IN THE MATTER OF AN ARBITRATION UNDER CHAPTER ELEVEN OF THE *NORTH AMERICAN FREE TRADE AGREEMENT*

BETWEEN:

POPE & TALBOT, INC.

Claimant/Investor

and

THE GOVERNMENT OF CANADA

Respondent/Party

GOVERNMENT OF CANADA

POST-HEARING SUBMISSION

(Damages Phase)

December 14, 2001

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PART A: INTRODUCTION

1. These are Canada's post-hearing submissions on damages. Canada continues to rely on its written submissions in its Counter-Memorial on Damages (August 18, 2001), Reply Counter-Memorial on Damages (October 5, 2001) and oral argument made during the hearing in Washington, D.C. on November 13 – 15, 2001.[1]

2. Three facts are determinative in this phase. First, the Investor admits that the Investment never lost a single sale as a result of the verification review episode.[2] Second, the Investment met all its sales commitments without exhausting the lumber it produced and maintained in inventory.[3] Third, the Investment never lost quota as a result of the verification review episode.

3. Nonetheless, the Investor has submitted a wildly exaggerated claim for damages exceeding US$ 2.2M, based largely on unsupported factual assertions and an untenable economic model.

4. The Investor also failed to prove that the majority of its claim arose out of or was caused by the verification review episode, although it certainly had ample opportunity to establish such causation, if it existed.

5. In the result, the Investor leaves the Tribunal to struggle heroically to understand the claim as presented, to devise a rational model to reflect any actual loss caused by the verification review episode and to identify evidence that would prove the claims put forward.

6. It is not the Tribunal's function to formulate and execute a rational model to assess loss. No loss can be established based on this record. The

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[1] Canada has filed its submissions in response to the Article 1128 submissions separately.
[2] Damages Hearing Transcript (hereinafter "Transcript"), p. 107. The Investor advanced no claim that it lost any sales opportunity (including prospective customers or additional sales to existing customers), nor did it tender any evidence upon which to found such a claim.
[3] Exhibits DC-4 and DC-5.

Investor lost no sales and therefore did not lose profit. Nor is it the Tribunal's function to guess what claims relate to the verification review episode. The Tribunal cannot award damages by "guesstimating" where the Investor submits no proof of loss.

7. The damages award should reflect only those losses proven on a balance of probabilities to have been caused by the verification review episode, that were incurred by the Investor and that are reasonable. Such an award must be significantly less than the millions claimed.

PART B: DAMAGES – CLAIM FOR LOSS OF INCREMENTAL REVENUE

1. OVERVIEW

8. The Investor's claim for loss of incremental revenue is flawed in various respects. In particular:

   (a) The causal link alleged between the verification review episode and the shutdown lacks credibility;

   (b) The claim that the shutdown caused a delay or loss of revenue is untenable, especially given the Investment's inventory at the time of shutdown and throughout this period, and its production capacity; and

   (c) The assumptions used to calculate incremental revenue are inappropriate.

9. An alternative claim based on lost profits must also fail. The Investment did not suffer any lost sales during the seven day shutdown, as evidenced by the continued shipment of product during this time by drawing down inventory. Additionally, the Tribunal lacks the information needed to apply the alternative approach of lost profits suggested during the hearing.

10. In any event, the Investor steadfastly maintained its delay model as presented in its memorials and at the hearing, despite numerous invitations from the Tribunal to consider a different approach.[4] It advanced no claim for profit on lost production in its memorials, its evidence or at the hearing. In light of these facts, it would not be appropriate for the Tribunal to substitute a damage calculation not advanced by the Investor, never reviewed by Canada or its experts and for which there is insufficient evidence.

2. NO CAUSAL LINK TO VERIFICATION REVIEW EPISODE

11. The Investor maintains that the December 1999 shutdown was caused solely by the verification review episode, unlike every other shutdown taken by the Investment, either before or after December 1999.[5]

12. This assertion cannot be reconciled with the facts. No contemporaneous record or testimony supports Mr. Friesen's assertion. The first time this was ever mentioned was in Mr. Friesen's June 15, 2001 affidavit, after the finding of NAFTA liability on the basis of the verification review episode made it salient.[6]

13. When Mr. Friesen testified in January 2000, immediately following the shutdown, he did not mention the verification review episode. In fact, he said something completely opposite. When asked about the cause of the shutdown, he said the "exact reason" for the December 1999 shutdown

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[4] For example, at p. 535 of the transcript Arbitrator Belman asked Mr. Appleton, "Are you continuing to adhere to the delay theory of damages on that?". Mr. Appleton replied, "Yes, and I'll turn to that as we go through...". Other examples are found at Transcript, pp. 214 – 5, 219. At page 642 Mr. Appleton advised he felt the delay theory was the best way to assess loss although he speculated that the Tribunal had the information to devise a different calculation. Canada disagrees that the Tribunal has the necessary information.

[5] Mr. Gray testified that apart from a strike, the only time a shutdown would be taken was when market conditions would not allow it to run economically, and that the combination of prices and export fees caused it to take down-time in December 1999 – Damages Counter-Memorial, para. 78, Gray Testimony, May 2, 2000, pp. 102 – 3.

[6] Transcript, p. 67.

was the declining price for lumber.[7] This cannot be reconciled with his explanation at the damages hearing that the cause was actually the verification review episode and that he assumed everyone knew about the verification review so there was no need to mention it.[8]

14. The contemporaneous record also contradicts the thesis that the verification review episode caused the December 1999 shutdown.

15. The notices to employees announcing the December 1999 shutdown are the same as all other shutdown notices issued by the Investment, blaming declining prices and the lumber market.[9]

16. Mr. Friesen decided on the Christmas shutdown on November 15, 1999 and announced it the same day.[10] If verification was the only reason to shut down in 1999, then Mr. Friesen surely could have reversed his decision on November 19, when Canada undertook that at most a 5% reduction in quota, if any, was possible.[11]

17. Mr. Friesen told the Tribunal that he was aware by the middle of November that he could have run in December but decided not to because he interpreted the George letter to be an affirmation that he would lose quota.[12] The letter said no such thing.

18. The record discloses that other compelling factors caused mill shutdowns, including the December 1999 shutdown.

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[7] Damages Counter-Memorial, para. 75; Friesen Testimony, January 7, 2000 at 326.
[8] Transcript, p. 68 –9.
[9] See chart at Tab 1 where Canada has summarized the shutdown announcements produced in this matter and found at Tab 17 of the Damages Counter-Memorial. See also Damages Counter-Memorial at para. 82.
[10] Transcript, p. 65.
[11] Damages Counter-Memorial, para 70.
[12] Transcript, p. 79 – 80.

19. The Investment closed for Christmas in 1998, 1999.and 2000.[13] Mr. Friesen advised that the Investment does not run on holidays including Christmas Day and Boxing Day.[14]

20. At the time of making the December 1999 shutdown decision Mr. Friesen knew that he was near the end of his allotment of EB quota[15] and that he would likely have to shut down at some time before the end of the quota year. Mr. Rosen agreed that the Investment would have had to shut in March 2000 if it had not shut in December.[16] Mr. Friesen also noted that the Investment was at the quota speed bump and that this was a factor in his decision to shutdown.[17]

21. The Investment's in-house expert on quota, Mr. McGrath, predicted on October 26, 1999 that the Investment would have to shut down for 24 days.[18] On December 21, 1999 he revised that to 25 days of shutdown.[19] In fact, the Investment shut down all its mills for one production day in November, seven production days in December 1999 and another ten production days at the Grand Forks plant in March 2000. Mr. McGrath's predictions were quite accurate, and show that the shutdowns were caused by lack of quota.

22. Canada submits that the December 1999 shutdown was simply a Christmas shutdown made with the knowledge that the Investment had insufficient quota for the year and would have to shutdown at some point before the end of March 2000. It makes sense to have done this over Christmas when people want a holiday and most businesses are not very

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[13] Damages Counter-Memorial, para. 80; Transcript, p. 85.
[14] Transcript, p. 84.
[15] The Investment had used 83.79% of its fee-free quota – Damages Counter-Memorial, para. 77.
[16] Transcript, p. 211; see also discussion at pp. 208, 218-219.
[17] Transcript, pp. 101-2.
[18] Damages Counter-Memorial, Tab 17.
[19] *Ibid.*

busy. The only logical conclusion is that the quota scheme, and not the verification review episode, caused the December 1999 shutdown.

3. CONCEPTUAL PROBLEMS WITH DELAY CLAIM

23. Even if the Tribunal accepts that the verification review episode caused the December 1999 shutdown, there can be no compensable loss unless the delay resulted in an actual loss of revenue. It did not.

24. The Investor has quantified its damages as a loss of incremental revenue. Its thesis is that the shutdown caused a delay in production which led to a delay in sales and caused the Investment to sell seven days later in a market characterized by falling prices.[20]

25. For an award to result from this theory the Investor must show that:

(1) The verification review episode caused the shutdown;

(2) The Investment received a lower price as a result of the shutdown;

(3) The Investment would have been able to sell all the lumber it could have produced during the December 1999 shutdown into the American market at an economically viable price; and

(4) The Investment lost sales either because it did not use inventory to make up for the production shutdown, or because it did not have excess production capacity to make up production foregone during the shutdown.[21]

(a) Causation

26. Whether the shutdown was caused by the verification review is addressed above.

(b) Lower Price Received

27. The premise that the Investment received a lower price is based on the hypothesis that the shutdown caused a seven day delay in sales and the

[20] Transcript, pp. 209, 213 – 5, 337.
[21] Transcript, pp. 297 – 8.

product was sold at a lower price. This premise fails based on the Investment's own operating statements. The operating statements indicate that while production was delayed, sales were not, because of the Investment's ability to use inventory to supply its sales in December 1999.

28. The evidence also shows that the Investment did not receive a lower price as a result of the shutdown, if one extends the calculation past the end of the SLA[22] (as one must if performing a delay calculation).[23]

29. As shown in Exhibit D-6, in January 2000 (when the December 1999 production would have been sold) the Random Lengths price was US$ 332 and the actual realized price was US$ 369. In May 2001 the Random Lengths price was $337 and the actual realized price was $384.[24] Whether using the Random Lengths or actual realized price, the Investment equalled or bettered its January 2000 price by May 2001. At this point there is no loss. In fact, when the price exceeded the December 2000 price, as it did by June 2001, the Investment actually benefited from the December 1999 shutdown.

(c) Constraints on Sales to U.S.

30. There is no evidence that the Investment could have sold the alleged lost production into the United States at an economically viable price before the end of the SLA. The quota system, prevailing prices and customer demand (none of which were caused by the verification review episode), constrained the company from making those sales. As Mr. Harder explained, "You can always produce it. You just, under a quota system,

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[22] Transcript, p. 299.

[23] Transcript, pp. 332 – 3. The delay calculation must be extended to the earlier of the date of the award or zeroing out since it is based on the premise that the Investment is forever 7 days delayed from where it otherwise might have been. As Mr Rosen noted at page 207, "...theoretically, by definition, you should never be able to catch that production, because when it's economical to produce wood, you do produce wood...The only time you don't produce is when it's noneconomical to produce".

[24] See also Harder Affidavit #3, October 26, 2001, Schedule 1 for prices. See also Transcript, pp. 266, 299, 332 – 7, 351.

may not be able to sell it."[25] Moreover, you may not be able to sell it at an economic price. If the selling price is too low the Investment cannot maintain that it had a loss.

31. Lost production is not the same as lost sales.[26] To have a financial loss it is not enough to state that there were days of production lost, as Mr. Friesen did. He testified that "the production lost during those seven days is lost forever, ...it can't be made up by inventory".[27] With respect, this misses the point.

32. The Investor must prove not only the fact of lost production, but also that this caused lost or delayed sales and hence revenue foregone that becomes recoverable as damages.[28] The Investment did not lose any lumber sales and did not suffer a decline in revenue because of the production delay.

33. Instead, the Investment remained open for business throughout the December 1999 shutdown and made sales during the period.[29]

34. Mr. Friesen explained that typically the Investment maintained "a week or a week-and-a-half or two-week order file at the most in these kinds of markets".[30] Hence, he would have known in advance of shutting down what the sales demand would be over the Christmas holiday.

35. Mr. Friesen knew there would be a shortfall in production capacity when he decided to shutdown in December 1999. [31] However, he was also

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[25] Transcript, p. 333. See also pp. 305 – 307 where Mr. Harder explained that while you could produce infinitely, the real issue is whether it can be sold at an economically viable price.
[26] Transcript, p. 459.
[27] Transcript, p. 59.
[28] Transcript, p. 319.
[29] Transcript, pp. 311 – 2. See also announcement of December 1999 (Canada's Authorities, Damages Counter-Memorial, Tab 17), which notes that "Shipping departments, log yard personnel, office and payroll personnel will be scheduled as required".
[30] Transcript, pp. 106 – 7.
[31] Transcript, p. 81.

confident that there was no question of losing a sale because of the shutdown.

> Q: (Evernden): So if you knew that there was an order that you could not meet at Christmas 1999 or in January of 2000 because you would be down in terms of production, you would not have closed down, would you?
>
> A: (Friesen): We had sufficient inventory that I don't think that was an issue, sir.

(d) Inventory

36. The premise for the delay or loss of revenue claim is that the shutdown caused a seven day delay in production which resulted in a seven day delay in sales. The Investment submitted no evidence to support the contention that the delay in production led to a delay in sales.

37. If a delay in production occurred, and there was a demand for lumber at an economic price, the Investment should have gone to inventory to complete those sales.[32]

38. In fact, the Investment did exactly that. The Investor 's monthly operating statements indicate the three mills had [redacted] of inventory in November 1999, [redacted] of inventory in December 1999 and [redacted] of inventory in January 2000. At the same time, shipments maintained their expected level.[33]

39. This net reduction of roughly [redacted] in inventory in December 1999 demonstrates that the Investment filled sales beyond production by shipping from inventory.[34] The impact of the shutdown was to draw down the inventory level. Thus, the Investment experienced no delay or loss of sales in December 1999.

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[32] Transcript, p. 311.
[33] Exhibits DC-4 and DC-5.
[34] Transcript, pp. 348 – 9.

40. Further, while the Investment turned to inventory to supply its sales in December 1999, it still had significant inventory left in the final quarter of the 1999-2000 quota year. Commenting on the first quarter of 2000, Mr. Harder noted that:

> Their inventory was either constant or building throughout the whole time period. So they could have gone to inventory at that point in time. If they didn't produce at the point in time in December 1999 and there was a sale waiting to be made because they didn't produce, they could have gone to their inventory and gone and gotten it and used it up to make that sale.[35]

41. The only logical conclusion is that the Investment could, and did, sell everything it could economically sell, notwithstanding the production shutdown.[36] There is no evidence the Investment turned away one sale at any point in time or that it did not have sufficient inventory to meet sales orders. The Investment sold as much lumber as it could at the highest prices it could.

42. The Investor does not deny that it had no lost sales. Its only reply to this has been that it was deprived of the ability to increase its inventory beyond what it otherwise would have been had there been no shutdown.[37]

43. In essence, the Investor now contends that the verification review episode deprived the Investment of the opportunity to increase its inventory and thereby incur higher manufacturing and inventory carrying costs. This represents a benefit to the Investor and not a loss, and cannot support an award of damages.

44. In any event, the inventory numbers show that the Investment replenished its inventory to pre-shutdown levels by January 2000. Indeed, the January 2000 inventory level [redacted] was higher than it had been at the same time in the previous year [redacted] in January 1999).

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[35] Transcript, p. 311.
[36] Transcript, p. 335. See also p. 316.
[37] Transcript, p. 543. See also pp. 432 – 3.

45. Mr. Friesen also testified that the Investment intentionally does not build inventory in the final quarter of the quota year to prevent a wall of wood that would bring down prices.[38] As a result, the advent of a new quota year could not have been a reason to build higher inventory levels.

46. It is therefore impossible to say that the Investor suffered any prejudice by not increasing its inventory during the December 1999 shutdown.

(e) Excess Production Capacity

47. Even if the Investment had no inventory to satisfy sales, which it is clear it did, the Investor could not succeed on its claim for delay unless it could show it was also unable to make up lost production through excess production capacity.

48. Mr. Friesen made the anecdotal statement that if the mills are running they run full out and therefore there is no excess capacity.[39] On the other hand, Mr. Friesen admitted that the mills run 5 days a week and it was possible to do a sixth day at overtime rates.[40] It therefore appears that some excess capacity existed.

49. Mr. Friesen's statement that there is no excess production capacity is difficult to reconcile with the Investment's actual production, which varied from a high of [redacted] in the January to March 2000 quarter to a low of [redacted] in the July to September 2000 quarter.[41]

50. The statement is equally difficult to reconcile with the Investment's stated capacity in the Investor's 10-K statement. Either Mr. Friesen's statement to the Tribunal about capacity is incorrect or the 10-K filed by his company is incorrect.

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[38] Transcript, p. 80.
[39] Transcript, p. 60.
[40] Transcript, p. 120.
[41] Exhibit DC-4 and DC-5.

51. The 10-K filed for 1999 states the capacity of the Canadian mills as 460,000,000 mbf, and notes that these "reflect reduced operations resulting from tariffs under the Softwood Lumber Agreement".[42]

52. On the other hand, if one calculated the average monthly production from January 1999 to June 2001 using the production information from the Investment's Operating Statements,[43] the Investment had an average monthly production for Midway [redacted], Grand Forks [redacted] and Castlegar [redacted] totalling averaging monthly production of [redacted] This suggests these plants have an average annual production of [redacted] mbf. Based on 10-K capacity of 460,000 mbf, it indicates there was annual excess capacity of approximately [redacted]

53. There was discussion at the hearing about how much faith can be placed in a 10-K statement,[44]

54. A 10-K statement is filed pursuant to Section 13 and 15 of the U.S. Securities and Exchange Act of 1934. The penalties for a false or misleading statement in a 10-K include fines of up to $1,000,000 or imprisonment for up to ten years, or both.[45] It is a serious public representation intended to be relied on by business analysts and prospective purchasers of corporate shares. As Mr. Harder noted, in his experience, statements in a 10-K are not made lightly and they are an indication of operating capability.[46] In other words, professional valuators rely upon this information.

55. Canada submits that it should be able to rely on this statement, especially since the Investor has not submitted any other production capacity statistics.

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[42] Harder Affidavit # 2, October 5, 2001, Appendix C in Canada's Reply Counter-Memorial on Damages.
[43] See Exhibits DC-1 and DC-4 for this information.
[44] Transcript, pp. 441 - 3.

56. Mr. Harder concluded that the Investment did have the capacity to work an extra shift, spread extra production over a quarter or otherwise make up the lost production it alleged.[47] Further, it is only reasonable for the Investment to be expected to mitigate its loss in this manner if it could.

57. As Mr. Harder noted:

> ... if there was excess capacity in the system and to the extent that they made up that sale of 14 million feet from their inventory and they could make up their production in the normal course, in a reasonable normal course, then there's no loss. What they might get is they might get the incremental cost of making up that production.[48]

58. In such a case, the only loss would be the amount of overtime paid to make up production lost as a result of the December 1999 shutdown.[49]

59. The Investment did not lose one sale and at all times had sufficient inventory to sell the approximately 14 million mbf of lumber production (2 million mbf per day for seven days of delayed production) it says it delayed.

60. In summary, the Investor has not met the conditions to justify an award: there are no lost sales and no lost profits.

4. ERRONEOUS ASSUMPTIONS

61. If the Tribunal determines that the delay calculation urged by the Investor is apt, Exhibit DC-3 lists the loss or gain by the Investor, depending on the array of assumptions used in the delay model.

62. Canada submits that the better assumptions to be used are:

(a) Actual realized prices as opposed to Random Lengths prices;

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[45] Section 32, Securities and Exchange Act of 1934.
[46] Transcript, p. 441 – 3. See also p. 583.
[47] Transcript, p. 446. See also pp. 312 – 3.
[48] Transcript, p. 317.
[49] Transcript, p. 313 – 4.

(b) Sales a month after production rather than sales immediately upon production; and

(c) No cut off date as opposed to a cut off in February or March 2001.

63. Additionally, Canada submits that any number derived from this calculation must be discounted to reflect that portion of sales to the non-U.S. market which were not affected by the SLA and which could not have been lost or delayed by reason of the verification review episode.

(a) Actual Realized Prices

64. The Investor's model uses Random Lengths prices instead of actual realized prices. The Investor's model relies on Random Lengths prices for Western SPF 2 x 4's.[50] The Investment sells a wide variety of other products priced higher than 2 x 4 SPF.[51]

65. While there is a rough correlation between Random Lengths and actual realized prices, it is not an absolute correlation.[52] Exhibit DC-6 demonstrates this.

66. Mr. Rosen used Random Lengths as an indication of the movement in price. He did not use actual prices, apparently because the Investment's records aggregate all revenues and do not show the price for any individual item. [53]

67. Canada suggests that actual realized prices are a better reflection of reality because they are based on the actual product mix and prices realized by the Investment over time. The fact that they do not show the price for any individual item is irrelevant. They show the aggregate of the real prices obtained by the Investment on the products it actually sells to the market.

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[50] Transcript, pp. 255, 377.
[51] Transcript, pp. 112, 255, 259, 287, 377.
[52] Transcript, p. 381.
[53] Transcript, p. 256.

(b) Sales Occur A Month After Production

68. There is no debate that the better assumption is that sales occur a month after production rather than immediately. The Investor admits this is accurate in practice[54] and made no attempt to rebut it during the hearing.

(c) Cut Off Date

69. Mr. Rosen ended his model at March 31, 2001, apparently on the thesis that:

> There was a pricing regime in existence and a regulatory regime in existence that created an artificial market, and when that market ceased, I thought, from an economic point of view, I should stop measuring it.[55]

70. This assumption distorts reality, in which the Investment continued to sell lumber despite the expiry of the SLA. In addition, the Investment has not realized any delay in its sales as of March 31, 2001, so it would be incorrect to use this date as the cut off date.

71. This assumption also contradicts Mr. Rosen's own statement that "in a classic delay claim...the delay goes on in perpetuity" and that[56] "theoretically, by definition, you should never be able to catch that production...".[57] To apply the delay model properly one would run the delay to the earlier of the date of judgment, or the point where the sales price reaches the December 1999 level and thus, through mitigation there is no loss. In this case, this results in a "zeroing out" by May or June of 2001 and there is no need to go further.[58]

(d) Non-U.S. Sales

72. Finally, any number derived from the delay model must be discounted to reflect sales not destined for the U.S. market. These sales could not have

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[54] Rosen Affidavit # 1, para. 7.
[55] Transcript, p. 206.
[56] Transcript, p. 206.
[57] Transcript, p. 206. See also pp. 205, 213, 214, 331 and 337.
[58] Transcript, p. 332-3. See also Harder Affidavit #3.

been affected by the verification review episode and were not governed by the quota regime.[59] Mr. Rosen does not take this into account.

73. While the Investment does not produce for a specific market or differentiate production based on its destination[60], it clearly sells a portion of its product to other destinations, including Canada. In 1999 the Investment sold 16% of its' production outside the U.S., while in 2000 it sold 26% of its production outside the U.S.[61] A discount to reflect non-U.S. sales should be applied to the Investor's damage calculation.

5. ALTERNATIVE OF A LOST PROFIT MODEL

74. For all of the reasons discussed above, the delay model of damages advanced by the Investor is unsatisfactory. Even Mr. Rosen, who proposed the model, stated, "It's a difficult way to measure it (damages), I agree".[62]

75. During the hearing the Tribunal suggested that the better approach would be to measure lost profit on seven days of production.[63] The Tribunal suggested that one would measure this by multiplying the amount of production lost by the selling price and deducting the cost of production ("lost profits approach").

76. Canada suggests that the lost profits approach suffers from the same flaws as the delay model, and in any event would result in the conclusion that there was no loss.

77. First, the lost profits approach also assumes the verification review episode caused the shutdown. For the reasons noted above, Canada suggests this is incorrect.

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[59] Transcript, p. 342.
[60] Transcript, p. 61.
[61] Canada suggests that a 16% reduction would therefore be appropriate. Harder Affidavit #2, October 5, 2001, para. 19 in Canada's Reply Counter-Memorial.
[62] Transcript, p. 219. See also pp. 210 & 334.
[63] Transcript, pp. 205, 210, 216, 306-8, 338.

78. Second, the lost profits approach assumes that lost production equals lost sales. However, again, it is not enough to know that there was lost production. The Tribunal must also be satisfied the lost production resulted in lost sales, and hence lost profit, if it is to apply this model.[64]

79. The evidence points to the contrary: the lost production in December 1999 did not result in any lost sales. Mr. Friesen agreed that not a single sale was lost as a result of the December shutdown.[65]

80. Third, the lost profits approach assumes that economically viable sales were missed or lost because there was insufficient inventory to satisfy them. In fact, if there were sales to be made, the Investment would, and did, use inventory to make up the sales.

81. The Investment's operating statements show that while production stopped for seven days in December 1999, shipments and sales continued during this period as the Investment used inventory to supply these sales.[66]

82. The record also shows there was sufficient inventory to service sales: inventory grew rather than declined between January and March 2000.[67]

83. In fact, inventory was so high in the final quarter of the 1999-2000 quota year that the Investment had to reduce inventory. There was a two-week shutdown at Grand Forks in the last two weeks of March 2000. The stated purpose of that shutdown was "to reduce inventory".[68] Again, if there were sales to be made, there is no viable explanation for shutting down a mill and reducing inventory in the last two weeks of March.

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[64] Transcript, pp. 309-10.
[65] Transcript, pp. 106-7. See also p. 224.
[66] Exhibits DC-1, DC-4 and DC-5.
[67] Transcript, pp. 311 - 312. See also Exhibits DC-4 & 5.
[68] Canada's Damages Counter-Memorial, Tab 17, Announcement of March 2000 shutdown.

84. The only logical conclusion is that there were no sales lost and that in fact the Investment made all the sales it could at an economically viable level. Again, Mr. Harder explained:

> We're assuming that they did sell everything that they produced, and so therefore, didn't they sell all they could at the market, and what sale did they miss? Because they had inventory, and so if somebody came to them and said I want to buy at the market, they went into their inventory or they produced and they went and got it.[69]

85. Alternatively, if the Tribunal did find that there were lost sales, then any quantification of lost profits requires the Tribunal to consider whether the Investment could mitigate and make up lost production through excess capacity. For the reasons noted above, Canada suggests that there was such capacity.

86. Another assumption upon which the lost profits theory depends is that the Investment could sell its production at an economically viable rate. The evidence suggests that this is not so. The Investment sold everything it could for the U.S. market and still shutdown in March 2000.

87. Fourth, the lost profits theory does not factor in the effect of the SLA, including speed bumps, tariffs and the super-fee. One would have to ask whether the Investment would have shut down for an even longer time in March or during the last quarter of the 1999-2000 quota year if they had not shut down in December.[70]

88. Mr. Rosen agreed with this concern. When asked by Arbitrator Belman whether "you can't just say in December they would have earned X, because you also have to look at whether by not producing and losing that opportunity in December, they gained an opportunity in March", Mr. Rosen replied: "Absolutely. What you're saying has merit".[71]

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[69] Transcript, p. 316.
[70] Transcript, p. 327.
[71] Transcript, p. 220. See also pp. 218, 337 - 4.

89. If the Tribunal concludes that the December shutdown simply forestalled additional shutdowns in the last quarter of the 1999-2000 quota year, then the Investor sustained no loss.

90. Finally, even if the Tribunal determines that there were lost sales and that the lost profits approach is the correct way conceptually to measure the loss, the information is not available to do so. To do the lost profit calculation the Tribunal would need to know what quantum of sales were lost, the price for those sales and the variable costs associated with the manufacture and sale of the lumber. There has been no reliable evidence on the Investment's variable costs of production, nor has Canada been able to test the validity of any evidence on the record about costs. Failure to factor in these costs does not reflect reality and inflates damages significantly.[72]

PART C: DAMAGES – OUT OF POCKET CLAIMS

1. GENERALLY

91. There is very little evidence that any of the out of pocket damages claimed were incurred on account of the verification review episode. Mr. Rosen admitted that he was told to include these claims and that he simply added them up. As he told the Tribunal "I simply took his [Mr. Appleton's] word that these were to be included in [the] out-of-pocket claim for verification review".[73]

92. As a result, the Tribunal has no accounting evidence on these claims and can only assess them based on the scant material produced on the record. Where there is no evidence, there is no basis for even a guesstimate of what might have been reasonable and whether in fact the expense was caused by the verification review episode.

[72] Transcript, pp. 171, 178, 179, 184
[73] Transcript, pp. 269 – 70

93. Canada also submits that where an out of pocket expense relates to preparation and conduct of the interim measures motion, it is not properly recoverable as a head of damages[74]. The bulk of such claims arise out of Appleton & Co and Davis & Co legal bills, although there are also claims for witness attendance[75] at the interim measures motion and the like. Such expenses were clearly part of the prosecution of the NAFTA case under Article 1134.

94. While concern arising from the verification review episode may have motivated the Investor to bring the interim measures motion, this does not change the fundamental nature of such expenses, which are as costs.

95. The Tribunal might ultimately award these costs in the next phase, but it should only do so after considering the Parties' positions on whether they should be awarded. To do otherwise would be to ignore the Tribunal's express order that damage and cost issues be considered separately.

96. Counsel for the Investor explained that it included such expenses in the damages claim because "It is an integral part of the verification review episode, and we believe that the Investor needs to be compensated during this phase of the arbitration for this as damages".[76]

97. With respect, neither consideration is relevant. Canada does not doubt that the Investor perceived the interim measures motion as related to verification review, but it is still part of prosecuting the NAFTA case. Similarly, the wish to be compensated now rather than later does not transform the essential nature of such costs, which is costs incurred to litigate an issue arising under Article 1134 of NAFTA.

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[74] See also Damages Counter-Memorial at paras 115, 164 – 166 and Damages Reply Counter-memorial at 86 – 92

[75] For example, the cost of Mr. Friesen and Mr. Flannery attending the motion is included in the claim for management time.

[76] Transcript, p. 561.

2. MANAGEMENT COSTS

98. Management costs are not recoverable for three reasons: first, such expenses are generally not recoverable at law; second, such expenses were a fixed expense that would have been incurred in any event and therefore there is no loss; and third, there is insufficient proof of these expenses.[77]

99. At law, management time is regarded as a normal cost of operation and is not compensable.[78]

100. On the facts of this case, the management costs claimed are salaries of employees of the Investor and the Investment. There is no debate that they are fixed costs. When asked about the claim for management time Mr. Rosen agreed, "...all of the time was fixed – a fixed expense".[79]

101. As fixed costs, it cannot be said that such salaries arose out of or by reason of the verification review episode. These costs do not represent a loss of income or an expense that would not have been incurred but for the verification review episode.

102. Finally, there is insufficient proof of the management expenses. The Investor provided no affidavit or documentary evidence concerning the nature or the amount of time spent on tasks allegedly related to the verification review.

103. While Canada requested information related to the time of employees spent on verification related tasks, it did not receive any. At the hearing it became clear that at least some information might have been produced, as Mr. Friesen explained he kept an agenda.[80] The Investor chose either not to ask for or not to produce such relevant documentation. One can

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[77] See generally Damages Counter-Memorial at paras 62 –66, 105 – 113 and Damages Reply Counter-Memorial at paras. 67 – 76.
[78] Damages Counter-Memorial, paras 62 – 66.
[79] Transcript, p. 269. See also Transcript, p. 293.

only surmise what else could have been produced but for some reason was not.

104. Apparently Mr. Gray wrote the particular employees and asked for the amount of time they spent on verification, and then calculated a claim based on salary.[81] However, neither Mr. Gray nor any of those employees testified or submitted evidence or documents bearing on the amount of time spent or whether the time claimed arose out of verification, the interim measures motion or other aspects of the claim.

105. Mr. Rosen freely admitted that he simply took the numbers provided by Mr. Gray and added them up. He undertook no assessment to determine the accuracy of the information and provided no opinion on the validity of claiming management expense.[82] Mr. Rosen stated:

> I was simply asked to include an apportionment of management time related to the verification review without regard to whether it was incremental or fixed, because it is definitely fixed, and it's never been suggested that it wasn't. It's never been suggested this was an incremental expense. Mr. Appleton felt that he could make an argument for compensation for this portion of management time and asked me to put a number on it, so I did. I make no judgment on whether it's compensable or not.[83]

106. The only person made available to testify about the claim for management expenses was Mr. Friesen. When asked about these claims Mr. Friesen explained that the amount claimed for him was based on his MBO (management by objectives) and not on time spent. Hence the claim for Mr. Friesen relates to a corporate value ascribed to a task by the Investor and not to any particular amount of time spent or dollar value.[84] He could not explain the basis for the claims made on behalf of other employees.

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[80] Transcript, pp. 118, 123.
[81] With the exception of Mr. Friesen. Transcript, p. 62.
[82] Transcript, p. 267. See pp. 266-9.
[83] Transcript, p. 293.
[84] Transcript, p. 114 – 6, 267.

107. In sum, the claim for management time has not been proved and should not be recovered in any event.

3. LRTS INVOICES

108. On December 3, 2001 LRTS produced dockets related to the damage claim made for LRTS fees. Canada has classified these using the same colour coding system as for the other out of pocket costs.[85]

109. From this review Canada submits that US$ 47,718.75 of the LRTS claim can now be said on the balance of probabilities to be caused by the verification review. The remaining US$ 68,813.60 either cannot be assessed based on the dockets, clearly relates to the interim measures motion or relates to other aspects of the NAFTA claim.[86] Canada's earlier submissions to the effect that these expenses lack proof remains.

110. Canada notes from the dockets that LRTS researched statistical sampling at least a month before Canada even suggested verification. This puts in question whether and to what extent the Investor and its expert considered statistical sampling to calculate the damage allegedly sustained as a consequence of the implementation of the SLA rather than verification review. If this research concerned the implementation of the SLA, it did not arise from the verification review episode and is therefore not recoverable. The Investor offers no evidence on this point.

4. APPLETON & CO

111. Canada repeats its submissions regarding these claims made in its written materials and during the hearing.[87]

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[85] Tab 2.

[86] $37,310.85 unable to assess, $6,6698.00 not related to verification and $24,804.75 interim measures motion

[87] Damages Counter-Memorial, paras 116 – 124, Damages Reply Counter-Memorial, paras 77 – 92, Schedules Related to Legal Expenses and Expert Fees October 8, 2001, Tabs 1 – 11, Transcript, pp. 31 – 48.

112. In assessing this claim the Tribunal should award only those costs that were caused by the verification review and were not incurred to prosecute the NAFTA claim and interim measures motion.

113. Mr. Rosen explained at the hearing that initially he relied on Mr. Appleton's assertion that these costs were all verification related and had simply added them up.[88] It was only after Canada questioned these and the Tribunal asked for an explanation that he reviewed the claim in respect of Appleton & Co.

114. As a result, the Investor's initial claim of US$ 617,626 for these costs was substantially reduced when the Investor addressed causation. The revised claim (October 24, 2001) was for $327,118.24, an almost 50% reduction.

115. In coming to this figure of US$ 327,118.24 the Investor (1) reduced the initial claim of US$ 617,626 to US$ 198,152.36[89] because US$ 419,474 was not verification related, then (2) added in US$ 128,956.39 from invoices for September to December 1999 which initially were expressly omitted[90] on the basis they were not verification related, and (3) applied a valuation scheme of 0, 50 or 100% to these invoices.

116. To prepare the revised claim (October 24, 2001 letter) Mr. Rosen apparently spoke to members of Mr. Appleton's staff. Based on information received from those people, notes of which have not been provided to this Tribunal, Mr. Rosen reduced the initial claim of US$ 617,626 to US$ 327,118.24.[91] Nothing further is known about the basis for this new assessment. Given the lack of due diligence with which this claim has been handled to date, the new assertions should be taken with caution.

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[88] Transcript, p. 275.
[89] Tab A, Exhibit DC-2.
[90] Tab B, Exhibit DC-2.
[91] Transcript, p. 137 – 9.

117. During the Damages hearing, Canada submitted that if the Tribunal assessed such costs, it should approach them in a manner consistent with the way in which courts tax or assess the value of lawyer's work. The Tribunal must ensure that the services were actually performed, the time expended and that the rates charges were reasonable. Here, of course, the Tribunal must also satisfy itself that the verification review episode caused the Investor to incur these fees and disbursements.

118. Canada notes the absence of any sworn evidence verifying these accounts and the reason the Investor incurred them. For this reason as well, the Tribunal should be loathe to accept the current claim.

5. DAVIS & CO

119. The Investor adduced no new evidence about the Davis & Co claim[92]. This leaves the Tribunal with the bald assertions of Counsel for the Investor that government relations worked performed by Davis & Co arose out of the verification review.[93] The record does not evidence this, and counsel's assertions do not constitute proof. There are no dockets, affidavits or other evidence on this account that would permit assessment of any portion of government relations work by Davis & Co.

120. While Mr. Rosen "confirmed" in his affidavit that the Davis & Co work related to government relations issues and potential judicial review advice given by Mr. Crawford[94], he contradicted this at the hearing. On November 14, 2001 Arbitrator Greenberg asked Mr. Rosen about the government relations claim and his knowledge of that. Mr. Rosen replied:

> Other than being told they (lobbyists) were working on it just vaguely. I don't know firsthand. I never met them. I never saw documents related to verification review. I heard about it in the document. ...I don't have any

[92] For Canada's position see Damages Counter-Memorial paras 135 – 8 and Damages Reply Counter-Memorial paras 99 – 100.
[93] Transcript, p. 22, 627, 637.
[94] Supplementary Statement of Rosen, September 17, 2001, para. 7 in Investor's Reply Memorial on Damages.

firsthand knowledge on that.[95]

121. The evidence on legal work by Davis & Co is equally inconclusive. The record contains invoices that expressly attribute Davis & Co work to a number of items, including "advising and assisting with your NAFTA claim" and "all communications with Ministers offices". To attribute any or all of this to verification review is pure speculation.

122. While some of this work might have related to legal advice on judicial review remedies arising out of verification, there is no way to assess the amount of time spent or whether it was reasonable. The Tribunal is in no position to attribute any damages to this work on the balance of probabilities. Any number would be pure speculation.

123. Canada also notes that to the extent that such work is attributable to the interim measures motion, this constitutes costs of the arbitration, not damages, and for the reasons noted above, is not recoverable in this phase of the arbitration.

6. APCO

124. The APCO invoices raise the same issues as the claim for Davis & Co government relations. There is no evidence showing what was done and whether it was on account of the verification review episode. All Mr. Rosen did was tally up numbers based on Mr. Appleton's assertion that this was verification related.[96]

125. The existing record indicates services such as media clipping with respect to the NAFTA claim, which could hardly be related to a confidential verification review.

[95] Transcript, pp. 294-6.
[96] Transcript, page 269.

7. BARNES THORNBERG

126. No further evidence was adduced regarding the Barnes, Thornberg invoices. The description of work in the invoices relates to the SLA. There is no evidence that shows this work arose out of the verification review episode.[97]

127. In closing argument Counsel for the Investor asserted that Mr. Hicks of Barnes Thornberg applied political or diplomatic pressure to resolve the Investor's grievances.[98] He suggested contacts with U.S.T.R., for example, were part of this.

128. Having been raised in closing argument, with no supporting testimony or affidavits, it is impossible to assess the veracity of this assertion, the extent to which the claim relates to verification review or the quantum of costs actually related to verification review.

8. STOEL RIVES

129. No additional evidence or argument was addressed to the Stoel Rives claim at the hearing.[99] All that can be gleaned is that a law firm in Oregon did work for the Investor between January and March 1999, before the events that constituted the breach[100]. The work appears to have no relationship to the verification review and is not recoverable.

9. CONCLUSION

130. Canada submits that unproven and infeasible claims such as this should reflect generally on the soundness of the damages claim. When the Tribunal considers the balance of probabilities or the reasonableness of the damages claim, it should be skeptical given the Investor's approach of inflating the claim, in many cases without any semblance of legitimacy. For

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[97] Damages Counter-memorial, paras 132-134 and Damages Reply Counter-Memorial, para 102.
[98] Transcript, p. 549 – 7.
[99] See Damages Counter-Memorial at paras 139 – 141.

Canada to expect proof of items claimed in these circumstances is neither unreasonable nor inappropriate.

PART D: BURDEN OF PROOF

131. There was considerable discussion at the hearing[101] concerning burden of proof. Canada made submissions on this in its Damages Counter-Memorial[102] and Damages Reply Counter-Memorial.[103]

132. At law, there is no doubt that the Tribunal must weigh the evidence on the balance of probabilities.

133. In practice, applying the balance of probabilities is most difficult where there is competing evidence on a particular fact. For example, where Mr. Rosen and Mr. Harder disagree, the Tribunal will have to weigh their evidence to determine the correct facts, on the balance of probability.[104]

134. In such circumstances, the credibility of the expert is relevant. Canada suggests that Mr. Harder is by far the more credible witness.[105] Unlike Mr. Rosen, Mr. Harder has extensive accounting credentials in the forestry industry and understands the quota scheme and its impact on lumber companies based on 15 years of working in this industry.[106]

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[100] The Investor concedes that the conduct commenced in April 1999, Transcript, p. 17.
[101] Transcript, pp. 35-36.
[102] Paras 19 – 29.
[103] Paras 1- 9.
[104] During argument, Counsel for the Investor urged the Tribunal to reject the "expert" testimony of Mr. Seebach. The Tribunal will recall that the Respondent tendered Mr. Seebach to testify about three things: the Investor's quota allocation; the quota utilization rates of the investment and certain of its competitors as at the end of 1999; and, newspaper articles announcing plant shutdowns of the Investment's competitors. Mr. Seebach did not testify as an expert. He testified about matters within his own knowledge. The Investor did not challenge the information he provided and, as it concerned plant shutdowns, Mr. Friesen confirmed that the closures occurred (Transcript pp. 97 – 98, 100).
[105] Transcript, p. 571.
[106] Harder Affidavit # 1, November 18, 2001Curriculum Vitae. See for example Transcript, pp. 357 – 459 where Counsel for the Investor attempted to challenge Mr Harder's expertise on the forestry industry. Canada submits it was clear from his replies that Mr Harder knows this industry extremely well and is the more knowledgeable expert with respect to this industry and the effect of the SLA quota system.

135. Although Mr. Rosen created the delay model, Mr. Harder had to correct basic methodological errors in that model.[107]

136. At the commencement of his testimony, Mr. Rosen corrected further errors in his own model.[108] Mr. Rosen then purported to correct the report of Mr. Harder.[109] In fact, the number "corrected" was noted by Mr. Harder to be an extrapolation necessitated by the Investor's failure to produce a month of Castlegar statements, despite repeated requests from Canada that it do so.[110]

137. Clearly Mr. Harder is the more knowledgeable of the two experts in this matter, and where his testimony deviates from that of Mr. Rosen, Mr. Harder's testimony should be preferred.

138. Different considerations arise with respect to most of the out of pocket claims. In these instances there is no competing information to be weighed. Rather there is generally no information that bears upon the assertion that an expense was caused by verification, was incurred and was reasonable.

139. Here, the Tribunal is not in a position to weigh evidence that would result in a determination on the balance of probabilities. There is nothing to weigh.

140. Canada suggests that the record related to the vast majority of the out of pocket claims does not prove that the expenses were caused by the verification. As a result, they cannot be recovered.

141. Similarly, even where an expense appears to be verification related, frequently there is no evidence whatsoever of the quantum related to verification. The Tribunal cannot guess at what a reasonable quantum

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[107] Harder Affidavit # 1, November 18, 2001, Report, para 32.
[108] Transcript, p. 127.
[109] Transcript, p. 131.

would be. The evidence must disclose some information that would permit weighing this on the balance of probability.

142. Throughout this hearing the Investor failed or refused to produce evidence of its claim, although it had the capacity to do so. For example, Counsel for the Investor refused to produce Appleton & Co dockets without a letter from the Tribunal advising it of the consequences of not doing so.[111] During the hearing Mr. Rosen advised that he was never asked to provide dockets or the like,[112] although Canada had requested such information from the Investor. Similarly, during the hearing Mr. Friesen advised he was never asked for agendas, calendars or the like, although he had these documents and Canada requested them.[113]

143. Canada does not seek to be overly technical. In an effort to be reasonable Canada revised the schedule of expenses claimed based on the new evidence ordered by the Tribunal to be produced and the evidence at the damage hearing.[114] As a result, Canada now agrees that it is reasonable to consider US$ 82,936 (in total) to have been proved as loss incurred as a result of the verification review episode (see Tab 3).

144. Nonetheless, despite ample opportunity to supplement its case, a significant number of expenses claimed by the Investor remain in the "unable to assess" category, either because they are not related to quantum or because nothing in the record makes it possible to attribute a quantum to verification. In these situations, Canada submits it would be unwarranted and unfair to simply "guess" a number that might seem

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[110] Transcript, p. 254.
[111] Appleton Letter, date,Tribunal letter, date. Canada would note that the purported basis of this refusal, solicitor-client privilege, is ridiculous. As is obvious in theory and from the dockets, a docket does not disclose the content of legal advice, which is a *sine qua non* for solicitor-client privilege.
[112] Transcript, p. 237.
[113] Transcript, p. 123.
[114] Tab 3.

reasonable. Absent sufficient proof enabling assessment of the balance of probability, there should be no recovery.

145. In short, where there is no evidence, the Tribunal cannot simply assume what might have been in a reasonable world. There is simply no proof and no award can be made.

PART E: INTEREST

146. Canada has nothing further to add to its submissions regarding interest in the Damages Counter-Memorial[115] and the Damages Reply Memorial.[116]

PART F: ARTICLE 1116

147. The application of Articles 1116 and 1117 was argued fully in Canada's Damages Counter-Memorial,[117] Damages Reply Counter-Memorial[118] and at the hearing.[119]

148. The provision contains no temporal limitation as suggested by the Investor[120] nor does it affect claims where the Investment is in a form other than an enterprise.[121]

149. The plain language and architecture of the NAFTA are clear. Article 1116 is for claims of direct damage to the Investor ("on its own behalf" as stipulated in the heading to Article 1116). Article 1117 is for claims of damage to the Investor derived from its interest in the enterprise Investment.

150. This difference between direct and derivative damages was expressly written into the NAFTA by the Parties[122] and is reflected in provisions such as Article 1119 and 1121. It cannot simply be ignored.

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[115] Para.
[116] Para
[117] Paras 49 – 54.
[118] Paras 14 – 24.
[119] Transcript, pp. 474 – 508.

151. While it may require interpretation of the evidence in some cases to determine whether the Investor has suffered a direct or derivative loss, there is no doubt on the facts of this case. The delay claim in this case is clearly one for derivative loss and must be made under Article 1117. Similarly, out of pocket expenses incurred by the Investment (as opposed to those incurred by the Investor directly) must be claimed under Article 1117.

152. Nothing prevents a Party from pleading both Article 1116 and 1117 in an appropriate case. The Investor decided not to do so and steadfastly maintains its' reliance on Article 1116 alone.

153. Finally, Canada was unable to raise this issue at an earlier stage. While the Claim pleaded Article 1105, it did not disclose the nature of the injury that had been sustained and there was no way to know that derivative damages would be claimed. This only became clear when the Phase 3 Damages Memorial actually made claims for derivative loss.

PART G: COSTS

154. Canada reiterates its request for costs of this phase.

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[120] Transcript, p. 468.
[121] Contrary to the Investor's submissions at Transcript, p. 469.
[122] See also Canadian Statement of Implementation and U.S. Statement of Administrative Action in Damages Counter-Memorial, paras 49 – 50.

155. The Investor's failure to produce relevant documents makes this request particularly appropriate. Further, Canada could not know the result of the Tribunal's determination on the effect of the Notes of Interpretation. As a result, there was no reason to request a postponement of the Damages hearing.

THE WHOLE OF WHICH IS RESPECTFULLY SUBMITTED

DATED in the City of Ottawa, Province of Ontario, this 14th day of December, 2001

Meg Kinnear & "BR Evernden"

Of Counsel for the Government of Canada

Meg Kinnear

Brian Evernden