

**REPORT TO
THE MINISTER OF FINANCE**

**REQUEST FOR TARIFF RELIEF BY
PHANTOM INDUSTRIES INC.
REGARDING
CERTAIN GIMPED YARNS FOR USE IN THE
MANUFACTURE OF WOMEN'S HOSIERY**

MAY 8, 1998

PHANTOM INDUSTRIES INC.

REQUEST NO. :TR-97-005

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INTRODUCTION

On July 14, 1994, the Canadian International Trade Tribunal (the Tribunal) received terms of reference¹ from the Minister of Finance (the Minister) pursuant to section 19 of the *Canadian International Trade Tribunal Act*.² The Minister directed the Tribunal to investigate requests from domestic producers for tariff relief on imported textile inputs for use in their manufacturing operations and to make recommendations in respect of those requests to the Minister.

Pursuant to the Minister's reference, on June 25, 1997, the Tribunal received a request from Phantom Industries Inc. (Phantom), of Toronto, Ontario, for the removal, for an indeterminate period of time, of the customs duty on importations from all countries of gimped yarns, consisting of a five-filament nylon yarn not greater than 15 decitex wound spirally around an elastomeric yarn (spandex), for use in the manufacture of women's hosiery (the subject yarns).

On October 30, 1997, the Tribunal, being satisfied that the request was properly documented, issued a notice of commencement of investigation, which was distributed and published in the November 8, 1997, edition of the *Canada Gazette*, Part I.³

As part of the investigation, the Tribunal's research staff sent a questionnaire to potential domestic producers of identical or substitutable yarns. A questionnaire was also sent to firms identified as importers and users of the subject yarns. A letter was sent to the Department of National Revenue (Revenue Canada) requesting information on the tariff classification of the subject yarns, and samples were sent for laboratory analysis. Letters were also sent to a number of other government departments for information and advice.

A staff investigation report, summarizing the information received from these government departments and firms that responded to the Tribunal's questionnaires, was provided to interested parties that had filed a notice of appearance for this investigation, i.e. Phantom, Rubyco (1987) Inc. (Rubyco), Shefford Textiles Ltée (Shefford), the Canadian Textiles Institute (CTI) and Fibretrade Canada Inc. (Fibretrade).

A public hearing was not held for this investigation.

PRODUCT INFORMATION

The yarns subject to this investigation are gimped⁴ yarns, consisting of a five-filament nylon yarn not greater than 15 decitex wound spirally around an elastomeric yarn (spandex), for use in the manufacture of women's hosiery.

1. On March 20 and July 24, 1996, and on November 26, 1997, the Minister of Finance revised the terms of reference.

2. R.S.C. 1985, c. 47 (4th Supp.).

3. Vol. 131, No. 45 at 3503.

4. *The Concise Oxford Dictionary*, 7th ed. (Oxford: Clarendon Press, 1982) at 417, defines "gimp" as "silk, worsted, or cotton twist with cord or wire running through it, used esp. as trimming; fishing-line of silk etc. bound with wire; coarser thread outlining design of lace."

The subject yarns contain two fibres: an elastomeric (spandex) core (usually referred to as 20 deniers⁵), which is sourced mostly from DuPont in the United States, and a nylon fibre cover, which comes from Nilit Ltd. (Nilit), in Israel. According to Phantom, the uniqueness of the subject yarns does not originate with the spandex core, but with the nylon cover, which is normally described as 12 deniers/5 filaments (decitex of approximately 12 to 15). The subject yarns and alleged identical yarns produced in Canada are normally described as 20/12/5 yarns in the trade.

The subject yarns are classified under classification No. 5606.00.90.10 (formerly tariff item No. 5606.00.19) and, as of January 1, 1998, are dutiable at 10 percent *ad valorem* under the MFN tariff; free under the US tariff and the Canada-Israel Agreement tariff, at 5 percent *ad valorem* and 5.5¢/kg under the Mexico tariff and the Chile tariff.

REPRESENTATIONS

User of the Subject Yarns

Phantom's request is for the permanent removal of the customs duty on importations of the subject yarns.

Phantom is a manufacturer of women's and girls' branded and private label hosiery, branded swim wear and private label casual and active wear. It has been in business for 75 years. All aspects of the business, including product design and manufacturing are located at its Toronto facility. Production of the subject hosiery, which includes knitting, drying, finishing and packaging is done completely by Phantom.

Through its counsel, Phantom submits that tariff relief should be granted on the grounds that, while there exists identical domestic production of gimped yarns in terms of their construction, the way the yarns are put on cones ("packages") differs significantly. Phantom submits that the subject yarns which it imports from the US producer, Unifi, Inc. (Unifi), are put on "take-up" packages, which Phantom claims run very efficiently on its equipment, while those available from the domestic producers, Rubyco and Shefford, use the "rewound" method of putting yarns on packages, which, according to Phantom, results in too many knots and uneven winding. Phantom submits that these defects result in a lot of rings in the finished hosiery, creating many seconds that would have to be sold at lower prices.

Phantom argues that it has given Rubyco full opportunity to supply the 20/12/5 gimped yarns, by identifying to Rubyco yarn content and specifications, requesting samples to test for initial compatibility, and for testing for factors such as ability to dye, fit and shrinkage, and trial production runs to test efficiency and overall performance under existing production conditions. Phantom adds that Rubyco supplied it with the best yarns that it could, but that those yarns simply did not meet its production and efficiency requirements. In support of this argument, Phantom included in its reply submission a number of internal evaluation reports which highlight the problems which it has encountered in utilizing the Rubyco yarns. Phantom states that these quality problems were communicated to Rubyco.

5. The denier is a unit of yarn measurement referring to the weight in grams of 9,000 metres of yarn. Another measurement used in this investigation, decitex, refers to the weight in grams of 10,000 metres of yarn.

To make up for the production inefficiencies using the gimped yarns from Rubyco, Phantom contends that significant added labour input and investment in additional equipment would be required. In Phantom's case, take-up packages, as supplied by Unifi, are argued to be a "must" in obtaining good production efficiency. Phantom also argues that no external laboratory could have performed proper testing for Phantom's production environment.

According to Phantom, Rubyco, as the Canadian division of Worldtex, Inc., has not been very profitable from 1993 through 1995. Phantom also notes that there were talks about closing down Rubyco's plant. Phantom adds that its comments regarding Rubyco's financial situation are not meant to suggest any financial difficulties, but rather to emphasize its supply dependency towards Rubyco. Phantom notes that it already purchases some 40 percent of its total yarn inputs from Rubyco and that this percentage would rise to over half of the total, should it decide to purchase the 20/12/5 yarns from Rubyco. Under the circumstances, Phantom argues that it is normal for a purchaser to have concerns before committing to purchase such a significant share of its total requirements from the same supplier.

Phantom contests Rubyco's assertions that it would be a stable supplier of the 20/12/5 yarns, given the lack of warehouse inventory for other required yarns, which became manifest during the recent power failure caused by the ice storm of January 1998, and the short shipping of regularly ordered yarn over the last three years.

Phantom argues that, while the yarn returns noted in its submissions do not include the 20/12/5 yarns, these examples have been provided to illustrate the reliability problems which it has encountered with Rubyco. Further, no 20/12/5 yarns were returned because the purchase of these yarns from Rubyco was only for trial production purposes.

Phantom acknowledges that the impact of tariff relief represents only about two cents per end product and would have little impact in the marketplace, but that, nonetheless, this duty cost is not irrelevant, given the quantity produced. Phantom disputes the claim by Rubyco that it would lose over \$1 million in business at Phantom in the event of tariff relief, since it did not have the business in the first place.

Phantom further argues that Rubyco's pricing has been inconsistent and has not reflected the duty-free status of the nylon component purchased from Nilit, under the terms of *Canada-Israel Free Trade Agreement*⁶ (CIFTA). It submits that the winding process used by Rubyco is more costly, which is also reflected in its pricing, and that this becomes a major issue when Phantom faces competition from products benefiting from duty-free status under the *North American Free Trade Agreement*⁷ (NAFTA).

Finally, Phantom submits that neither Rubyco nor Shefford would suffer losses should tariff relief be granted, since no domestic rewind yarn packages will ever be used on Phantom's knitting machines. Conversely, should tariff relief not be granted, Phantom argues that it would lose market share to its competitors benefiting from NAFTA status and sustain a substantial loss of jobs.

6. Assented to December 18, 1996, and came into force on January 1, 1997.

7. Done at Ottawa, Ontario, on December 11 and 17, 1992, at Mexico, D.F., on December 14 and 17, 1992, and at Washington, D.C., on December 8 and 17, 1992 (in force for Canada on January 1, 1994).

Domestic Textile Producers

CTI and Rubyco

In his submissions made on behalf of the CTI and Rubyco, counsel argues that Rubyco produces goods in Canada which are identical to the subject yarns and that Rubyco is equipped in all respects to supply Phantom's requirements. The CTI and Rubyco take the position that the request for tariff relief is without merit and should be denied.

Counsel argues that the yarns produced by Rubyco are based on exactly the same components as those used by Unifi to make the subject yarns and that the same process is used to wrap the nylon covering around the spandex core. As well, counsel submits that the Revenue Canada laboratory reports reveal no difference of any significance between the 20/12/5 domestic yarns and the subject yarns.

Counsel submits that Phantom's allegations of Rubyco's financial unsoundness are unfounded and responded with evidence attesting to Rubyco's financial stability. Counsel also disputes the assertion by Phantom that it cannot rely on Canadian producers because of quality requirements and argues that the record shows that the returns filed by Rubyco were trivial in relation to the large volume of covered yarns sold by Rubyco to Phantom over the last three years. As well, no returns were reported by Phantom on the 20/12/5 yarns supplied by Rubyco.

Regarding pricing, counsel argues that Phantom's objective has been to force a major price reduction on Rubyco. It is further argued that it is unrealistic to assume that tariff relief would lead to a commensurate price reduction on the subject yarns. For example, Unifi, the US supplier, might choose to obtain a higher export price for the subject yarns. Finally, counsel argues that, over the last 12 months, Rubyco's 20/12/5 yarns have been offered to Phantom at a lower price than the landed import price paid by Phantom for the subject yarns.

Counsel submits that the arguments made by Fibretrade concerning the yarns' production and packaging methods have been refuted by Rubyco and Shefford and that Fibretrade is not a producer of the yarns, but only a sales agent. For example, Rubyco considers its rewinding process for producing packages superior to the "take-up" method for technical reasons and for flexibility. It also believes its yarn packages are more stable and have a better shelf life. Further, regarding the issue of the number of knots, Rubyco argues that its packages comprise only one knot per 150,000 metres, or three knots per total package. This apparently represents only one knot per every 132 hosiery legs knitted and that a properly tied knot does not generate a defect in the knitted goods.

Counsel questions the credibility of Phantom's assertions that Rubyco, a highly regarded producer of many nylon-covered yarns, becomes incompetent when it turns to the production of the 20/12/5 yarns. Further, counsel observes that none of the evidence filed by Phantom has been subjected to independent quality control lab testing. Counsel further alleges that the internal memos filed by Phantom regarding quality problems are suspect both for the manner in which they were drafted and for the late filing of these key documents.

Counsel argues that there is a complete absence in the evidence filed of any communication to Rubyco of any problems or dissatisfaction with the 20/12/5 yarns. Rubyco's response includes two affidavits from its own company officials swearing that on no occasion did any representative of Phantom ever advise it

of any problems on the 213-1 yarns⁸ shipped to Phantom. Rubyco also included a detailed log of correspondence between it and Phantom, in support of the argument that Rubyco's inquiries on the performance of the 213-1 yarns were not answered by Phantom. Counsel adds that it is Rubyco's concern and business interest to diagnose and rectify any product deficiency.

In regard to allegations that Phantom encountered difficulties in obtaining yarn deliveries during the recent ice storm, counsel responds that Rubyco was diligently supplying Phantom with daily deliveries of yarns by courier.

Regarding the quality of Rubyco's production, counsel argues that there is no evidence from other parties that Rubyco's quality is other than excellent and that Phantom itself attests to the soundness of Rubyco's production and services by purchasing a considerable variety of yarns from this producer.

Finally, counsel argues that the commercial benefit figure found in the staff report is substantially outweighed by the additional wages which Rubyco would pay its workforce at its Montréal facility, should it become the supplier of the 20/12/5 yarns to Phantom.

Shefford

Shefford argues that it produces gimped yarns which have the same characteristics as those of the subject yarns. In fact, it produces gimped yarns with a 10/7 yarn cover, which is finer than the 12/5 yarn used in the gimped yarns under investigation

Shefford contends that Phantom has made no effort to find an alternate source of supply other than Rubyco. The many oral and written efforts by Shefford to contact Phantom have remained unanswered. In its reply submission, Shefford documented a number of telephone contacts that its sales director made to Phantom in 1993 and 1994, and which were allegedly not followed up by Phantom.

In response to arguments presented by Phantom, Shefford argues that Phantom's performance problems with Rubyco's 20/12/5 yarns should be subject to an independent outside evaluation, since Phantom is an interested party.

In response to Fibretrade's assertions that take-up packages are superior to the rewind method, Shefford argues that, in fact, the take-up method is a shortcut in production and results in a lesser quality yarn than that of rewind yarn. Shefford adds that, in Europe, close to 100 percent of single gimped yarns are rewind and that, in the United States, a lesser proportion is rewind because many knitters accept a lesser quality in exchange for a lower price. Shefford further argues that the rewind method does not result in a greater number of knots than the take-up method and that the number and the quality of the knots are, in fact, dependent on many variables.

Shefford questions why tariff relief is sought by Phantom, given its statement that the duty relief would not change its sourcing decision. In Shefford's view, if tariff relief were given, US suppliers would flood the Canadian market with identical and similar products without any countermeasure. It submits that, even if the United States were to consent to tariff relief into its own market, Shefford would not be in a

8. "213-1" is Rubyco's product code for the 20/12/5 gimped yarns.

position to enter that vast market over the short to medium term. Shefford believes that, in the meantime, the damage caused to it could be irreversible.

Other Submissions

Fibretrade

Fibretrade is the agent and warehouse distributor of Unifi, North Carolina, United States, for its nylon and spandex products. It sells the subject yarns to only one Canadian customer, Phantom.

Fibretrade supports the request for tariff relief and argues that, in the event of a favourable ruling, it is not expecting an increase in import volume. Rather, it believes that tariff relief would make Phantom more profitable and fortify the Canadian hosiery base.

With regard to quality of product, Fibretrade argues that Unifi supplies Phantom with take-up packages, in which the covering machine is run until it has produced a full package of yarn. According to Fibretrade, this method takes longer to produce, but results in a more consistent and superior quality to the knitter, with a significant reduction in seconds being produced.

On the other hand, Fibretrade believes that the 20/12/5 yarns offered by Rubyco are made using the rewound method. Under this method, less than full packages are removed from the covering machine and rewound and knotted in order to produce a full package. Fibretrade argues that this is a shortcut used by the producer to increase productivity at the expense of quality. However, Fibretrade contends that, with the rewound method, the number of knots increases dramatically, which has a direct negative impact on operating efficiency and increases the number of seconds produced by the knitter.

In response to arguments that Rubyco and Shefford can satisfy Phantom's requirements, Fibretrade argues that Rubyco had quality and delivery problems in 1988 and believes that Rubyco has not invested in conventional covering equipment since that time. The company also believes that Shefford does not have the capacity to supply Phantom.

Finally, Fibretrade argues that Phantom's "Silks" line, which uses the subject yarns, is marketed at the higher end of the retail price range and that any cost savings from tariff relief would not be significant enough overall to allow Phantom's products to be mass marketed at the lower price levels. Therefore, granting tariff relief would not damage any domestic manufacturers, but would allow Phantom to remain competitive against imports of similar end products.

Government Departments

The Department of Foreign Affairs and International Trade informed the Tribunal that Canada does not maintain quota restrictions on yarns solely of any single man-made filament classified under tariff item No. 5606.00.19. Therefore, the subject yarns are not subject to any quantitative import restrictions.

Revenue Canada indicated that there would be no additional costs, over and above those already incurred by it, to administer the tariff relief, should it be granted.

ANALYSIS

The terms of reference from the Minister direct the Tribunal to evaluate the economic impact that reducing or removing a tariff would have on domestic producers and downstream producers and, in so doing, to consider all relevant factors, such as the substitutability of the subject yarns with domestic yarns, the ability of domestic producers to serve downstream industries and the competitiveness of those industries at home and abroad. Ultimately, the Tribunal's decision to recommend tariff relief is based on the extent to which it considers that such tariff relief would provide net economic gains for Canada.

In the present case, there was no disagreement among the parties that identical gimped yarns are produced in Canada in terms of yarn construction. Indeed, the evidence clearly shows that Rubyco does produce identical yarns made from exactly the same raw materials as the subject yarns and that these yarns were supplied to Phantom for trial testing purposes as recently as 1997. Rather, the debate centered on the performance problems of the yarns supplied by Rubyco to Phantom and on the efforts that Phantom made to communicate these problems to Rubyco.

There was considerable written debate from both sides relating to the pros and cons of the two methods of putting the gimped yarns on cones. Rubyco's 20/12/5 yarns use the rewind method of putting the yarns on packages, which Phantom contends results in too many knots and in uneven winding, while the 20/12/5 yarns imported from Unifi use the take-up method, which Phantom claims run efficiently on its machinery.

On the other hand, both Rubyco and Shefford contested Phantom's claims that the take-up method is superior, arguing that, in fact, the rewind method contains no more knots than the take-up method and is superior for technical reasons such as better shelf life and yarn stability. The Tribunal is unable to resolve this issue at this time, but considers that the more important issue is that of the efforts made by Phantom to obtain domestic supply.

Phantom's evidence concerning the domestic producers' ability to supply the 20/12/5 yarns includes a number of internal plant evaluation reports which highlight the problems that it allegedly encountered in its trial runs of the Rubyco yarns. Phantom submitted that it ran a full gamut of production tests of Rubyco's 20/12/5 yarns, but that those yarns caused a lot of rings in the finished hosiery, creating many seconds. However, Phantom's submissions contain little evidence that it communicated these problems to Rubyco. In fact, the only mention that any effort was made to communicate these problems to Rubyco consists of an allegation that the Rubyco representative who calls upon Phantom was verbally kept informed of these developments. In response to this allegation, Rubyco filed affidavits from two of its company officials, including the representative who calls upon Phantom, stating that they had never been informed by Phantom of any operating problems with the 20/12/5 yarns. The Tribunal notes that these affidavits were not challenged in Phantom's final rebuttal. The Tribunal also notes that Rubyco's written requests to Phantom on the status of the performance of the 20/12/5 yarns, which were included in Rubyco's submissions, were left unanswered.

The Tribunal also observes that Phantom appears satisfied with the many other yarns that it has purchased from Rubyco over the years, but not with the 20/12/5 yarns. It would seem to the Tribunal that, as a minimum, Phantom should have actively communicated its problems to Rubyco and allowed it the opportunity to bring modifications or remedies that would make the yarns acceptable. As Rubyco noted, it is

the normal business and concern of a yarn manufacturer to work out any problems with any of the products that it supplies to a customer.

Finally, the Tribunal notes that Shefford, a smaller manufacturer that has already produced similar gimped yarns and has the capability to produce identical yarns, has documented its efforts to establish contact with Phantom, but that these efforts were not followed up by Phantom. While it is unclear what proportion of Phantom's requirements could be supplied by Shefford, what is clear to the Tribunal is that Shefford has not been allowed the opportunity to demonstrate that it can supply 20/12/5 yarns to Phantom.

To sum up, the Tribunal finds that, while there may well be some operating differences between the subject yarns and the 20/12/5 yarns produced in Canada, Phantom has not demonstrated that sufficient efforts have been made to obtain domestic supply, nor that domestic yarns cannot be substituted for the subject yarns. Under the circumstances, the Tribunal is unable to find that granting tariff relief would provide net economic gains for Canada.

If, in the future, Phantom can clearly show that it has provided a full opportunity to domestic producers to supply yarns that meet its requirements and that, once these efforts have been made, it can demonstrate that the yarns still do not meet its operational needs, then the Tribunal would be prepared to consider a renewed request for tariff relief by Phantom.

RECOMMENDATION

In light of the foregoing, the Tribunal hereby recommends to the Minister that tariff relief not be granted on importations from all countries of gimped yarns, consisting of a five-filament nylon yarn not greater than 15 decitex wound spirally around an elastomeric yarn (spandex), for use in the manufacture of women's hosiery.

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