TRADE POLICY DEVELOPMENTS

NAFTA NEGOTIATIONS MOVE SWIFTLY

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The *North American Free Trade Agreement* (*NAFTA*) negotiations have made substantial progress since their inception only seven months ago. With the uncertainty over the fate of the Uruguay Round negotiations, the U.S. administration seems to have turned its attention to creating a North American free trade area. While certain major negotiating sectors remain unsettled, negotiators have drafted a bracketed text that reportedly covers almost 80 percent of the final agreement. The text was reviewed by the trade ministers of Canada, Mexico and the United States at their fourth meeting in Chantilly, Virginia on February 9 and 10.

In early February, the chief negotiators for the three countries met in Ottawa in an attempt to finalize the provisional text prior to the February 9 ministers' meeting. The meeting was reportedly unsuccessful in settling the most contentious issues: rules of origin for autos, financial services, foreign investment, antidumping and countervailing duty laws, and textiles. While these controversial issues were not resolved by the ministers in Chantilly, Mexican Trade Minister Jaime Serra Puche noted that the ministers would be able to give clear instructions to their negotiators for the negotiations in Dallas. Little information concerning the progress of the Dallas talks had been released at the time of writing, but the negotiations reportedly were "intensive."

One of the most difficult areas facing negotiators is rules of origin for the auto trade. The United States has pressed for rules of origin for autos that are more streamlined than those under the *Canada-U.S. Free Trade Agreement* (*FTA*), which have been criticized by the U.S. auto industry as being administratively burdensome and poorly defined. The U.S. proposal is based on value-added criteria where the value-added calculation would include labour, fringe benefits and the cost of materials. Under the *FTA*, an automobile satisfies the origin requirements if 50 percent of the direct processing costs are incurred in an *FTA* country. The definition of direct processing costs is currently the subject of a dispute-resolution panel between Canada and the United States. U.S. automakers have lobbied for a 60 percent value-added threshold in the *NAFTA*, while Mexico an Canada have sought to preserve the 50 percent requirement under the *FTA*.

Mexico has objected to a value-added rule mainly because the low wage rates in Mexico would make it difficult for auto manufacturers in Mexico to meet the requirements. Mexico has suggested that auto origin under the *NAFTA* be determined by the country where certain critical processes have occurred. The Mexican proposal would adopt both the value-added and the critical process rules and would allow automakers to choose between the two methods.

Rules of origin for textile trade have also been a sticking point in the negotiations. The most recent U.S. proposal would require that textiles and apparel be made from fibre spun in North America in order to receive the tariff benefits of the *NAFTA*. The U.S. proposal would require triple transformation (*e.g.*, spinning, cutting and assembly). The United States has expressed its intention to create one textile rule for North America, thus implying that it will seek to replace the *FTA* rule with the *NAFTA* rule. Mexico, as a fibre producing country, appears to favour the U.S. proposal while Canada, whose textile industry relies heavily on imported fibre, opposes the U.S. position. The countries have agreed that the basic rule of origin under the *NAFTA*, which will apply to most other goods, will be substantial

transformation as defined by change in tariff heading.

In the antidumping (AD) and countervailing duty (CVD) law areas, both Mexico and Canada have sought amendments to the U.S. laws with respect to North American imports. Canada made similar requests unsuccessfully in the *FTA*, which resulted in the creation of a special dispute-resolution mechanism for AD and CVD cases. The United States continues to refuse to change its AD and CVD laws, and has yet to endorse a dispute-resolution system similar to the *FTA* because of the vast differences in the U.S. and Mexican legal systems.

The financial services area has been a priority for Canada in the *NAFTA* negotiations. Canada, which has four of the largest banks in North America, has pressed for access to the Mexican financial services market as well as for better access to the U.S. market than currently available under the *FTA*. Mexico seeks to protect its newly privatized banks by keeping its market closed until 1998 and then restricting access for a further twelve years. Mexico has also proposed a waiver for Mexican banks of certain U.S. banking laws that separate securities and commercial banking, and restrict interstate branches and banks' involvement in insurance. Sources claim that a final agreement will probably involve a phase-in period for foreign involvement in the Mexican banking market.

A bone of contention in the foreign investment negotiations is Mexico's constitutional prohibition of foreign ownership in the oil industry. Mexico has indicated some willingness to allow foreign investment in the petrochemical sector in return for some concessions from the United States and Canada on other issues.

Although the difficult issues were not resolved at the ministerial meeting, negotiators remain confident that the talks are on track. At the current pace, some sources claim, an agreement could be concluded this spring, thus facing President Bush with the question of whether or not to submit the Agreement to Congress during the presidential campaign season.

Political analysts believe that the President's decision will be based upon which Democrat will likely be his opponent in the fall. If Bush's opponent has been critical of the *NAFTA*, the President probably will not submit the Agreement to Congress this year, so as to avoid making it a campaign issue. The timing of the Agreement is also important politically. If it is submitted this spring, Congress will not consider it until mid-summer, when both political parties will be preoccupied with their respective conventions.

Congressional approval of the *NAFTA* will be an uphill battle for the President under any scenario. Congressional Representatives and Senators have expressed deep concern over labour and environmental issues, which they feel have not been addressed adequately by the administration. With the political stakes as high as they are, it is more than likely that the *NAFTA* will not be submitted to Congress this year, even if an agreement is completed by the end of March.

BEER, CANADA, THE PROVINCES, THE UNITED STATES, THE GATT, AND...

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The two-way trade disputes over beer marketing practices in Canada and the United States may be reaching some resolution, and removing interprovincial barriers to trade in beer in the process. Two *GATT* Panel reports have concluded that each country discriminates against beer produced in the other. Canadian movement toward opening up its markets to U.S. beer has spurred the provinces to move to tear down the historic barriers to interprovincial trade in beer—or face the embarrassing anomaly of U.S. beer having better access to Canadian markets than Canadian beer brewed in another province.

Canada-U.S. Beer Disputes

Beer was exempted from national treatment under Article 12.04 of the *Canada-U.S. Free Trade Agreement* (*FTA*), but the *FTA* also preserved the right of either party to complain to the *GATT* about any alleged infringements. The United States entered into formal consultations with

Canada concerning beer in 1990. A *GATT* dispute settlement panel was formed in February 1991 at the request of the United States to inquire into Canadian provincial restrictions to the importation and marketing of U.S. beer.

The Panel reported on September 18, 1991. It found that many provincial marketing practices were in violation of the *GATT*. Specifically impugned were:

- Ontario's requirement that imported beer be sold only in the six-pack size;
- The requirement of all provinces except Prince Edward Island and Saskatchewan that imported beer be sold only in certain government stores, while domestic beer enjoyed much wider access to points of sale;
- The prohibition in those same eight provinces against the private delivery of imported beer to licensed establishments;
- Differential mark-ups, including differential mark-ups based on unsubstantiated cost-of-service charges, levied in all provinces except P.E.I.; and
- The imposition in British Columbia, New Brunswick, Newfoundland and Ontario of a minimum price for both imported and domestic beer, but fixed in relation to the supply price for domestic beer.

The Panel further found that, despite being notified in 1988 in connection with an EC complaint that Canadian practices in respect of access to points of sale and differential mark-ups violated the *GATT*, Canada had failed to make "serious, persistent and convincing efforts" to ensure observance by the provincial liquor boards of the Panel ruling. The Panel members, who had also written that 1988 report, clearly did not condone such behaviour, stating:

> [B]y agreeing, in 1991, to become party to an agreement [discussed below] which sanctioned postponement until the end of 1994 of a practice which the Contracting Parties had found in 1988 to be inconsistent with the General Agreement, the Government of Canada could hardly claim that it had taken a reasonable measure in compliance with the Contracting Parties' request.

The Panel report on Canadian beer marketing practices was accepted by Canada in November 1991. It gave Canada until March 31, 1992 to report to the *GATT* on measures taken in respect of access to points of sale and differential mark-ups, and until July 31, 1992 to report with a plan for bringing the other impugned practices into line.

Canada has been given added incentive to comply with the Panel report by a threat of unilateral retaliation by the United States. Under section 301 of the United States *Trade Act* of 1974, the United States Trade Representative (U.S.T.R.) was required to decide by December 29, 1991 whether or not to impose unilateral import duties on Canadian beer. On December 27, 1991, the Deputy U.S.T.R. announced that the imposition of duties would be delayed until April 10, 1992—a move which clearly links unilateral retaliation to the *GATT* process. In all likelihood, if the first stage report by Canada is sufficient to ward off the section 301 duty, that duty will be further postponed until just after the July deadline in order to provide a continued incentive for Canadian compliance with this *GATT* Panel report.

Canada has its own ace in the hole in any negotiations with the United States, however, in the form of a finding in February 1992 by another *GATT* Panel that the United States itself is guilty of discriminatory treatment of Canadian beer which restricts the access of Canadian beer to the giant U.S. market. While the report has not been accepted by the United States and so has not been officially released, government sources have verified press reports of a Panel finding that the U.S. excise tax differential for small U.S. wine and beer producers, and state tax concessions for in-state beer and wine producers, violate the *GATT*.

While it appears that the United States may have as long as two years within which to comply with the latest Panel recommendations, the finding against the United States will provide Canada with added leverage at the bargaining table to press for more open U.S. markets in exchange for its own liberalization. And access to U.S. markets already means much more to Canadian breweries than does access to Canadian markets for U.S. breweries. The U.S. beer market is worth around $20 billion annually. Canadian breweries' current one percent share of the U.S. market translates into over $200 million a year, about one-sixth of total Canadian production. By contrast, the $30 million or so of U.S. suds exported to Canada

account for about three percent of the total $1 billion Canadian market.

While Canadian breweries welcome the prospect of open access to U.S. markets, they fear being swamped by the huge U.S. breweries if the provincial practices condemned by the *GATT* Panel remain in place with respect to out-of-province Canadian beer.

Interprovincial Barriers to Trade in Beer

Progress on the international front toward open North American beer markets seems to have finally moved along the slow process for dismantling interprovincial barriers to trade in beer in Canada. Faced with the very real prospect that there would be fewer barriers to beer imports at international borders than there would be at provincial borders, the provinces have agreed to co-ordinate the timing of interprovincial trade liberalization to coincide with Canada's compliance with the *GATT* Panel report.

In short, the provinces are finally moving away from their historic general requirement that beer sold in a province must be brewed in that province. If foreign brands are to be exempt from that requirement, as the *GATT* has basically said they must be, the provincial governments have concluded that Canadian brands should be exempt too. This should be helpful to Canadian breweries, whose efficiency has been greatly hampered by their inability to centralize production for the Canadian market, and who will seemingly face open competition from U.S. breweries capable of supplying the entire Canadian market from a single plant. While the brewed-at-home policy originally existed to ensure that there were brewery jobs in every province (an aim achieved at great cost to the consumer), the provinces realize that it could mean the elimination of many brewery jobs if Canadian breweries succumb to U.S. competition because of their inability to streamline production.

Of course, liberalization of interprovincial trade in beer is not a new concept. The federal government and the main beer-producing provinces reached a limited agreement effective January 1991 that provided for removal of some of the interprovincial barriers, such as listing and pricing practices, over a four-year period. However, in light of the *GATT* rulings, the governments agreed in February 1992 to dismantle interprovincial barriers at the same pace at which the barriers to foreign brands come down.

Now, with a *GATT* ruling requiring changes to the U.S. treatment of Canadian beer, it is possible that provincial co-operation with the federal government in implementing the first *GATT* ruling will be predicated upon U.S. federal and state governments taking similar steps to open their lucrative market to Canadian beer.

U.S. CLAIMS HYDRO-QUÉBEC PROVIDES UNFAIR SUBSIDIES

By: Paul K. Lepsoe
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The trade dispute between Canada and the United States over the export of allegedly subsidized magnesium from Québec has a lower profile, at least outside of Québec, than do the much-publicized disputes over softwood lumber, the Canadian content of Honda cars and beer marketing practices. But the implications for Québec's multi-billion dollar investment in hydro-electricity, and for the provision of services by Crown corporations generally, are potentially enormous.

On December 2, 1991, the U.S. Department of Commerce made a preliminary determination that a Norwegian-owned magnesium producer in Québec, Norsk-Hydro Canada Inc., was benefitting from countervailable subsidies close to 32 percent of the value of the product. It therefore imposed what amounts to a provisional import duty of 33 percent. In February 1992, the Department made a similar finding with respect to dumping of the product. A final determination concerning both the subsidies and the dumping levels is expected in late April. A hearing by the United States International Trade Commission concerning material injury to U.S. industry from the subsidization or dumping is tentatively scheduled for early May.

The preliminary ruling was based on the price that Norsk-Hydro pays for electricity from Hydro-Québec. Electricity is a major production cost for a smelter, and its price was undoubtedly a factor in Norsk-Hydro's decision to build a $500 million facility at Bécancour in Québec. It is undisputed that Norsk-Hydro has a special risk-sharing contract with Hydro-Québec. Readers may recall the controversy earlier in 1991 over Hydro-Québec's refusal to make the contract public. It was eventually leaked in Norway. Twelve other major industrial producers in Québec have similar contracts. Norsk-Hydro has apparently been paying about half the rate for electricity charged to standard industrial customers.

The dispute highlights the lack of a definition of what constitutes a subsidy in the *Canada-U.S. Free Trade Agreement*. Additionally, very little is contained in the *GATT*. However, negotiators have attempted to reach a definition in the *GATT* Uruguay round. The Québec Manufacturers Association, undoubtedly frightened by the magnesium action, claimed that the draft *GATT* proposal would prevent the Québec government from providing industrial subsidies. In response, the federal Minister for International Trade, Michael Wilson, issued a statement on February 18, 1992. He said that "*Caisse de dépôt* loans and loan guarantees provided at commercial rates, as well as government bonds, would not constitute subsidies" and that there were "absolutely no new prohibitions of any Québec industrial development instruments under the proposed GATT deal."

The Canadian government has already taken the position that the U.S. actions concerning magnesium are inconsistent with the current *GATT*, and has sought *GATT* review. It also has the option of having the findings of the U.S. agencies reviewed by a binational panel under Chapter 19 of the *Canada-U.S. Free Trade Agreement*.

GOVERNMENT SIGNS ON TO GATT PATENT CHANGES

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The federal government's announcement concerning changes in patent protection in Canada arising from the *GATT* negotiations has rekindled memories of the bitter debate over the 1987 amendments to the *Patent Act* contained in Bill C-22.

Thus far, intellectual property has not been part of the *GATT* régime. The elimination of differences in the degree of protection in *GATT* member countries for various kinds of intellectual property, such as patents for medicines and electronics, has been an important aspect of the Uruguay Round of *GATT* negotiations.

The draft text of *GATT* Director General Arthur Dunkel was released to the parties just before Christmas, but has still not been made public. On January 14, 1992, the Canadian government announced that it was endorsing the proposal for strengthened patent protection contained in the text. The government's acceptance of the controversial patent proposals contrasts sharply with its reticent position on another, more explosive issue for Canada at the *GATT*: the proposals with respect to agricultural imports that would affect the supply management system.

If the proposed *GATT* provisions for intellectual property are adopted and then incorporated into the *Patent Act* in Canada, the result would be a longer period of exclusivity for pharmaceutical patents for which a compulsory licence has not already been granted. The period of exclusivity would be twenty years, the same as it now is for patents in other fields in Canada. Effectively, no further compulsory licences for patented medicines would be granted in Canada after implementation of the changes.

Since 1923, Canada has had a régime of compulsory licences for the production of patented medicines by non-patent holders. In 1969, this system was extended to imported medicines produced by processes covered by a Canadian patent. This led to the growth of firms manufacturing generic drugs in Canada. In

1987, the *Patent Act* was amended by Bill C-22 such that drug patent holders were granted a period of market exclusivity of seven years against manufacturing in Canada and ten years against importation, with both time periods starting to run only after the drug has been approved for sale to the public (leaving aside the complexities of a transition period). That approval, in the form of a notice of compliance from Health and Welfare Canada, is usually not obtained until several years after a drug has been developed and patented.

Assuming that the period to obtain a notice of compliance after patenting is ten years, then the Dunkel proposals would have the effect of adding three years to the period of exclusivity against manufacturing in Canada. The government referred to a three-year extension in its announcement on January 14. However, this would not always be the case, as there have been drugs for which a notice of compliance is obtained in less than ten years. For such drugs, after the changes in the law, the additional period before a generic product could come on the market would therefore be more than three years.

The government's announcement of its acceptance of the proposals has led to a revival of the intense war of words waged by both sides during the prolonged passage of amendments to the drug patent régime in 1987. Readers may recall that the Liberal majority in the Senate stalled the bill containing amendments to the *Patent Act* for months. It was contended that consumers would be harmed by much higher prices for drugs. On the other side, the Progressive Conservative government and the large innovative or brand name pharmaceutical manufacturers argued that prices would not rise unreasonably. They pointed to the creation of the Patented Medicine Prices Review Board (PMPRB) contained in the Bill as an assurance against price-gouging. Additionally, because of the increased protection, the manufacturers committed to increasing R&D expenditures in Canada as a percentage of sales from 4.9 percent to 8 percent by the end of 1991, and to ten percent by the end of 1996.

According to reports of the PMPRB, from January 1987 to December 1990 the prices of patented pharmaceutical products increased at an average annual rate of 3.1 percent, which is less than the rate of inflation. The PMPRB also reports that the R&D-to-sales ratio had risen to 8.8 percent in 1990. According to the government's announcement, as part of the changes, the powers of the PMPRB to review price increases would be enhanced.

In response to the proposed changes, the Canadian Drug Manufacturers Association, representing the generic pharmaceutical industry in Canada, stated that the policy would "destroy" the industry and be "disastrous" for provincial health care budgets. On the other hand, the Pharmaceutical Manufacturers' Association of Canada, representing the brand name companies, predicted further investment in Canada as a result of the changes. It noted that the generic industry was again predicting "its own demise," as it had done over Bill C-22. The PMAC claimed that the generic industry had nonetheless experienced a growth in sales of 150 percent since 1987. However, it is to be noted that the generic industry does not produce only medicines under compulsory licence, and other areas have probably contributed to any growth in sales.

If implemented in Canada, the proposals would arguably only bring patent protection for pharmaceuticals in Canada into line with régimes already existing in the United States and the European Community. Nonetheless, as with the proposed changes because of *GATT* to Canada's agricultural import prohibitions, arguments of international comity will probably not be persuasive. The federal government will likely face considerable political difficulty in implementing the proposals.

CALIFORNIA GIVES ALBERTA GAS

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Over thirty years ago the predecessor of Pacific Gas and Electric Company (PG&E) decided to look to Alberta for a significant portion of its natural gas supply. It created a company, Alberta and Southern (A&S), to acquire gas from Alberta

producers. It built a pipeline (ANG) from the Alberta border where it connected to the Alberta pipeline system to Kingsgate, British Columbia where it connected with Pacific Gas Transmission (PGT), a pipeline which was built to bring that gas to northern California.

The delivery of the gas to northern California involved a chain of contracts beginning with a large number of contracts between producers and A&S, a sales contract between A&S and PGT, and a sales contract from PGT to PG&E. The gas purchases of PG&E are subject to regulation by the California Public Utilities Commission. The CPUC has decided that the monopoly of purchasing natural gas is no longer in the California public interest. It wants end users to have the opportunity to purchase gas directly from producers. California is convinced that California consumers can obtain Alberta gas at lower prices than is reflected in the existing A&S arrangements.

To that end, the CPUC has required PG&E to offer its customers direct access to Alberta gas through the brokering of existing pipeline capacity. If implemented, this would effectively undermine the existing A&S sales arrangements in much the same way that the virtual monopoly of TransCanada Pipelines in selling gas to eastern Canada was broken following deregulation in 1986. TransCanada, through its sales affiliate Western Gas Marketing Limited, now holds something in the order of forty percent of the domestic market, as opposed to over eighty percent of the market six years ago.

Alberta is violently opposed to the actions of the CPUC, viewing them as regulatory interference in commercial arrangements. The A&S export licence was extended by the National Energy Board only a few years ago. The CPUC made representations in that proceeding as to the importance of a secure long-term supply of natural gas to California.

The Canadian Petroleum Association has applied to the National Energy Board to review the A&S export licence. The Board, after considerable delay, is in the process of conducting that review. It is a tortuous proceeding which the Board clearly does not relish.

Action by the NEB on the review application followed the support given by the Federal Minister of Energy Mines and Resources to the Alberta government in its conflict with the CPUC. Since that time, expensive consultations have taken place among Canadian and U.S. federal energy officials and California and Alberta energy officials, through the consultation mechanism established under Chapter 9 of the *Canada-U.S. Free Trade Agreement*. At the end of January, the Minister of Energy Mines and Resources and the Alberta Minister of Energy made public announcements with great fanfare that significant progress had been reached in these consultations. It was stated that preliminary agreements had been reached on key aspects of the dispute. The broad principles of an open-access régime connecting Alberta producers to California end users were laid out. That arrangement would allow end users and producers to deal directly with each other through the existing pipeline capacity. Shippers would be able to broker unused capacity to others. Marketers such as A&S would be free to compete in the market along with all others.

The major issue remaining to be discussed was said to be compensation to Alberta producers who had made investments on the strength of long-term sales agreements involving A&S. There has been no indication since of movement on this point.

In considering the prospects for Alberta achieving all of what it might want from these negotiations, two points are worth keeping in mind.

The first is that the CPUC is convinced, and the consumer interests which it represents are even more convinced, that California consumers have been gouged by Alberta. In fact, the Division of Ratepayer Advocates (DRA) claims that Alberta producers owe California consumers hundreds of thousands of dollars in overcharges during the past years. There is, therefore, a counter-claim to Alberta's claim for compensation.

The calculations of the CPUC or the DRA as to the price at which California consumers are able to obtain Alberta gas involve comparing the prices paid by A&S with the prices of gas available in the Alberta market under short-term or spot contracts. Alberta is awash with excess gas deliverability and the prices of gas in the spot market are very low. Alberta considers that those prices are not an appropriate reflection of the true value of the

gas. Among other things, Alberta points to the delay in putting into place major new pipeline projects which would give Alberta Gas greater market access and hence bring supply and demand into a better balance.

A second issue to keep in mind involves the treatment of the producers and interstate natural gas pipelines when the U.S. Federal Energy Regulatory Commission started down the path of creating a competitive natural gas market in 1983. It issued orders breaking the contractual link between the interstate pipelines and their customers, but left in place the contractual links between the interstate pipelines and their suppliers. Interstate pipelines, who had been the virtual monopoly suppliers of natural gas, immediately lost market but remained obligated to purchase gas from producers who themselves remained obligated to deliver gas to the pipelines when called upon to do so. The pipelines became liable for enormous costs under "take or pay" provisions of contracts. The net result was serious dislocation and a very difficult adjustment to a competitive market which has yet to be fully achieved.

The move to create competition in natural gas markets in the United States has been driven by a clear consumer interest. Against that backdrop, producers in Alberta are but small voices in a distant wilderness.