to imply that suspension of concessions or other obligations is only a means of obtaining some form of temporary compensation, even when the negotiation of

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[4] *US – Upland Cotton (Article 22.6 and SCM Article 4.11)*, para. 2.6

[5] *US – Upland Cotton (Article 22.6 and SCM Article 4.11)*, at para 1.13.

[6] *US – Upland Cotton (Article 22.6 and SCM Article 4.11),* at para. 3.2.

[7] *US – Upland Cotton (Article 22.6 and SCM Article 4.11)*, at para. 3.50. While the *US – Upland Cotton* arbitration was under the SCM Agreement, the issue of retroactivity is not one that depends on the different standard under that Agreement.

compensations has failed."[8] This forward-looking analysis contradicts Mexico's "remedy" approach.

25. (United States and Japan) Please explain how the text of Article 22 of the DSU, read in its context and in the light of the treaty's object and purpose, supports your respective position on whether there may be suspension of concessions for nullification or impairment arising after the end of the RPT but before the date of the DSB's authorization to suspend concessions.

9. First, the term "level" in Article 22.4 supports the United States' argument that suspension of concessions for past nullification or impairment is inconsistent with the DSU. The most natural reading of the term "level" refers to a specific amount being compared at a specific point in time to the level of nullification or impairment at that time. In order for the level to be ascertainable by the Arbitrator at the time of award, measuring the effects at the present time rather than as a cumulation of past effects is the most natural reading. If the intent of this provision were to allow a complaining party to obtain suspension based upon past nullification or impairment based upon a retroactive analysis, an alternate term, such as "total," "cumulation," or "sum," would have been more appropriate. Similarly, the lack of any definition of what past nullification or impairment would be subject to such cumulation further supports the forward-looking nature of the analysis.

10. Second, neither the term "level" nor the supporting language in Article 22.4 and 22.7 makes reference to past effects. Article 22.4 provides that the level of suspension "shall be equivalent to the level of the nullification or impairment." Similarly, Article 22.7 provides that the task of the Arbitrator is to determine whether the level of suspension "is equivalent to the level of nullification or impairment" This lack of any reference to past nullification or impairment within the text of the agreement demonstrates that a suspension based on past acts would be inappropriate.

11. Third, the use of tense "shall be" and "is" in Article 22 of the DSU supports the U.S. argument that there may be no suspension of concessions for past nullification or impairment because both verbs are in the present tense. The most natural reading of the use of the present tense is to refer to the present state of affairs. Similarly, the absence of any definition using the past tense demonstrates both the forward-looking nature of the analysis and the absence of guidance for any backward-looking analysis. As such, the use of the present tense in Article 22.4 and 22.7 supports the position of the United States that the suspension of concessions for past nullification or impairment is inconsistent with Article 22.

[8] *US – CDSOA (Article 22.6) (EC)*, para. 6.3.

12. Fourth, as discussed in paragraph 80 of the U.S. Written Submission, one of the underlying principles for authorizing suspension of concessions is maintaining the balance of trade benefits accruing to the parties. Where a Member's measure is nullifying or impairing the benefits promised to another Member under the covered agreements, the Member whose benefits are being nullified or impaired is not required to continue providing the full level of its trade concessions to the Member in breach. Under Article 22.4, the level of suspension may not exceed the level of nullification or impairment. This limit does not permit a Member to suspend concessions due to past nullification or impairment, but is forward-looking. That is, suspension is limited to the level at which benefits are currently being nullified or impaired.

13. In addition, the context of Article 22 reaffirms the forward-looking nature of the analysis. Article XXIII:1 of the GATT 1994 refers to "any benefit" that "*is being* nullified or impaired." (Emphasis added.) Again, the language is in the present tense and makes clear that it is not concerned with past nullification or impairment. Article XXIII formed the basis for the DSU and is explicitly "affirmed" in Article 3.1 of the DSU. Furthermore, the arbitrator in CDSOA stated that: "In this arbitration, we have interpreted the concept of nullification or impairment, inter alia, from the terms of Article XXIII of GATT 1994 and Article 3.8 of the DSU."[9] As with the use of the present tense in Article 22.4 and Article 22.7, this formulation of nullification or impairment is inconsistent with the concept that suspension should be based upon a cumulation of past acts.

26. (United States) In paragraph 78 of its written submission, the United States argues that:

> **"The underlying premise of Japan's claim – that Japan may properly cumulate suspending measures for the first year based upon all the time that has passed from the end of the RPT until the present – is contradicted by the Article 22.4 requirement that the level of suspension be equivalent to the level of nullification or impairment. As the 'level' does not refer to cumulation of past effects, the underlying premise of Japan's contention is fundamentally flawed."**

In response, Japan contends that:

> **"The United States offers no explanation as to why the term 'level' has any *temporal* significance whatsoever, much less why it means that suspension of concessions must be limited to amounts accruing from the time of the arbitration forward, rather than include amounts associated with N/I accruing after the end of the RPT. The relevant definition of 'level' is: 'A position (on a real or imaginary scale) in respect of amount, intensity, extent,**

[9] *US – CDSOA (Article 22.6) (EC)*, para. 6.6.

> **etc.; a relative height, amount, or value'. Thus, 'level' simply refers to the 'amount' or 'value' of N/I and suspension of concessions, and has no bearing whatsoever on the time period over which N/I and suspension of concessions are to be assessed." (Footnote omitted.)**

Please explain why the use of the word "level" in Article 22.4 of the DSU would support the United States' argument that there may be no suspension of concessions for past nullification or impairment.

14. Please see Response to Question 25. Furthermore, if the negotiators of the DSU had contemplated that the amount to be authorized would be constantly growing from the end of the RPT until the award was finally issued, they would have needed to have addressed the questions identified in this arbitration – for example, how to allocate such an increased amount (for example, suspend additional concessions all in the first year? Allocate it in decreasing amounts over a period of *x* years?). In addition, increasing the amount of concessions to be suspended by multiple times the level of nullification and impairment could have meant that the complaining party could stop all trade with a particular responding party, depending on the levels of trade between them. This would have a much greater trade-distorting effect than the measure at issue and could lead to serious disruption in the world trading system. An arbitrator should not presume that negotiators decided not to address this possibility.

15. Also, Japan would appear essentially to be presenting a Member concerned with the choice of participating in legitimate DSU compliance proceedings to determine if the Member concerned were correct that it had achieved full or at least partial compliance, but at the cost of steadily mounting trade damage (in the sense of increasing level of suspension of concessions), or of forgoing the opportunity to establish that it had achieved compliance in order to avoid the steadily mounting trade damage.

27. (United States) In paragraph 9 of its response to question 1 from the arbitrator, the United States argues that:

> **"[T] he correct level of suspension in this dispute should be forward-looking. In particular, Article 22.4 of the DSU provides that the 'level of the suspension of concessions or other obligations authorized by the DSB *shall be* equivalent to the level of nullification or impairment.' (Emphasis added.) Similarly, Article 22.7 of the DSU provides that the Arbitrator 'shall determine whether the level of such suspension *is* equivalent to the level of nullification or impairment.' (Emphasis added.) In neither case does the DSU provide for a determination a level of suspension that *would have been* equivalent to the level of nullification or impairment that *had been caused* by the measures."**

Please explain how the use of the tense "shall be" and "is" in Article 22.7 of the DSU supports the United States' argument that there may be no suspension of concession for past nullification or impairment.

16. Please see Response to Question 25.

28. (United States and Japan) In addition to the text of Article 22 of the DSU, can the United States and Japan point to any supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, which would support each party's respective position on whether there may be suspension of concessions for nullification or impairment arising after the end of the RPT but before the date of the DSB's authorization to suspend concessions.

17. Please see Response to Question 25.

29. (United States) Japan has argued (paragraph 36 of Japan's written submission) that:

"Excluding part of the N/I resulting from post-RPT actions would undermine the dispute settlement process by *extending* the period of grace and impunity for WTO-inconsistent actions beyond the end of the RPT."

Can the United States comment on this statement.

18. The United States disagrees with Japan's argument that excluding nullification or impairment resulting from post-RPT actions other than current-year nullification or impairment would somehow undermine the dispute settlement process. To the contrary, as discussed in the U.S. responses to Questions 23 through 28, Japan's request for suspension based upon past nullification or impairment is inconsistent with the text of the DSU.

19. Japan's argument also does not acknowledge the distortive effect of cumulating potentially several years of nullification or impairment and then adding that cumulative amount to the amount of concessions to be suspended, for example during the first year of suspension of concessions. Under Japan's theory, the length of time between the expiration of the RPT and the suspension of concessions may significantly alter the magnitude of suspension. That is, under Japan's theory, the longer the time period between the end of the RPT and the suspension of concessions, the greater the level of suspension which could be awarded. The practical result of this theory, then, is that a complaining Member can significantly magnify the level of suspension of concessions simply by being willing to continue the suspension of an arbitration proceeding. Nothing in the DSU contemplates the magnitude of suspension varying so greatly based merely on the passage of time.

20. Japan's request for suspension in this proceeding makes evident this distortive effect. Although Japan estimates the level of nullification or impairment for the current year to be approximately $48 million, it nonetheless requests suspension of approximately $265 million (the total of the $121.1 million for pre-RPT entries, $96.1 million for historical post-RPT entries, and $48 million for present-year entries).

21. By Japan's admission, this proposed level of suspension is more than *five* times Japan's own estimate of the level of nullification or impairment for the current year. Such a distortion is not contemplated by the requirement in Article 22.4 that the level of suspension be equivalent to the level of nullification or impairment. Such a cumulation would not balance Japan's current benefits under the covered agreements, but would instead award Japan a suspension of concessions based on nullification or impairment that Japan has conceded to have occurred in the past.

22. Furthermore, a complaining party's decision to wait some period of time after the expiration of the RPT to pursue its request for authorization to suspend concessions should not permit that party to cumulate several years of suspension and add that amount (in full or in part) to the amount equivalent to the level of nullification or impairment in a particular year. This also demonstrates that limiting the current level of suspension of concessions to an amount equivalent to the current level of nullification or impairment does not "undermine" the dispute resolution process – instead, it reflects the proper functioning of that system.

32. (United States) In its questions posed to the parties on 25 August 2010, the arbitrator noted Japan's argument that "[a]s a matter of law, the relevant date for determining the level of N/I, and accordingly the level of suspension of concessions, is the end of the RPT" (paragraph 20 of Japan's written submission). The arbitrator asked the United States what is, in its view, the *precise relevant date* for determining the level of nullification or impairment in the present case. In its response, the United States noted its disagreement with Japan's statement. The United States then seems to suggest that the relevant date that in its view should constitute the starting point for determining the level of nullification or impairment should be the date of the most recent DSB recommendations and rulings in this dispute (paragraph 9 of the United States' response to question 1 from the arbitrator). In paragraph 77 of its written submission, however, the United States seems to suggest that in the present case nullification or impairment "prior to the present year" should not be considered by the arbitrator. Can the United States confirm this would be in its view the proper starting point for determining the level of nullification or impairment in the present case.

23. As discussed in the U.S. Response to Question 1, the appropriate question is what is the level of nullification or impairment when the suspension of concessions or other obligations is being applied. The correct counterfactual to be used should be based on the most recent DSB recommendations and rulings in this dispute. However, the most recent DSB recommendations

and rulings could nonetheless be a year or more in the past, for example as in this arbitration proceeding. Accordingly, the proper temporal starting point should be the arbitrator's award. This would help provide that the level of suspension of concessions is equivalent to the current level of nullification and impairment. As we have discussed above, this is a forward-looking analysis.

24. In this dispute, the proper starting point for determining the level of nullification or impairment would be the date of the Arbitrator's award. A current-year analysis provides a proxy for the estimated level of nullification or impairment for the year following the starting date for suspension.

33. (United States and Japan) In their respective statements at the meeting with the arbitrator, both the United States and Japan referred to the possible effects import measures may have on price changes. (See, paragraph 69 of the United States' opening statement at the meeting with the arbitrator; paragraph 11 of Japan's opening statement at the meeting with the arbitrator). In your view, would price changes be an acceptable form of determining the level of nullification or impairment?

25. The United States understands that price changes are not exactly a "form" of determining the level of nullification or impairment. Rather, where the non-compliant measure affects the price of the imported good, the level of the price change – along with other information such as elasticities – may be used to determine the level of nullification or impairment. Indeed, the U.S. calculation uses price change in conjunction with a demand elasticity and trade volume to determine the trade effects of increased dumping margins due to zeroing.

26. Japan's methodology utilizes a source substitution elasticity that, even if accepted by the Arbitrator, would require information regarding changes both to import prices and domestic prices as a result of compliance. The United States disagrees with Japan's use of estimated margin changes as a proxy for changes to import prices. Even if the Arbitrator were to accept Japan's use of estimated margin changes as a proxy for changes to import prices, however, Japan has provided neither data nor a methodology for estimating any change to domestic prices. Correspondingly, Japan's methodology does not provide the means to determine the level of nullification or impairment using price changes.

36. (United States and Japan) The panel on *Australia - Automotive Leather II (Article 21.5 - US)*, after having concluded that the term "withdraw the subsidy" in Article 4.7 of the SCM Agreement also encompassed in certain circumstances the "repayment in full" of prohibited subsidies, rejected the inclusion of "interest" in the repayment of the subsidy at issue in that case. That panel was of the view that the remedy under Article 4.7 of the SCM was not designed to "fully restore the status quo ante" nor was it a remedy intended to provide for "reparation or compensation in any sense." Do you think that the same

rationale could apply *mutatis mutandis* to a proper interpretation of the remedy provided for under Article 22 of the DSU? Please, explain.

27. In concluding that the repayment of a subsidy did not include any interest component, the panel in *Australia – Automotive Leather II (Article 21.5)* found the following:

> In our view, the required repayment does not include any interest component. We believe that withdrawal of the subsidy was intended by the drafters of the SCM Agreement to be a specific and effective remedy for violations of the prohibition in Article 3.1(a). However, we do not understand it to be a remedy intended to fully restore the *status quo ante* by depriving the recipient of the prohibited subsidy of the benefits it may have enjoyed in the past. Nor do we consider it to be a remedy intended to provide reparation or compensation in any sense. A requirement of interest would go beyond the requirement of repayment encompassed by the term "withdraw the subsidy", and is therefore, we believe, beyond any reasonable understanding of that term.[10]

28. The panel's reasoning in *Automotive Leather*, while not directly applicable to the case at hand because it involved an Article 21.5 proceeding under the *SCM* Agreement, nonetheless demonstrates why no interest component would be appropriate in this Article 22.6 proceeding. Just as the *Automotive Leather* panel concluded that the remedy under the *SCM* Agreement was not "intended to fully restore the *status quo ante*," nor is the remedy under Article 22 intended to restore past benefits.

29. As discussed in the U.S. Response to Question 25, the remedy under Article 22 does not address the amount of past harm resulting from a prohibited practice. Instead, Article 22.4 provides that the level of suspension shall be equivalent to the level of nullification or impairment. An award of interest would, by definition, be in excess of the level of nullification or impairment actually suffered at the time it was incurred. Thus, any award of interest would deviate from this principle.

40. (United States and Japan) What are the relative roles of excess duties and lost trade in determining and ensuring equivalence under Articles 22.4 and 22.7 of the DSU?

30. In this case, lost trade would be the appropriate metric for determining and ensuring equivalence under Articles 22.4 and 22.7 of the DSU. The matter before the Arbitrator presents a straightforward situation – the imposition of excessive duties – for which it is natural to look to trade loss for determining the level of nullification or impairment. In the present case, the nullification or impairment of benefits arises from the use of zeroing in particular antidumping

[10] *Australia – Automotive Leather II (Article 21.5)*, para. 6.49.

duty administrative reviews to calculate the applicable antidumping duty rates. This may result in the imposition of excess duties on goods. In such cases, the Arbitrator need not look beyond the effect of the excess duties on the trade in goods to determine the level of nullification or impairment.

31. Determining the level of nullification or impairment, however, is a highly case-specific exercise. And the present dispute does not present facts that require the Arbitrator to adopt an approach different from the trade effects approach typically used by past arbitrators.

32. Past arbitrators have refused to award suspension of concessions based on claims which are "too remote, too speculative or not meaningfully quantified."[11] Here, in its response to Question 12, Japan acknowledges that it has only calculated excess duties for pre-RPT entries because it has "no reliable method" of calculating lost trade for those pre-RPT entries. In paragraph 44 of its oral statement, Japan further conceded that the lost exports associated with these pre-RPT entries accrued, by definition, at the time of entry, and that it was not aware of any reliable method to quantify any downward effects on future trade that may take place after the end of the RPT from those pre-RPT entries. Accordingly, Japan's calculation of excess duties is not an appropriate measurement of the level of nullification or impairment under the facts of this case.

47. (United States) Does the United States consider that a variable level of suspension based on the formula in paragraph 66 of Japan's methodology paper would create more than minimal unpredictability for the United States? How easy is it to predictably determine the various elements of this formula?

33. Yes – a variable level of suspension based on the formula in paragraph 66 of Japan's methodology paper would create significant unpredictability for the United States. This unpredictability results from the variability of the inputs in the formula and Japan's proposal to determine, in its sole discretion, under what circumstances Japan would update the variable level of suspension. Even if Japan used the same formula as in the award by the Arbitrator, the variability in the inputs from year to year and discretion regarding timing would permit Japan to choose the relevant time period so as to maximize the resulting level of suspension.

34. The formula proposed by Japan has two variables that are likely to change with time: the antidumping duty rates imposed and the value of trade. Even assuming that the antidumping duty rates remain constant, the value of trade is likely to vary significantly from year to year. For example, Japan's trade value for 2007 through 2009 ranged from $102.2 million to $160.8 million, a difference of more than 50 percent. This would result in the level of nullification or

[11] *US – CDSOA (Article 22.6)(EEC)*, para. 3.76 (citations omitted); *see also US – 1916 Act (Article 22.6)*, paras. 5.76-5.78 (amounts which cannot be meaningfully quantified cannot be included in the calculation of level of nullification or impairment).

impairment varying more than 50 percent from year to year as well. Thus, if a party were to choose to perform a new calculation after having observed a particularly high level of trade in a given year, it could set the level of suspension of concessions at that level going forward, even if the level of trade returned to lower levels the next year.

35. With respect to the ease of determining the various elements of the formula, none of the variables may be predicted with certainty in advance. Even if the United States would be able to know the value of each variable at the end of a given year, the year-to-year variability of the inputs would result in significant unpredictability. Thus, it will not be easy – or even possible – for the United States to predict the outcome of such a calculation in advance.

36. In the event that the Arbitrator nevertheless chooses to authorize Japan to update the level of suspension after the date of award, this variation in trade value also weighs in favor of using three years of data so as to minimize the potential for such disruption caused by choosing trade levels for a particular year. This danger is particularly acute given Japan's request to be able to choose the timing for any adjustment in its sole discretion, and to do so in hindsight. The averaging of three years of data removes distortions from an exceptionally high or low level of trade for a given year. Although the changes in trade levels demonstrate why a variable method is not appropriate in this case, at minimum any calculation should be based upon three years of data rather than two years to minimize this potential disruption. Similarly, any authorized changes should, at minimum, be authorized after a fixed period of time, *e.g.*, after three years, rather than being at the discretion of the complaining party.

50. (United States) Can the United States comment on Japan's response to question 17, regarding Japan's use of *source substitution elasticities* and *import demand elasticities*.

37. The United States disagrees with Japan's assertion that the import demand elasticity and the import-domestic source substitution elasticity are identical under the present circumstances of this dispute. Japan attempts three different arguments to convince the Arbitrator. None of the these arguments is convincing.

38. As an initial matter, it is important to recall that, as the Arbitrator found in *United States – 1916 Act*,[12] in accordance with normal rules applicable to the burden of proof, where the existence of a specific fact is alleged a party alleging a fact must prove its existence. As described below, Japan bases its arguments in favor of a source substitution elasticity on key

[12] *See, US – 1916 Act (Article 22.6)*, para. 6.11 ("We also recall that in accordance with the normal rules applicable to the burden of proof, as stated in *EC – Hormones (Article 22.6) (US)* and *EC – Hormones (Article 22.6) (Canada)*, 'where the existence of a specific fact is alleged….[i]t is for the party alleging the fact to prove its existence.' In the present case, the European Communities has alleged 'specific facts' – the settlement of claims under the 1916 Act involving EC entities. Yet it has not proved such facts.")

facts, the existence of which Japan has never proven. On this basis, alone, the Arbitrator should reject Japan's argument.

39. First, Japan argues that economic theory supports its assertion that these two elasticities are identical. Japan argues that the source substitution elasticity collapses into the import demand elasticity when the following two assumptions are made concurrently: constant elasticity of substitution (CES) preferences and a fixed price index. Even assuming such a theoretical possibility to be true – a conclusion the United States does not share – Japan has supported neither assumption in this case.

40. To support its assumption that CES preferences exist, Japan makes the factual assertion that U.S. ball bearing consumers are indifferent to the source of their ball bearings, implying that all sources are equally substitutable. Japan provides no evidence to support this characterization of the U.S. ball bearing market.

41. Japan further argues that the GTAP elasticities can be used as import demand elasticities because the GTAP model explicitly makes the assumption of CES preferences. The GTAP model, however, does not assume CES preferences. Instead, the GTAP model employs substitution elasticity parameters that remain constant regardless of relative prices, although the rate of substitution may vary across sources. This is different from CES preferences, where all sources are equally substitutable. In the GTAP model, imports are less substitutable to domestically produced products than to other imports. This is demonstrated by the fact that the import-import source substitution is twice as large as the import-domestic source substitution.

42. Furthermore, Japan's discussion of the fixed price index assumption does not support its factual assumption that U.S. producers would not adjust their prices in response to a reduction in the price of Japanese ball bearings. Japan has equated the fixed price index assumption with fixed expenditure by consumers for ball bearings. Again, Japan has provided no evidence to support this assumption.

43. Even accepting, for the sake of argument, Japan's factual assumption that consumers have a fixed expenditure for ball bearings, this assumption has no effect upon producer behavior. Fixed expenditures by consumers do not prevent competing suppliers to Japanese producers from adjusting their prices given price changes to Japanese ball bearings. Especially if assuming that all sources are equally substitutable, the assumption becomes even more implausible that U.S. producers and other suppliers would not adjust their prices when their Japanese competitors' prices change. Additionally, Japan's assumption of fixed expenditures implies a demand elasticity of -1, compared to Japan's use of the GTAP source substitution elasticity of -4.05.

44. Second, Japan argues for the use of the GTAP source substitution elasticity as an import demand elasticity because the Arbitrator in the *US – CDSOA* dispute used the GTAP source

substitution elasticity in its formula to determine nullification or impairment. While the United States does not necessarily endorse the approach taken by the Arbitrator in the *CDSOA* dispute, the United States would note that the Arbitrator included an additional element into its formula to represent import penetration in the U.S. market. Import penetration was calculated by the following formula: value of imports/value of domestic shipments.

45. This import penetration calculation served to reduce the initial GTAP elasticity proportionately to the level of import penetration. For example, if Japan's import penetration level were 25%, then Japan's -4.05 source substitution elasticity would become roughly equivalent to the -1.16 import demand elasticity in the U.S. calculation. Japan made no such adjustment in its calculations. Thus, the *CDSOA* decision does not support Japan's use of the GTAP source substitution elasticity in this case.

46. Third, Japan incorrectly asserts that both parties agree that the counterfactual assumes that U.S. prices and quantities would not change in response to a reduction in price of Japanese ball bearings due to compliance. To the contrary, the United States does not agree that bringing its measures into compliance would have no effect on U.S. prices and quantities. Indeed, such a change in U.S. prices and quantities is a likely outcome of a reduction in the price of Japanese ball bearings. The likelihood of such a change in U.S. prices and quantities refutes the use of the GTAP substitution elasticity in an equation that calls for an import demand elasticity.

47. As the United States has explained in its Written Submission and answers to Arbitrator questions, the conceptually correct elasticity to use in the proposed lost trade equations by the United States and Japan is the import demand elasticity. Japan has failed to demonstrate that the GTAP sourcing substitution elasticity collapses into an import demand elasticity. As such, the import demand elasticities estimated by the World Bank are the best alternative for the Arbitrator as the elasticity input into the lost trade equation. The World Bank import demand elasticities were specifically estimated for the United States. Moreover, the degree of aggregation provides for a much better estimate for these products than the highly aggregated GTAP substitution elasticity.

56. (United States and Japan) In footnote 64 to paragraph 63 of its response to question 18 from the arbitrator, Japan states that the elasticity of substitution it uses has been sourced from the study by Hertel et al. (2004). However, this study seems to estimate the elasticity of substitution between different import sources. The domestic-import elasticity of substitution used by Japan in its calculations seem to be derived from this, using the so-called "rule of two". Can parties comment on the appropriateness of this rule in the context of the present dispute.

48. The Arbitrator is correct that the import-domestic elasticity of substitution used by Japan was not empirically estimated. In the Hertel, *et al.* study, the authors estimated import-to-import elasticities of substitution. For the GTAP, import-to-domestic elasticity of substitution was

determined using the so-called "rule of two" based on the values of the import-to-import elasticities of substitution estimated in Hertel, *et al.*

49. The economic literature is sparse regarding the so-called "rule of two." A 2004 study by Liu, *et al.*,[13] attempts to confirm the "rule of two." In this study, the authors estimate the import-domestic and import-import elasticities simultaneously in a structural framework, first constraining them to abide by the "rule of two" and then relaxing the constraint that the ratio between them be two. When the authors relaxed the constraint, they found the ratio to be 2.69 instead of two. So, although the authors could not statistically reject the "rule of two," they also could not confirm this relationship.

50. Moreover, Liu, *et al.* estimated that the probability that the ratio exactly equals two was only 16%. In other words, there is an 84% chance that the "rule of two" does not hold exactly. If the ratio is larger than two, as estimated by Liu *et al.*, this higher ratio implies that import-domestic elasticities are lower than those used by GTAP and in the Japanese submission.

51. For this reason and those the United States has previously presented to the Arbitrator, the Kee, *et al.* import demand elasticities are a more appropriate choice for this analysis than the GTAP source substitution elasticities.

58. (United States) Can the United States provide the description of the products associated with the 20 HTS six-digit tariff [items] that are listed in Exhibit US-19.

52. The product descriptions for the 20 HTS tariff items are listed below. For the source documents for these descriptions, please refer to the corresponding pages of the Harmonized Tariff Schedule (HTS).[14] The United States also notes that ball bearings primarily enter the United States under the following 6-digit headings: 8482.10, 8482.80, 8482.91, 8482.99 and 8483.20. The remaining headings were included as a result of scope determinations following the original investigations. The descriptions are:

HTS Code	Description
3926.90	Other articles of plastics and articles of other materials of headings 3901 to 3914: other
4016.93	Other articles of vulcanized rubber other than hard rubber: gaskets, washers and other seals

[13] Liu, Jing, Channing Arndt, and Thomas Hertel, "Parameter Estimation and Measures of Fit in a Global General Equilibrium Model," *Journal of Economic Integration*, 19(3):626-649 (attached as Exhibit US-21).

[14] *See* Excerpts from *Harmonized Tariff Schedule of the United States* (2010) (Rev. 2) (attached as Exhibit US-22).

6909.19	Ceramic wares for laboratory, chemical or other technical uses: other
8431.20	Parts suitable for use solely or principally with machinery of heading 8425
8431.39	Parts suitable for use solely or principally with the machinery of headings 8425 to 8430: other
8482.10	Ball or roller bearings and parts thereof: ball bearings
8482.80	Ball or roller bearings and parts thereof: other, including combined ball/roller bearings
8482.91	Ball or roller bearings and parts thereof: Parts: balls, needles and rollers
8482.99	Ball or roller bearings and parts thereof:
8483.20	Housed bearings, incorporating ball or roller bearings
8483.50	Flywheels and pulleys, including pulley blocks
8483.90	Toothed wheels, chain sprockets and other transmission elements presented separately; parts
8708.50	Parts and accessories of motor vehicles of headings 8701 to 8705: Drive axles with differential, whether or not provided with other transmission components: for tractors (except road tractors)*
8708.60	Parts and accessories of motor vehicles of headings 8701 to 8705: Non-driving axles; parts thereof: for tractors (except road tractors) *
8708.93	Parts and accessories of motor vehicles of headings 8701 to 8705: Clutches and parts thereof
8708.99	Parts and accessories of motor vehicles of headings 8701 to 8705: other
8803.10	Parts of goods of heading 8801 to 8802: propellers and rotors and parts thereof
8803.20	Parts of goods of heading 8801 to 8802: undercarriages and parts thereof
8803.30	Parts of goods of heading 8801 to 8802: other parts of airplanes or helicopters
8803.90	Parts of goods of heading 8801 to 8802: other

* Beginning in 2007, line 8708.60 was discontinued and merged with 8708.50 with the new description of 8708.50 as drive axles with differential, whether or not provided with other transmission components, and non-driving axles; parts thereof: for tractors (except road tractors).[15]

[15] *See* Excerpts from *Harmonized Tariff Schedule of the United States* (2006) – Supplement 1 (Rev. 2); *Harmonized Tariff Schedule of the United States* (2007) (Rev. 2) (attached as Exhibit US-23).

TABLE OF EXHIBITS

Exhibit No.	Description
US-21	Jing Liu, Channing Arndt, and Thomas Hertel, "Parameter Estimation and Measures of Fit in a Global General Equilibrium Model," *Journal of Economic Integration*, 19(3):626-649
US-22	Excerpts from *Harmonized Tariff Schedule of the United States* (2010) (Rev. 2)
US-23	Excerpts from *Harmonized Tariff Schedule of the United States* (2006) – Supplement 1 (Rev. 2); *Harmonized Tariff Schedule of the United States* (2007) (Rev. 2)